To assess a corporation's external financing premium accurately, it is essential to incorporate both equity and debt financing costs. This approach draws upon Aswath Damodaran's concepts of the Equity Risk Premium (ERP) and the Debt Financing Spread (DFS). ERP, calculated as the market return minus the risk-free rate (often represented by U.S. Treasury bond yields), serves to gauge the cost of equity financing. It signifies the additional return investors demand to compensate for the risks associated with investing in the stock market. An increase in ERP is indicative of a higher perceived risk, thereby suggesting an elevated cost of equity.

To measure the external financing premium from a debt perspective, we can use the spread between the interest rates of AAA corporate bonds and U.S. Treasury bonds. This spread reflects the additional yield investors demand for bearing the credit risk associated with corporate debt compared to risk-free government securities. The formula for the debt financing spread (DFS) is:

Combining these perspectives, the overall external financing premium for a corporation can be quantified by weighting the ERP and DFS according to the firm's capital structure.

While this formula provides a simplified and holistic view of a company's external financing costs, enabling the analysis of how shifts in market conditions or changes in capital structure influence financing expenses, it is underpinned by certain assumptions and limitations:

Simplification of Equity Costs: The cost of equity is not fully captured by ERP alone, as it does not account for company-specific risks or variations in beta across different firms. These nuances can significantly affect the actual cost of equity but are not reflected in the simplified model.

Homogenization of Debt Costs: Similarly, the DFS assumes a uniform risk profile for all AAA-rated corporate bonds, disregarding the varying degrees of credit risk that can exist within this rating category. The actual cost of debt for a company might be influenced by its specific financial condition and market perceptions, which this model does not fully incorporate.

Static Capital Structure: The model assumes a static capital structure, which might not reflect the dynamic adjustments companies make in response to changing market conditions or strategic initiatives.

Market Conditions: Both ERP and DFS are based on market data that can fluctuate significantly over time. These measures might not accurately predict future costs due to unforeseen economic shifts or investor sentiment changes.

Implied Equity Risk Premium (ERP) Formula:

The implied ERP can be calculated using the formula:

Where:

- Expected Dividend per Share is the dividend expected to be paid out in the next year.

- Current Price per Share is the current market price of the share.

- Expected Growth Rate is the rate at which dividends are expected to grow over time.

- Risk-free Rate is typically the yield on long-term government bonds, such as the 10-year U.S. Treasury bond.

This formula provides a forward-looking estimate of the equity risk premium, based on current market conditions and expectations of future dividends and growth.