**The Weighted Average Cost of Capital (or WACC)**

E = market value of the firm’s equity

D = market value of the firm’s debt

rE =firm’s cost of equity

rD = firm’s cost of debt

TC = firm’s corporate tax rate

The WACC and its components should be based on current expectations and not driven solely based on historic outcomes.

**Cost of Debt**

The cost of debt can be estimated based on the yield-to-maturity on a firm’s existing bonds, based on the rate that the firm is currently paying on its debt, or based on the current or estimated bond rating of the firm.

**Cost of Equity**

Gordon Growth Model

Rearranging the Gordon Growth Model:

or or

For a constant growth company, the dividend growth rate is equal to the capital gains yield.

What else can we use for growth?

Capital Asset Pricing Model

rf is the risk-free rate

βE is the beta of the firm, which is a measure of the firm’s equity sensitivity to market fluctuations. It is estimated using the market model:

E(rM) is the expected return on the market portfolio

E(rM­)-rf is the Equity Risk Premium or the Market Risk Premium and is the additional return above the risk-free rate that investors are expected to require to take on the risk of the average investment.

What is the risk-free rate?

What is the Equity Risk Premium?