Cost of Capital

Business & Management

What it costs a firm to raise money, weighted across its sources.

The weighted average cost of capital blends the cost of equity and the after-tax cost of debt.

$$WACC = (E/V \times Re) + (D/V \times Rd \times (1 - t))$$

Cost of equity $Rf + \beta(Rm - Rf)$.	**Usually via CAPM**
Cost of debt Interest is tax-deductible.	**Interest rate, after tax**
Weights	**Market values, not book**

THE COMMON MISTAKE

× **Assuming debt is cheap so more is better**

✓ **Gearing raises the cost of equity too**

More debt raises financial risk, so shareholders demand more. Beyond a point WACC rises again.

Equity is more expensive than debt, because equity holders are paid last and bear the residual risk.