Cost of capital

Health & Medicine

Cost of Capital Introduction The increasing patient expectations, technological advancement and innovative care models are rapidly changing health facilities and health care services. A major challenge in designing large-scale investment projects in healthcare is the long-term period involved in planning, financing and implementing new projects. With the current economic conditions, raising capital to fund hospital projects is a great challenge. The current paper underpins the advantages and disadvantages of investing in bonds to raise capital for the hospital and for investors. Further, the paper determines if bonds offer investors an advantage over investments with the risk-free return of 5% and the bonds are held to their maturity date.

A corporate bond is a low-risk investment used for raising money from investors. Choosing to invest in bonds has numerous benefits and disadvantages both to the hospital and to the investor. For investors, bonds offer attractive yields compared to government bonds or other investments. Bonds offer dependable and fixed flow of income given that interest is paid semi-annually until maturity (Maeda et al., 2009). This means that the hospital bond is safer given that it is evaluated based on credit history and ability to repay. Another benefit of bonds to the investor is that they are flexible in terms of providing investors with the opportunity to choose investments that meet their goals and objectives (Maeda et al., 2009). However, bonds have their disadvantages. Most of the disadvantages are inherent in the risks involved. One of the fundamental disadvantages of bonds is attributed to the safety, such that the lower the risk, the lower the returns (Appel, 2010). This is especially important in a period of economic expansion when stocks earn more return than bonds. Further, the fluctuation

of interest rates with an economy affects bond prices (Johnson and Polk, 2002). Generally, the prices of bonds and interest rates are inversely proportional. Another disadvantage to the hospital and to the investor is that because bonds are fixed, they do not offer any protection during changes in inflation rates. If the rate of inflation is higher than the expected or average, the investor loses their purchasing power within the portfolio (Maeda et al., 2009).

Using the investment yield formula

Investment Yield Formula = ((FV-PP)/PP) * (365 or 366/M)

Where:

FV = Face Value ($ 1000)

PP= Purchase Price ($ 500)

M= Maturity in days (10 * 365)

In the case study:

Bond price = $500

Bond par price (face value) = $1000

Bond coupon rate = 2%

Years to Maturity = 10

((1000-500)/500) x (365/3650)

Bond yield percentages

Current yield: 4. 000%

Yield to maturity (YTM): 10. 212%

Bond coupon payment: $20. 00

Total coupon payments; $200. 00

Principle gain (-loss) at redemption: $500. 00

Total return: $700. 00

From the calculations above, a bond with a face value of $1, 000 and purchased for $500, paying annual coupon payment of $ 20. 00 will have an annual rate of return of 10. 212% if the bond is held until its maturity in 10 years.

Note: this calculation assumes that the coupon payments will be reinvested at the entered coupon rate.

The risk-free return on investments (5%) is lower than the annual rate of return (10. 212%) calculated above meaning that bonds offer investors an advantage over investments with risk-free return of 5%.

Conclusion

A critical analysis reveals that bonds present a big opportunity for non-profit hospitals to raise capital and for investors to earn returns. With the increasing cost of financing health care, leveraging on the bond market could reduce overall costs incurred by hospitals. However, the bond market is generally complex, and successful investment requires considerable understanding of the economic factors and ability to identify opportunities.

References

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