What is meant by weighted average cost of capital (wacc) essay sample

Business, Company

Discussion questions on Corporate Finance

The weighted average cost of capital represents the average cost that a firm has to pay on its fund. It is used as a discount rate to analyze whether an investment project is attractive, and sets the minimum return that a firm must generate on its assets.

What are some components of WACC?

The WACC is an average of the cost of equity and the cost of debt (which are the two main sources of financing for a firm). These two components are weighted with their relative weights in the capital structure of the firm: the cost of equity is multiplied by the percentage of equity used and the cost of debt is multiplied by the percentage of debt used for the firm's financing.

The formula is:

WACC= ED+E*re+DD+E*rd

where E is the market value of equity and D is the market value of debt, re is the cost of equity capital and rd is the after-tax cost of debt.

Why is WACC a more appropriate discount rate when doing capital budgeting?

The WACC is the most appropriate discount rate when doing capital budgeting because as mentioned above, it represents the required rate of return a firm must generate on its assets. If the return of the firm is lower than the WACC, investors will not allocate capital to this company/project.

What is the effect on WACC when an organization raises long-term capital?

If an organization raises equity, the WACC will most often increase because equity is more expensive than debt. If the firm raises debt (debt being a cheaper source of financing), the WACC will fall, possibly making a project attractive while it wouldn't have been under equity financing.

What is an initial public offering (IPO)?

An IPO designs the first time a company's shares become publically listed and available for the general public. After an IPO, a company is thus called a public company.

How does an IPO allow an organization to grow financially?

An IPO allows an organization to grow financially by raising equity capital and being exposed to more investors. During an IPO, the funds raised go directly to the company.

When is a merger or an acquisition, instead of an IPO, more appropriate?

The fees associated with an IPO being very high, they make more sense for rather large companies who really need financing in order to fund their growth. Mergers or acquisitions make more sense for smaller companies, who do not need cash as urgently but can acquire shares of the acquiring company. Moreover, mergers & acquisitions can create synergy if the two companies integrate strategically, and acquirers can pay a premium for the acquisition. Mergers & acquisitions require less disclosure efforts and are less costly.

References

Berk, J. B. and Demarzo, P. M. 2007. Corporate finance. Boston: Pearson Addison Wesley.