Cost of Equity Concept

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

Holding equity comes along with rights and rewards, but also embeds risks: To start with, shareholders may direct questions to the board and vote in shareholder meetings on all major issues concerning the company. Further, they have a right for their portion of dividends, provided they agree to the board´s proposal that such should 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 reflected in a positive share price momentum.

Shareholders also assume substantial risks, even though they cannot lose more than the amount they invested: A firm cannot force shareholders to provide additional funds, even in times of financial distress. Also, a share price cannot fall below zero. – However, in a worst-case scenario (i.e. the liquidation of a firm due to bankruptcy) shareholders may be left with nothing. With de-facto all other claims having priority, such as those by banks, bondholders, employees, social security, or tax authorities, shareholders are positioned at the very bottom of the distribution cascade (also referred to as: waterfall). Only once all priority claimants have been satisfied, shareholders will receive what´s left.

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

Developing the theoretical framework behind the CoE concept and eventually making it applicable on the basis of concrete, numerical figures required the joint effort of several Nobel Prize laureates. Whereby the structure of the CoE formula - as it is fairly 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 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 (as per various indices). - And finally, as one can invest in more and less risky industries or companies (e.g. the risk profile of a stable, well-diversified food producer markedly differs from that of a firm operating in the cyclical, highly volatile luxury goods sector) the market risk premium is adjusted by a multiplier, referred to as: beta factor. This factor 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 when 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, CoE 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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