The Cost Of Retained Earnings Differs From The Cost Of New Equity Due To: A. Flotation Costs B. Dividends

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Understanding the nuances of the cost of capital is essential for firms aiming to optimize their financing strategies. Among various sources of finance, equity capital stands out as a critical component, with retained earnings and new equity being two primary options. While both represent ownership claims in a company, their costs are not identical. This discrepancy primarily stems from factors such as flotation costs and dividend implications. This article explores in detail why the cost of retained earnings differs from that of new equity, focusing on the roles played by flotation costs and dividends, and their impact on corporate financial decision-making.

Understanding the Cost of Equity

Before delving into the differences, it is vital to understand what constitutes the cost of equity.

Definition of Cost of Equity

- The cost of equity refers to the return that investors require to hold a company's equity securities.
- It is an opportunity cost for shareholders, reflecting the risk associated with the company's equity investments.
- It is used by firms to evaluate investment projects, determine the weighted average cost of capital (WACC), and make capital budgeting decisions.

Methods to Estimate Cost of Equity

- Dividend Discount Model (DDM): Uses expected dividends and growth rates.
- Capital Asset Pricing Model (CAPM): Considers systemic risk relative to the market.
- Earnings Capitalization: Based on expected earnings and price-earnings ratios.

While these methods estimate the cost of equity, the actual cost incurred by a company depends on its financing choices—retained earnings versus issuing new equity.

Retained Earnings Versus New Equity: The Fundamental Difference

Retained Earnings

- Profits kept within the company to finance operations or growth.
- No new external funds are raised, hence avoiding flotation costs.
- The cost is generally considered to be the opportunity cost of reinvested earnings, often approximated by the firm's existing cost of equity.

New Equity

- Funds raised by issuing new shares to public or private investors.
- Incurs additional costs, such as flotation costs, underwriting fees, and administrative expenses.
- The cost of new equity tends to be higher than retained earnings due to these associated costs.

Why Does the Cost of Retained Earnings Differ From the Cost of New Equity?

The core reasons for the difference are primarily attributable to flotation costs and dividend implications, which influence the effective cost of raising funds.

A. Flotation Costs

Flotation costs are expenses incurred by a company when issuing new securities. These costs reduce the net proceeds from the issue, effectively increasing the cost of new equity.

Understanding Flotation Costs

- Definition: The total costs associated with issuing new securities, including underwriting fees, legal fees, registration fees, and other administrative expenses.
- Impact: These costs mean that for every dollar raised through new equity, the company receives less than the total amount paid by investors.

Effect on Cost of New Equity

- The cost of new equity (Re) is calculated considering flotation costs as:

$$Re_{new} = \frac{D1}{P_0(1 - F)} + g$$

where:

- $D1$ = Dividend expected next year
- P_0 = Current stock price
- F = Flotation cost as a percentage of the gross proceeds
- g = Growth rate of dividends

- Alternatively, in the CAPM framework, flotation costs are incorporated by adjusting the required rate or by considering the net proceeds from the issue.

Illustration of the Impact

Suppose a company wants to raise $1,000,000 through new equity:

- Without flotation costs, the company would need to sell shares worth exactly $1,000,000.
- With flotation costs of 5%, the company must issue shares worth approximately $1,052,632 to net $1,000,000 after costs.
- This increased amount raises the effective cost of new equity, making it more expensive than retained earnings.

Implication for Financial Strategy

- Since issuing new equity is costlier due to flotation expenses, firms may prefer to finance projects using retained earnings whenever possible.
- The decision hinges on balancing the cost of raising external funds versus the opportunity cost of retained earnings.

B. Dividends

Dividends influence the perceived cost of retained earnings, as they embody the returns that shareholders forego when profits are reinvested rather than paid out.

Dividends and Their Role in Cost of Equity

- Dividends are cash distributions to shareholders, representing a direct return on their investment.
- The dividend policy impacts the cost of retained earnings because retained earnings are essentially the dividends that are not paid out.

Dividends and the Cost of Retained Earnings

- When a company retains earnings instead of paying dividends, shareholders forgo immediate income.
- To compensate for this, shareholders require a return (cost of equity) that reflects the expected growth and risk.
- The cost of retained earnings is often approximated by the firm's existing cost of equity, derived from dividend discount models or CAPM.

Dividend Policies and Investor Expectations

- If a firm consistently pays high dividends, shareholders might demand higher returns, increasing the cost of equity.
- Conversely, if dividends are low or retained earnings are high, the perceived risk may be lower, reducing the required return.
- Changes in dividend policy can influence the firm's stock price and, consequently, the cost of equity.

Reinvestment and Growth Expectations

- Retained earnings are used to fund growth projects, which can lead to higher future dividends and stock price appreciation.
- The expected growth rate in dividends (g) directly affects the cost of retained earnings.
- Higher growth expectations can increase the cost of retained earnings, reflecting the higher risk associated with growth investments.

Summary of Key Differences and Their Implications

Aspect	Retained Earnings	New Equity
Flotation Costs	None	Present, increasing cost
Dividend Impact	Not directly affected, as earnings are retained	Dividends represent shareholder returns foregone
Cost Calculation	Approximate as existing cost of equity	Higher due to flotation costs and issuance expenses
Effect on Cost of Capital	Lower, as no issuance costs	Higher, reflecting additional costs and risks

Implications for Corporate Finance
- Firms tend to favor retained earnings over new equity to minimize financing costs.
- When external funds are necessary, understanding the additional costs involved in issuing new equity is essential for optimal decision-making.
- Dividend policies influence investor expectations and the perceived risk, affecting the cost of equity.

Conclusion

The cost of retained earnings differs from the cost of new equity primarily because of flotation costs and dividend considerations. Flotation costs elevate the effective cost of raising external equity, making new equity more expensive than retained earnings. Similarly, dividends represent an opportunity cost to shareholders; retained earnings are essentially deferred dividends, and their valuation depends on growth prospects and risk perceptions. Recognizing these distinctions allows firms to make more informed financing decisions, balancing the benefits of internal funding against the costs associated with external capital markets. Ultimately, a comprehensive understanding of these factors enables companies to optimize their capital structure, reduce financing costs, and enhance shareholder value.

Frequently Asked Questions

What is the primary reason the cost of retained earnings differs from the cost of new equity?

The primary reason is the presence of flotation costs, which are incurred when issuing new equity but not when using retained earnings.

How do flotation costs impact the cost of new equity compared to retained earnings?

Flotation costs increase the cost of new equity because they add expenses such as underwriting and issuance fees, whereas retained earnings do not involve these costs.

Why are dividends considered in the context of the cost of retained earnings?

Dividends reflect the opportunity cost of using retained earnings for financing, but they do not directly add to the cost since retained earnings are already part of equity.

Can the cost of retained earnings be considered equal to the cost of equity without flotation costs?

Yes, in theory, the cost of retained earnings is equal to the cost of equity, but in practice, differences arise due to flotation costs for new equity issuance.

In what way do flotation costs affect a company's decision to use retained earnings versus issuing new equity?

Flotation costs make issuing new equity more expensive, encouraging companies to use retained earnings when possible to minimize financing costs.

Are dividends directly included in calculating the cost of retained earnings?

No, dividends are not directly included; instead, the cost of retained earnings is often estimated using models like the dividend discount model, which considers expected dividend growth.

How does the presence of flotation costs influence the weighted average cost of capital (WACC)?

Flotation costs increase the effective cost of raising new equity, thus potentially raising the WACC if new equity is used, but they do not affect the cost of retained earnings directly.

What is the typical impact of flotation costs on the decision to finance through retained earnings or new equity?

Higher flotation costs make issuing new equity less attractive, leading firms to prefer financing through retained earnings or debt whenever possible.

Is the cost of retained earnings always lower than the cost of new equity?

Generally, yes, because retained earnings do not involve flotation costs, whereas new equity issuance includes additional expenses that increase its cost.

How do dividends influence the calculation of the cost of retained earnings?

Dividends are used in models like the dividend discount model to estimate the cost of retained earnings, reflecting shareholders' expected returns, but they do not directly alter the cost calculation.

Additional Resources

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Introduction

In the complex landscape of corporate finance, understanding the nuances of different sources of capital is essential for effective decision-making. Among these sources, retained earnings and new equity are pivotal components that influence a company's cost of capital, investment strategies, and overall financial health. While both serve as vital avenues for raising funds, their associated costs are not identical. This discrepancy primarily stems from factors such as flotation costs and dividend obligations, which create a notable divergence between the cost of retained earnings and the cost of new equity.

This article delves into the intricacies of why and how the cost of retained earnings differs from the cost of new equity, emphasizing the roles of flotation costs and dividends. Through thorough analysis and detailed explanations, we aim to equip financial professionals, students, and researchers with a comprehensive understanding of these fundamental concepts.

Understanding the Cost of Equity and Retained Earnings

Before exploring the differences, it is essential to define the core concepts:

- Cost of Equity: The return required by equity investors to compensate for the risk of investing in a company's shares. It reflects the opportunity cost of capital and serves as a benchmark for evaluating investment projects.

- Retained Earnings: Profits that a company retains rather than distributing as dividends. These funds are internally generated and used for reinvestment or debt reduction.

- New Equity: Freshly issued shares obtained from the capital markets, often through public offerings or private placements, to finance expansion or other strategic initiatives.

While retained earnings are considered an internal source of finance, issuing new equity involves external transaction costs, which influence the overall cost to the firm.

The Role of Flotation Costs in Elevating the Cost of New Equity

What Are Flotation Costs?

Flotation costs encompass all expenses associated with raising new capital through equity issuance. These costs include, but are not limited to:

- Underwriting fees
- Legal and accounting fees
- Registration and SEC filing fees
- Printing and distribution costs
- Other administrative expenses

Typically expressed as a percentage of the gross proceeds, flotation costs can significantly impact the net funds received by the company.

Impact of Flotation Costs on the Cost of New Equity

When a company issues new equity, it does not receive the total amount paid by investors. Instead, a portion is siphoned off to cover flotation costs, effectively increasing the company's cost of obtaining funds. This can be illustrated through the formula:

$$
\text{Cost of New Equity} = \frac{D_1}{P_0 (1 - F)} + g
$$

where:

- D_1 = Dividend next year
- P_0 = Current stock price
- F = Flotation cost percentage
- g = Growth rate of dividends

The denominator adjustment $(1 - F)$ reflects the reduction in net proceeds due to flotation costs, which directly inflates the cost of new equity relative to the firm's existing retained earnings.

Why Flotation Costs Make New Equity More Expensive

The fundamental reason is that issuing new shares incurs additional expenses that are absent when using retained earnings. These costs:

- Reduce the net amount of capital raised
- Increase the effective cost of capital needed to justify the issuance
- Result in a higher required rate of return from investors to compensate for the associated expenses

Consequently, even if the market conditions remain unchanged, the firm's cost of new equity surpasses that of retained earnings primarily due to flotation costs.

Dividends and Their Influence on the Cost of Retained Earnings

Dividends as a Signal and a Cost Element

Retained earnings are internally generated funds, but their cost is intertwined with dividend policies and investor expectations. The key points include:

- Dividends serve as a signal of company performance and stability
- Investors often expect dividends as a return on their investment
- The decision to retain earnings or pay dividends affects the company's valuation and perceived risk

Cost of Retained Earnings as an Implicit Cost

Although retained earnings do not involve direct flotation costs, their cost can be viewed as the opportunity cost of dividends not paid out. This is often estimated using models such as the Gordon Growth Model:

$$
\text{Cost of Retained Earnings} = \frac{D_1}{P_0} + g
$$

where:

- D_1 = Expected dividend next year
- P_0 = Current market price of the stock
- g = Growth rate of dividends

This reflects the return that shareholders forego when the company retains earnings instead of distributing them as dividends.

Dividends and the Cost Differential

The dividend policy influences the cost of retained earnings in several ways:

- A higher dividend payout ratio may lead to higher investor expectations, increasing the required return
- Retaining earnings can reduce the immediate dividend, potentially lowering the perceived risk and cost
- Conversely, aggressive retention might signal growth prospects, influencing investor required return

Thus, dividend decisions directly impact the implicit cost of retained earnings, differentiating it from the externally sourced new equity.

Comparative Analysis: Cost of Retained Earnings vs. Cost of New Equity

Aspect	Cost of Retained Earnings	Cost of New Equity
Flotation Costs	Absent	Present and significant
Dividends	Implicitly influences via dividend policy	Not directly involved
External Costs	None	Underwriting, legal, registration fees
Impact on Cost	Generally lower	Higher due to external expenses
Flexibility	Readily available	Dependent on market conditions

This comparison underscores that while retained earnings are a cheaper source of capital, their use is often constrained by dividend policies and growth considerations. Conversely, issuing new equity, though more expensive, provides additional funds when internal sources are insufficient.

Implications for Financial Management

Understanding the divergence in costs has practical implications:

- Optimal Capital Structure: Firms aim to balance the use of retained earnings and new equity to minimize

the overall cost of capital.
- Dividend Policy Decisions: Maintaining a stable dividend policy can influence investor expectations and the perceived implicit cost of retained earnings.
- Timing of Equity Issues: Companies often prefer to utilize retained earnings to avoid flotation costs unless external funds are urgently needed.

Moreover, recognizing that flotation costs elevate the cost of new equity guides firms in strategic planning, especially in markets with high issuance costs or volatile investor sentiment.

Conclusion

The cost of retained earnings differs markedly from the cost of new equity primarily due to flotation costs and dividend considerations. Flotation costs, comprising fees and expenses associated with external issuance, directly inflate the effective cost of raising new equity funds. Meanwhile, dividends influence the implicit cost of retained earnings, as they embody the opportunity cost of reinvested profits and shareholder expectations.

For corporate financial managers, appreciating these differences is crucial for designing optimal capital structures and dividend policies. While retained earnings often represent a more economical source of funds, their availability and cost are influenced by dividend policies and market perceptions. Conversely, raising new equity, though sometimes necessary, entails additional costs that can impact project viability and corporate valuation.

In sum, a comprehensive understanding of these factors enables firms to make informed capital budgeting decisions, balancing internal and external sources to achieve sustainable growth at the lowest possible cost.

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