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Textbook Reference:
Financial Management: Theory and Practice
by: Eugene F. Brigham and Michael C. Ehrhardt

Discuss comprehensively of the following terms:

1. Weighted average cost of capital; or after-tax cost of debt

Weighted Average Cost of Capital (WACC) / After-Tax Cost of Debt

The weighted average cost of capital (WACC) is the overall rate of return a company must earn on its investments to maintain its market value and satisfy its investors (creditors and shareholders). It combines the cost of equity, the cost of debt (after adjusting for taxes), and the cost of any preferred stock, weighted according to their proportion in the company's capital structure. The after-tax cost of debt refers specifically to the effective interest rate a company pays on its debt after accounting for the tax deductibility of interest expenses. This adjustment is important because interest payments reduce taxable income, lowering the real cost of borrowing.

2. Cost of common stock

The cost of common stock, or cost of equity, is the return that shareholders expect for investing in the company. It reflects the compensation investors demand for the risk of owning the company's shares. This cost can be estimated based on expected dividends and capital gains or by comparing the company's risk level to the broader market. A firm must meet or exceed this expected return to maintain its stock price and attract future investment.

3. Cost of preferred stock.

Preferred stock has characteristics of both debt and equity. It typically pays fixed dividends and has priority over common stock in dividend payments and during liquidation. The cost of preferred stock represents the return required by investors to purchase and hold these shares. Because the dividends are usually fixed, the cost is more stable than that of common equity. However, unlike interest on debt, preferred dividends are not tax-deductible, making them relatively more expensive.

4. Target capital structure

The target capital structure is the mix of debt, equity, and preferred stock that a firm aims to maintain over time. This strategic balance is designed to minimize the company's cost of capital while optimizing financial flexibility and risk. Companies determine their target structure based on factors like business risk, tax implications, market conditions, and industry standards. Staying close to the target helps maintain investor confidence and supports long-term planning and growth.

5. Cost of new external common equity

When a firm raises funds by issuing new common stock instead of using retained earnings, it incurs additional costs. These include underwriting fees, legal fees, and other expenses related to issuing the stock. As a result, the cost of new external equity is typically higher than that of internally generated equity. Companies must consider these extra costs when evaluating whether to raise capital through new stock offerings.

6. Flotation cost

Flotation costs are the expenses a company incurs when it issues new securities, such as common stock, preferred stock, or debt. These costs can include underwriting fees, legal and accounting services, and registration fees. While they are a one-time cost, they effectively reduce the amount of capital a company receives from the issuance, thus increasing the cost of capital. Companies often account for flotation costs when assessing the feasibility of raising funds through external financing.