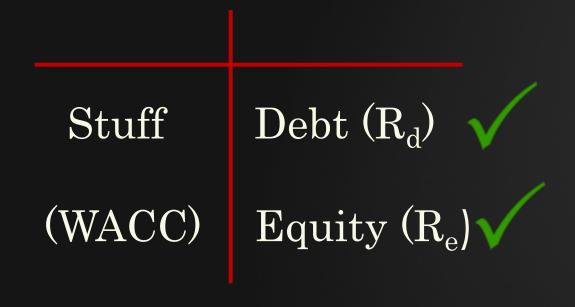
# RISK, RETURN, AND THE COST OF CAPITAL

Putting It All Together as the WACC

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## COST OF CAPITAL

Simple Balance Sheet



#### COST OF CAPITAL

WACC = 
$$\frac{\text{Equity}}{\text{Equity} + \text{Debt}} R_e + \frac{\text{Debt}}{\text{Equity} + \text{Debt}} (1 - t) R_d$$

► Cost of capital for the firm

▶Balances debt and equity

#### WACC: AN EXAMPLE

#### Example:

The equity value of Target is about \$40B.

They have roughly 15B in long-term debt.

They pay a 35% corporate tax rate.

Their beta is 0.6.

Assume treasury rates are 2.5% and the equity premium is 5.5%.

They are A-rated with a quality spread of 120bps.

Estimate Target's cost of capital.

### **WACC: SUMMARY**

- ►Firm's cost of capital → WACC
- ► Weighted average of debt and equity
- ▶ Debt receives tax shield