FLOATATION COST

While raising new capital, a company incurs cost, which is paid as a fee to the investment bankers.

This fee is referred to as the flotation cost. The amount of fee depends on the size and type of offering.

Flotation cost is generally less for debt and preferred issues, and most analysts ignore it while calculating the cost of capital. However, the flotation cost can be substantial for issue of common stock, and can go as high as 6-8%.

There are flotation costs associated with issuing new equity, or newly issued common stock. These include costs such as investment banking and legal fees, accounting and audit fees, and fees paid to a stock exchange to list the company's shares. The difference between the cost of existing equity and the cost of new equity is the flotation cost.

The flotation cost is expressed as a percentage of the issue price and is incorporated into the price of new shares as a reduction. A company will often use a weighted cost of capital (WACC) calculation to determine what share of its funding should be raised from new equity and what portion from debt.

Example of a Flotation Cost Calculation

As an example, assume Company A needs capital and decides to raise $100 million in common stock at $10 per share to meet its capital requirements. Investment bankers receive 7% of the funds raised. Company A pays out $1 in dividends per share next year and is expected to increase dividends by 10% the following year.

Using these variables, the cost of new equity is calculated with the following equation:

- ($1 / ($10 * (1-7%)) + 10% $\frac{D1}{NP} + g$

The answer is 20.7%. If the analyst assumes no flotation cost, the answer is the cost of existing equity. The cost of existing equity is calculated with the following formula:

- ($1 / ($10 * (1-0%)) + 10%

The answer is 20.0%. The difference between the cost of new equity and the cost of existing equity is the flotation cost, which is (20.7-20.0%) = 0.7%. In other words, the flotation costs increased the cost of the new equity issuance by 0.7%.

If we decide to include the flotation costs in our calculation, then the formula for the cost of equity will be modified as follows:

$$r_e = \frac{D_1}{P_0(1-f)} + g$$

Where f is the flotation costs expressed as a percentage.

Example

The following details about a company are available with us:

Current Stock price	$105
Current dividend (D0)	$5 per share
Growth rate	5%
Flotation cost	4%

The cost of equity will be calculated as follows:

$$r_e = \frac{5(1+0.05)}{105(1-4\%)} + 0.05$$

= 10.21%

Many analysts consider this approach inappropriate because flotation cost is actually a cash out flow at the beginning of the project. The project is actually affected as the initial cash flow reduces. What we are doing instead is adjusting the PV of future cash flows by a fixed percentage.

The alternative method is to adjust the cash flows while valuing the project. So, we first calculate the NPV of the project and then deduct the flotation costs from it. This is a preferred method used by most analysts.

So understand if cost of existing equity shares is to be calculated then

Market price should be considered while calculating cost

If cost of fresh /new issue of equity shares is to be calculated then flotation cost should be calculated on

This approach was suggested by john R. Ezzell and R. Burr Porter in their paper “Flotation Costs and the Weighted Average Cost of Capital” In this paper they

argue that the correct way of treating flotation costs is to deduct it as a part of the valuation.