Discussion week 5 question 2 cost of capital chapter 9

Finance

COST OF CAPITAL al Affiliation) Cost of capital is the cost of an investment made by a company. It is the requiredrate of return on an investment. A company’s cost of capital is the applicable when estimating the cost of raising future revenue and thus is always subject to uncertainty. A company’s capital consists of debt and equity. Debt refers to bonds and loans for a big company, and it means a trade credit for small companies. Equity refers to trading stock in the stock market where investors buy them and thus provide funding to the company. When these components combine, it forms the cost structure of a company (Besley, 2011).

There are various methods of computing the cost of capital of a company. These methods include; computing the cost of debt and computing the cost of equity. Cost of equity is a company’s shareholders rate of return on their investment on the equity of the company (Pratt, 2010). The formula used in computing cost of equity is;

Ke = D1÷P0 + g

The cost of debt is the cost that a company incurs on its bonds. It is computed by using the formula;

Cost of Debt = Coupon Rate on Bonds (1 - tax rate)

The interest on a bond is tax deductible and thus is deducted from the coupon rate when computing the cost of debt.

Among the two methods, computing the cost of equity is the most difficult method. This is because even though the stock price can be obtained easily, it is difficult to estimate the correct amount of dividend and the earnings growth rate of the company. To avoid this, the company needs to get the current price of equity, the correct number of dividend expected and the

correct rate of growth in dividend (Besley, 2011).

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