Weighted avarage cost of capital

Finance

Weighted Average Cost of Capital WACC Any project or business in the organization is financed by either equity or debt. In order to enhance the value of equity, the project is never financed 100 percent by equity route, instead an appropriate debt proportion is chosen to finance the project. Equity and debt proportion varies with the business and depends upon several factors; however, usually the proportion is found to be 1: 1, or 1: 2 or somewhere in that line. Rarely, the proportion of equity and debt in the project exceeds 1: 2 because higher debt increases the risk of the firm as during the market downturn, higher interest burden might put the firm in jeopardy.

Weighted average cost of the capital (WACC) is calculated based on their weights or proportion in the total project cost. In other words, WACC also indicates about the minimum required return on the total project outlay.

Mathematically, WACC can be represented as per the following:

Equity proportion × cost of equity + debt proportion × Cost of debt × (1-Corporate tax rate)

The cost of equity is directly proportional to its return. That means higher the return on equity; the greater will be the cost of equity. In other words, higher return will increase the weighted average cost of capital. The calculation of WACC often helps to determine the economic feasibility while undertaking any mergers of the two different entities or expanding existing business activities.

WACC is the actual cost that takes into account both equity and debt based on their actual proportion involved and that is why it is the most appropriate rate while doing capital budgeting exercise. When an organization raises any long-term capital, the WACC cost will get altered as per the new proportion

of equity and debt.

Initial Public Offering (IPO)

Initial public offering is made to raise the capital (equity) required for the project. When the promoter of the project is unable to finance the project fully through their own resources, they go to public and issue part equity and thereby raise the capital required for the project. Thus, depending upon the confidence levels shown by the public in the promoter and their project, the required amount in the form of the equity can be raised. This additional capital raised from the public completes the minimum requirement of the equity as proposed by the institutions.

Usually, the financial institutions appraise the project and provide the necessary debt necessary to meet the entire financial needs of the project. Each time, when funds are needed for expansionary purposes, the financial needs are met through equity and debt components derived in an appropriate proportion.

Mergers and acquisitions are done to take advantage of synergy in the operations. In mergers, two organizations merge and form a single organization. Shareholders of the organization who is going to merge will get the shares of the parent organization in a predetermined ratio. There is no payment to the shareholders. Further, in case of acquisition, if the cost of acquisition is favorable or low compared to the cost of IPO, it is obvious that the firm will go for acquisition rather than floating an IPO as in this process a running company, ready with its infrastructure and network, can be acquired and that will save huge time of the acquirer.

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