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COST OF CAPITAL

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Cost of Capital

- The investments a company makes are essential for fulfilling its corporate purpose. The cost of capital becomes a relevant factor in the evaluation the finance manager makes of short-term investment projects.

Cost of Capital

- The cost of capital is the rate of return the company should get on its investments so that its market value can remain unchanged, taking into account that this cost is also the discount rate on future corporate profits. For this reason the corporate finance manager should use the necessary tools for making decisions on which investments to make and, thus, which are the best for the organization.
- The cost of capital is also defined as the cost to the company of each dollar it invests in assets. This statement assumes two things:
  - All assets have the same cost.
  - All assets are financed in the same proportion of liabilities and equity.

Cost of Capital

- The cost of capital study takes specific capital sources as a base for finding the essential inputs for determining the company's total cost of capital. These sources should be long-term, since these are the ones that grant ongoing financing.
- The main long-term funding sources are long-term debt, preferred stock, common stock and retained profit – each associated with a specific cost that leads to consolidation of the total cost of capital.

Fundamental Factors Inherent to Cost of Capital

- The level of business and financial risk
- Tax burdens and taxes
- Supply and demand for financing money

Special Considerations

- The cost of financing with supplier credit is the opportunity cost implied by not having the discounts they offer for prompt payment.
- **Equity** is the most expensive source for the company. This cost is implied and represented by the owner's opportunity cost.
- Current liabilities are **not taken** into account in calculating cost of capital, which is calculated on the basis of the long-term structure or capital structure.
- Cost of capital is generally calculated as a cash cost **after taxes.**

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Costs of Capital Sources

Cost of long-term debt

- This source of funds has two primary components: annual interest and amortization of discounts and premiums received when the debt is taken on. The cost of debt can be found by determining the internal rate of return of the cash flow related to the debt. This cost represents the annual percentage cost of the debt before taxes for the company.

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Costs of Capital Sources

Cost of Preferred Stock

- The cost of preferred stock is found by dividing the stock's annual dividend by the net yield from its sale.

$$\text{C.P.S.} = \frac{\text{Annual dividend per share}}{\text{net yield from sale of preferred stock}}$$

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Costs of Capital Sources

Cost of Common Stock

- The cost of common stock is a bit difficult to calculate, since the price of these shares is based on the present value of all future dividends to be paid on each share. The rate at which future dividends are discounted for converting to present value represents the cost of common stock.

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Costs of Capital Sources

Cost of Retained Profit

- The cost of retained profit is closely linked to the cost of common stock, since if the profit were not retained it would be paid out to common stock shareholders in the form of dividends. Thus, the cost of retained profit is considered the opportunity cost of the dividends assigned to existing common stock shareholders.

Calculating the Cost of Capital

- Upon calculating the costs of specific long-term funding sources, the technique is shown that is usually used for determining the total cost of capital used in financial evaluation of the company's future investments.
- The main method for determining the appropriate total cost of capital is to find the average cost of capital using historical or marginal costs as a basis.
- The financial manager should use analysis of the cost of capital for accepting or rejecting investments, since these are what will determine achievement of organizational goals.

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http://www.monografias.com/trabajos38/costo-de-capital/costo-de-capital.shtml

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