THE COST OF CAPITAL

THE WEIGHTED AVERAGE COST OF CAPITAL (WACC)

- What are the sources of capital?
- How do I calculate the WACC?

THE COST OF DEBT

- What do I use for the cost of debt?

THE COST OF PREFERRED STOCK

- How do I estimate the cost of preferred stock?

THE COST OF COMMON STOCK

- Is it costly to issue common stock?
- How do I estimate the cost of common stock?
    1. ______________
    2. Dividend Yield Plus Growth Rate (DCF Model)

USING THE CAPM

- What is the risk-free rate?
- What is the market risk premium?
- Where does beta come from?

USING DIVIDEND YIELD PLUS GROWTH RATE (DCF MODEL)

- How do I estimate the growth rate?
  1.
  2.
  3.

THE WEIGHTED AVERAGE COST OF CAPITAL (WACC)

- The formula:

$$WACC = \left(\frac{\text{Common Equity}}{\text{Total Capital}}\right) \times R_E + \left(\frac{\text{Preferred Equity}}{\text{Total Capital}}\right) \times R_P + \left(\frac{\text{Debt}}{\text{Total Capital}}\right) \times R_D (1 - t)$$

- Keep in mind:
  - ______________ Capital Structure
  - ___________________ NOT Book Values
  - What does the WACC measure?

WHAT AFFECTS THE WACC?

- Interest Rates
- Market Risk Premium
- Taxes
- Capital Structure
- Dividend Policy
- Investment Policy

RISK AND THE APPROPRIATE DISCOUNT RATE

- What if the risk of a project or division is different than that of the firm?
- Using Betas
  - Pure Play Method
  - Accounting Beta Method
- Risk-Adjusted Cost of Capital

FLOTATION COSTS

- What are flotation costs?
- How do I estimate the costs of debt and equity including flotation costs?

FLOTATION COSTS

WACC EXAMPLE

As CFO of Callipygian, Inc., you are trying to determine the firm's weighted average cost of capital (WACC). You have gathered the following information: The firm has 2,000 bonds, 35,000 preferred shares, and 100,000 common shares of stock outstanding. The bonds currently have a yield to maturity of 6.5881% and trade at 125% of par. The preferred stock pays a $5.25 annual dividend and currently trades at $70. The firm's common stock currently sells for $32.10 and has a beta of 0.95. You know the yield on 10 year U.S. Treasuries is 5.3%, the historical market risk premium is 6 percent, and the firm has a marginal tax rate of 40 percent.

CHAPTER 13 SUGGESTED PROBLEMS

- Concept Questions
  - 1, 2, 5, 6, and 7
- Questions and Problems
  - 1, 3, 5, 6, 11, 12, and 17