

# ESTIMATING THE COST OF CAPITAL

## General approach

- Find levered cost of equity  $r_e(L)$ .
- Find cost of debt  $r_D$
- Calculated WACC:

$$WACC = r_e(L) \frac{E}{D + E} + r_D (1 - t_c) \frac{D}{D + E}$$

- Discount FCFs at WACC to get total value of firm
- Derive cost of shares by subtracting value of more senior claims (Debt, Preferred Stock, Warrants, etc.)

### 3 METHODS FOR CALCULATING THE COST OF CAPITAL

1. CAPM: Capital Asset Pricing Model
2. Use Gordon model and variations.
3. P/E model

**THERE ARE MANY VARIATIONS ON THESE  
METHODS!**

## 4 EASY STEPS TO CALCULATING THE COST OF CAPITAL WITH A P/E MODEL

(isn't it about time for an end to this "easy step"  
business?!)

1. Estimate the dividend payout ratio,  $b$ .
2. Estimate the growth of future earnings,  $g$ .
3. Calculate the cost of equity  $r_e(L)$ .

$$r_e(L) = \frac{b(1+g)}{P/E} + g$$

Note: Use *trailing* P/E (see chapter 9).

4. Calculate WACC as before.