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1. Why is the cost of capital the minimum acceptable rate of return on an investment?

## What is a minimum acceptable rate of return (MARR)?

A minimum acceptable rate of return (MARR) is the minimum profit an investor expects to make from an investment, taking into account the risks of the investment and the opportunity cost of undertaking it instead of other investments.

## Where have you heard about minimum acceptable rates of returns (MARR)?

If you've done any research and cost analysis before making an investment, you've probably worked out the minimum acceptable rate of return. Minimum acceptable rates of return are also known as hurdle rates, cut-off rates or benchmarks.

## What you need to know about minimum acceptable rates of returns (MARR).

MARRs are a useful way of weighing up whether an investment is worth the risks associated with it. To calculate the MARR, you need to look at different aspects of the investment opportunity, including the opportunities for expanding operation and rate of return on investments.

An investment has been a successful one if the actual rate of return is above the minimum acceptable rate of return. If it is below, it's seen as an unsuccessful investment and you might, as an [investor](https://capital.com/investor-definition), pull out of the investment.

### Types of investor

You will hear about many types of investors, from angel investors to ethical investors, but these refer to the things they are investing in rather than their own characteristics. Essentially there are two types of investor, retail and institutional.

Retail investors are individuals operating on their own account or trusts acting on behalf of individuals. As they are not allowed to be members of any stock exchange they must buy or sell through broker-dealers.

Institutional investors are large entities investing on behalf of their clients, such as pension funds, hedge funds, unit trusts or mutual funds. Client assets might be held by broker-dealers but can also be held by custodian banks. Hedge funds are generally regarded by the market as having a greater risk appetite than investment managers acting on behalf of, say, pension funds. Investment collectives such as private equity funds acting on behalf of a group of individuals are still regarded as institutional investors.

### Investment strategy

Investment can be defined along three lines:

* Cash equivalents, for example money market funds
* Loans, for example government treasuries
* Ownership, for example property or shares

Which of these broad groups is best suited to each investor will depend on their circumstances, goals and desires. How often can they invest and how much? How long do they want to hold onto the investment? How quickly might they need to realise their gains? What is their attitude to risk? Are they experienced or do they need advice? What sort of return are they seeking - capital appreciation or income?

**Outlined below are some common investment strategies.**

**Buy and hold:** as its name suggests, the investor buys shares or funds with a view to holding them for a long time in the hope of capital appreciation and/or income. The idea is that holding over the long term will flatten out volatile market periods. This also removes the imperative for the investor to try and buy at a market low and sell at a market high.

**Value vs growth:** essentially, value investing is looking for a bargain. The investor believes that the market is currently under-pricing a selected company’ shares and that it has a higher intrinsic value. Growth investors focus on the earnings potential of the company and whether this is forecast to beat the rest of the sector. In both cases, the aim is to maximise capital appreciation.

**Dividend growth investment:** certain companies, especially large caps, have a strong track record of increasing dividend payments over time and also tend to have more stable share prices. Investors who reinvest their dividends will gain a compound benefit over time.

**Indexing:** the investor buys a small share of all of the stocks in a given index such as the FTSE 100 or more easily they can do the same thing via a mutual fund or exchange-traded fund (ETF).

**Passive and active:** buy and hold is regarded as a passive investment strategy as is investing in index funds, which will track a portfolio rather than trying to outperform it. The advantage is that less analysis is required and fewer trades undertaken, keeping costs down. Active traders try to bring superior financial skills to bear to outperform benchmarks.

**Momentum trading:** this is an example of an active strategy where investments are chosen according to their recent past performance, typically a stock that is moving strongly in one direction with high volume. This is a short-term speculative investment strategy. Other technical and speculative trading strategies include ‘long short’ and ‘pairs trading’.

**Contrarian:** the investor buys many shares in a strong company in a depressed market with a view to make a profit in the long run. A strong company is one with solid fundamentals: for example earnings potential, the financial ability to withstand the down market and a defined competitive edge in its sector.

### Investment bias

Shoppers will often employ sophisticated thought processes to justify the purchase of a new pair of shoes or a smartphone. Investors are human too, well much of the time, and are prey to the same instincts. The difference is that investors can lose many thousands of pounds if they make the wrong decision.

A whole investment psychology has grown up within financial markets with investors aiming to forewarn themselves and avoid making irrational purchases. The various pitfalls have come to be categorised into two types: cognitive bias and emotional bias.

The CFA Institute has identified 20 biases as shown below. Organisations run [courses](https://capital.com/online-finance-courses) on the bias topic and there is too much to discuss here so we will explain a few of the more interesting or less obvious ones below.

**Cognitive dissonance:** here an investor has two opposing thoughts at the same time. This is best illustrated by way of an example. The investor decides a fair price to buy share X, which is currently trading at £23, is £20. However the market then experiences an upturn and the [share price](https://capital.com/live-share-prices) starts tracking up to £26. The investors’ valuation is being contradicted by the market and they end up buying at £27 to align with the trend and remove the apparently conflicting valuations. This is not a good reason to buy the shares at that price.

**Confirmation bias:** it’s human nature to value opinions that align with your own. This is how newspapers have succeeded over decades and social media works in a similar way. The same goes for investors who find one research report that tips the stock they were eyeing and buy. What about the three other analysts with a ‘sell’ recommendation?

**Framing bias:** here the investor will make different decisions based on the context of exactly the same offer. To return to the shopping analogy, we are more likely to go for meat that is 80% lean than that labelled with 20% fat. Similarly, investors are more likely to seek risk when something is framed positively and avoid risk when an investment is framed negatively.

**Regency bias:** this is where investors make incorrect decisions about their portfolios based on recent market performance or how they perceive recent results, leading to a flawed outcome. They may for example be looking at a small part of the cycle that does not fit with their portfolio strategy.

**Loss-aversion bias:** a paper loss is a lot more palatable to an investor than realising the reduced cash from a stock that has fallen by 30% since it was purchased. But rationally the under-performing stock may be reaching its intrinsic value and the albeit smaller sum realised could be reinvested into a stronger stock.

**Overconfidence bias:** this is the investor who believes they have more information or superior skills to their peers. For example the amateur investor who thinks they know about computing company shares because they work in IT. The market has caught out many experienced financial professionals, let alone small investors with limited time and resources.

**Status-quo bias:** investors can be reassured by familiarity and may end up returning to the same investment universe they researched back in the day. This approach might not be disastrous but the lack of confidence or laziness not to investigate new options is likely to limit investment gains.

**Endowment bias:** this is where the investor assigns an irrationally high value to what they own and lose objective sight of what the market is prepared to pay for it.

There are plenty of other investment biases based on fear, greed or incorrect extrapolations of outcomes.

**How to overcome bias**

Ignoring investment hunches and impulses is hard and takes time and experience. A good way to bring these into check is for the investor to set themselves strict parameters on how they want to trade and not to deviate from those rules.

A spread sheet is a useful way to keep track of the performance of every stock to assess the returns and associated risk. Investors can set upper and lower targets, either in absolute terms or relative to their preferred benchmark index, and then buy or sell accordingly.

**2. How is the Cost of Debt Capital ascertained? Give examples.**

Companies don’t get to use the money they raise from investors for free. The cost of capital, or weighted average cost of capital, is what a company must pay for the funds. Measuring cost of capital matters because a firm that doesn’t produce a return greater than the cost of capital may not be able to generate enough money to grow.

## Weighted Average Cost of Capital

To calculate cost of capital, first determine the total capital invested, which equals the market value of equity plus the firm’s total debt. The formula for cost of capital is equity as a percentage of total capital multiplied by the cost of equity, plus debt as a percentage of total capital multiplied by the cost of debt.

## WACC Example

Suppose equity is 40 present of capital and the cost of equity is 15 present. Debt is 60 present of capital and the cost of debt is 10 present. You have 40 present times 15 present plus 60 present times 10 present. This works out to a cost of capital of 12 present of total capital invested.

## Know Your Terms

Analysts usually use after-tax yield to maturity as the cost of debt, but may substitute after-tax current yields when YTM can't be determined. Equity value is the market value of stock or the book value if market value is unavailable. Cost of equity is an estimate that can be based on various analytical models such as dividend growth and capital asset pricing models.

Debt and equity are the two components that constitute a company’s capital funding. Lenders and equity holders will expect to receive certain returns on the funds or capital they have provided. Since the cost of capital is the return that equity owners (or shareholders) and debt holders will expect, WACC indicates the return that both kinds of stakeholders (equity owners and lenders) can expect to receive. Put another way, WACC is an investor’s opportunity cost of taking on the risk of investing money in a company.

A firm's WACC is the overall required return for a firm. Because of this, company directors will often use WACC internally in order to make decisions, like determining the economic feasibility of mergers and other expansionary opportunities. WACC is the discount rate that should be used for cash flows with the risk that is similar to that of the overall firm.

To help understand WACC, try to think of a company as a pool of money. Money enters the pool from two separate sources: debt and equity. Proceeds earned through business operations are not considered a third source because, after a company pays off debt, the company retains any leftover money that is not returned to shareholders (in the form of dividends) on behal

3. How will you calculate the Cost of Preferences Share Capital?

**Cost of Preference Share Capital:** An amount paid by company as dividend to preference shareholder is known as Cost of Preference Share Capital.

Preference share is a small unit of a company’s capital which bears fixed rate of dividend and holder of it gets dividend when company earn profit. Dividend payable is not a tax deductible amount. So, there is no tax adjustments required for comparing with cost of debt.

The cost of preference shares should be treated as a separate component (and therefore a separate calculation) to the cost of equity or the cost of debt.

Formula to use:

**Kpref = d/p0**

d = preference dividend

P0 = market value of preference shares

4. The following details are available:

|  |  |
| --- | --- |
| Equity (Expected Dividend 12%) | Rs. 1000000 |
| Tax Rate | 50% |
| 10% Preference | Rs. 500000 |
| 8% Loan | Rs. 1500000 |

You are required to calculate Weighted Average Cost of Capital?

5. What is Net Present Value and how does it change by variation in discount rate.

Present value of the expected cash flows is computed by discounting them at the required rate of return.

An investment of $1,000 today at 10 present will yield $1,100 at the end of the year; therefore, the present value of $1,100 at the desired rate of return (10 present) is $1,000. The amount of investment ($1,000 in this example) is deducted from this figure to arrive at net present value which here is zero ($1,000-$1,000). A zero net present value means the project repays original investment plus the required rate of return.

The difference between the present value of the future cash flows from an investment and the amount of investment. Present value of the expected cash flows is computed by discounting them at the required rate of return.  
  
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A zero net present value means the project repays original investment plus the required rate of return.

A positive net present value means a better return, and a negative net present value means a worse return, than the return from zero net present value. It is one of the two discounted cash flow techniques (the other is internal rate of return) used in comparative appraisal of investment proposals where the flow of income varies over time.

You have to discount the future money by an appropriate value in order to translate it into today’s value. How much you discount it by can vary. You could, for example, use a “risk-free” rate of return, such as the yield on a U.S.

Government Treasury Bill. Or, you could use Weighted Average Cost of Capital (WACC). More appropriately (and simply) in my view, what you should usually use is your targeted rate of return, which would naturally be at a premium to whatever the current risk free rate of return is. This spares you from making a series of calculations and gets straight to the point.

If you want to get, say, a 10% rate of return on your money, then you should use a discount rate of 10% per year when translating future dollars into present dollars. You may also alter it depending on your estimation of the level of risk involved. For a higher risk investment I’d use a higher discount rate (perhaps 12% or so), while in the case of a very defensive and reliable business I may use a discount rate of 8%. It could also be tied to the current risk free rate of return, such as being equal to the current U.S. Treasury Bill return + 8% or so.

So how much is $10 a year from now, worth to you today, if you seek a 10% rate of return on your money? The answer is $9.09. If you had $9.09 right now, and you could invest that money at an annual rate of 10%, then you could turn that $9.09 into $10 in one year, since $9.09 multiplied by 1.1 equals $10. So $10 one year from now is only worth $9.09 to you today. In this scenario, $10 in a year or $9.09 today, is equivalent.

DPV = FV / (1 + r)

Here DPV means “discounted present value”, and FV means “future value”, and r is your discount rate (which in this case is 10% or 0.1). The $10 is future value, and you want to know the discounted present value of those ten dollars, so you divide the FV by (1 + 0.1) to get the DPV of that money.

If you wanted to know what $10 that you’ll get in two years is worth today, you make a minor adjustment to that equation, and use DPV = FV / (1 + r)^2, since the discount rate must be applied for two years. The answer is that receiving $10 two years from now is worth $8.26 to you today, since you can take $8.26 and multiply it by 1.1, and then multiply it by 1.1 again, to get $10. In this scenario, $10 in two years, or $8.26 today, are equivalent.

So we see that DPV = FV / (1 + r) ^n, for a given future value, where n is years. If we have a series of future cash flows each year, then the equation is this:

DPV = (FV1)/(1+r) + (FV2)/(1+r)^2 + … + (FVn)/(1+r)^n

## Different Stock, Different Discount Rate

As previously mentioned, I customize the discount rate in my calculation according to the company I analyse. I think it makes more sense that way as I would expect a higher rate of return from a company showing more risk and vice-versa. This is at the foundation of any stock valuation process as every investor wants to be rewarded for the risk taken.

The discount rates I use vary between 9% and 12%. A company with stellar numbers that will stabilize my portfolio such as 3M Co (MMM) will be discounted at 9% while a company evolving in a highly volatile environment such as Helmerich & Payne (a drilling company in the oil industry) will require a higher return on my investment and will be discounted at 12%.

The use of a low discount rate (9-10%) obviously leads to more undervalued stocks according to your calculation. This is why it is important to be very cautious about the reasons you discount with such low rate. I’ve read other bloggers going under 9% based on the fact that the current risk-free rate is almost zero and the premium shouldn’t be that high. Unfortunately, while such rationale seems to make sense at first glance, this puts almost all dividend growth stocks in an undervalued position. We all know this isn’t possible.

There are no rules preventing you comparing multiple discount rates for a single stock valuation process. Using different rates will help you assess the direct impact of a 1% change and will expose the right margin of safety. The margin of safety is some kind of buffer between what the stock will really be worth in a year from now and how much you calculated its value at. If you can benefit from a 10-20% margin of safety, you have a very good chance of making a good investment.

## Example of Discount Rate Use for Present Value of a Stock

In order to help you understand, I will make a dividend discount model (DDM) calculation example with Johnson & Johnson (JNJ) since everybody knows this company.

Since the company is a well-established dividend aristocrat, I don’t expect JNJ to double its value in the near future. The company is well diversified with a world class brand portfolio and sells in just about every country across the planet. For these reasons, the discount rate used is 9%. I also like to use a double stage DDM to see the impact of a first growth rate for the first 10 years and another for the years after.

I use a DDM with a 7.5% dividend growth rate (matching the past 5 years) for the first 10 years and reduce it to 6% afterwards:

The company is currently trading at close to a 20% discount according to my calculation. As you can see, the stock price is completely different if I use a 10% discount rate. In fact, there is a gap of roughly 25% between the fair value with a 9% rate and a 10% rate. A one present spread makes difference between an undervalued stock by 20% and an overvalued stock by 10%.

This is a good example to show you that the calculation is useful, but can’t be the only reason why you buy or sell a stock. The use of the right discount rate included in a complete stock analysis process will make sense as you will validate your investment thesis with such calculations. This is how you will end-up with a sound investment decision.

6. Distinguish between NPV and PI. Which of these you consider better?

A profitability index presents a parallel between the costs and profits of a certain project. By dividing the present value of the property’s future cash flows by the initial investment, we get the profitability index.

If the profitability index is over 1.0, then the profitability is positive, but if it is below 1.0 then the investment will probably fail. To put it another way, profitability index is constituted of the ratio between the present value of future cash flows and the initial investment.

A profitability index measure of 1.0 is likely the lowest desired number, and if it is lower than that, it signifies that the present value of the project is lower than the initial investment. Therefore, the project would probably be discarded.

Actually, both measures consider an investment property’s future **CASH FLOW**. However, net present value gives you the **dollar difference**, while the profitability index gives the **ratio.**

For example, let’s say that a **commercial real estate investment property** requires an investment of 1 million dollars. Its present worth with a revenue stream is $1,100,000. The net present value (**NPV**) would be $100,000, while the ratio would be 1.10. This demonstrates that the project is likely to be successful.

Even though these appear the same, understanding the difference between the two can help you compare **commercial income properties** quickly and easily. Because profitability index is a ratio, **it is absolute:** it tells you the proportion of dollars returned to dollars invested( instead of a specific amount).

**Profitability index allows you to compare the profitability of two properties without regard to the amount of money invested in each**

The profitability index shows how much value we would gain by investing. Here, each dollar gives $1.10. The profitability index is an **alternative** of the net present value. Profitability Index would be bigger than 1.0 if the net present value appears positive. Otherwise, it would be negative.

These two calculations are crucial to determine whether the project would succeed or fail. They are often referred to as being similar because of their close relationship**.** However, there is a **slight difference** between these two terms: that is, the profitability index does not suggest **the amount of the actual cash flows.**

You should be careful when using both methods together, as it has been detected that they can rate projects differently. A certain project could be classified first with one method whereas last with the other method.

For an investor making one or a few property investments, NPV may provide a better insight by giving the total expected return.

For an investor making multiple investments in multiple properties, profitability index may provide for better decision-making in that it delivers, in essence, a percentage of return on the investment per property.

**Present Value of Future Cash Flows / Initial Investment Required**

This is the same as **1 + net present value/initial investment required.**

**A profitability index of 1.0** means that the property’s net present value is greater than its initial investment; 1.0 is, therefore the **minimum ratio** acceptable for the PI. A profitability index greater than 1.0 means that the initial investment goals have been exceeded, and thus the property may be a good investment.

Keep in mind that while using the PI is an efficient way of ranking investment projects in terms of desirability, it does not take into account the[interest rate](https://westwoodnetlease.com/interest-rates-why-nnn-investments-differ-for-each-property/), and it may not provide an accurate number for mutually exclusive projects.

## ****Profitability Index Method****

Profitability index serves as a tool to classify projects. If the value of the index is bigger, then the project would be more attractive.

The acceptable measure of profitability index for a single project is 1.0 or more. This suggests that the business will move forward. But if it is lower than 1.0, the project would be dismissed. The index can serve as a **substitute for NPV** when determining the profits per dollar of investment.

## **Net Present Value Method**

NPV or Net Present Value is one of the primary methods or techniques for evaluating an investment

When using this method, it is essential to choose a proper **discount rate**. Usually, the weighted average cost of capital or the return rate on unconventional investments is used.

If the NPV is lower, the discount rate would be higher. Investments with higher risk have a higher discount rate than risk-free investments.

**NPV Single investment formula is as it follows:**

* Net Present Value = Present Value less Investment

**Whereas for multiple investments:**

* CF (Cash flow)/ (1 + r)t

Here, **r** indicates the discount rate, while **t** is the time of the cash flow.

Let’s take an **example** to explain this calculation.

* **Single investment : $150,000 – $10,000 = $140,000**
* **Multiple investments: $150,000 / 1.1 = 136,363**

The downside of these methods is their relativity. The project may hold corresponding profitability index with separate investments and different dollar return, which contributes to dominant NPV.

## ****Conclusion****

Net Present Value is considered as **one of the most desirable types of** evaluation, analysis, and selection of great investments. However, we should note that we have to be very careful when estimating cash flows, since incorrect cash flow estimation may lead to deceptive NPV.

Another thing you should take into account is that the discount rate is the same for both cash inflows and outflows, and the thing here is that the rates are different when lending or borrowing.

Still, NPV is the **first and foremost measure** of investment evaluation, compared to other methods such as determining the rate of return, payback period, internal rate of return (and Profitability Index). In fact, profitability index is related to Net Present Value, where the value presents an absolute measure, and the index presents a relative measure.

Proprietors raise investors’ wealth by welcoming projects that have a higher value than they actually cost, that has a **positive expected Net Present Value.** Sometimes the investment can be postponed and choose a time that is the most suitable for investment, and thus improve the cash flow.

**8. What purpose do capital markets serve?**

A capital markets group is a division within a larger company that uses its expertise in financial markets to provide financial services to specific types of clients. [Capital markets](https://www.investopedia.com/terms/c/capitalmarkets.asp) groups can help companies meet a wide variety of financial goals such as raising equity of issuing debt. A capital markets group may provide [investment management](https://www.investopedia.com/terms/i/investment-management.asp) services, lending services, equity sales and trading, research, consulting services or any number of other types of financial services.

### BREAKING DOWN Capital Markets Group

The types of services that may be provided by a capital markets group vary widely and depend on the focus of the company as a whole and on its customers' needs. Examples include helping a healthcare company to lease or finance expensive equipment, helping a young company find investors, helping an existing company expand its operations or even providing [financing](https://www.investopedia.com/terms/f/financing.asp) for a company's customers and other operational tasks such as corporate [restructuring](https://www.investopedia.com/terms/r/restructuring.asp).

In order to help companies that face increasingly complex sets of challenges and opportunities, capital markets groups effectively provide assistance to help them operate their business and stay competitive amid changing or uncertain conditions.

The resulting alliance provides an enhanced ability for a company to navigate the sophisticated economic and business landscape, providing analysis, advice and high-quality execution that helps propel a company's growth.

Capital markets teams focus on building on these types of strategic relationships in order to build deep understanding of clients' needs that will enable them to deliver advice and solutions that will make a significant difference.

### Capital Markets Groups Services and Expertise

* **Investment banking services:** From syndicated loans to import solutions and integrated receivables, capital markets groups offer universal, strategic advice and solutions that make a significant difference in our clients' futures.
* **Mergers and acquisitions:**Capital markets groups help clients with their most critical and complex business issues, such as mergers and acquisitions. Typically, this sort of expertise comes from seasoned, senior bankers that are able to leverage their long-established industry relationships and specialized insights to help ensure that every merger or acquisition transaction is executed flawlessly.
* **Debt capital markets:** Capital markets groups help companies raise capital and assemble financing through a broad range of sophisticated solutions. Usually spearheaded by senior-level bankers with long-standing industry, these groups help companies structure and execute financing solutions.
* **Equity capital markets:** Capital markets groups help companies develop the origination and execution of equity offerings, such as IPOs, follow-ons, and convertible notes. Capital markets groups provide potential issuers with advice and education on transaction size, timing, structure, execution alternatives and selection of underwriters.

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**9. What are the factors that would go into deciding whether a company should resort to debt or equity for financing its requirement of long-term funds?**

Few businesses can survive without some form of financing. Even entrepreneurs who bootstrap their companies that is, pay for it themselves often rely on credit cards to get things going in the short term.

There is a variety of financing available out there, from bank loans and [factoring services](https://www.businessnewsdaily.com/9335-best-factoring-services.html), to crowd funding and venture capital. So, how can you know what to select?

There are two broad categories of financing available to businesses: debt and equity. Figuring out which avenue is right for your business can be confusing, and both come with a set of pros and cons. Here's an introduction to each, what they mean, and important things to know before making your decision. **[Learn about other** [alternative financing methods for start-ups](https://www.businessnewsdaily.com/1733-small-business-financing-options-.html) **in our guide.]**

## ****What is debt financing?****

Many of us are familiar with loans, whether you've borrowed money for a mortgage or college. Debt financing a business is much the same. The borrower accepts funds from an outside source and promises to repay the principal plus interest, which represents the "cost" of the money you initially borrowed.

Borrowers will then make monthly payments toward both interest and principal, as well as put up some assets as collateral as reassurance to the lender. Collateral can include inventory, real estate, accounts receivable, insurance policies or equipment, which will be used as repayment in the event the borrower defaults on the loan.

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Alternatives to business loans include *m*erchant cash advances, personal lines of credit and business credit cards. With some of the alternative financing methods, borrowers may be required to make weekly payments or repay a percentage of their profits, rather than make fixed monthly payments.

### Pros and cons of debt financing

Debt financing is widely available in one form or another for most small business owners. It is a popular avenue for many businesses because the terms are often clear and finite, and owners retain full control of their operations unlike an equity financing arrangement.

However, the repayment and interest terms can be steep depending on the loan. Borrowers typically begin making payments the first month after the loan has funded, which can be challenging for a start-up because the business isn't on firm financial footing yet.

Another disadvantage of debt financing is the potential for personal financial losses if it becomes impossible to repay the loan. Whether a business owner is risking their personal credit score, personal property or previous investments in their business, it can be devastating to default on a loan.

## What is equity financing?

Equity financing means selling a stake in your company to investors that hope to share in the future profits of the business.

There are several ways to obtain equity financing, such as through a deal with a venture capitalist or equity crowd funding.

Business owners who go this route won't have to repay money in regular instalments or deal with steep interest rates.

Instead, investors will be partial owners who are entitled to a portion of company profits and, perhaps, even a voting stake in company decisions depending on the terms of the sale.

Angel investors and venture capitalists are often on the lookout for start-ups with the potential to grow to great heights rapidly, if only they had the capital investment required to scale.

To convince an angel or VC to invest, entrepreneurs will need a pro forma with solid financials, some semblance of a working product or service, and a qualified management team.

Angels and VCs can be difficult to contact if they're not already in your network, but incubator and accelerator programs have cropped up to coach start-ups on streamlining their operations and getting in front of investors.

Another version of equity financing, known as [equity crowd funding](https://www.businessnewsdaily.com/9415-title-3-equity-crowdfunding-business.html), allows businesses to sell very small shares of the company to many investors throughout their state.

These campaigns usually require immense marketing efforts and a great deal of groundwork to hit the intended goal and become funded. The specifics of equity crowd funding are laid out under Title III of the JOBS Act.

### Pros and cons of equity financing

Unlike debt financing, equity financing is a lot harder to come by for most businesses. This type of funding is well suited for start-ups in high growth industries, such as the technology sector, and it requires a strong personal network, an attractive business plan, and the foundation to back it all up.

However, companies that score investments will have capital on hand to scale up and will not be required to start paying it back (with interest) until the business is profitable.

Equity financing allows the business owner to distribute the financial risk among a larger group of people. When you aren't making a profit, you don't have to make repayments. And if the business fails, none of the money needs to be repaid.

Business owners should be careful when selling shares of the company. If they relinquish more than 49 present of the business, even to separate investors, they will lose their majority stake in the company.

That means having less control over company operations and, potentially, risking removal from a management position if the other shareholders deem it prudent to change leadership.

Ultimately, the decision between whether debt or equity financing is best depends on the type of business you have and whether the advantages outweigh the risks. Do some research on what is the norm in your industry, and what your competitors are doing?

Investigate several financial products to see what suits your needs, and if you are considering selling equity, do so in a manner that is legal and allows you to retain control over your company.

**10. Discuss the role of an underwriter in managing an IPO.**

The Initial Public Offering (IPO) for a new [public company](https://www.wisegeek.com/what-is-a-public-company.htm) is the first opportunity for the investing public to be able to purchase [shares](https://www.wisegeek.com/what-are-shares.htm) in the company. An IPO is a very exciting time for the company, and IPOs are often eagerly anticipated by the investing public as well.

There are several reasons for which a [private company](https://www.wisegeek.com/what-is-a-private-company.htm) may wish to become a public company. The two biggest reasons are to raise capital and to allow the original investors or [entrepreneurs](https://www.wisegeek.com/what-is-an-entrepreneur.htm) who started the company to realize profits on their investment and time.

A private company is one in which investment or ownership is limited to select individuals or organizations. A public company is one in which anyone can invest and obtain ownership by purchasing shares on a publicly traded exchange.

Undertaking an IPO is a large and exciting event for a new company. A well-received IPO means that the company will have cash to further its development and growth. It also usually means that the people who started the company realize some significant profits for their efforts.

An IPO requires a great deal of work, from filing the necessary paperwork with the regulatory bodies and writing a prospectus for potential investors to devising and implementing a sales campaign for the sale of the initial shares.

The investing public is usually excited about an IPO. It is hard to understand why, since most stocks that are sold during an IPO tend to perform badly at first.

Some companies also do not survive, so investing in an IPO is more risky and usually less rewarding then investing in more established stocks.

Perhaps investors believe the sales hype that usually accompanies an IPO. Perhaps they are excited about being among the first to own the next potential IBM or Microsoft.

Some IPOs do very well right from the start, and it is these IPOs that are remembered. The IPOs that fail are quickly forgotten, while stories of successful IPOs are re-told and their returns frequently exaggerated. Sometimes, investing is like fishing, more hype than fact.

**11 Why is a stock exchange an important institution of the capital markets?**

The following are some of the important functions of stock exchange. For more, refer this article: [What are the functions of stock exchange?](https://accountlearning.com/what-are-the-functions-of-stock-exchange/)

**1. Determination of Fair price**

Stock exchanges help to discover fair prices for securities traded on them. Continuous trading activity in stocks and [debentures](https://accountlearning.com/brief-explanation-of-various-types-of-debentures/) helps in ascertaining price of securities.

**2. Industrial financing**

Industrial development of a country depends on the availability of capital. [Stock exchanges](https://accountlearning.com/stock-exchange-meaning-definition-various-aspects/) provide the required capital for investment in industries. Industries are assured of [long term capital](http://mymbaguide.com/sources-long-term-finance-advantages/) essential for industrial and economic development.

**3. Regulation of the corporate sector**

Every listed company in a stock exchange has to file documents in the stock exchange such as annual returns, and provide information regarding plans to merge with or acquire other companies, change in management, and plans to enter into new businesses. This enables investors to plan their future investment based on information provided by the companies to the stock exchange.

**4. Optimum resource allocation**

Stock exchanges enable optimum allocation of scare capital resources. Capital is the life blood of all businesses. Stock exchanges aid in the allocation of capital to companies which are performing well and have potential for profitable growth in the future.

**5. Investor education**

Stock exchanges provide vital information to the investors in their web sites, [advertise in newspapers](https://accountlearning.com/merits-demerits-advertising-newspapers/) and business magazines regarding the dos and don’ts in investing and encourage conduct of investor awareness programmes. This enables investors both in the urban as well in rural areas to become aware of stock market investment and make prudent investment decisions.

**6. Mobilization of savings**

Stock exchanges play an important role in mobilizing savings of individuals and institutions. Savings so mobilized can be utilized to invest in various projects boosting industrial and [economic development of a country](https://accountlearning.com/role-of-financial-system-in-economic-development-of-a-country/).

**7. Protection of investors**

Companies which are [listed in the stock exchanges](https://accountlearning.com/listing-of-securities-conditions-types-procedures/) have to comply with various rules and regulations. They have to submit various documents and returns and provide information regarding any important activity they plan to undertake. Stock exchanges have formulated regulations to ensure safety of investors’ funds.

**8. New venture creation**

Stock exchanges enable creation of new ventures. Any new venture requires financing. Stock exchanges are an important avenue for new ventures to raise capital for meeting their capital needs. The stock exchange has aided new venture creation by enabling promoters to raise the required funds.

For e.g. the phenomenal growth of Reliance can be attributed to the public issues of shares on a large scale which provided the company large funds to employ in large scale projects.

**9. Meeting financial needs of government**

The government requires funds to undertake various projects and government companies need funds for expansion, diversification etc. The Central and State governments, municipal corporations, state financial corporations etc. have raised cores through the issue of shares, bonds etc.

**10. Liquidity**

Stock exchanges provide liquidity to investments made by investors. They serve as a platform where buyers and sellers of securities come into contact to buy and sell securities. Therefore any person who owns a security can sell his security in a stock exchange and convert into cash.

**11. Facilitate transfer of ownership**

Stock exchanges facilitate transfer of ownership of stocks, shares and securities. Securities are regularly traded on stock exchanges which help both the buyers and sellers of securities.

**12. Opportunity to create wealth**

Stock exchanges enable public to share in the wealth created by the corporate sector. They help investors who are spread across the length and breadth to purchase securities issued by companies. [Dividends](https://accountlearning.com/rules-regarding-declaration-payment-dividend/), [bonus shares](https://accountlearning.com/sebi-guidelines-regarding-issue-bonus-shares/) and benefit of increase in share prices are enjoyed by investors.

**13. Industrial development**

Industrial development depends on the availability of funds for investment. Stock exchanges enable organizations to issue various types of securities according to their requirements and raise the necessary funds. Thus they aid in the economic development of a country.

**14. Attracting foreign investment**

Stock exchanges aid in attracting [foreign investment](https://accountlearning.com/factors-influencing-foreign-direct-investment-in-a-country/). They enable foreign institutional investors (mutual funds, pension funds, hedge funds, corporate of other countries) to invest in securities of Indian companies. Thus they provide an opportunity to companies to attract foreign investment.

**15. Reduced dependence on debt**

Stock exchanges provide opportunity to companies to raise ownership capital. They enable organizations to reduce their dependence on debt.

**16. Serves as an economic barometer**

Stock exchange indexes act as an economic barometer of an economy. By looking at the index one can judge the health of the corporate sector. The index is now at around 10,000 points which reflects the healthy trend prevailing in the economy.

**17. Aid valuation of corporate**

During [mergers](https://accountlearning.com/7-different-types-of-mergers-with-examples/), [acquisitions](https://accountlearning.com/what-are-the-pitfalls-of-mergers-and-acquisitions/) and takeovers, valuation of companies presents a challenge. Since securities of corporate are traded on a stock exchange and quotations of share prices are made available by the stock exchange, valuation of companies becomes easier.

**18. Facilitates expansion and diversification**

Stock exchanges facilitate expansion and diversification of organizations. They aid organizations in issuing securities to tap the savings of investors. Funds so collected can be utilized for expansion and diversification activities.

**19. Motivates better performance**

Share prices of companies are influenced by their performance. Companies which report better performance on a sustained basis, find their share prices increasing, whereas companies which are not performing well find their share prices declining. Since share prices are in the public domain and investors keep monitoring prices of securities, it serves as a motivation to companies to improve their performance.

REFFERENCE PAGES

1. <http://www.businessdictionary.com/definition/net-present-value-NPV.htm>
2. <https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=3&ved=2ahUKEwi0nc6wgMvjAhWLN8AKHVdBAaIQFjACegQIDBAH&url=https%3A%2F%2Fwww.wallstreetmojo.com%2Fweighted-average-cost-capital-wacc%2F&usg=AOvVaw0X_hqGksHixieK4UDMUrbU>
3. <https://www.wallstreetmojo.com/weighted-average-cost-capital-wacc/>