

## 10.3: The Key Components of the Cost of Capital

There are four critical components that must be estimated in order to estimate the cost of capital.

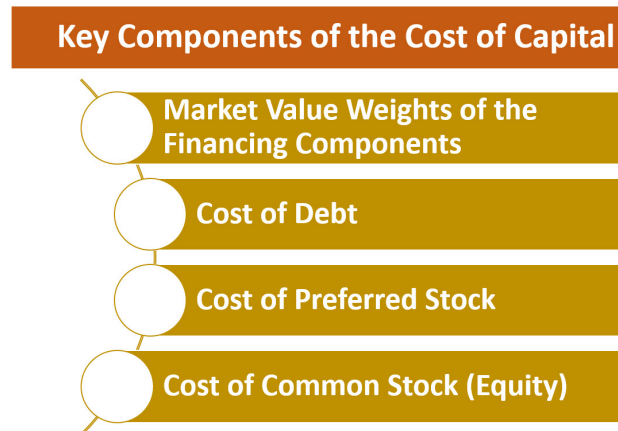


Figure 10.3.1: Four critical components for estimating the cost of capital are market value, cost of debt, and costs of preferred and common stock.

Note: We will be ignoring the role of flotation costs for this course. However, if you are interested in this topic, an optional discussion of flotation costs is provided at the appendix of the chapter.

Once these are estimated, we use the following equation to estimate the MCC

$$MCC = W_{\text{debt}} k_i + W_{\text{pref}} k_p + W_{\text{com}} k_s$$

Where

$W_{\text{debt}}$  represents the proportion of total financing coming from LT Debt

$k_i$  represents the after-tax cost of debt financing

$W_{\text{pref}}$  represents the proportion of total financing coming from preferred stock

$k_p$  represents the cost of preferred stock financing

$W_{\text{com}}$  represents the proportion of total financing coming from common stock

$k_s$  represents the cost of common stock financing

Note that the weights should all be plugged into the formula as a decimal (10% = 0.10) while the costs should be written as a percentage (10% = 10)

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