

# Chapter 10

## The Cost of Capital

### LEARNING OBJECTIVES

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After reading this chapter, students should be able to:

- Explain what is meant by a firm's weighted average cost of capital.
- Define and calculate the component costs of debt and preferred stock.
- Explain why retained earnings are not free and use three approaches to estimate the component cost of retained earnings.
- Briefly explain why the cost of new equity is higher than the cost of retained earnings, calculate the cost of new equity, and calculate the retained earnings breakpoint--which is the point where new equity would have to be issued.
- Briefly explain the two alternative approaches that can be used to account for flotation costs.
- Calculate the firm's composite, or weighted average, cost of capital.
- Identify some of the factors that affect the overall, composite cost of capital.
- Briefly explain how firms should evaluate projects with different risks, and the problems encountered when divisions within the same firm all use the firm's composite WACC when considering capital budgeting projects.
- List and briefly explain the three separate and distinct types of risk that can be identified, and explain the procedure many firms use when developing subjective risk-adjusted costs of capital.
- Use the CAPM to directly estimate the cost of capital for specific projects or divisions.
- Identify and explain the two approaches that have been used to estimate individual assets' betas.
- List some problem areas in estimating the cost of capital.