

The Cost of Equity Concept

Cost of Equity (CoE) is a benchmark to assess whether holding a firm's stock as an investment makes sense. If the return of the respective investment - the return on equity - at least matches CoE, then the engagement seems reasonable, otherwise not.

Holding equity embeds rights and rewards, but also risks: On the one hand, shareholders are allowed to vote in shareholder meetings on all major issues concerning the company and can direct questions to the board. In addition, they have a right for their portion of dividends, provided shareholders agree to the board's proposal that such will be paid out. Hence, next to receiving cash dividends, shareholders can pro-actively influence a firm's strategy by voting in a way which should create value, eventually to be reflected in a positive share price momentum.

Shareholders also assume substantial risks, even though they cannot lose more than the amount they have invested: A firm cannot force shareholders to provide any additional funds, such as in case of financial distress. Also, a share price can never fall below zero. – But in a worst-case scenario (i.e. the liquidation of a firm in the course of a bankruptcy) shareholders may be left with nothing at all. Their position is at the very bottom of a distribution cascade (waterfall), with de-facto all other claims having priority, such as those by banks, bondholders, employees, social security, or tax authorities. Only once these priority claimants have been satisfied, shareholders will receive what's left.

This is also the reason why CoE must be higher than cost of debt, as any creditor will be in a better, more favorable position, if a firm were liquidated: Hence, shareholders assume the highest, the ultimate risk.

Developing the theoretical framework behind the CoE concept and eventually making it applicable by means of concrete, numerical figures took a few

Nobel Prize laureates some decades. Whereby the structure of the CoE formula - as it is common today - combines the concepts of the risk-free rate, the beta factor and the market risk premium. Despite the approach having its flaws, most financial investors, professionals and analysts have ever since applied it.

To start with, a shareholder must receive at least the yield achievable by investing in the least risky investment alternative available in capital markets: The yields of long-term government bonds, referred to as risk-free rate. – Further, for assuming (substantial) additional risks, a so-called market risk premium will be added. This premium is derived by subtracting the average historical risk-free rate from the average historical return of the stock market (reflected in various indices). – And finally, as there are more and less risky industries or companies to invest in (e.g. the risk profile of a stable, well-diversified food producer markedly differs from that of a firm operating in the cyclical and highly volatile luxury goods sector) the market risk premium is adjusted by a multiplier, referred to as beta factor. The beta indicates whether the return of a specific stock or investment is more, less or equally volatile (i.e. risky) as the average return of a well-diversified market portfolio (e.g. some credible, established index). Beta will also rise with a firm's indebtedness or its leverage increasing.

Once the (current or expected) return of investing in a stock, the return on equity (net income / equity), exceeds CoE, then this investment may be deemed as reasonable.

NOTE: Could it be that in a year in which a company didn't pay dividends, its equity was (from the corporate's perspective) actually "for free"? – No. At best, that corporate's cash costs of equity were "for free", but not its equity as such. Instead, shareholders would expect to be compensated with an increase in the corporate's share price or net profits not paid out as dividends to accrue in the retained earnings position. – CoE has nothing to do with dividend payments as such: Instead, this is a conceptual, benchmark-driven approach.

COST OF EQUITY

$$\text{RISK FREE RATE (RFR)} + \text{BETA} \times \text{MARKET RISK PREMIUM (MARKET RETURN - RFR)}$$

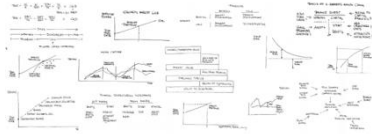
LONG-TERM
GOVERNMENT BOND
AS PER
EXPECTED
HOLDING PERIOD

EARNINGS
VOLATILITY
(COMPANY,
INDUSTRY)
↳
LEVERAGE

INDEX SELECTION

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