Importance and Financial Uses of Weighted Average Cost Capital:

Discussion Question:
Suppose you were hired as an Assistant Finance Manager in a leather manufacturing concern last month. The first task assigned to you was to calculate company’s weighted average cost of capital (WACC) and provide a detailed report about it to the CEO of the company. Although you have calculated the WACC after incorporating the required data but the problem is there in reporting it to the CEO because he doesn’t have enough financial knowledge. For him, the WACC is just a rate that is used in different financial affairs of the company whereas you have to make him understand the financial usages of WACC. You are, therefore, required to identify the different financial usages for which this particular rate can be used by the company.

Weighted Average Capital Cost:
A calculation of a firm’s cost of capital in which each category of capital is proportionately weighted. All capital sources - common stock, preferred stock, bonds and any other long-term debt - are included in a WACC calculation.

And its Equation is,

$$ WACC = \frac{E}{V} \times R_e + \frac{D}{V} \times R_d \times (1-T_c) $$

Where:

- $R_e$ = Cost of equity
- $R_d$ = cost of debt
- $V = E+D$ (Market Value of Equity + Market Value of Debit)
- $T_c = \text{Corporate tax rate}$
- $\frac{E}{V} = \text{percentage of financing that is equity}$
- $\frac{D}{V} = \text{percentage of financing that is debt}$

$$ WACC = (E/V) \times R_e + (D/V) \times R_d \times (1-T_c) $$

Where:

- $R_e = \text{cost of equity}$
- $R_d = \text{cost of debt}$
- $E = \text{market value of the firm's equity}$
D = market value of the firm's debt
V = E + D
E/V = percentage of financing that is equity
D/V = percentage of financing that is debt
Tc = corporate tax rate

- It will be conveyed to CEO that this WACC shows us that how much interest the company has to pay for every dollar it finances.

- It will be conveyed to CEO that an increase in WACC notes a decrease in valuation and a higher risk as the WACC of a firm increases as the debt and rate of return on equity increases.

- It will be conveyed to CEO that WACC will be used to calculate the Net Present Value (NPV) which will allow the evaluation of projects or investment. As,

\[ NPV = \text{Cost of Project} + \frac{\text{Expected Saving}}{\sum_{n=1}^{n} (1+WACC)^n} \]

\[ NPV = \text{Cost of Project} + (\text{Expected Saving} / \text{Sum}(1+WACC)^n) \]

The positive NPV means that project under consideration offers advantages and may be preceded.

The negative NPV means that the financial market offers superior projects in the same risk class, so the project should be rejected.

- The CEO will be briefed that this calculated WACC will also be used as the appropriate discount rate at which to evaluate the projects. Because the costs of financing (receiving the loan, making interest payments and repaying principal) are never included as cash flows when estimating the cash flows to investment, thus cost of financing will be taken account of in the discount rate.

- CEO will be told that using this WACC it can be seen that how much interest, the company has to pay for every dollar it finances. Also calculated WACC will reflect what a firm needs to earn on a new investment.

- CEO will be told that this calculated WACC shows the value of the firm or its earning’s potential. Earning potential is maximized if WACC is minimized & vice versa.
References:

Ms Lee Lister
The Biz Guru
http://www.StartMyNewBusiness.com
FINANCIAL ACCOUNTING AND REPORTING 14th Edition By Barry Elliott & Jamie Elliott

Essentials of financial analysis / George T. Friedlob, Lydia L. F. Schleifer.

Keywords:

WACC, Weighted average capital cost, NPV, Net present Value, ACC501 GDB No. 2, MBA Executive, Importance of WACC, Uses of WACC, Business Finance