The Cost of Capital: Principles and Practice
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Overview

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To learn how some of the most financially sophisticated companies and financial advisers estimate cost of capitals

The Weighted Average Cost of Capital (WACC)

\[ WACC = (W_{debt} (1-t) K_{debt}) + (W_{preferred} K_{preferred}) + (W_{equity} K_{equity}) \]

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- looking to develop new products
- expand factories
- install new information technologies

measuring the cost of capital is a critical element
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Survey Findings
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- A sample of 27 firms
- Similarity
  Discounted cash flow (DCF) is the dominant investment-evaluation technique
  WACC is the dominant discount rate
  Weights are based on market value, not book
- The after-tax cost of debt

Capital Asset Pricing Model

\[ K = R_f + \beta(R_m - R_f) \]

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- The purpose of CAPM is to calculate the required rate of return on any asset
- the return on risk free bonds (R\(_f\)), the stock's equity beta (\(\beta\)), and the market risk premium, (R\(_m\) - R\(_f\))
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- the return on risk free bonds (Rf), the stock’s equity beta (\(\beta\)), and the market risk premium (Rm – Rf).
Variations Within the Components of CAPM

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1. Risk free rate of return
2. Beta
3. Market risk premium

Risk free rate of return

In the risk-free rate of return, the choice of the risk-free rate can have an effect on the cost of equity.

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EXHIBIT 3 | Choice of Bond Market Proxy

Some of our best-practice companies noted that their choice of a bond market proxy for a risk-free rate depended specifically on how they were proposing to spend funds. We asked, “What do you use for a risk-free rate?” and heard the following:

- “Ten-year Treasury bond or other duration Treasury bond if needed to better match project horizon.”
- “We use a three- to five-year Treasury note yield, which is the typical length of our company's investment. We match our average investment horizon with maturity of debt.”
Beta Estimates

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Calculate it yourself based on historical data

Use published sources such as Bloomberg, Value Line and Standard & Poor's

Equity Market Risk Premium

For the market risk premium, the problem areas for the market risk premium are how a company measures the expected future returns on the market portfolio and on riskless assets.