Cost of Capital

Applications and Examples

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marketability from the estimated publicly traded equivalent value. Two sets of studies to provide quantitative guidance for this are:

a. Restricted stock studies

b. Pre–IPO studies

2. *Adjust the discount rate.* Add percentage points to the discount rate used to discount the expected cash flows to present value.

A commonly used estimate of the minimum increase in the cost of equity for the lack of marketability of the subject closely held investment is to adjust the cost of equity for hypothetical flotation costs. This adjustment is recognition that the cost of capital for an illiquid investment is greater than the cost of equity capital for publicly traded companies. Flotation costs occur when a company issues new stock. The business usually incurs several kinds of flotation or transaction costs, which reduce the actual proceeds received by the business. Some of these are direct out-of-pocket outlays, such as fees paid to underwriters, legal expenses, and prospectus preparation costs. Because of this reduction in proceeds, the business's required returns must be greater to compensate for the additional costs. Flotation costs can be accounted for either by amortizing the cost, thus reducing the net cash flow to discount, or by incorporating the cost into the cost of equity capital. Since flotation costs typically are not applied to operating cash flow, they must be incorporated into the cost of equity capital. The cost of flotation is a function of size and risk. The greater the size of the hypothetical stock offering, the lower the flotation cost relative to the size of the offering. Obviously the flotation cost estimate understates the appropriate increase in the cost of equity capital due to lack of marketability in cases where the subject closely held business could never become public. In addition, the owner of a minority interest could never cause the business to become public.

We also discussed results of Ashok Abbott's study of the cost of illiquidity for public companies.