Importance of managing the firms weighted average cost of capital (wacc)

Business

A. Importance of managing the firm's weighted average cost of capital (WACC) The WACC of a firm is the best indicator of its profitability. It is theaverage cost at which a company raises its capital from various sources, as all companies must, through debt or equity. This includes common stock, preferred stock, bonds, and any other long-term debt.

This cost is calculated as a weighted average, by taking into account the proportional relevance of each source, including the effects of taxes. If the cost of capital of a company is high, or it has a high WACC, the chances of its success are lower. A WACC higher than the company's after-tax returns means that the company is functioning at a financial loss: it tries to take up only those capital projects where the after-tax return is greater than the after-tax cost of providing returns to claimholders.

Managing WACC thus means keeping the WACC value lower than the company's after-tax returns, or in other words, reducing the cost of capital. This can be done by financing a major percentage of the purchase with the lowest cost of capital available, secured debts for instance, and the rest with personal equity held as cash, or by means of capital prioritisation, that is, using the cheapest source of capital first. A low WACC means that investors will be interested in the company in case additional capital needs to be raised for expansion or other purposes.

Calculating WACC is often tricky because though the cost of debt is easy to track down, cost of equity can be an elusive factor. But it is worth the exercise, because knowing its WACC helps a company to try and restrict the WACC value for projects to levels far below those of its after-tax returns, thus adding to profitability.

B. How loan agreements can prevent or constrain firms from raising additional capital.

All firms need to take recourse to loans at some stage of their life cycle. But they need to carefully and critically evaluate their loan agreements, whether in the public or the private sector. All loan agreements naturally contain provisions for the protection of the lenders' interests, and these might hamper rather than aid the growth of a company.

The provision for the protection of lender interests involve the placement of certain limitations on the borrower's activities involving repayment terms, the use of collateral and periodic reporting, all of which are covered in the covenant section. The agreement may actually end up adding reporting costs, placing limits on the firm's actions, or setting financial standards that constrain its business and financial flexibility, which make it difficult for the firm to raise additional capital. Raising any capital has its costs, and the firm may not be able to afford these. This is because some conditions imposed by the agreement like maintaining a certain level of cash balance, constrain its spending power which is further reduced by additional reporting costs.

The lender may also place limitations on the borrower's total debt, and ask for an agreement not to pledge assets to other creditors, as well as limitations on the amount of dividends that may be issued. All of these may prevent the firm from raising futher additional capital, because a firm can only raise capital through debt and equity, and both these avenues are restricted in this case.

Failure to stick by agreed conditions may lead to abrupt cancellation of the loan making the entire amount due immediately, or trigger acceleration and

foreclosure against the assets of the firm that were pledged under the agreement. Loan agreements can thus have a great say in a firm's ability to raise additional capital, and should be carefully negotiated in order to ensure the financial stability of the firm.