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## The cost of funds

### About this chapter

The purpose of this chapter is to illustrate the relationship between the cost of capital and the sources of finance, and to demonstrate how the cost of capital can be calculated for each source of funds. From this overall cost, value can be determined, reflecting the capital structure of the business. Establishing the cost of capital accurately is essential for evaluating projects, as was illustrated in Chapter 10, but in practice can be difficult to achieve. The aim of this chapter is to provide a simple overview of the key issues surrounding the cost of capital calculation, in order to enable the reader to understand the principles involved.

### Learning objectives

On completion of this chapter, you should be able to:

- Understand the concept of gearing and financial leverage
- Explain the meaning of the weighted average cost of capital (WACC)
- Understand the relationship between wacc and the gearing ratio
- Appreciate the factors which impact on the selection of capital for the financing of a business or capital expenditure.

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### Introduction

The potential sources of funds available to an organisation have already been described in Chapter 9. These can be divided into two main groupings: equity sources and those termed as borrowings or debt capital. Equity sources include:

- Ordinary shares
- Preference shares
- Reserves and retained profits.

Debt financing can include:

- Bank loans
- Debentures
- Convertibles
- Bonds
- Mezzanine finance
- Creditors.

It has already been noted that equity sources can expect a varying level of return whereas borrowed funds normally require a fixed return in the form of interest. In general, the providers of the finance expect a level of return which is directly linked to the perceived level of risk. The higher the risk, the greater the expected return. The advantages of debt financing include the cost of the funding which is usually lower than equity financing. This is because:

- The pretax rate of interest is lower than that expected by shareholders, as share capital is perceived to be riskier, as the return – i.e. the dividend – is not guaranteed
- Debt interest falls above taxation in the structure of the profit and loss account, reducing the overall cost of the interest
- The administrative costs of debt capital, such as the issuing costs, are normally lower than those required for issuing share capital.

## Cost of capital

CIMA (2023) defines the cost of capital as:

*“The minimum acceptable return on an investment, generally computed as a hurdle rate for use in investment appraisal exercises. The computation of the optimal cost of capital can be complex and many ways of determining this opportunity cost have been suggested.”*

If a company is to survive in the long term it must achieve a return in excess of the cost of the funds invested in it. The total cost is dependent on the cost of funds from equity sources and on those from borrowings. The return on equity is made up of the dividends paid to shareholders and the funds that belong to shareholders which have been retained within the company for reinvestment. The simplest approach to finding the cost of capital requires estimating the cost for each source of funds and combining these to provide a single value using a weighted average.

## The cost of equity

Equity consists of the share capital and the retained profits invested in a business. Retained profits are often, mistakenly, considered to be a free source of finance. However, this is not the case, because there is an opportunity cost associated with using these funds. The calculations for the cost of equity should therefore reflect this fact. The cost of equity can be calculated in two ways. The first of these, the dividend growth model, provides the simplest approach to determining the cost of equity. The second approach, the capital asset pricing model, is more complex and will only be considered briefly here. However, some of the issues surrounding the second approach are of importance and these merit further discussion.

### The dividend growth model

This approach calculates the cost of equity from the annual dividend payment and the current market price of the share as quoted on the capital markets, this being the dividend yield ratio.