Part 4

Long-Term Financial Decisions

Chapter 10
The Cost of Capital

Chapter 11
Leverage and Capital Structure

Chapter 12
Dividend Policy
Chapter 10
The Cost of Capital

Learning Goals

LG1 Understand the key assumptions that underlie cost of capital, the basic concept of cost of capital, and the specific sources of capital that it includes.

LG2 Determine the cost of long-term debt and the cost of preferred stock.

LG3 Calculate the cost of common stock equity and convert it into the cost of retained earnings and the cost of new issues of common stock.

LG4 Calculate the weighted average cost of capital (WACC) and discuss the alternative weighting schemes.

LG5 Describe the procedures used to determine break points and the weighted marginal cost of capital (WMCC).

LG6 Explain how the weighted marginal cost of capital (WMCC) can be used with the investment opportunities schedule (IOS) to make the firm’s financing/investment decisions.

Across the Disciplines
Why This Chapter Matters To You

Accounting: You need to understand the various sources of capital and how their costs are calculated in order to provide data used in determining the firm’s overall cost of capital.

Information systems: You need to understand the various sources of capital and how their costs are calculated in order to develop systems that will estimate the costs of those sources of capital, as well as the overall cost of capital.

Management: You need to understand the cost of capital in order to assess the acceptability and relative rankings of proposed long-term investments.

Marketing: You need to understand what the firm’s cost of capital is because proposed projects will face rejection if their promised returns are less than the firm’s cost of capital.

Operations: You need to understand the cost of capital in order to assess the economic viability of investments in plant and equipment needed to improve or expand the firm’s capacity.
The cost of capital is used to select capital investments that increase shareholder value. In applying the net present value and internal rate of return techniques in Chapter 9, we simply assumed a reasonable cost of capital. Now we will demonstrate how the cost of capital is calculated. This chapter considers the costs of long-term debt, preferred stock, common stock, and retained earnings and shows how to combine them to determine cost of capital measures the firm will use in making long-term financing/investment decisions.

### An Overview of the Cost of Capital

The cost of capital is the rate of return that a firm must earn on the projects in which it invests to maintain the market value of its stock. It can also be thought of as the rate of return required by the market suppliers of capital to attract their funds to the firm. If risk is held constant, projects with a rate of return above the cost of capital will increase the value of the firm, and projects with a rate of return below the cost of capital will decrease the value of the firm.

The cost of capital is an extremely important financial concept. It acts as a major link between the firm’s long-term investment decisions (discussed in Part 3) and the wealth of the owners as determined by investors in the marketplace. It is in effect the “magic number” that is used to decide whether a proposed corporate investment will increase or decrease the firm’s stock price. Clearly, only those investments that are expected to increase stock price (NPV > 0, or IRR > cost of capital) would be recommended. Because of its key role in financial decision making, the importance of the cost of capital cannot be overemphasized.

### Some Key Assumptions

The cost of capital is a dynamic concept affected by a variety of economic and firm-specific factors. To isolate the basic structure of the cost of capital, we make some key assumptions relative to risk and taxes:

1. **Business risk**—the risk to the firm of being unable to cover operating costs—is assumed to be unchanged. This assumption means that the firm’s acceptance of a given project does not affect its ability to meet operating costs.
2. **Financial risk**—the risk to the firm of being unable to cover required financial obligations (interest, lease payments, preferred stock dividends)—is assumed to be unchanged. This assumption means that projects are financed in such a way that the firm’s ability to meet required financing costs is unchanged.
3. After-tax costs are considered relevant. In other words, the cost of capital is measured on an after-tax basis. This assumption is consistent with the framework used to make capital budgeting decisions.

### The Basic Concept

The cost of capital is estimated at a given point in time. It reflects the expected average future cost of funds over the long run. Although firms typically raise money in lumps, the cost of capital should reflect the interrelatedness of financing activities. For example, if a firm raises funds with debt (borrowing) today, it is likely that
some form of equity, such as common stock, will have to be used the next time it needs funds. Most firms attempt to maintain a desired optimal mix of debt and equity financing. This mix is commonly called a target capital structure—a topic that will be addressed in Chapter 11. Here, it is sufficient to say that although firms raise money in lumps, they tend toward some desired mix of financing.

To capture the interrelatedness of financing assuming the presence of a target capital structure, we need to look at the overall cost of capital rather than the cost of the specific source of funds used to finance a given expenditure.

**EXAMPLE**

A firm is currently faced with an investment opportunity. Assume the following:

**Best project available today**

- Cost = $100,000
- Life = 20 years
- IRR = 7%

**Cost of least-cost financing source available**

- Debt = 6%

Because it can earn 7% on the investment of funds costing only 6%, the firm undertakes the opportunity. Imagine that 1 week later a new investment opportunity is available:

**Best project available 1 week later**

- Cost = $100,000
- Life = 20 years
- IRR = 12%

**Cost of least-cost financing source available**

- Equity = 14%

In this instance, the firm rejects the opportunity, because the 14% financing cost is greater than the 12% expected return. Were the firm’s actions in the best interests of its owners? No; it accepted a project yielding a 7% return and rejected one with a 12% return. Clearly, there should be a better way, and there is: The firm can use a combined cost, which over the long run will yield better decisions. By weighting the cost of each source of financing by its target proportion in the firm’s capital structure, the firm can obtain a weighted average cost that reflects the interrelationship of financing decisions. Assuming that a 50–50 mix of debt and equity is targeted, the weighted average cost here would be 10% \([0.50 \times 6\% \text{ debt}) + (0.50 \times 14\% \text{ equity})\]. With this cost, the first opportunity would have been rejected (7% IRR < 10% weighted average cost), and the second would have been accepted (12% IRR > 10% weighted average cost). Such an outcome would clearly be more desirable.

**The Cost of Specific Sources of Capital**

This chapter focuses on finding the costs of specific sources of capital and combining them to determine the weighted average cost of capital. Our concern is only with the long-term sources of funds available to a business firm, because
these sources supply the permanent financing. Long-term financing supports the firm’s fixed-asset investments. We assume throughout the chapter that such investments are selected by using appropriate capital budgeting techniques.

There are four basic sources of long-term funds for the business firm: long-term debt, preferred stock, common stock, and retained earnings. The right-hand side of a balance sheet can be used to illustrate these sources:

<table>
<thead>
<tr>
<th>Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current liabilities</td>
</tr>
<tr>
<td>Long-term debt</td>
</tr>
<tr>
<td>Sources of long-term funds</td>
</tr>
<tr>
<td>Stockholders’ equity</td>
</tr>
<tr>
<td>Preferred stock</td>
</tr>
<tr>
<td>Common stock equity</td>
</tr>
<tr>
<td>Common stock</td>
</tr>
<tr>
<td>Retained earnings</td>
</tr>
</tbody>
</table>

Although not every firm will use all of these methods of financing, each firm is expected to have funds from some of these sources in its capital structure.

The *specific cost* of each source of financing is the *after-tax* cost of obtaining the financing today, not the historically based cost reflected by the existing financing on the firm’s books. Techniques for determining the specific cost of each source of long-term funds are presented on the following pages. Although these techniques tend to develop precisely calculated values, the resulting values are at best *rough approximations* because of the numerous assumptions and forecasts that underlie them. Although we round calculated costs to the nearest 0.1 percent throughout this chapter, it is not unusual for practicing financial managers to use costs rounded to the nearest 1 percent because these values are merely estimates.

### Review Questions

10–1 What is the *cost of capital*? What role does it play in long-term investment decisions?

10–2 Why do we assume that *business risk* and *financial risk* are unchanged when evaluating the cost of capital? Discuss the implications of these assumptions on the acceptance and financing of new projects.

10–3 Why is the cost of capital measured on an *after-tax basis*? Why is use of a weighted average cost of capital rather than the cost of the specific source of funds recommended?

10–4 You have just been told, “Because we are going to finance this project with debt, its required rate of return must exceed the cost of debt.” Do you agree or disagree? Explain.

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1. The role of both long-term and short-term financing in supporting both fixed and current asset investments is addressed in Chapter 13. Suffice it to say that long-term funds are at a minimum used to finance fixed assets.
The cost of long-term debt, \( k_i \), is the after-tax cost today of raising long-term funds through borrowing. For convenience, we typically assume that the funds are raised through the sale of bonds. In addition, as we did in Chapter 6, we assume that the bonds pay annual (rather than semiannual) interest.

**Net Proceeds**

Most corporate long-term debts are incurred through the sale of bonds. The net proceeds from the sale of a bond, or any security, are the funds that are actually received from the sale. Flotation costs—the total costs of issuing and selling a security—reduce the net proceeds from the sale. These costs apply to all public offerings of securities—debt, preferred stock, and common stock. They include two components: (1) underwriting costs—compensation earned by investment bankers for selling the security, and (2) administrative costs—issuer expenses such as legal, accounting, printing, and other expenses.

**EXAMPLE**

Duchess Corporation, a major hardware manufacturer, is contemplating selling $10 million worth of 20-year, 9% coupon (stated annual interest rate) bonds, each with a par value of $1,000. Because similar-risk bonds earn returns greater than 9%, the firm must sell the bonds for $980 to compensate for the lower coupon interest rate. The flotation costs are 2% of the par value of the bond (0.02 \times $1,000), or $20. The net proceeds to the firm from the sale of each bond are therefore $960 ($980 − $20).

**Before-Tax Cost of Debt**

The before-tax cost of debt, \( k_d \), for a bond can be obtained in any of three ways: quotation, calculation, or approximation.

**Using Cost Quotations**

When the net proceeds from sale of a bond equal its par value, the before-tax cost just equals the coupon interest rate. For example, a bond with a 10 percent coupon interest rate that nets proceeds equal to the bond’s $1,000 par value would have a before-tax cost, \( k_d \), of 10 percent.

A second quotation that is sometimes used is the yield to maturity (YTM) on a similar-risk bond\(^2\) (see Chapter 6). For example, if a similar-risk bond has a YTM of 9.7 percent, this value can be used as the before-tax cost of debt, \( k_d \).

**Calculating the Cost**

This approach finds the before-tax cost of debt by calculating the internal rate of return (IRR) on the bond cash flows. From the issuer’s point of view, this value is the cost to maturity of the cash flows associated with the debt. The cost to

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2. Generally, the yield to maturity of bonds with a similar “rating” is used. Bond ratings, which are published by independent agencies, were discussed in Chapter 6.
The interest rate on the issue was similar to what Dow would have paid using the traditional syndication process, but the underwriting fee was over 50 percent lower. “To me, it’s a no-brainer,” said Dow treasurer Geoffrey Merszei.

In the future, market watchers expect Internet auctions to lower issuance costs for debt capital through more efficient pricing that reflects market demand. All bidders have equal access to securities, and investors can see a real-time, fully visible demand curve for a bond issue as it unfolds, resulting in improved distribution and enhanced liquidity.

Despite Dow’s success, few corporations have followed it online. Ford Motor Credit issued $750 million of 3-year notes in March 2001. In February 2001, government-sponsored residential mortgage agency Freddie Mac announced that it would use OpenBook for eight auctions. So far, most major investment bankers have resisted endorsing a method that would undercut their more lucrative traditional underwriting business. However, both proponents and opponents of online Dutch auctions of corporate debt believe that this method works best for large, standard-issue bonds from investment-grade issuers.


maturity can be calculated by using either a trial-and-error technique or a financial calculator. It represents the annual before-tax percentage cost of the debt.

In the preceding example, the net proceeds of a $1,000, 9% coupon interest rate, 20-year bond were found to be $960. The calculation of the annual cost is quite simple. The cash flow pattern is exactly the opposite of a conventional pattern; it consists of an initial inflow (the net proceeds) followed by a series of annual outlays (the interest payments). In the final year, when the debt is retired, an outlay representing the repayment of the principal also occurs. The cash flows associated with Duchess Corporation’s bond issue are as follows:

<table>
<thead>
<tr>
<th>End of year(s)</th>
<th>Cash flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>$ 960</td>
</tr>
<tr>
<td>1–20</td>
<td>$ 90</td>
</tr>
<tr>
<td>20</td>
<td>$1,000</td>
</tr>
</tbody>
</table>

The initial $960 inflow is followed by annual interest outflows of $90 (9% coupon interest rate × $1,000 par value) over the 20-year life of the bond. In year 20, an outflow of $1,000 (the repayment of the principal) occurs. We can determine the cost of debt by finding the IRR, which is the discount rate that equates the present value of the outflows to the initial inflow.

**Calculator Use**  
[Note: Most calculators require either the present (net proceeds) or the future (annual interest payments and repayment of principal) values to be input as negative numbers when we calculate cost to maturity. That approach is used here.] Using the calculator and the inputs shown at the left, you should find the before-tax cost (cost to maturity) to be 9.452%.

**Approximating the Cost**

The before-tax cost of debt, \( k_d \), for a bond with a $1,000 par value can be approximated by using the following equation:

\[
k_d = \frac{I + \frac{1,000 - N_d}{n}}{\frac{N_d + $1,000}{2}}
\]

where

\( I = \) annual interest in dollars
\( N_d = \) net proceeds from the sale of debt (bond)
\( n = \) number of years to the bond’s maturity

**EXAMPLE**

Substituting the appropriate values from the Duchess Corporation example into the approximation formula given in Equation 10.1, we get

\[
k_d = \frac{90 + 2}{\frac{960 + 1,000}{2}} = \frac{92}{980} = 9.4\%
\]

This approximate before-tax cost of debt is close to the 9.452% value calculated precisely in the preceding example.

**After-Tax Cost of Debt**

However, as indicated earlier, the specific cost of financing must be stated on an after-tax basis. Because interest on debt is tax deductible, it reduces the firm’s taxable income. The after-tax cost of debt, \( k_i \), can be found by multiplying the before-tax cost, \( k_d \), by 1 minus the tax rate, \( T \), as stated in the following equation:

\[
k_i = k_d \times (1 - T)
\]
EXAMPLE

Duchess Corporation has a 40% tax rate. Using the 9.4% before-tax debt cost calculated above, and applying Equation 10.2, we find an after-tax cost of debt of 5.6% \( [9.4\% \times (1 - 0.40)] \). Typically, the explicit cost of long-term debt is less than the explicit cost of any of the alternative forms of long-term financing, primarily because of the tax deductibility of interest.

Review Questions

10–5 What are the net proceeds from the sale of a bond? What are flotation costs and how do they affect a bond’s net proceeds?
10–6 What three methods can be used to find the before-tax cost of debt?
10–7 How is the before-tax cost of debt converted into the after-tax cost?

The Cost of Preferred Stock

Preferred stock represents a special type of ownership interest in the firm. It gives preferred stockholders the right to receive their stated dividends before any earnings can be distributed to common stockholders. Because preferred stock is a form of ownership, the proceeds from its sale are expected to be held for an infinite period of time. The key characteristics of preferred stock were described in Chapter 7. However, the one aspect of preferred stock that requires review is dividends.

Preferred Stock Dividends

Most preferred stock dividends are stated as a dollar amount: “x dollars per year.” When dividends are stated this way, the stock is often referred to as “x-dollar preferred stock.” Thus a “$4 preferred stock” is expected to pay preferred stockholders $4 in dividends each year on each share of preferred stock owned.

Sometimes preferred stock dividends are stated as an annual percentage rate. This rate represents the percentage of the stock’s par value, or face value, that equals the annual dividend. For instance, an 8 percent preferred stock with a $50 par value would be expected to pay an annual dividend of $4 a share \( (0.08 \times 50 \text{ par} = 4) \). Before the cost of preferred stock is calculated, any dividends stated as percentages should be converted to annual dollar dividends.

Calculating the Cost of Preferred Stock

The cost of preferred stock, \( k_p \), is the ratio of the preferred stock dividend to the firm’s net proceeds from the sale of the preferred stock. The net proceeds represent the amount of money to be received minus any flotation costs. Equation 10.3 gives the cost of preferred stock, \( k_p \), in terms of the annual dollar dividend, \( D_p \), and the net proceeds from the sale of the stock, \( N_p \):

\[
k_p = \frac{D_p}{N_p}
\]
Because preferred stock dividends are paid out of the firm’s after-tax cash flows, a tax adjustment is not required.

EXAMPLE

Duchess Corporation is contemplating issuance of a 10% preferred stock that is expected to sell for its $87-per-share par value. The cost of issuing and selling the stock is expected to be $5 per share. The first step in finding the cost of the stock is to calculate the dollar amount of the annual preferred dividend, which is $8.70 (0.10 × $87). The net proceeds per share from the proposed sale of stock equals the sale price minus the flotation costs ($87 – $5 = $82). Substituting the annual dividend, $D_p$, of $8.70 and the net proceeds, $N_p$, of $82 into Equation 10.3 gives the cost of preferred stock, 10.6% ($8.70 / $82).

The cost of Duchess’s preferred stock (10.6%) is much greater than the cost of its long-term debt (5.6%). This difference exists primarily because the cost of long-term debt (the interest) is tax deductible.

Review Question

10–8 How would you calculate the cost of preferred stock?

The Cost of Common Stock

The cost of common stock is the return required on the stock by investors in the marketplace. There are two forms of common stock financing: (1) retained earnings and (2) new issues of common stock. As a first step in finding each of these costs, we must estimate the cost of common stock equity.

Finding the Cost of Common Stock Equity

The cost of common stock equity, $k_s$, is the rate at which investors discount the expected dividends of the firm to determine its share value. Two techniques are used to measure the cost of common stock equity. One relies on the constant-growth valuation model, the other on the capital asset pricing model (CAPM).

Using the Constant-Growth Valuation (Gordon) Model

In Chapter 7 we found the value of a share of stock to be equal to the present value of all future dividends, which in one model were assumed to grow at a constant annual rate over an infinite time horizon. This is the constant-growth valuation model, also known as the Gordon model. The key expression derived for this model was presented as Equation 7.4 and is restated here:

$$ P_0 = \frac{D_1}{k_s - g} $$  (10.4)
where
\[
P_0 = \text{value of common stock} \\
D_1 = \text{per-share dividend expected at the end of year 1} \\
k_s = \text{required return on common stock} \\
g = \text{constant rate of growth in dividends}
\]

Solving Equation 10.4 for \(k_s\) results in the following expression for the cost of common stock equity:
\[
k_s = \frac{D_1}{P_0} + g \tag{10.5}
\]

Equation 10.5 indicates that the cost of common stock equity can be found by dividing the dividend expected at the end of year 1 by the current price of the stock and adding the expected growth rate. Because common stock dividends are paid from after-tax income, no tax adjustment is required.

**Example**

Duchess Corporation wishes to determine its cost of common stock equity, \(k_s\). The market price, \(P_0\), of its common stock is $50 per share. The firm expects to pay a dividend, \(D_1\), of $4 at the end of the coming year, 2004. The dividends paid on the outstanding stock over the past 6 years (1998–2003) were as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Dividend</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>$3.80</td>
</tr>
<tr>
<td>2002</td>
<td>3.62</td>
</tr>
<tr>
<td>2001</td>
<td>3.47</td>
</tr>
<tr>
<td>2000</td>
<td>3.33</td>
</tr>
<tr>
<td>1999</td>
<td>3.12</td>
</tr>
<tr>
<td>1998</td>
<td>2.97</td>
</tr>
</tbody>
</table>

Using the table for the present value interest factors, \(PVIF\) (Table A–2), or a financial calculator in conjunction with the technique described for finding growth rates in Chapter 4, we can calculate the annual growth rate of dividends, \(g\). It turns out to be approximately 5% (more precisely, it is 5.05%). Substituting \(D_1 = 4\), \(P_0 = 50\), and \(g = 5\%\) into Equation 10.5 yields the cost of common stock equity:
\[
k_s = \frac{4}{50} + 0.05 = 0.08 + 0.05 = 0.130, \text{ or } 13.0\%
\]

The 13.0% cost of common stock equity represents the return required by existing shareholders on their investment. If the actual return is less than that, shareholders are likely to begin selling their stock.

**Using the Capital Asset Pricing Model (CAPM)**

Recall from Chapter 5 that the capital asset pricing model (CAPM) describes the relationship between the required return, \(k_s\), and the nondiversifiable risk of the firm as measured by the beta coefficient, \(b\). The basic CAPM is
\[
k_s = R_F + [b \times (k_m - R_F)] \tag{10.6}
\]
where

\[ R_F = \text{risk-free rate of return} \]
\[ k_m = \text{market return; return on the market portfolio of assets} \]

Using CAPM indicates that the cost of common stock equity is the return required by investors as compensation for the firm’s nondiversifiable risk, measured by beta.

**EXAMPLE**

Duchess Corporation now wishes to calculate its cost of common stock equity, \( k_s \), by using the capital asset pricing model. The firm’s investment advisers and its own analyses indicate that the risk-free rate, \( R_F \), equals 7%; the firm’s beta, \( b \), equals 1.5; and the market return, \( k_m \), equals 11%. Substituting these values into Equation 10.6, the company estimates the cost of common stock equity, \( k_s \), to be

\[
\frac{k_s}{7.0\%} = 7.0\% + [1.5 \times (11.0\% - 7.0\%)]
\]

The 13.0% cost of common stock equity represents the required return of investors in Duchess Corporation common stock. It is the same as that found by using the constant-growth valuation model.

**The Cost of Retained Earnings**

As you know, dividends are paid out of a firm’s earnings. Their payment, made in cash to common stockholders, reduces the firm’s retained earnings. Let’s say a firm needs common stock equity financing of a certain amount; it has two choices relative to retained earnings: It can issue additional common stock in that amount and still pay dividends to stockholders out of retained earnings. Or it can increase common stock equity by retaining the earnings (not paying the cash dividends) in the needed amount. In a strict accounting sense, the retention of earnings increases common stock equity in the same way that the sale of additional shares of common stock does. Thus the cost of retained earnings, \( k_r \), to the firm is the same as the cost of an **equivalent fully subscribed issue of additional common stock**. Stockholders find the firm’s retention of earnings acceptable only if they expect that it will earn at least their required return on the reinvested funds.

Viewing retained earnings as a fully subscribed issue of additional common stock, we can set the firm’s cost of retained earnings, \( k_r \), equal to the cost of common stock equity as given by Equations 10.5 and 10.6.\(^4\)

\[
k_r = k_s \quad (10.7)
\]

It is not necessary to adjust the cost of retained earnings for flotation costs, because by retaining earnings, the firm “raises” equity capital without incurring these costs.

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\(^4\) Technically, if a stockholder received dividends and wished to invest them in additional shares of the firm’s stock, he or she would first have to pay personal taxes on the dividends and then pay brokerage fees before acquiring additional shares. By using \( pt \) as the average stockholder’s personal tax rate and \( bf \) as the average brokerage fees stated as a percentage, we can specify the cost of retained earnings, \( k_r \), as \( k_r = k_s \times (1 - pt) \times (1 - bf) \). Because of the difficulty in estimating \( pt \) and \( bf \), only the simpler definition of \( k_r \), given in Equation 10.7 is used here.
The cost of retained earnings for Duchess Corporation was actually calculated in the preceding examples: It is equal to the cost of common stock equity. Thus $k_r$ equals 13.0%. As we will show in the next section, the cost of retained earnings is always lower than the cost of a new issue of common stock, because it entails no flotation costs.

The Cost of New Issues of Common Stock

Our purpose in finding the firm’s overall cost of capital is to determine the after-tax cost of new funds required for financing projects. The cost of a new issue of common stock, $k_n$, is determined by calculating the cost of common stock, net of underpricing and associated flotation costs. Normally, for a new issue to sell, it has to be underpriced—sold at a price below its current market price, $P_0$.

Firms underprice new issues for a variety of reasons. First, when the market is in equilibrium (that is, the demand for shares equals the supply of shares), additional demand for shares can be achieved only at a lower price. Second, when additional shares are issued, each share’s percent of ownership in the firm is diluted, thereby justifying a lower share value. Finally, many investors view the issuance of additional shares as a signal that management is using common stock equity financing because it believes that the shares are currently overpriced. Recognizing this information, they will buy shares only at a price below the current market price. Clearly, these and other factors necessitate underpricing of new offerings of common stock. Flotation costs paid for issuing and selling the new issue will further reduce proceeds.

We can use the constant-growth valuation model expression for the cost of existing common stock, $k_s$, as a starting point. If we let $N_n$ represent the net proceeds from the sale of new common stock after subtracting underpricing and flotation costs, the cost of the new issue, $k_n$, can be expressed as follows:

$$k_n = \frac{D_1}{N_n} + g$$

(10.8)

The net proceeds from sale of new common stock, $N_n$, will be less than the current market price, $P_0$. Therefore, the cost of new issues, $k_n$, will always be greater than the cost of existing issues, $k_s$, which is equal to the cost of retained earnings, $k_r$. The cost of new common stock is normally greater than any other long-term financing cost. Because common stock dividends are paid from after-tax cash flows, no tax adjustment is required.

In the constant-growth valuation example, we found Duchess Corporation’s cost of common stock equity, $k_s$, to be 13%, using the following values: an expected dividend, $D_1$, of $4; a current market price, $P_0$, of $50; and an expected growth rate of dividends, $g$, of 5%.

To determine its cost of new common stock, $k_n$, Duchess Corporation has estimated that on the average, new shares can be sold for $47. The $3-per-share underpricing is due to the competitive nature of the market. A second cost associated with a new issue is flotation costs of $2.50 per share that would be paid to issue and sell the new shares. The total underpricing and flotation costs per share are therefore expected to be $5.50.
Subtracting the $5.50 per share underpricing and flotation cost from the current $50 share price results in expected net proceeds of $44.50 per share ($50.00 − $5.50). Substituting \( D_1 = $4 \), \( N_n = $44.50 \), and \( g = 5\% \) into Equation 10.8 results in a cost of new common stock, \( k_n \), as follows:

\[
k_n = \frac{\$4.00}{\$44.50} + 0.05 = 0.09 + 0.05 = 0.140, \text{ or } 14.0\%
\]

Duchess Corporation’s cost of new common stock is therefore 14.0%. This is the value to be used in subsequent calculations of the firm’s overall cost of capital.

**Review Questions**

10–9 What premise about share value underlies the constant-growth valuation (Gordon) model that is used to measure the cost of common stock equity, \( k_s \)?

10–10 Why is the cost of financing a project with retained earnings less than the cost of financing it with a new issue of common stock?

### The Weighted Average Cost of Capital

Now that we have calculated the cost of specific sources of financing, we can determine the overall cost of capital. As noted earlier, the **weighted average cost of capital** (WACC), \( k_w \), reflects the expected average future cost of funds over the long run. It is found by weighting the cost of each specific type of capital by its proportion in the firm’s capital structure.

**Calculating the Weighted Average Cost of Capital (WACC)**

Calculating the weighted average cost of capital (WACC) is straightforward: Multiply the specific cost of each form of financing by its proportion in the firm’s capital structure and sum the weighted values. As an equation, the weighted average cost of capital, \( k_w \), can be specified as follows:

\[
k_w = (w_d \times k_d) + (w_p \times k_p) + (w_s \times k_s)
\]

where

- \( w_d \) = proportion of long-term debt in capital structure
- \( w_p \) = proportion of preferred stock in capital structure
- \( w_s \) = proportion of common stock equity in capital structure

\( w_d + w_p + w_s = 1.0 \)

Three important points should be noted in Equation 10.9:

1. For computational convenience, it is best to convert the weights into decimal form and leave the specific costs in percentage terms.
2. *The sum of the weights must equal 1.0.* Simply stated, all capital structure components must be accounted for.

3. The firm’s common stock equity weight, $w_s$, is multiplied by either the cost of retained earnings, $k_r$, or the cost of new common stock, $k_n$. Which cost is used depends on whether the firm’s common stock equity will be financed using retained earnings, $k_r$, or new common stock, $k_n$.

**EXAMPLE**

In earlier examples, we found the costs of the various types of capital for Duchess Corporation to be as follows:

- Cost of debt, $k_i = 5.6\%$
- Cost of preferred stock, $k_p = 10.6\%$
- Cost of retained earnings, $k_r = 13.0\%$
- Cost of new common stock, $k_n = 14.0\%$

The company uses the following weights in calculating its weighted average cost of capital:

<table>
<thead>
<tr>
<th>Source of capital</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term debt</td>
<td>40%</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>10</td>
</tr>
<tr>
<td>Common stock equity</td>
<td>50</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
</tr>
</tbody>
</table>

Because the firm expects to have a sizable amount of retained earnings available ($300,000), it plans to use its cost of retained earnings, $k_r$, as the cost of common stock equity. Duchess Corporation’s weighted average cost of capital is calculated in Table 10.1. The resulting weighted average cost of capital for Duchess is 9.8%. Assuming an unchanged risk level, the firm should accept all projects that will earn a return greater than 9.8%.

**TABLE 10.1 Calculation of the Weighted Average Cost of Capital for Duchess Corporation**

<table>
<thead>
<tr>
<th>Source of capital</th>
<th>Weight</th>
<th>Cost</th>
<th>Weighted cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term debt</td>
<td>0.40</td>
<td>5.6%</td>
<td>2.2%</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>0.10</td>
<td>10.6</td>
<td>1.1</td>
</tr>
<tr>
<td>Common stock equity</td>
<td>0.50</td>
<td>13.0</td>
<td>6.5</td>
</tr>
<tr>
<td>Totals</td>
<td>1.00</td>
<td></td>
<td>9.8%</td>
</tr>
</tbody>
</table>

Weighted average cost of capital = 9.8%
Weighting Schemes

Weights can be calculated on the basis of either book value or market value and using either historical or target proportions.

Book Value Versus Market Value

Book value weights use accounting values to measure the proportion of each type of capital in the firm’s financial structure. Market value weights measure the proportion of each type of capital at its market value. Market value weights are appealing, because the market values of securities closely approximate the actual dollars to be received from their sale. Moreover, because the costs of the various types of capital are calculated by using prevailing market prices, it seems reasonable to use market value weights. In addition, the long-term investment cash flows to which the cost of capital is applied are estimated in terms of current as well as future market values. Market value weights are clearly preferred over book value weights.

Historical Versus Target

Historical weights can be either book or market value weights based on actual capital structure proportions. For example, past or current book value proportions would constitute a form of historical weighting, as would past or current market value proportions. Such a weighting scheme would therefore be based on real—rather than desired—proportions.

Target weights, which can also be based on either book or market values, reflect the firm’s desired capital structure proportions. Firms using target weights establish such proportions on the basis of the “optimal” capital structure they wish to achieve. (The development of these proportions and the optimal structure are discussed in detail in Chapter 11.)

When one considers the somewhat approximate nature of the calculation of weighted average cost of capital, the choice of weights may not be critical. However, from a strictly theoretical point of view, the preferred weighting scheme is target market value proportions, and these are assumed throughout this chapter.

Review Questions

10–11 What is the weighted average cost of capital (WACC), and how is it calculated?
10–12 Describe the logic underlying the use of target capital structure weights, and compare and contrast this approach with the use of historical weights. What is the preferred weighting scheme?

The Marginal Cost and Investment Decisions

The firm’s weighted average cost of capital is a key input to the investment decision-making process. As demonstrated earlier in the chapter, the firm should make only those investments for which the expected return is greater
than the weighted average cost of capital. Of course, at any given time, the firm’s financing costs and investment returns will be affected by the volume of financing and investment undertaken. The weighted marginal cost of capital and the investment opportunities schedule are mechanisms whereby financing and investment decisions can be made simultaneously.

The Weighted Marginal Cost of Capital (WMCC)

The weighted average cost of capital may vary over time, depending on the volume of financing that the firm plans to raise. As the volume of financing increases, the costs of the various types of financing will increase, raising the firm’s weighted average cost of capital. Therefore, it is useful to calculate the weighted marginal cost of capital (WMCC), which is simply the firm’s weighted average cost of capital (WACC) associated with its next dollar of total new financing. This marginal cost is relevant to current decisions.

The costs of the financing components (debt, preferred stock, and common stock) rise as larger amounts are raised. Suppliers of funds require greater returns in the form of interest, dividends, or growth as compensation for the increased risk introduced by larger volumes of new financing. The WMCC is therefore an increasing function of the level of total new financing.

Another factor that causes the weighted average cost of capital to increase is the use of common stock equity financing. New financing provided by common stock equity will be taken from available retained earnings until this supply is exhausted and then will be obtained through new common stock financing. Because retained earnings are a less expensive form of common stock equity financing than the sale of new common stock, the weighted average cost of capital will rise with the addition of new common stock.

Finding Break Points

To calculate the WMCC, we must calculate break points, which reflect the level of total new financing at which the cost of one of the financing components rises. The following general equation can be used to find break points:

$$BP_j = \frac{AF_j}{w_j}$$  \hspace{1cm} (10.10)

where

- $BP_j$ = break point for financing source $j$
- $AF_j$ = amount of funds available from financing source $j$ at a given cost
- $w_j$ = capital structure weight (stated in decimal form) for financing source $j$

**EXAMPLE**

When Duchess Corporation exhausts its $300,000 of available retained earnings (at $k_r = 13.0\%$), it must use the more expensive new common stock financing (at $k_u = 14.0\%$) to meet its common stock equity needs. In addition, the firm expects that it can borrow only $400,000 of debt at the 5.6\% cost; additional debt will have an after-tax cost ($k_i$) of 8.4\%. Two break points therefore exist: (1) when the $300,000 of retained earnings costing 13.0\% is exhausted, and (2) when the $400,000 of long-term debt costing 5.6\% is exhausted.
The break points can be found by substituting these values and the corresponding capital structure weights given earlier into Equation 10.10. We get the dollar amounts of total new financing at which the costs of the given financing sources rise:

\[ BP_{\text{common equity}} = \frac{\$300,000}{0.50} = \$600,000 \]

\[ BP_{\text{long-term debt}} = \frac{\$400,000}{0.40} = \$1,000,000 \]

**Calculating the WMCC**

Once the break points have been determined, the next step is to calculate the weighted average cost of capital over the range of total new financing between break points. First, we find the WACC for a level of total new financing between zero and the first break point. Next, we find the WACC for a level of total new financing between the first and second break points, and so on. By definition, for each of the ranges of total new financing between break points, certain component capital costs (such as debt or common equity) will increase. This will cause the weighted average cost of capital to increase to a higher level than that over the preceding range.

Together, these data can be used to prepare a **weighted marginal cost of capital (WMCC) schedule**. This is a graph that relates the firm’s weighted average cost of capital to the level of total new financing.

**EXAMPLE**

Table 10.2 summarizes the calculation of the WACC for Duchess Corporation over the three ranges of total new financing created by the two break points—

<table>
<thead>
<tr>
<th>Range of total new financing</th>
<th>Source of capital (1)</th>
<th>Weight (2)</th>
<th>Cost (3)</th>
<th>Weighted cost [(2) × (3)] (4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 to $600,000</td>
<td>Debt</td>
<td>.40</td>
<td>5.6%</td>
<td>2.2%</td>
</tr>
<tr>
<td></td>
<td>Preferred</td>
<td>.10</td>
<td>10.6</td>
<td>1.1</td>
</tr>
<tr>
<td></td>
<td>Common</td>
<td>.50</td>
<td>13.0</td>
<td>6.5</td>
</tr>
<tr>
<td></td>
<td><strong>Weighted average cost of capital</strong></td>
<td></td>
<td></td>
<td><strong>9.8%</strong></td>
</tr>
<tr>
<td>$600,000 to $1,000,000</td>
<td>Debt</td>
<td>.40</td>
<td>5.6%</td>
<td>2.2%</td>
</tr>
<tr>
<td></td>
<td>Preferred</td>
<td>.10</td>
<td>10.6</td>
<td>1.1</td>
</tr>
<tr>
<td></td>
<td>Common</td>
<td>.50</td>
<td>14.0</td>
<td><strong>7.0</strong></td>
</tr>
<tr>
<td></td>
<td><strong>Weighted average cost of capital</strong></td>
<td></td>
<td></td>
<td><strong>10.3%</strong></td>
</tr>
<tr>
<td>$1,000,000 and above</td>
<td>Debt</td>
<td>.40</td>
<td>8.4%</td>
<td>3.4%</td>
</tr>
<tr>
<td></td>
<td>Preferred</td>
<td>.10</td>
<td>10.6</td>
<td>1.1</td>
</tr>
<tr>
<td></td>
<td>Common</td>
<td>.50</td>
<td>14.0</td>
<td><strong>7.0</strong></td>
</tr>
<tr>
<td></td>
<td><strong>Weighted average cost of capital</strong></td>
<td></td>
<td></td>
<td><strong>11.5%</strong></td>
</tr>
</tbody>
</table>
The Investment Opportunities Schedule (IOS)

At any given time, a firm has certain investment opportunities available to it. These opportunities differ with respect to the size of investment, risk, and return. The firm’s investment opportunities schedule (IOS) is a ranking of investment possibilities from best (highest return) to worst (lowest return). Generally, the first project selected will have the highest return, the next project the second highest, and so on. The return on investments will decrease as the firm accepts additional projects.

---

$600,000 and $1,000,000. Comparing the costs in column 3 of the table for each of the three ranges, we can see that the costs in the first range ($0 to $600,000) are those calculated in earlier examples and used in Table 10.1. The second range ($600,000 to $1,000,000) reflects the increase in the common stock equity cost to 14.0%. In the final range, the increase in the long-term debt cost to 8.4% is introduced.

The weighted average costs of capital (WACC) for the three ranges are summarized in the table shown at the bottom of Figure 10.1. These data describe the weighted marginal cost of capital (WMCC), which increases as levels of total new financing increase. Figure 10.1 presents the WMCC schedule. Again, it is clear that the WMCC is an increasing function of the amount of total new financing raised.

---

5. Because the calculated weighted average cost of capital does not apply to risk-changing investments, we assume that all opportunities have equal risk similar to the firm’s risk.
Column 1 of Table 10.3 shows Duchess Corporation’s current investment opportunities schedule (IOS) listing the investment possibilities from best (highest return) to worst (lowest return). Column 2 of the table shows the initial investment required by each project. Column 3 shows the cumulative total invested funds necessary to finance all projects better than and including the corresponding investment opportunity. Plotting the project returns against the cumulative investment (column 1 against column 3) results in the firm’s investment opportunities schedule (IOS). A graph of the IOS for Duchess Corporation is given in Figure 10.2.

Using the WMCC and IOS to Make Financing/Investment Decisions

As long as a project’s internal rate of return is greater than the weighted marginal cost of new financing, the firm should accept the project. The return will decrease with the acceptance of more projects, and the weighted marginal cost of capital will increase because greater amounts of financing will be required. The decision rule therefore would be: Accept projects up to the point at which the marginal return on an investment equals its weighted marginal cost of capital. Beyond that point, its investment return will be less than its capital cost.

This approach is consistent with the maximization of net present value (NPV) for conventional projects for two reasons: (1) The NPV is positive as long as the IRR exceeds the weighted average cost of capital, $k_w$. (2) The larger the difference between the IRR and $k_w$, the larger the resulting NPV. Therefore, the acceptance of projects beginning with those that have the greatest positive difference between IRR and $k_w$, down to the point at which IRR just equals $k_w$, should result in the maximum total NPV for all independent projects accepted. Such an outcome is completely consistent with the firm’s goal of maximizing owner wealth.

Figure 10.2 shows Duchess Corporation’s WMCC schedule and IOS on the same set of axes. By raising $1,100,000 of new financing and investing these funds in

<table>
<thead>
<tr>
<th>Investment opportunity</th>
<th>Internal rate of return (IRR) (1)</th>
<th>Initial investment (2)</th>
<th>Cumulative investment (3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>15.0%</td>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>B</td>
<td>14.5</td>
<td>200,000</td>
<td>300,000</td>
</tr>
<tr>
<td>C</td>
<td>14.0</td>
<td>400,000</td>
<td>700,000</td>
</tr>
<tr>
<td>D</td>
<td>13.0</td>
<td>100,000</td>
<td>800,000</td>
</tr>
<tr>
<td>E</td>
<td>12.0</td>
<td>300,000</td>
<td>1,100,000</td>
</tr>
<tr>
<td>F</td>
<td>11.0</td>
<td>200,000</td>
<td>1,300,000</td>
</tr>
<tr>
<td>G</td>
<td>10.0</td>
<td>100,000</td>
<td>1,400,000</td>
</tr>
</tbody>
</table>

*aThe cumulative investment represents the total amount invested in projects with higher returns plus the investment required for the corresponding investment opportunity.

6. Although net present value could be used to make these decisions, the internal rate of return is used here because of the ease of comparison it offers.
projects A, B, C, D, and E, the firm should maximize the wealth of its owners, because these projects result in the maximum total net present value. Note that the 12.0% return on the last dollar invested (in project E) exceeds its 11.5% weighted average cost. Investment in project F is not feasible, because its 11.0% return is less than the 11.5% cost of funds available for investment.

The firm’s optimal capital budget of $1,100,000 is marked with an X in Figure 10.2. At that point, the IRR equals the weighted average cost of capital, and the firm’s size as well as its shareholder value will be optimized. In a sense, the size of the firm is determined by the market—the availability of and returns on investment opportunities, and the availability and cost of financing.

In practice, most firms operate under capital rationing. That is, management imposes constraints that keep the capital expenditure budget below optimal (where $\text{IRR} = \text{k}_j$). Because of this, a gap frequently exists between the theoretically optimal capital budget and the firm’s actual level of financing/investment.

**Review Questions**

10–13 What is the weighted marginal cost of capital (WMCC)? What does the WMCC schedule represent? Why does this schedule increase?

10–14 What is the investment opportunities schedule (IOS)? Is it typically depicted as an increasing or a decreasing function? Why?

10–15 How can the WMCC schedule and the IOS be used to find the level of financing/investment that maximizes owner wealth? Why do many firms finance/invest at a level below this optimum?
PART 4 Long-Term Financial Decisions

SUMMARY

FOCUS ON VALUE

The cost of capital is an extremely important rate of return used by the firm in the long-term decision process, particularly in capital budgeting decisions. It is the expected average future cost to the firm of funds over the long run. Because the cost of capital is the pivotal rate of return used in the investment decision process, its accuracy can significantly affect the quality of these decisions.

Even with good estimates of project cash flows, the application of NPV and IRR decision techniques, and adequate consideration of project risk, a poorly estimated cost of capital can result in the destruction of shareholder value. Underestimation of the cost of capital can result in the mistaken acceptance of poor projects, whereas overestimation can cause good projects to be rejected. In either situation, the firm’s action could be detrimental to the firm’s value. By applying the techniques presented in this chapter to estimate the firm’s cost of capital, the financial manager will improve the likelihood that the firm’s long-term decisions are consistent with the firm’s overall goal of maximizing stock price (owner wealth).

REVIEW OF LEARNING GOALS

Understand the key assumptions that underlie cost of capital, the basic concept of cost of capital, and the specific sources of capital that it includes. The cost of capital is the rate of return that a firm must earn on its investments to maintain its market value and attract needed funds. It is affected by business and financial risks, which are assumed to be unchanged. To capture the interrelatedness of financing, a weighted average cost of capital should be used to find the expected average future cost of funds over the long run. The specific costs of the basic sources of capital (long-term debt, preferred stock, retained earnings, and common stock) can be calculated individually.

Calculate the cost of common stock equity and convert it into the cost of retained earnings and the cost of new issues of common stock. The cost of common stock equity can be calculated by using the constant-growth valuation (Gordon) model or the CAPM. The cost of retained earnings is equal to the cost of common stock equity. An adjustment in the cost of common stock equity to reflect underpricing and flotation costs is necessary to find the cost of new issues of common stock. The key formulas for the cost of common stock equity, the cost of retained earnings, and the cost of new issues of common stock are given in Table 10.4.

Calculate the weighted average cost of capital (WACC) and discuss the alternative weighting schemes. The firm’s WACC reflects the expected...
### TABLE 10.4 Summary of Key Definitions and Formulas for Cost of Capital

<table>
<thead>
<tr>
<th>Definitions of variables</th>
<th>Cost of capital formulas</th>
</tr>
</thead>
<tbody>
<tr>
<td>( AF_j ) = amount of funds available from financing source ( j ) at a given cost</td>
<td>( k_d = \frac{I + \frac{$1,000 - N_d}{n}}{N_d + \frac{$1,000}{1000}} ) [Eq. 10.1]</td>
</tr>
<tr>
<td>( b ) = beta coefficient or measure of nondiversifiable risk</td>
<td>( k_s = k_d \times (1 - T) ) [Eq. 10.2]</td>
</tr>
<tr>
<td>( BP_j ) = break point for financing source ( j )</td>
<td>( k_p = \frac{D_p}{N_p} ) [Eq. 10.3]</td>
</tr>
<tr>
<td>( D_1 ) = per share dividend <em>expected</em> at the end of year 1</td>
<td>Cost of preferred stock:</td>
</tr>
<tr>
<td>( D_p ) = annual preferred stock dividend (in dollars)</td>
<td>Cost of common stock equity:</td>
</tr>
<tr>
<td>( g ) = constant rate of growth in dividends</td>
<td>Using constant-growth valuation model:</td>
</tr>
<tr>
<td>( l ) = annual interest in dollars</td>
<td>( k_s = \frac{D_1}{P_0} + g ) [Eq. 10.5]</td>
</tr>
<tr>
<td>( k_d ) = before-tax cost of debt</td>
<td>Using CAPM:</td>
</tr>
<tr>
<td>( k_i ) = after-tax cost of debt</td>
<td>( k_s = R_F + [b \times (k_m - R_F)] ) [Eq. 10.6]</td>
</tr>
<tr>
<td>( k_m ) = required return on the market portfolio</td>
<td>Cost of retained earnings:</td>
</tr>
<tr>
<td>( k_n ) = cost of a new issue of common stock</td>
<td>( k_r = k_s ) [Eq. 10.7]</td>
</tr>
<tr>
<td>( k_p ) = cost of preferred stock</td>
<td>Cost of new issues of common stock:</td>
</tr>
<tr>
<td>( k_r ) = cost of retained earnings</td>
<td>( k_n = \frac{D_1}{N_n} + g ) [Eq. 10.8]</td>
</tr>
<tr>
<td>( n ) = number of years to the bond’s maturity</td>
<td>Weighted average cost of capital (WACC):</td>
</tr>
<tr>
<td>( N_d ) = net proceeds from the sale of debt (bond)</td>
<td>( k_d = (w_d \times k_d) + (w_p \times k_p) + (w_s \times k_r) ) [Eq. 10.9]</td>
</tr>
<tr>
<td>( N_p ) = net proceeds from the sale of preferred stock</td>
<td>Break point:</td>
</tr>
<tr>
<td>( P_0 ) = value of common stock</td>
<td>( BP_j = \frac{AF_j}{w_j} ) [Eq. 10.10]</td>
</tr>
</tbody>
</table>
average future cost of funds over the long run. It can be determined by combining the costs of specific types of capital after weighting each of them by its proportion using historical book or market value weights, or target book or market value weights. The theoretically preferred approach uses target weights based on market values. The key formula for WACC is given in Table 10.4.

Describe the procedures used to determine break points and the weighted marginal cost of capital (WMCC). As the volume of total new financing increases, the costs of the various types of financing will increase, raising the firm’s WACC. The WMCC is the firm’s WACC associated with its next dollar of total new financing. Break points represent the level of total new financing at which the cost of one of the financing components rises, causing an upward shift in the WMCC. The general formula for break points is given in Table 10.4. The WMCC schedule relates the WACC to each level of total new financing.

SELF-TEST PROBLEM (Solution in Appendix B)

ST 10–1 Specific costs, WACC, WMCC, and IOS

Humble Manufacturing is interested in measuring its overall cost of capital. The firm is in the 40% tax bracket. Current investigation has gathered the following data:

Debt

The firm can raise an unlimited amount of debt by selling $1,000-par-value, 10% coupon interest rate, 10-year bonds on which annual interest payments will be made. To sell the issue, an average discount of $30 per bond must be given. The firm must also pay flotation costs of $20 per bond.

Preferred stock

The firm can sell 11% (annual dividend) preferred stock at its $100-per-share par value. The cost of issuing and selling the preferred stock is expected to be $4 per share. An unlimited amount of preferred stock can be sold under these terms.

Common stock

The firm’s common stock is currently selling for $80 per share. The firm expects to pay cash dividends of $6 per share next year. The firm’s dividends have been growing at an annual rate of 6%, and this rate is expected to continue in the future. The stock will have to be underpriced by $4 per share, and flotation costs are expected to amount to $4 per share. The firm can sell an unlimited amount of new common stock under these terms.

Retained earnings

The firm expects to have $225,000 of retained earnings available in the coming year. Once these retained earnings are exhausted, the firm will use new common stock as the form of common stock equity financing.

a. Calculate the specific cost of each source of financing. (Round to the nearest 0.1%.)
b. The firm uses the weights shown in the following table, which are based on target capital structure proportions, to calculate its weighted average cost of capital. (Round to the nearest 0.1%.)

<table>
<thead>
<tr>
<th>Source of capital</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term debt</td>
<td>40%</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>15</td>
</tr>
<tr>
<td>Common stock equity</td>
<td>45</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
</tr>
</tbody>
</table>

(1) Calculate the single break point associated with the firm’s financial situation. (Hint: This point results from the exhaustion of the firm’s retained earnings.)

(2) Calculate the weighted average cost of capital associated with total new financing below the break point calculated in part (1).

(3) Calculate the weighted average cost of capital associated with total new financing above the break point calculated in part (1).

c. Using the results of part b along with the information shown in the following table on the available investment opportunities, draw the firm’s weighted marginal cost of capital (WMCC) schedule and investment opportunities schedule (IOS) on the same set of axes (total new financing or investment on the x axis and weighted average cost of capital and IRR on the y axis).

<table>
<thead>
<tr>
<th>Investment opportunity</th>
<th>Internal rate of return (IRR)</th>
<th>Initial investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>11.2%</td>
<td>$100,000</td>
</tr>
<tr>
<td>B</td>
<td>9.7</td>
<td>500,000</td>
</tr>
<tr>
<td>C</td>
<td>12.9</td>
<td>150,000</td>
</tr>
<tr>
<td>D</td>
<td>16.5</td>
<td>200,000</td>
</tr>
<tr>
<td>E</td>
<td>11.8</td>
<td>450,000</td>
</tr>
<tr>
<td>F</td>
<td>10.1</td>
<td>600,000</td>
</tr>
<tr>
<td>G</td>
<td>10.5</td>
<td>300,000</td>
</tr>
</tbody>
</table>

d. Which, if any, of the available investments do you recommend that the firm accept? Explain your answer. How much total new financing is required?

PROBLEMS

10–1 Concept of cost of capital Wren Manufacturing is in the process of analyzing its investment decision-making procedures. The two projects evaluated by the firm during the past month were projects 263 and 264. The basic variables surrounding each project analysis, using the IRR decision technique, and the resulting decision actions are summarized in the following table.
a. Evaluate the firm’s decision-making procedures, and explain why the acceptance of project 263 and rejection of project 264 may not be in the owners’ best interest.

b. If the firm maintains a capital structure containing 40% debt and 60% equity, find its weighted average cost using the data in the table.

c. Had the firm used the weighted average cost calculated in part b, what actions would have been indicated relative to projects 263 and 264?

d. Compare and contrast the firm’s actions with your findings in part c. Which decision method seems more appropriate? Explain why.

### 10–2 Cost of debt using both methods
Currently, Warren Industries can sell 15-year, $1,000-par-value bonds paying annual interest at a 12% coupon rate. As a result of current interest rates, the bonds can be sold for $1,010 each; flotation costs of $30 per bond will be incurred in this process. The firm is in the 40% tax bracket.

a. Find the net proceeds from sale of the bond, \( N_d \).

b. Show the cash flows from the firm’s point of view over the maturity of the bond.

c. Use the IRR approach to calculate the before-tax and after-tax costs of debt.

d. Use the approximation formula to estimate the before-tax and after-tax costs of debt.

e. Compare and contrast the costs of debt calculated in parts c and d. Which approach do you prefer? Why?

### 10–3 Cost of debt using the approximation formula
For each of the following $1,000-par-value bonds, assuming annual interest payment and a 40% tax rate, calculate the after-tax cost to maturity using the approximation formula.

<table>
<thead>
<tr>
<th>Bond</th>
<th>Life</th>
<th>Underwriting fee</th>
<th>Discount (−) or premium (+)</th>
<th>Coupon interest rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>20</td>
<td>$25</td>
<td>−$20</td>
<td>9%</td>
</tr>
<tr>
<td>B</td>
<td>16</td>
<td>40</td>
<td>+10</td>
<td>10%</td>
</tr>
<tr>
<td>C</td>
<td>15</td>
<td>30</td>
<td>−15</td>
<td>12%</td>
</tr>
<tr>
<td>D</td>
<td>25</td>
<td>15</td>
<td>Par</td>
<td>9%</td>
</tr>
<tr>
<td>E</td>
<td>22</td>
<td>20</td>
<td>−60</td>
<td>11%</td>
</tr>
</tbody>
</table>
10–4 Cost of preferred stock  Taylor Systems has just issued preferred stock. The stock has a 12% annual dividend and a $100 par value and was sold at $97.50 per share. In addition, flotation costs of $2.50 per share must be paid.
   a. Calculate the cost of the preferred stock.
   b. If the firm sells the preferred stock with a 10% annual dividend and nets $90.00 after flotation costs, what is its cost?

10–5 Cost of preferred stock  Determine the cost for each of the following preferred stocks.

<table>
<thead>
<tr>
<th>Preferred stock</th>
<th>Par value</th>
<th>Sale price</th>
<th>Flotation cost</th>
<th>Annual dividend</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$100</td>
<td>$101</td>
<td>$9.00</td>
<td>11%</td>
</tr>
<tr>
<td>B</td>
<td>40</td>
<td>38</td>
<td>$3.50</td>
<td>8%</td>
</tr>
<tr>
<td>C</td>
<td>35</td>
<td>37</td>
<td>$4.00</td>
<td>$5.00</td>
</tr>
<tr>
<td>D</td>
<td>30</td>
<td>26</td>
<td>5% of par</td>
<td>$3.00</td>
</tr>
<tr>
<td>E</td>
<td>20</td>
<td>20</td>
<td>$2.50</td>
<td>9%</td>
</tr>
</tbody>
</table>

10–6 Cost of common stock equity—CAPM  J&M Corporation common stock has a beta, $b$, of 1.2. The risk-free rate is 6%, and the market return is 11%.
   a. Determine the risk premium on J&M common stock.
   b. Determine the required return that J&M common stock should provide.
   c. Determine J&M’s cost of common stock equity using the CAPM.

10–7 Cost of common stock equity  Ross Textiles wishes to measure its cost of common stock equity. The firm’s stock is currently selling for $57.50. The firm expects to pay a $3.40 dividend at the end of the year (2004). The dividends for the past 5 years are shown in the following table.

<table>
<thead>
<tr>
<th>Year</th>
<th>Dividend</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>$3.10</td>
</tr>
<tr>
<td>2002</td>
<td>2.92</td>
</tr>
<tr>
<td>2001</td>
<td>2.60</td>
</tr>
<tr>
<td>2000</td>
<td>2.30</td>
</tr>
<tr>
<td>1999</td>
<td>2.12</td>
</tr>
</tbody>
</table>

After underpricing and flotation costs, the firm expects to net $52 per share on a new issue.
   a. Determine the growth rate of dividends.
   b. Determine the net proceeds, $N_n$, that the firm actually receives.
   c. Using the constant-growth valuation model, determine the cost of retained earnings, $k_r$.
   d. Using the constant-growth valuation model, determine the cost of new common stock, $k_n$. 
10–8 Retained earnings versus new common stock  Using the data for each firm shown in the following table, calculate the cost of retained earnings and the cost of new common stock using the constant-growth valuation model.

<table>
<thead>
<tr>
<th>Firm</th>
<th>Current market price per share</th>
<th>Dividend growth rate</th>
<th>Projected dividend per share next year</th>
<th>Underpricing per share</th>
<th>Flotation cost per share</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$50.00</td>
<td>8%</td>
<td>$2.25</td>
<td>$2.00</td>
<td>$1.00</td>
</tr>
<tr>
<td>B</td>
<td>20.00</td>
<td>4</td>
<td>1.00</td>
<td>0.50</td>
<td>1.50</td>
</tr>
<tr>
<td>C</td>
<td>42.50</td>
<td>6</td>
<td>2.00</td>
<td>1.00</td>
<td>2.00</td>
</tr>
<tr>
<td>D</td>
<td>19.00</td>
<td>2</td>
<td>2.10</td>
<td>1.30</td>
<td>1.70</td>
</tr>
</tbody>
</table>

10–9 WACC—Book weights  Ridge Tool has on its books the amounts and specific (after-tax) costs shown in the following table for each source of capital.

<table>
<thead>
<tr>
<th>Source of capital</th>
<th>Book value</th>
<th>Specific cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term debt</td>
<td>$700,000</td>
<td>5.3%</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>50,000</td>
<td>12.0</td>
</tr>
<tr>
<td>Common stock equity</td>
<td>650,000</td>
<td>16.0</td>
</tr>
</tbody>
</table>

a. Calculate the firm’s weighted average cost of capital using book value weights.
b. Explain how the firm can use this cost in the investment decision-making process.

10–10 WACC—Book weights and market weights  Webster Company has compiled the information shown in the following table.

<table>
<thead>
<tr>
<th>Source of capital</th>
<th>Book value</th>
<th>Market value</th>
<th>After-tax cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term debt</td>
<td>$4,000,000</td>
<td>$3,840,000</td>
<td>6.0%</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>40,000</td>
<td>60,000</td>
<td>13.0</td>
</tr>
<tr>
<td>Common stock equity</td>
<td>1,060,000</td>
<td>3,000,000</td>
<td>17.0</td>
</tr>
<tr>
<td>Totals</td>
<td>$5,100,000</td>
<td>$6,900,000</td>
<td></td>
</tr>
</tbody>
</table>

a. Calculate the weighted average cost of capital using book value weights.
b. Calculate the weighted average cost of capital using market value weights.
c. Compare the answers obtained in parts a and b. Explain the differences.

10–11 WACC and target weights  After careful analysis, Dexter Brothers has determined that its optimal capital structure is composed of the sources and target market value weights shown in the following table.
The cost of debt is estimated to be 7.2%; the cost of preferred stock is estimated to be 13.5%; the cost of retained earnings is estimated to be 16.0%; and the cost of new common stock is estimated to be 18.0%. All of these are after-tax rates. The company’s debt represents 25%, the preferred stock represents 10%, and the common stock equity represents 65% of total capital on the basis of the market values of the three components. The company expects to have a significant amount of retained earnings available and does not expect to sell any new common stock.

a. Calculate the weighted average cost of capital on the basis of historical market value weights.

b. Calculate the weighted average cost of capital on the basis of target market value weights.

### 10–12 Calculation of specific costs, WACC, and WMCC

Dillon Labs has asked its financial manager to measure the cost of each specific type of capital as well as the weighted average cost of capital. The weighted average cost is to be measured by using the following weights: 40% long-term debt, 10% preferred stock, and 50% common stock equity (retained earnings, new common stock, or both). The firm’s tax rate is 40%.

**Debt**

The firm can sell for $980 a 10-year, $1,000-par-value bond paying annual interest at a 10% coupon rate. A flotation cost of 3% of the par value is required in addition to the discount of $20 per bond.

**Preferred stock**

Eight percent (annual dividend) preferred stock having a par value of $100 can be sold for $65. An additional fee of $2 per share must be paid to the underwriters.

**Common stock**

The firm’s common stock is currently selling for $50 per share. The dividend expected to be paid at the end of the coming year (2004) is $4. Its dividend payments, which have been approximately 60% of earnings per share in each of the past 5 years, were as shown in the following table.

<table>
<thead>
<tr>
<th>Year</th>
<th>Dividend</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>$3.75</td>
</tr>
<tr>
<td>2002</td>
<td>3.50</td>
</tr>
<tr>
<td>2001</td>
<td>3.30</td>
</tr>
<tr>
<td>2000</td>
<td>3.15</td>
</tr>
<tr>
<td>1999</td>
<td>2.85</td>
</tr>
</tbody>
</table>
It is expected that in order to sell, new common stock must be underpriced $5 per share, and the firm must also pay $3 per share in flotation costs. Dividend payments are expected to continue at 60% of earnings.

a. Calculate the specific cost of each source of financing. (Assume that \( k_r = k_s \).)

b. If earnings available to common shareholders are expected to be $7 million, what is the break point associated with the exhaustion of retained earnings?

c. Determine the weighted average cost of capital between zero and the break point calculated in part b.

d. Determine the weighted average cost of capital just beyond the break point calculated in part b.

10–13 Calculation of specific costs, WACC, and WMCC

Lang Enterprises is interested in measuring its overall cost of capital. Current investigation has gathered the following data. The firm is in the 40% tax bracket.

Debt The firm can raise an unlimited amount of debt by selling $1,000-par-value, 8% coupon interest rate, 20-year bonds on which annual interest payments will be made. To sell the issue, an average discount of $30 per bond would have to be given. The firm also must pay flotation costs of $30 per bond.

Preferred stock The firm can sell 8% preferred stock at its $95-per-share par value. The cost of issuing and selling the preferred stock is expected to be $5 per share. An unlimited amount of preferred stock can be sold under these terms.

Common stock The firm’s common stock is currently selling for $90 per share. The firm expects to pay cash dividends of $7 per share next year. The firm’s dividends have been growing at an annual rate of 6%, and this is expected to continue into the future. The stock must be underpriced by $7 per share, and flotation costs are expected to amount to $5 per share. The firm can sell an unlimited amount of new common stock under these terms.

Retained earnings When measuring this cost, the firm does not concern itself with the tax bracket or brokerage fees of owners. It expects to have available $100,000 of retained earnings in the coming year; once these retained earnings are exhausted, the firm will use new common stock as the form of common stock equity financing.

a. Calculate the specific cost of each source of financing. (Round answers to the nearest 0.1%).

<table>
<thead>
<tr>
<th>Source of capital</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term debt</td>
<td>30%</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>20</td>
</tr>
<tr>
<td>Common stock equity</td>
<td>50</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
</tr>
</tbody>
</table>
b. The firm’s capital structure weights used in calculating its weighted average cost of capital are shown in the table at the bottom of page 416. (Round answer to the nearest 0.1%.)

(1) Calculate the single break point associated with the firm’s financial situation. (Hint: This point results from exhaustion of the firm’s retained earnings.)

(2) Calculate the weighted average cost of capital associated with total new financing below the break point calculated in part (1).

(3) Calculate the weighted average cost of capital associated with total new financing above the break point calculated in part (1).

10–14 Integrative—WACC, WMCC, and IOS Cartwell Products has compiled the data shown in the following table for the current costs of its three basic sources of capital—long-term debt, preferred stock, and common stock equity—for various ranges of new financing.

<table>
<thead>
<tr>
<th>Source of capital</th>
<th>Range of new financing</th>
<th>After-tax cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term debt</td>
<td>$0 to $320,000</td>
<td>6%</td>
</tr>
<tr>
<td></td>
<td>$320,000 and above</td>
<td>8%</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>$0 and above</td>
<td>17%</td>
</tr>
<tr>
<td>Common stock equity</td>
<td>$0 to $200,000</td>
<td>20%</td>
</tr>
<tr>
<td></td>
<td>$200,000 and above</td>
<td>24%</td>
</tr>
</tbody>
</table>

The company’s capital structure weights used in calculating its weighted average cost of capital are shown in the following table.

<table>
<thead>
<tr>
<th>Source of capital</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term debt</td>
<td>40%</td>
</tr>
<tr>
<td>Preferred stock</td>
<td>20%</td>
</tr>
<tr>
<td>Common stock equity</td>
<td>40%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
</tr>
</tbody>
</table>

a. Determine the break points and ranges of total new financing associated with each source of capital.

b. Using the data developed in part a, determine the break points (levels of total new financing) at which the firm’s weighted average cost of capital will change.

c. Calculate the weighted average cost of capital for each range of total new financing found in part b. (Hint: There are three ranges.)

d. Using the results of part c, along with the following information on the available investment opportunities, draw the firm’s weighted marginal cost of capital (WMCC) schedule and investment opportunities schedule (IOS) on the same set of axes (total new financing or investment on the x axis and weighted average cost of capital and IRR on the y axis).
Which, if any, of the available investments do you recommend that the firm accept? Explain your answer.

**CHAPTER 10 CASE  Making Star Products’ Financing/Investment Decision**

Star Products Company is a growing manufacturer of automobile accessories whose stock is actively traded on the over-the-counter exchange. During 2003, the Dallas-based company experienced sharp increases in both sales and earnings. Because of this recent growth, Melissa Jen, the company’s treasurer, wants to make sure that available funds are being used to their fullest. Management policy is to maintain the current capital structure proportions of 30% long-term debt, 10% preferred stock, and 60% common stock equity for at least the next 3 years. The firm is in the 40% tax bracket.

Star’s division and product managers have presented several competing investment opportunities to Ms. Jen. However, because funds are limited, choices of which projects to accept must be made. The investment opportunities schedule (IOS) is shown in the following table.

<table>
<thead>
<tr>
<th>Investment opportunity</th>
<th>Internal rate of return (IRR)</th>
<th>Initial investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>19%</td>
<td>$200,000</td>
</tr>
<tr>
<td>B</td>
<td>15%</td>
<td>$300,000</td>
</tr>
<tr>
<td>C</td>
<td>22%</td>
<td>$100,000</td>
</tr>
<tr>
<td>D</td>
<td>14%</td>
<td>$600,000</td>
</tr>
<tr>
<td>E</td>
<td>23%</td>
<td>$200,000</td>
</tr>
<tr>
<td>F</td>
<td>13%</td>
<td>$100,000</td>
</tr>
<tr>
<td>G</td>
<td>21%</td>
<td>$300,000</td>
</tr>
<tr>
<td>H</td>
<td>17%</td>
<td>$100,000</td>
</tr>
<tr>
<td>I</td>
<td>16%</td>
<td>$400,000</td>
</tr>
</tbody>
</table>
To estimate the firm’s weighted average cost of capital (WACC), Ms. Jen contacted a leading investment banking firm, which provided the financing cost data shown in the following table.

<table>
<thead>
<tr>
<th>Financing Cost Data</th>
</tr>
</thead>
<tbody>
<tr>
<td>Star Products Company</td>
</tr>
</tbody>
</table>

**Long-term debt:** The firm can raise $450,000 of additional debt by selling 15-year, $1,000-par-value, 9% coupon interest rate bonds that pay *annual interest*. It expects to net $960 per bond after flotation costs. Any debt in excess of $450,000 will have a before-tax cost, $k_d$, of 13%.

**Preferred stock:** Preferred stock, regardless of the amount sold, can be issued with a $70 par value and a 14% annual dividend rate and will net $65 per share after flotation costs.

**Common stock equity:** The firm expects dividends and earnings per share to be $0.96 and $3.20, respectively, in 2004 and to continue to grow at a constant rate of 11% per year. The firm’s stock currently sells for $12 per share. Star expects to have $1,500,000 of retained earnings available in the coming year. Once the retained earnings have been exhausted, the firm can raise additional funds by selling new common stock, netting $9 per share after underpricing and flotation costs.

**Required**

a. Calculate the cost of each source of financing, as specified:
   1. Long-term debt, first $450,000.
   2. Long-term debt, greater than $450,000.
   3. Preferred stock, all amounts.
   4. Common stock equity, first $1,500,000.
   5. Common stock equity, greater than $1,500,000.

b. Find the break points associated with each source of capital, and use them to specify each of the ranges of total new financing over which the firm’s weighted average cost of capital (WACC) remains constant.

c. Calculate the weighted average cost of capital (WACC) over each of the ranges of total new financing specified in part b.

d. Using your findings in part c along with the investment opportunities schedule (IOS), draw the firm’s weighted marginal cost of capital (WMCC) and IOS on the same set of axes (total new financing or investment on the x axis and weighted average cost of capital and IRR on the y axis).

e. Which, if any, of the available investments would you recommend that the firm accept? Explain your answer.
WEB EXERCISE

Go to the St. Louis Federal Reserve Bank Web site www.stls.frb.org. Click on Economic Research; click on Fred; click on Monthly Interest Rates; and then click on Bank Prime Loan Rate Changes—Historic Dates of Changes and Rates—1929.

1. What was the prime interest rate in 1934? 
2. What is the highest the prime interest rate has been? When was that? 
3. What has been the highest prime interest rate since you were born? 
4. What is the present prime interest rate? 
5. Over the past 10 years, what was the lowest prime interest rate? What has been the highest prime interest rate over the past 10 years?

Now go to Barra’s Web site www.barra.com and click on Research + Indexes and then on S&P/Barra U.S. Equity Indexes.

6. What was the average annual 10-year return on large-cap stocks, as measured by growth in the S&P 500 (annualized 10-year return)? How does this compare to your answers in question 5?

Remember to check the book’s Web site at www.aw.com/gitman for additional resources, including additional Web exercises.