# Contents

About the Authors xiii  
Foreword xxiii  
Preface xxv  
Acknowledgments xxix

## PART ONE  
Cost of Capital Basics 1  
CHAPTER 1  
Defining Cost of Capital 3  
CHAPTER 2  
Introduction to Cost of Capital Applications: Valuation, Project Selection, and Ratemaking 11  
CHAPTER 3  
Net Cash Flow: The Preferred Measure of Economic Income 17  
APPENDIX 3A  
Alternative Measures of Economic Income 30  
CHAPTER 4  
Discounting versus Capitalizing 36  
APPENDIX 4A  
Equivalency of Capitalizing Residual Income 56  
CHAPTER 5  
Discounting—Beyond the Basics 60  
CHAPTER 6  
Relationship between Risk and the Cost of Capital 70
PART TWO

Estimating the Cost of Equity Capital 89

CHAPTER 7
Risk-free Rate 91

CHAPTER 8
Equity Risk Premium 110

APPENDIX 8A
Deriving ERP Estimates 141

APPENDIX 8B
Other Sources of ERP Estimates 173

CHAPTER 9
Build-up Method 177

CHAPTER 10
Capital Asset Pricing Model 189

CHAPTER 11
Beta: Differing Definitions and Estimates 202

APPENDIX 11A
Examples of Computing OLS Beta, Sum Beta, and Full-information Beta Estimates 225

APPENDIX 11B
Estimating Beta: Interpreting Regression Statistics 234

CHAPTER 12
Unlevering and Levering Equity Betas 243

CHAPTER 13
Criticism of CAPM and Beta versus Other Risk Measures 269

APPENDIX 13A
Example of Computing Downside Beta Estimates 298

CHAPTER 14
Size Effect 301
<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>15</td>
<td>Criticisms of the Size Effect</td>
<td>331</td>
</tr>
<tr>
<td>15A</td>
<td>Other Data Issues Regarding the Size Effect</td>
<td>363</td>
</tr>
<tr>
<td>16</td>
<td>Company-specific Risk</td>
<td>372</td>
</tr>
<tr>
<td>17</td>
<td>Distressed Businesses</td>
<td>400</td>
</tr>
<tr>
<td>17A</td>
<td>Cost of Capital and the Valuation of Worthless Stock</td>
<td>428</td>
</tr>
<tr>
<td>18</td>
<td>Other Methods of Estimating the Cost of Equity Capital</td>
<td>444</td>
</tr>
<tr>
<td>19</td>
<td>Using the Duff &amp; Phelps Risk Premium Report Data</td>
<td>471</td>
</tr>
<tr>
<td>19A</td>
<td>Examples Using the Duff &amp; Phelps Risk Premium Report Data</td>
<td>499</td>
</tr>
<tr>
<td></td>
<td><strong>PART THREE</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Estimating the Overall Cost of Capital</td>
<td>519</td>
</tr>
<tr>
<td>20</td>
<td>Other Components of a Business’s Capital Structure</td>
<td>521</td>
</tr>
<tr>
<td>21</td>
<td>Weighted Average Cost of Capital</td>
<td>544</td>
</tr>
<tr>
<td>21A</td>
<td>Iterative Process Using CAPM to Calculate the Cost of Equity Component of the Weighted Average Cost of Capital</td>
<td>576</td>
</tr>
<tr>
<td></td>
<td><strong>PART FOUR</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Estimating the Cost of Capital—Non-Freely Traded Interests</td>
<td>609</td>
</tr>
<tr>
<td>22</td>
<td>Handling Discounts for Lack of Marketability and Liquidity for Minority Interests in Operating Businesses</td>
<td>611</td>
</tr>
<tr>
<td>CHAPTER 23</td>
<td>Cost of Capital of Family Holding Company Interests</td>
<td>630</td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>CHAPTER 24</td>
<td>The Private Company Discount for Operating Businesses</td>
<td>650</td>
</tr>
<tr>
<td>CHAPTER 25</td>
<td>Cost of Capital of Interests in Pass-through Entities</td>
<td>663</td>
</tr>
<tr>
<td>CHAPTER 26</td>
<td>Relationship between Risk and Returns in Venture Capital and Private Equity Investments</td>
<td>680</td>
</tr>
<tr>
<td>CHAPTER 27</td>
<td>Cost of Capital for Closely Held Businesses</td>
<td>693</td>
</tr>
<tr>
<td>PART FIVE</td>
<td>Corporate Finance Officers: Using Cost of Capital Data</td>
<td>711</td>
</tr>
<tr>
<td>CHAPTER 28</td>
<td>Capital Budgeting and Feasibility Studies</td>
<td>713</td>
</tr>
<tr>
<td>CHAPTER 29</td>
<td>Cost of Capital for Divisions and Reporting Units</td>
<td>722</td>
</tr>
<tr>
<td>CHAPTER 30</td>
<td>Cost of Capital for Fair Value Reporting of Intangible Assets</td>
<td>757</td>
</tr>
<tr>
<td>CHAPTER 31</td>
<td>Cost of Capital in Evaluating Mergers and Acquisitions</td>
<td>779</td>
</tr>
<tr>
<td>CHAPTER 32</td>
<td>Cost of Capital in Transfer Pricing</td>
<td>793</td>
</tr>
<tr>
<td>APPENDIX 32A</td>
<td>Cost of Capital in Transfer Pricing Example</td>
<td>822</td>
</tr>
<tr>
<td>CHAPTER 33</td>
<td>The Role of the Cost of Capital in EVA and in Corporate Value-Based Management</td>
<td>825</td>
</tr>
<tr>
<td>PART SIX</td>
<td>Other Cost of Capital Considerations</td>
<td>839</td>
</tr>
<tr>
<td>CHAPTER 34</td>
<td>Estimating Economic Income</td>
<td>841</td>
</tr>
</tbody>
</table>
CHAPTER 35
Minority versus Control Implications of Cost of Capital Data 861

CHAPTER 36
How Cost of Capital Relates to the Excess Earnings Method of Valuation 873

CHAPTER 37
Adjusting the Discount Rate to Alternative Economic Income Measures 881

PART SEVEN
Considerations in Special Applications 897

CHAPTER 38
How Courts View Cost of Capital 899

CHAPTER 39
Global Cost of Capital Models 1011

CHAPTER 40
Cost of Capital of Real Property—Individual Assets 1052

APPENDIX 40A
Valuing Real Property 1076

CHAPTER 41
Cost of Capital of Real Estate Entities 1084

APPENDIX 41A
Valuing Real Estate Entities 1122

PART EIGHT
Case Studies 1129

CHAPTER 42
Cost of Capital for a Mid-Sized Company 1131

APPENDIX 42A
Report for Cost of Capital for a Mid-Sized Company 1138

CHAPTER 43
Cost of Capital for a Smaller-Sized Company 1162

APPENDIX 43A
Report for Cost of Capital for a Smaller-Sized Company 1168
PART NINE

Advice to Practitioners 1179

CHAPTER 44
Common Errors in Estimation and Use of Cost of Capital 1181

CHAPTER 45
Advice on Dealing with Cost of Capital Issues 1199

APPENDIX I
Bibliography 1213

APPENDIX II
Data Resources 1239

APPENDIX III
Glossary of Cost of Capital Terms 1253

About the Website 1266

Index of Cases 1267

Index 1271