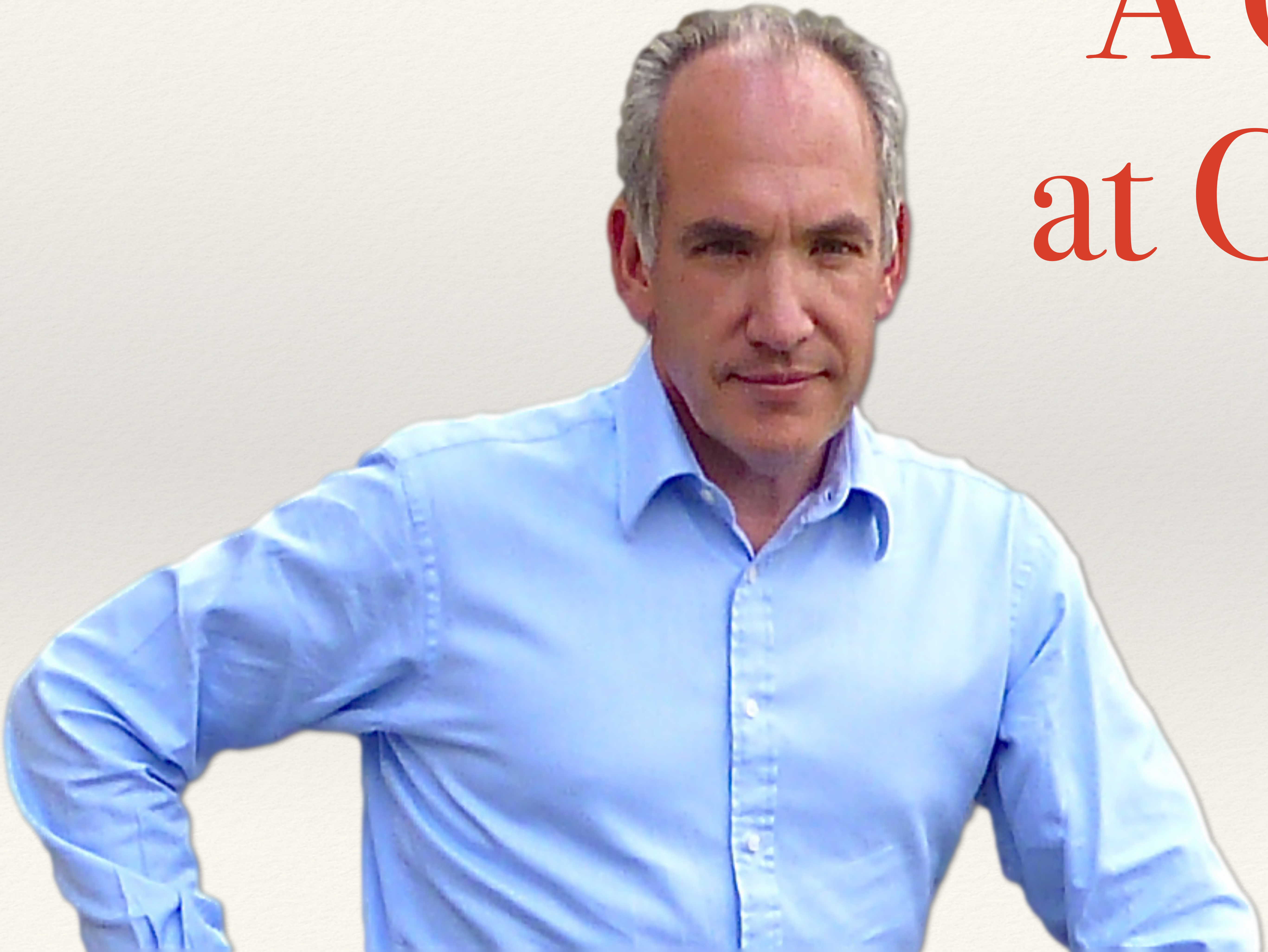


A Critical Look at Cost of Capital

A Critical Look at Cost of Capital

- As you learn more about valuation, the more you will realise it is more of an art than a science
- That is to say that there is no correct answer
- You should always keep a critical eye on concepts, formulas and assumptions

A Critical Look at Cost of Capital

- So lets spend a little time looking at Cost of Capital critically

A Critical Look at Cost of Capital

- You cannot go any where is valuation without considering cost of capital, hurdle rates, ROI, NPV and they all rely on the same concept
- Discounting to the present value to account for the time value of money

A Critical Look at Cost of Capital

- The subjectivity of the CAPM leaves it wide open for debate
  - Risk Free Rate
  - Country Risk Premium
  - Equity Risk Premium
  - Company Specific Beta
- Small changes can make significant differences to result of your valuation

A Critical Look at Cost of Capital

- I do not have all the answers but I do want to challenge you to think critically

A Critical Look at Cost of Capital

- In the CAPM
  - A 10 year treasury bill or UK Government gilt cannot be "risk free" as it is still at risk from inflation. There is a premium for the 10 year bond which is not in the shorter term bonds which recognises this
  - If you take weekly or monthly betas - you get completely different results - oops! If markets were truly efficient this would not be the case
  - The Equity Market Risk Premium is wide open to debate at 5.6%
  - As soon as you start making further adjustments for country risk or small company risk, arguably you move into the realm of pure guess work.

A Critical Look at Cost of Capital

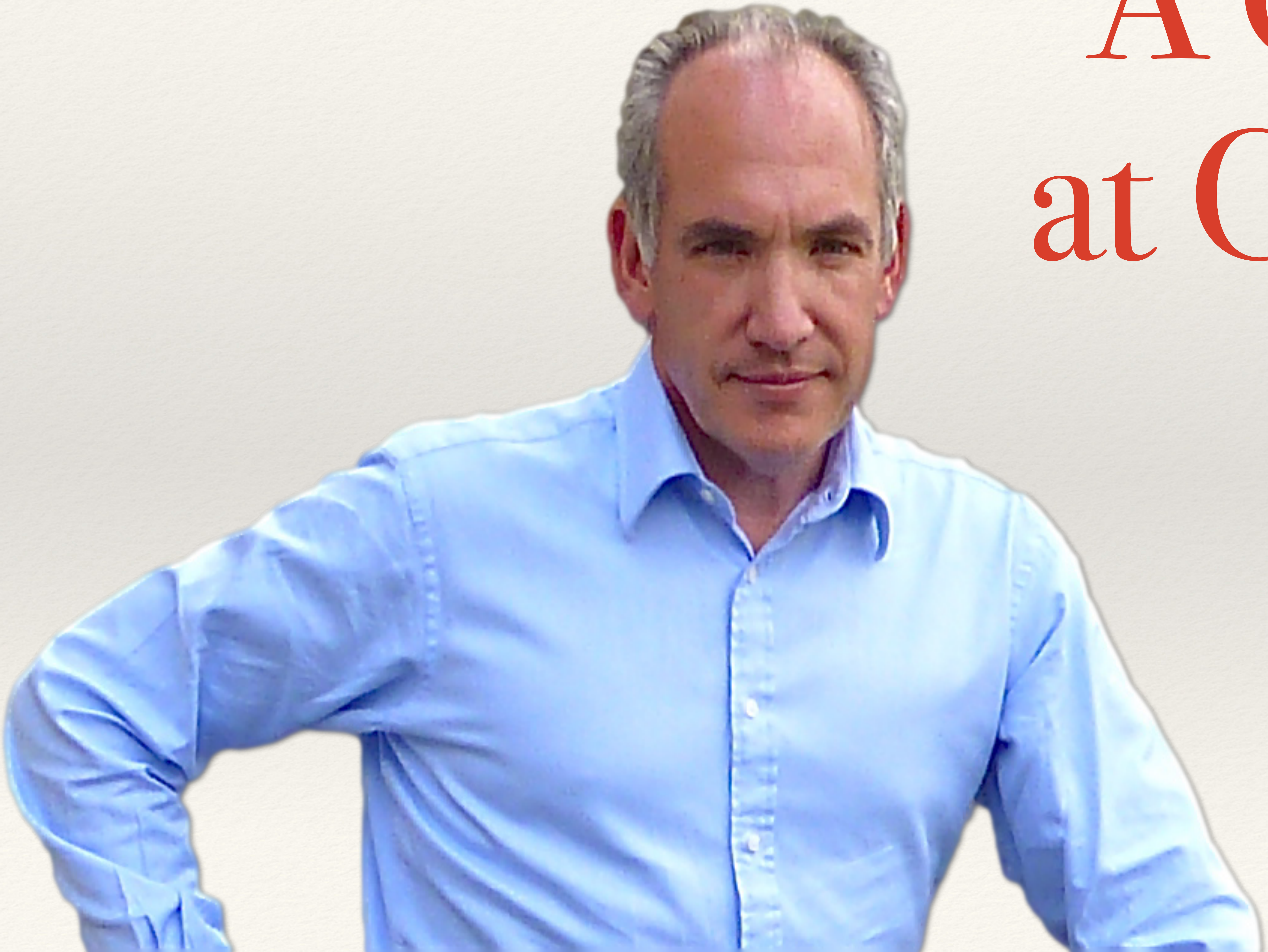
- This error is compounded by assumptions relating to the Terminal Value
- The Perpetual Growth Model assumes constant growth of the firm in perpetuity which at best is simplistic
- Any analysis of any firm will show you that historically there has never been a period when any firm grew at a constant rate of growth for multiple periods.

A Critical Look at Cost of Capital

- Further more when we calculate the cost of equity using the CAPM we include a beta for the company specific risk
- I do not understand why we do not use a similar (but not the same) beta for the debt part of the equation when it comes to the WACC
- The more leverage in a firm, the higher the risk of default and so the greater the risk.
- This should be reflected in the cost of debt in my view

A Critical Look at Cost of Capital

- As we have seen, small changes to the WACC have profound implications for our valuation
- I believe that you should be prepared to challenge the assumptions behind the calculation of every hurdle rate
- Too often they are arbitrarily adjusted and left unquestioned



A Critical Look at Cost of Capital