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

RISK FREE RATE (RFR) + BETA × MARKET RISK PREMIUM (MARKET RETURN − RFR)

LONG-TERM GOVERNMENT BOND AS PER EXPECTED HOLDING PERIOD

EARNINGS VOLATILITY (COMPANY, INDUSTRY) & LEVERAGE

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