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This blog is written by **Mr. Usman Ghani.** Please read this blog and provide your valued comments

COST OF CAPITAL THROUGH COST OF EQUITY CAPITAL

LEARNING OUTCOMES

1. Meaning of cost of capital.
2. Cost of Equity capital using Dividend growth model, Dividend yield growth model, Price earing model and capital asset pricing model
3. Summary of formulas.

COST OF CAPITAL (MEANINGS)

- The cost or the rate of return company have to pay against the funds borrowed from different sources or the quantum.
- Companies mainly raised funds from different sources to invest in different projects which give return in excess of the cost of capital, the various sources are Equity or the Debt (in different form).

- The main objective of the Company is to maximize the wealth of its shareholders and to increase or maintain the Earing per share to stand in the market or to sustain and attract the investors.

- Company can either raise funds through Equity or Debt, only equity, only debt or some portion of equity and some portion from debt.

- The raising of funds from Equity or the debt have direct impact on the wealth of the shareholder or the Earning per share. Company have to invest its funds in such a project from which the rate of return would be greater than or equal to the cost of capital to maintain or to increase the EPS.

- Cost of capital rate is used as a bench mark in the investment appraisal or as a target rate of return comparing with internal rate of return.

- Cost of capital is the minimum rate of return which consists of risk free return plus premium of risk associated with the particular business.

The long-term funds generally raised from following resources.

- Equity share capital
- Preference share capital
- Retained earnings
- Debentures and bonds
- Term loans from financial institutions and Banks

Cost of capital is the benchmark rate for the firm, of the firm earns more than the its cost of capital, then it will increase the value of the firm and the wealth of shareholders.

The cost of capital consist of the following elements.

a) Cost of Equity capital.
b) Cost of retained earnings.
c) Cost of Preferred capital
d) Cost of debt includes both debentures, bonds and term loans.

Cost of Equity capital

Funds raised from the issuance of the equity share holders which is not refundable expect of on liquidation of the firm but at that time shareholders are on the least priority. The equity shareholders are considered to the owner of the company. The objective of the firm is to maximize the shareholder's wealth. If the Company rate of return on the different project is more than its cost of capital the shareholders would get dividends from the company.

Methods used to calculate the cost of Equity capital.

- Dividend yield method
- Dividend growth model
- Price earing method
- Capital asset pricing method

Dividend yield method

Formula

$$\text{Cost of equity capital} = \frac{\text{Annual dividend per share on equity capital in period one}}{\text{Current market price of the equity share } \textbf{or} \text{ the net proceeds of each equity share}}$$

Assumptions

There is no growth over time and the rate of dividend remain constant

The market value of the equity shares is directly proportional to the future dividends on the shares.

Dividend growth model

Formula

$$\textbf{Cost of equity capital} = \frac{\text{Expected dividend per equity share}}{\text{Current market price of the equity share } \textbf{or} \text{ the net proceeds of each equity share}} + \text{expected growth rate of dividend}$$

Assumptions:

Growth of dividend would be year after year would not be constant.

Growth is future casted not on real basis.

Criticism

The Gordon Growth Model was criticized on following basis.

- The prediction of the future growth of the rate of dividend is unpredictable.
- The rate of dividend depend on the retain earing of the company and it change with time therefor difficult to assume.

Price Earing method

Assumptions

- The profits would not be distributed in the form of dividend and not in any form of cash consideration,
- Shareholders and the investor want to capitalize the future earnings of the share.
- The earnings of the company was accumulated in the retain earnings and it would be distributed among the shareholders due to which the value company and the market price of the share gradually increase.

Formula

$$\textbf{Cost of equity capital} = \frac{\text{Current earing per share}}{\text{Current market price of the share}}$$

Capital Asset Pricing model (CAPM):

CAPM divides the cost of equity into two components, first the near risk free return available on the governments bonds or the bank.

2nd the investments of the funds in specific volatile market or investment. Therefor another factor introduced called Beta which is the average of all the return of overall market portfolio.

Formula

Cost of equity capital= Risk free rate of return+ Beta of the investment (Average market return + Risk free return).

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