What does a firm’s overall cost of capital mean?

Countries

Cost of capital is the return necessary to make a capital budgeting process worthwhile. Further, it is the returns that a company gets after an investment. This is themoneythat evaluates any new project of a company for it determines the minimum profit expected by investors in the business. To satisfy investors, the return on capital employed must be above the company’s average debts, thus making investments worthwhile. That is, the expected output must be more than the invested capital; the returns are more than the capital (Armitage, 2005).

Moreover, if a project costs the same as the company’s average business activities, then it is wise to use the average cost of capital of the company as the base. This ensures that the company’s security on the cost of capital is calculated. It is done by first calculating the cost of debt and equity. Afterwards, calculate the expected returns after doing business. This is done by dividing the dividend payment per share with the market price then adding the growth rate. One can thus issue dividends to investors.

From a financial manager's perspective, discuss the capital budgeting process used to identify projects that add to the firm's value? How do capital budgeting decisions help to define a firm's strategic direction? The capital budgeting process is used to identify projects that add value to a firm. Afterwards, the managers have to calculate the cash required acquiring a new building or equipment without deriving any cash benefits from the disposal of the replaced commodity.

Any additional working capital in relation to the new equipment is initially outlaid and the initial investment is included as a part only if changes occur at the beginning of the project. After this, the managers calculate the

terminal cash flow after the sale of the assets, savings after the operations, as well as the net present value of the assets. This procedure helps them to calculate the feasibility of purchasing an equipment or building. Capital budgeting decisions help to define a firm’s strategic direction by deciding whether to invest in a specific asset or project.

This process helps to determine whether to engage the firm in acquiring certain assets which were not formerly used by the firm. In addition, this undertaking can help to replace any outdated assets, thus maintaining their efficiency. How does a firm’s capital structure relate to your personal capital structure? In what ways are they similar? Provide examples of how you use debt and equity in your personal financial life that parallels the basic capital structure decisions made by a firm.

Capital structure is the combination of equity, debt, and otherfinancesources used to fund other long-term finances. It is therefore related to personal capital structure since the 2 represent the money working in the business, thus showing money flow in the business. Both are similar for they are the working capital of a business. They indicate the amount of money invested in the business as well as the profit gained. They both indicate the amount of borrowed capital flowing in the business.

Further, they indicate any other form of capital that are used to run a personal business, such as, a dealer servicing one’s business with goods then settling the dues later. Debt and equity in personal financial life parallels the basic capital structure decisions made by a firm since the amount of money invested at the launch of the business, together with the

sum total of goods provided by a dealer to be paid later in form of equity, is indicated.

The amount of money borrowed by an individual to help strengthen their capital is indicated as equity for it represents the total amount borrowed to run the business. Modigliani and Miller [MM] employed the concept of arbitrage to develop their theory. Explain the concept of arbitrage and the role of arbitrage in the MM model. Discuss the assumptions and the issues underlying the MM model. http://www. rdboehme. com/MBA_CF/Chap_15. pdf The concept of arbitrage can be explained using the analogy two different markets with one selling at a lower price.

Sellers will buy from the low-price market and sell in the market with high prices. The prices thus tend to rise in the low-priced market until the difference is bridged. The role of the MM model is to indicate the safety of investments, that is, if a firm runs two companies, then one might have high market value per share but be very risky regarding market price per share. Conversely, the other may be low market price. Investors will then sell the shares of the risky firms and purchase the other’s, thus standardizing the average cost of capital of the group.

The assumptions of the MM model are that the capital market is perfect if only the investors know the market forces. Further, the model classifies firms in groups according to business risks. Investors are assumed to use the operating income to determine the market price. It is also assumed that there are no corporate income taxes. The issues underlying the MM model are that it is very hard to run a business without paying of taxes. Further, the

market prices fluctuate, thus the knowledge about market prices is not conclusive. It is thus hard to gauge the market price.