# Transcript: IT Pod - EP 170 - C928 - P2\_mixdown - cost of capital-145343

*The following transcript is a verbatim account of the video or audio file accompanying this transcript.*

Speaker #1 (Narrator):

WGU’s IT audio series, flexible, portable, profound.

Speaker #2 (Lavender):

Hi, this is Lavender. I'm a program mentor in the MSITM program here at WGU. With me today is Jerry Geyser.

Speaker #3 (Jerry Geyser):

Hello, Lavender.

Speaker #2 (Lavender):

We're going to talk today about everyone's favorite course, C928 financial management for IT professionals. In this podcast, we're going to tackle Section E, cost of capital. The first two parts of that. We're going to discuss some definitions and some concepts. Jerry, why don't you tell us a little bit about that.

Speaker #3 (Jerry Geyser):

Thank you Lavender. The first part that we want to talk about is how to find the material to support the task. We go into our course material button and then we go to Section 7, expand the arrow next to less than one, and then go to reading and resources and click on the link "Cost of Capital". What will come up is a video and you'll go to Section 4 of that video and then you'll find the WACC and the MCC. Let's first talk about the MCC. There is a formula that the companies used to generate the cost of capital. That's beyond the scope of this course. What we're looking for is for you guys to provide a definition of the MCC. This area is often overlooked by students. Usually it causes revisions because people do not take the time and give a detailed explanation of the MCC. What the MCC is. Let's think about it this way. If a company is raising money to do a project, the cost of capital to do that project has to be a certain amount and any project over that, the internal rate of return has to be higher than what they project as the amount that they need in return. In this case, when you invest in a particular project, the project, let's say you have three projects and the projects are seven percent, nine percent, 10 percent. Your WACC, which we'll describe in just a second, comes back at 6.4 percent. All three of those projects would qualify because they're higher on their internal rate of return than the WACC. But the problem is that the cost for raising capital does not stay the same. It becomes more expensive, the more projects you do. Eventually, the rate of return drops below the cost and that is what the MCC is. If you watch this video, you'll get the explanation of it, understand its role, and then all you have to put in for that part is the definition and explanation of it. That leads us into the next situation where we talk about the WACC. We use three elements to complete Section E. We use the cost to equity, the cost of debt, and the cost of preferred stock. Now, the companies that we use by default do not issue preferred stock, they issue common stock. But for this exercise, we use preferred stock. You will use all three components. On the financial formula sheet, there is a formula for the WACC that includes all three components and includes the cost of equity, the cost of debt, and the cost of preferred stock. All three of those are given to you on the financial fact sheet. The stuff that you have to come up with, or your formula and this goes back to the WACC, is you have to come up with the weighted amounts or the percentages of each of those that will make your project. I get a lot of questions that say, well, what is the correct amount? The overall picture that we want you to get to, is we want your project going back to the internal rate of return. The internal rate of return has to be higher than the marginal cost of capital. For our exercise, what we're looking for is your WACC, the land somewhere between six and 12 percent. That will keep your project profitable and then you can keep moving forward as you're building your portfolio. The balance that you want a strike is that each element will have to add up to 100 percent. If you said, I wanted to say let me use 40 percent equity, 40 percent debt, and 20 percent preferred stock. As long as your final whack number ends up between six and 12 percent, you're fine. If you said 80,10,10 again, this same rule applies. Two things have to happen. It has to add up to a 100 percent and the WACC has to land somewhere between 6-12 percent. Now, the logic behind what we're doing or to the extent that we're talking about will go in detail in another podcast. But for now, I think this is a good start to understanding both the MCC and the WACC. If you have any additional questions, feel free to reach out to your CI and thank you for joining us today.

Speaker #2 (Lavender):

Now, thank you, Jerry. That was really informative. Everyone, I hope you all learned something and have a great day. Thank you.

Speaker #1 (Narrator):

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