### SESSION PLAN

**COURSE:** ABE Level 6 Corporate Finance

**ELEMENT:** Element 3 – The cost of capital

## **LEARNING OUTCOME 3**

**3 Critically evaluate approaches to the calculation of the cost of capital that take account of techniques for the valuation of equity and different types of risk (Weighting 20%)**

1. Critically evaluate the alternative approaches to the valuation of equity
2. Apply appropriate methods for the calculation of the cost of capital in order to provide a basis on which strategic financing and investment decisions can be made
3. Critically evaluate the effects of different types of risk on the cost of capital by applying techniques that reflect the strategic environment in which the business operates

**NUMBER OF SESSIONS:** Three - approximately twelve hours in total (plus self-study)

**SESSION TOPICS:** Session 1: Critically evaluate the alternative approaches to the valuation of equity

Session 2: Apply appropriate methods for the calculation of the cost of capital in order to provide a basis on which strategic financing and investment decisions can be made

Session 3: Critically evaluate the effects of different types of risk on the cost of capital by applying techniques that reflect the strategic environment in which the business operates

**Note to tutors: this is the recommended session plan for learning outcome 3, element 3 of ABE Level 6 Corporate Finance. You should follow the plan, using the resources (referenced as ‘slides’ here) and activities provided. It is important to enhance all sessions with local examples and case studies, involving the learners ACTIVELY wherever possible.**

### SESSION 1: Critically evaluate the alternative approaches to the valuation of equity

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| **Approx.****Duration** | **Topic** | **Tutor Activity** | **Slides** | **Learner Activity** | **Formative Assessment** |
| 3-4 hours | The cost of capital | Use filename**: 6UCF Presentation E3**Explain the unit, and what is going to be covered. Assessment criterion 3.1 Discuss the nature of equity and debt finance. Explain that the mix of equity and debt finance together represents a business’s financial structure. Define the cost of capital.Play this to help to explain the cost of capital:<https://www.youtube.com/watch?v=ZiIFtmxt3vU> | 1-6 | In small groups, learners should identify what they want to learn from the unit. Set out some personal learning objectivesAsk all learners to describe an organisation with which they are familiar. Note that the organisation must have raised finance from an equity or debt market. Give them all 5 minutes to do this, and explain that you will be using these organisations as examples throughout the module. | **6UCF E3 LO3 Activity** 1 – Types of debt financing |
| The capital asset pricing model (CAPM) | Introduce the CAPM. The capital asset pricing model provides a prediction of the relationship between the risk of an asset and its expected return. It tells us that expectations of returns will be enhanced by the extent of the covariance of expected returns from a particular security with those of the market portfolio.Beta is a measure of the level of systematic risk that relates to a particular asset or investment.Go back to the study guide for an explanation of the CAPM and how it can be calculated.Play this film: <http://www.investopedia.com/video/play/capm/> | 7-8 | Ask learners to consider the case study on the CAPM. Ask learners to calculate the return that can be expected from an asset that has each of the beta coefficients. | **6UCF E3 LO3 Activity 2** – Capital asset pricing model |
| Capital asset pricing model (CAPM): evaluation | Look at the study guide for an outline of the assumptions on which the CAPM is based and the criticisms to which it has been subject.Criticisms of the CAPM include investor concerns, the lack of a ‘true’ market portfolio, the lack of a ‘true’ risk free rate and difficulties in making predictions and projections. | 9 | Now that you have considered how to apply the CAPM, consider its strengths and weaknesses. Learners try to consider each of the assumptions and criticisms. Consider how each of these might affect the use of the CAPM to calculate the cost of capital. Allow them 30 minutes to discuss this in small groups, and then 30 minutes to present back to each other in one large group, | **6UCF E3 LO3 Activity 3 –** Critical Evaluation of CAPM |
|  | Review of session and learning outcomes | Ask students to read the second section of the study guide prior to the next session. |  | Pre-session preparation |  |

### SESSION 2: Apply appropriate methods for the calculation of the cost of capital in order to provide a basis on which strategic financing and investment decisions can be made

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| **Approx.****Duration** | **Topic** | **Tutor Activity** | **Slides** | **Learner Activity** | **Formative assessment** |
|  3-4 hours | Introduction to session and learning outcomes | Use file: **6UCF Presentation E3** Assessment criterion 3.2  | 10 |  |  |
|  | Dividend valuation model (DVM) (1) | Outline the nature of and define dividends. Dividends are payments made by businesses (specifically, limited companies) to their equity investors. Use this film to explain this in more detail:<http://www.investopedia.com/video/play/dividend-discount-model/>  | 11-14 | Ask learners to consider the first case study on the DVM and Gordon’s Growth model.Ask learners to calculate the cost of equity capital using Gordon’s growth model. Allow them 30 minutes to discuss this in small groups, and then 30 minutes to present back to each other in one large group. | **6UCF E3 LO3 Activity 4** – Key features of dividend valuation model |
|  | Dividend valuation model (DVM) (2) | Outline the key criticisms of the dividend valuation model.These include the difficulties in the forecasting of dividend payments and the tendency for dividend payments to vary over time.  | 11-14 | Ask learners to consider the second case study on the DVM and Gordon’s Growth model.Ask learners to calculate the cost of equity capital using Gordon’s growth model. Allow them 30 minutes to discuss this in small groups, and then 30 minutes to present back to each other in one large group. | **6UCF E3 LO3 Activity 5 –** Dividend valuation model and Gordon’s Growth Model |
|  | Weighted average cost of capital | Explain the concept of the weighted average cost of capital (WACC): this measure reflects the costs of the individual sources of finance, which are weighted according to their relative importance as sources of finance.The WACC is a popular approach to the calculation of the cost of capital, but it is not perfect. Relate WACC to the general concept of the cost of capital that was introduced earlier in the session. Play this film the help to explain the WACC:<https://www.youtube.com/watch?v=lVpH4kZZxBE>Use the study guide. See the Case studies and Activities on weighted average cost of capital numbered (1), (2), (3) and (4). | 15-17 | Ask learners to discuss the advantages and disadvantages of the weighted average cost of capital. Allow them 30 minutes to discuss this in small groups, and then 30 minutes to present back to each other in one large group, | **6UCF E3 LO3 Activity 6** – Weighted average cost capital |
|  | Review of session and learning outcomes | Ask students to read next section of the study guide prior to the next session. |  | Pre-session preparation |  |

### SESSION 3: Critically evaluate the effects of different types of risk on the cost of capital by applying techniques that reflect the strategic environment in which the business operates

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| **Approx.****Duration** | **Topic** | **Tutor Activity** | **Slides** | **Learner Activity** | **Formative Assessment** |
| 3-4 hours | Introduction to session and learning outcomes | Use file: **6UCF Presentation E3.** Assessment criterion 3.3  | 18 |  |  |
| Techniques for the evaluation of financial risk | Introduce the topic of approaches to financial risk management that reduce exposure to financial risks. Outline the four key techniques: sensitivity analysis, scenario analysis, expected values and simulations.Use the study materials. Illustrate how sensitivity analysis and expected values can be used as a technique with which to reduce exposure to financial risks.When learners have completed the activity ask them to present back their findings to the whole group. | 19-21 | Ask learners to consider the advantages and disadvantages of each of the four key techniques. Allow them 30 minutes to discuss this in small groups, and then 30 minutes to present back to each other in one large group. | **6UCF E3 LO3 Activity 7** – Different types of risk**6UCF E3 LO3 Activity 8** – Risk management techniques |
| Alternative approaches to the calculation of the cost of capital: Adjusted present value (APV) | Outline the nature of APV. Whereas a WACC calculation seeks to reflect the effects of financing and other factors such as corporate taxation, APV rests instead on a series of present value calculations.Play this film to help to explain APV:<http://www.investopedia.com/terms/a/apv.asp> | 22-24 | Use the study guide. See the case study on APV.Ask learners to calculate the unlevered cost of capital. Estimate the project’s value without leverage. Allow them 30 minutes to discuss this in small groups, and then 30 minutes to present back to each other in one large group. | **6UCF E3 LO3 Activity 9** – Adjusted present value |
| The flow to equity method | Outline the nature of the flow to equity method. The flow to equity method fills this gap as it calculates the cash flow that is available to shareholders after taking into consideration all the payments from/to debt holders. | 25 | Use the study guide. See the case study on the flow to equity method.Ask learners to calculate the flow to equity for the project. Allow them 30 minutes to discuss this in small groups, and then 30 minutes to present back to each other in one large group. |  |
| Review of session and learning outcomes | Ask students to prepare for the next session by reading the first section of the next chapter in the study guide.  |  | Pre-session preparation |  |

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