10.2: When is the MCC appropriately used as the required return for capital budgeting?

As mentioned previously, there are two basic conditions that must be met before we can use the MCC as the required return in capital budgeting analysis. These assumptions are as follows:

1. The risk of the project must be of average risk for the firm. The MCC is influenced by the perceived riskiness of the firm as a whole. Since investors set the MCC by "charging" the firm enough to compensate for the risk of investing in the firm. The higher the perceived risk, the more investors will demand as a rate of return (cost of financing). Since the firm can be thought of as the sum of all of its various projects, then we can say that the MCC appropriately captures the risk of the average project. Many projects will be more risky or less risky than what is considered "average." If we undertake high-risk projects, the average risk of the firm will increase (causing the MCC to increase) so we need to earn more to compensate us for the risk of that project. The opposite holds for low-risk projects. Anytime we evaluate a high-risk project we should use a required return higher than the MCC and anytime we evaluate a low-risk project we should use a required return lower than the MCC.
2. The financing weights should not change in a significant manner due to financing the project. The MCC is based on the financing weights for the firm as a whole. If we alter that financing mix to undertake a project we must account for it. Therefore, if the financing weights for the project are significantly different than our present financing mix, we need to use the weights associated with the project. Another complication that is more difficult to correct is that drastically different financing weights may alter the risk of the firm and thus change financing costs. Specifically, increasing the amount of debt financing should increase the risk of the firm (and result in higher financing costs from each source of financing) while increasing the amount of equity financing should lower the risk of the firm (and result in lower financing costs from each source of financing).