10.10: Key Takeaways

Key Takeaways

Firms raise capital from investors in the form of debt and equity with the intention of investing that capital into developing products and services for customers. Back in Chapter One, we introduced the goal of maximizing shareholder wealth and, in order to accomplish this goal, the firm needs to invest this capital in such a manner as to ensure that the return generated exceeds the cost of acquiring the capital. To evaluate this, the firm needs to be able to estimate their marginal cost of capital. This is done by determining the market value weights of the appropriate financing sources and the costs of the individual financing sources. These values are then used to create a weighted average to estimate the firms cost of capital. It is important to remember that the appropriate cost of each financing source is effectively the required return demanded by investors. However, there are some challenges that occur in that we need to acknowledge that interest expense is a pre-tax expense, so the cost of debt needs to reflect the interest tax shield. In addition, the cost of common is difficult to model precisely, so we often use an average of multiple methods in order to try to get a more reliable estimate. Finally, it is important to recognize that the cost of capital will vary depending on the mix of debt vs. equity financing (capital structure) that the firm chooses. Therefore, firms need to reflect on how their decision related to capital structure can be optimized to keep the cost of capital low and the value of the firm high.

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