

# Nike case

[Business](#), [Company](#)



## **Corporate Finance Nike, INC: Cost of capital**

What is the WACC and why is it important to estimate a firm's cost of capital? Do you agree with Joanna Cohen's WACC calculation? Why or why not? Definition of WACC (Weighted Average Cost of Capital): WACC is basically the average of the cost of finance (debt and equity). Since a company's assets can be financed by debt or equity, WACC can show the averages of the costs involved in the sources of financing. These costs are then weighted by the users of the information as required in a specific situation.

This shows how much both debt holders expect to pay in interest and how much return the shareholder can expect to receive, for each dollar of financing (Investopedia, ND). The calculation of the cost of capital is one of the important elements that decide the enterprise value. The value of the enterprise can significantly change when the percentage of cost of capital changes in the business model, with the cost of capital representing the expected return for shareholders. We disagree with Joanna's WACC calculation for following reasons: The calculations of WACC and DCF can be effected as they are subjective by her human judgment.

Even though there are no right answers to make these decisions, our team disagrees with some of the assumptions Joanna Cohen made. ' Ratio of debt financing' and ' Ratio of equity financing' It has to be applied the market value because current shareholders' expected return has to be reflected. Both ratios should be calculated not by using ' Book Value' but ' Market Value'.

Cost of Debt Cost of Debt can be calculated with the current yield publicly traded in the market, because we are projecting the future cash flows. Joanna calculated this by using historical data.

However cost of debt should be calculated using current YTM of debt.

Cost of Equity Joanna calculated cost of debt by using following CAPM formula: Cost of Equity = 5.74% (20 year Treasury bond) + 0.80 (Average Historic Nike beta) \* 5.9% (Average premium of the market over Treasury) = 10.5% When calculating the beta, using the most current beta is better than using the average, because the current beta reflects the most recent environment of Nike stock.

If you do not agree with Cohen's analysis, calculate your own WACC for Nike and be prepared to justify your assumptions.

Ratio of debt financing' and ' Ratio of equity financing' Market value of debt = 5.4 + 855.3 + 435.9 = \$1,296.6 million Market Value of equity = There is no information about market value of debt. We will use ' Book Value' \$1296.6 million Market Value of equity = Share price (\$42.09) \* Shares outstanding (271.5 million) = \$11,427.4 million Ratio of debt financing = 1,296.6 / (1,296.6 + 11,427.4) = 10.19% Ratio of equity financing = 11,427.4 / (1,296.6 + 11,427.4) = 89.81% WACC = 9.81% \* 89.81% + 7.168% \* (1 - 38%) \* 10.19% = 9.26%

Cost of Debt Market value of debt should be: Current price of debt: \$95.60  
 Coupon rate: 6.75% (semiannual) = coupon \$3.375 per 6 month Period to maturity: 20 years = 40 period Face value: \$100 YTM (= cost of debt) = 3.584% (semi annual) = 7.168% (annual)

Cost of Equity Using CAPM formula Cost of Equity = 5.74% (20 year Treasury bond) + 0.69 (Latest beta)

5.9% (Average premium of the market over Treasury) = 9.81% 3. Calculate the costs of equity using CAPM and the dividend discount model.

### **What are the advantages and disadvantages of each method?**

- CAPM Cost of Equity = 5.4% (20 year Treasury bond) + 0.69 (Latest beta)
- 5.9% (Average premium of the market over Treasury) = 9.81%  
Advantage:|
- CAPM considers only systematic risk, beta. It does not consider company specific risk.
- It is useful to see an individual stock in entire portfolio.

### **Disadvantage:**

- Some inputs are hard to reflect the situation of real world.
- Relatively difficult to use compared to DDM
- DDM Share Price(\$42.09) = Dividend(\$0.48) / (re - Dividend Growth(5.5%)) re(Cost of Equity) = 6.64%

### **Advantage:**

- DDM only focuses on an individual stock rather than a portfolio. Always use, when calculating stock price.
- Relatively easy to use compared to CAPM.

### **Disadvantage:**

- Results are very sensitive to change when assumptions are inputted

- What should Kimi Ford recommend regarding an investment in Nike?

RECOMMENDATION: should buy NIKE stock. NIKE stock price should be \$58.22 under the condition WACC, 9.26%. Currently Nike stock is \$42.09. Now Nike stock is under value by  $\$58.22 - \$42.09 = \$16.13$  per share.

## **Works Referenced**

1. Investopedia, ND. M&A, Preferred Shares, Investopedia. [Online] Available at: <http://www.investopedia.com/terms/w/wacc.asp> [Accessed 1 April 2013].