

7%

Cost of Debt and Equity

2

3%

The Cost of Equity

It is defined as the returns that shareholders are entitled to basing on the amounts of their investment. In reality the Cost of equity is a cost to the Company. Calculations for the cost of equity are done in two ways;

- Dividend Valuation model
- Capital Asset Pricing model

Applying the CAMP Model we have the following results;

5%

$$k_e = (R_m - R_f) * \text{Beta}$$

R_m is the market return while R_f is the Risk Free Return

(Pandey, 2009).

Applying the Dividend Model of valuation

6%

$k_e = \text{Dividend per share divided by the current market value of stock plus the growth rate of those dividends}$

Cost of Debt

Borrowings that a company incurs to finance its projects are referred to as debts. The resulting interest that an organization pays to those borrowings is the cost of debt.

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Prep. ETS

Cost of Debt and Equity

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Notes

- In scenarios where the company is financed fully by equity, then resulting capital cost is that cost of equity
- In scenarios where the corporation is financed by debts, ^{4%} then the resulting cost of capital will be that cost of debt.
- ^{3%} If an organization uses both debt and equity financing then the cost of capital will be calculated using the WACC.

^{4%}

Frag. (ETS)

Weighted Average Cost of Capital

Article Error (ETS)

It is a combination of both equity and debt. WACC is the required Rate of Return by the help of

discounting cash flows gotten from NPV Projects.

^{5%}

$$WACC = k_e * \text{Equity} / \text{Equity} + \text{Debt} + K_d (1-t) * \text{Debt} / \text{Equity} + \text{Debt}.$$

Cost of Debt and Equity

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Reference

Pandey, I, M. (2009) *Financial Management*. Vikas Publishing House: Business Enterprise

Cost of Debt. Web Link: <http://www.investopedia.com/terms/c/costofdebt.asp>