

10.1: What is the Marginal Cost of Capital?

The Marginal Cost of Capital (MCC), which is sometimes called the Opportunity Cost of Capital (OCC) or Weighted Average Cost of Capital (WACC), tells us how much we are paying for our financing. This will help us determine the required return for our investment projects. Specifically, under two basic assumptions (discussed below), the MCC will be the required return that we use when performing capital budgeting analysis from Chapter Eight.

Let's expand on the idea that the Marginal Cost of Capital represents our cost of financing and, in turn, the required return for our capital budgeting projects. Firms need to raise capital in order to invest in various capital budgeting projects. For instance, if a company wants to spend \$500 Million to launch a new satellite they need to find a way to pay for that. There are two primary ways in which companies can raise capital — (A) debt or (B) equity.

Debt

The firm can issue bonds in order to raise capital.

Equity

The firm can have stockholders provide capital in one of three ways.

Preferred Stock

Issuing shares of preferred stock will help provide capital for the firm.

Common Stock

Issuing shares of common stock will help provide capital for the firm.

Internal Equity

Any profits that the firm makes and doesn't pay out to shareholders in the form of dividends can be used to provide capital for future periods. Since this money technically belongs to existing common stockholders, it is considered a form of common stock financing. Some models separate out internally generated equity from the issuance of additional shares, however we will not do this. For the purposes of our class, we will treat both newly issued common stock and internally generated equity as the same since they both represent capital provided by common stockholders.

Once we figure out where our financing is coming from, we must figure out how much it is costing us. The details of this are discussed below. Our Marginal Cost of Capital calculation incorporates the cost from each source along with how much financing is being provided from each source. This gives us an average cost for each dollar of financing that we are using as a firm.

Once we know how much each dollar of financing is costing us, we can determine if we are using that financing appropriately. For instance, pretend that our MCC is 9.5%. Then, we have the opportunity to invest in a capital budgeting project that has an IRR of 8.5%. That means we are paying 9.5% to raise money and then investing this money to earn 8.5%. Since we are earning less on our investments than it is costing us to raise our money, the project is not worthwhile. On the other hand, if we have a project that will generate an IRR of 12% we will earn more on our investment project than it is costing us to raise our money. This makes the project profitable and we should pursue it. We cannot properly evaluate our capital budgeting projects without having a reasonable estimate of our cost of capital.

One of the themes for this chapter is that when we are estimating the costs of each source of financing, we are going to focus on estimating the required return for investors who buy those securities. The idea is that we have been focusing on stocks and bonds previously in this class from the perspective of investors. However, the return that these investors receive is paid by the corporations. Therefore, the investors' required return is the firm's cost of capital. This means that we are going to rely on concepts we already have covered that focus on required return, but now instead of referring to it as the required return, we will call it a cost of capital.

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