

Lecture 03

Wacc : Definition and Importance

Weighted Average Cost of Capital (WACC) is the average rate that a company is expected to pay to finance its assets from all sources of capital, including equity and debt. It represents the company's overall cost of capital, weighted by the proportion of each capital source in its capital structure

- WACC shows the average after-tax cost a company incurs to finance its operations through various capital sources such as common stock, preferred stock, and debt.
- It's used as a hurdle rate for investment decisions, helping companies and investors evaluate whether projects or acquisitions are worthwhile by comparing expected returns with the WACC

A higher WACC indicates higher risk and cost of financing, while a lower WACC suggests cheaper financing and lower risk

$$WACC = \left(\frac{E}{V} * Re\right) + \left(\frac{D}{V} * Rd * (1 - Tc)\right)$$

Where:

- E = Market value of equity
- D = Market value of debt
- $v=E+D$ = Total market value of the company's financing (equity + debt)
- Re = Cost of equity (expected return required by shareholders)
- Rd = Cost of debt (interest rate on debt)
- Tc = Corporate tax rate (because interest is tax-deductible)

Key Academic Differences

Aspect	Financial Structure	Capital Structure
Scope	Includes all liabilities (short-term and long-term) plus equity	Includes only long-term liabilities and equity
Components	Short-term loans, trade payables, long-term debt, equity	Long-term debt, common and preferred equity, retained earnings
Representation	Represents total financial obligations	Represents permanent financing mix
Objective	Ensures liquidity and ability to meet both short- and long-term obligations	Optimizes mix of long-term debt and equity for cost and control
Balance Sheet	Covers entire liabilities section plus equity	Part of the liabilities and equity section focusing on long-term funds

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Financial Strategy