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Cost of capital against the backdrop of highly volatile financial variables



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The current economic climate dictates the re-estimation of the cost of capital

The returns required by businesses on their investments constitute a key input to corporate decision-making. These returns are mirrored in the cost of capital used by companies to analyse their investments.

Companies should review their cost of capital regularly in order to evaluate whether financial and sector conditions mean that the hurdle rates applied in the past remain valid or need updating.

Considering whether the cost of capital used to analyse investment alternatives needs reviewing is particularly important in the current environment, which is being shaped by a number of factors that directly affect investor hurdle rates, such as:

- The downturn in economic conditions in Spain and abroad
- Sharp volatility in financial variables
- Heightened political and economic instability in multiple countries
- A significant increase in business risk premiums
- A credit squeeze
- Higher borrowing costs

Against this backdrop, companies are urged to consider whether the cost of capital they have been using the past to analyse their investment opportunities remains a valid benchmark in a markedly more adverse economic environment. This exercise is particularly advisable for companies with international presence.

Which cost of capital variables are companies currently reconsidering?

- What benchmark risk-free rate should a multinational use?
- Against the backdrop of highly volatile credit markets, are current yields on long-term sovereign bonds the best benchmark for the risk-free rate or would other benchmarks be more appropriate?
- How should the country risk premium be measured for countries subject to bailouts? What about countries with underdeveloped bond markets?
- How does the credit crunch affect the ability to leverage investments?
- How should the more stringent guarantees being demanded by financiers be factored into the cost of capital?
- Does the prevailing economic climate amplify regulatory risk?
- Is Beta the best yardstick for project-specific risk at a time of such heightened global stock market volatility?



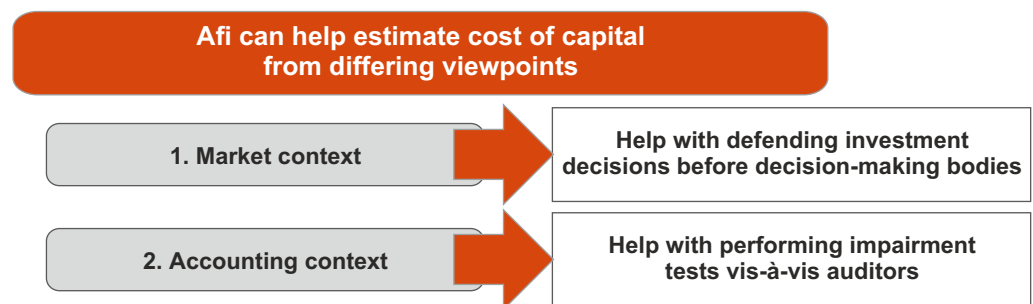
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- Should we apply a different market risk premium depending on the country in which the target investment would be made?
- How should we treat exchange rate volatility and hedging strategies when it comes to analysing investment opportunities?
- Should the higher returns being demanded by parent company shareholders be passed on in the form of higher investment hurdle rates?

What Afi offers

Afi can help businesses to analyse the methodology used to estimate the returns required on national and international investment opportunities by helping them to define overall cost of capital methodology and calculating rates for individual projects, assets or businesses.



Afi can help companies with their cost of capital estimates in two contexts:

- **Market context:** determining the hurdle rate that companies should required on their investments for internal analysis purposes and for certification vis-à-vis the Board of Directors or potential third parties (investors, rating agencies, etc.)
- **Accounting context:** determining the appropriate discount rates for performing annual asset/goodwill impairment tests for showing and defending to the auditor.

Afi performs this work in two consecutive stages:

- 1. Determining the best methodology for calculating the discount rate used to evaluate investment opportunities**
 - WACC or cost of equity (K_e)
 - Rate denominated in project currency or functional currency
 - Static versus rolling WACC
 - Analysis of alternative ways to treat exchange rate risk



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2. Calculation of the cost of capital for specific projects/assets/businesses

- Risk-free rate
- Country risk premium
- Market risk premium
- Business beta
- Leverage
- Cost of debt
- Cost of equity
- WACC

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