CHAPTER OVERVIEW

10: Marginal Cost of Capital

Learning Objectives

Upon completion of this chapter, students should be able to:

- Define cost of capital and explain its relevance
- Explain basic sources of financing
- Calculate the financing weights and explain why market values are preferred to book values
- Calculate the after-tax cost of debt
- Explain why the Yield-to-Maturity is preferred to the coupon rate as the before-tax cost of debt and why debt is expressed as an after-tax cost
- Calculate the cost of preferred stock
- Calculate the cost of common stock using an average of the three different approaches (dividend valuation, SML, and bond yield plus risk premium)
- Explain why we use three different approaches for the cost of common stock financing and issues associated with each of the three methods
- Calculate the cost of capital and use it to evaluate capital budgeting projects
- Explain two key situations where the cost of capital needs modified before it can be used to evaluate capital budgeting projects
- Explain the concept of a target capital structure
- Diagram the cost of capital and value of the firm as the ratio of debt/equity increases
- Explain why the target capital structure may be different for different firms

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