Macro Roundup Article

Headline: Firms' Perceived Cost of Capital

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Tweet: Public company managers’ conference call comments about their cost of capital vary widely from its actual cost; 80% of the variance suggests managerial error. Those who perceive higher capital cost invest less, reducing TFP by 5%. @NielsGormsen

Summary: We study hand-collected data on firms’ perceptions of their cost of capital. The perceived cost of capital is partially related to the true cost of capital, which is determined by risk premia and interest rates, but there are also large deviations between the perceived and true cost of capital. Only 20% of the variation in the perceived cost of capital is justified by variation in the true cost of capital. The remaining 80% reflects deviations that are consistent with managers making mistakes. We find that, in the long run, firms with a higher perceived cost of capital have a higher return on invested capital, lower investment rate, and lower capital-labor ratio. These results suggest that the perceived cost of capital reported on conference calls is used for long-run capital allocation in line with standard models. The deviations lead to misallocation of capital that lowers long-run aggregate productivity by 5% in a benchmark model. Forcing all firms to apply the same cost of capital would improve the allocation of capital relative to current corporate practice.

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