Monday Morning
October 27, 2008

ONE EIGHTY

Upcoming Events

- CAM-I Fourth Quarter Meeting Scottsdale AZ December 7-10
- APQC Annual Knowledge Management Conference Houston TX May 4-5 2009 Call for presentations end November 17

People in the News

Many thanks to all the speakers at last weeks CAM-I/CMA conference in Toronto

Cost of Capital

Even in high level meetings of senior management, people talk about creating shareholder value without understanding the role of capital costs in determining the success of a business.

Only when a company earns a Return on Investment greater then its Cost of Capital is value created for the shareholder.

The Cost of Capital is the weighted sum of the cost of equity and the after tax cost of debt.

In a company where one half of its capital structure is debt with a cost of 6% (after tax of 4%) and one half is equity at a cost of 12%, the weighted average of 8% is its cost of capital.

A key concept in calculating the cost of capital is that debt and equity are based on market values, not the amounts reported on the balance sheet (book value).

In practice, the cost of debt is the interest rate on the debt instrument. Interest rates include a risk component which incorporates a probable rate of default.

A low risk of default leads to a lower risk component and lower interest rates. Companies with similar risk or credit rating have similar interest rates.

Calculating the cost of equity is more challenging because equity does not pay a set return to investors.

A starting point for calculating the cost of equity is the S&P 500 (or similar broad index).

Measured over the last 100 years, the S&P 500 has yielded about a 10% return to investors (dividends plus increase in stock price). For the S&P 500 overall the cost of equity is 10%, the expectation of investors for the next 100 years.

But all companies in the S&P 500 don't have the same investment risk.

That's where Beta comes in, a measurement of the risk of a specific company or even an industry.

Industries with revenues and market cycles that gyrate up and down are less predictable and have more risk.

Companies that have a higher risk than the average for the market have a beta higher than 1.0. Companies with less risk than the average for the market have a beta of less than 1.0.

The beta, in effect becomes a multiplier to determine the cost of equity for a specific company. For a company with a beta of 1.4, the inferred cost of equity would be 14% (based on market average of 10%)

The two principal ways organizations reduce their cost of capital is by changing their debt to equity ratio (debt is cheaper than equity) and stability and predictability of operations to reduce the risk premium (beta) on the invested capital.

Know the Cost of Capital for your company…

John A. Miller

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