

PRINCIPLES OF FINANCE 2





LEARNING JOURNAL UNIT 6

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INSTRUCTOR: SHWETA POOJARI

CAPITAL BUDGETING AND COST OF CAPITAL CONNECTION

In capital budgeting, the cost of capital plays a crucial role. It serves as the discount rate in the net present value (NPV) model. This model helps evaluate potential projects and investments. Companies employ capital budgeting as a methodology to assess the viability and potential return of substantial projects or investments under consideration. Initiatives like constructing new manufacturing facilities or acquiring a significant ownership position in an external enterprise typically necessitate thorough capital budgeting analysis before receiving approval or rejection from executive leadership. This rigorous process enables organizations to make informed decisions about allocating financial resources towards endeavors that align with their strategic objectives and offer favorable long-term prospects (Kenton, 2024). The cost of capital represents the minimum required rate of return. It ensures the company satisfies the return expectations of creditors and shareholders. “Cost of capital is a calculation of the minimum return that would be necessary in order to justify undertaking a capital budgeting project, such as building a new factory. It is an evaluation of whether a projected decision can be justified by its cost” (Hayes, 2023).

CALCULATING THE COST OF CAPITAL

The company's cost of capital stems from a weighted average of financing costs. This includes debt, preferred stock, and common equity. It shows the required returns investors demand based on risk. A higher WACC means greater risk and return requirements. When pursuing growth opportunities, numerous enterprises opt to fund their expansion initiatives through a combination of debt and equity financing sources. For these companies, the overall expense associated with securing capital is calculated as a weighted average of the costs incurred from each individual source of capital employed. This metric, referred to as the weighted average cost of capital

(WACC), considers the relative proportions of debt and equity utilized, as well as the respective costs of obtaining financing from each source. By determining their WACC, businesses can effectively evaluate the true cost of the capital required to finance prospective projects and make informed decisions regarding the optimal capital structure to support their development plans (Hayes, 2023).

EVALUATING PROJECT RETURNS VS COST OF CAPITAL

In theory, a company should not pursue projects with expected returns below the cost of capital. These projects destroy shareholder value. They invest in opportunities generating lower returns than existing operations or alternatives. This poor capital allocation erodes wealth over time.

However, a company may selectively take on projects slightly under the WACC. This allows for strategic positioning, market factors, or operational synergies not captured financially. Short payback periods with continued positive cash flows could also justify a minor return shortfall versus the cost of capital.

Wordcount: 441

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