Business Learning by Dan

Understanding out Members' Businesses: Cost of Capital

Dan Topf, CPT

This month's topic is "Cost of Capital." I'm glad that it is. It's going to be WAY better than my second choice, which was "Reverse-engineered Dynamic Infrastructure." I believe you'll find this column to be a lot more useful, understandable, and well, valuable.

Hey, I think I just defined Cost of Capital for you! Did you get it? Well, let me be clearer. The Cost of Capital is a standard that businesses use to evaluate decisions. Simply put, it shows what the cost of the second best option was (a.k.a. "opportunity cost"), and if you're results on the first option beat the second best option, you're a winner! Let's break it down further and relate it to training and development.

> Cost of Capital:
>
> The return you may have otherwise earned at the same risk level of the investment you selected.

All businesses require capital to operate. Capital is money. If you were to start a business tomorrow, the first thing you'd need is money – to buy raw materials, supplies, office space, brochures, order forms, and invoicing software. Capital, like any other asset, is put to work to generate profits. So, it makes sense that our businesses need to track and evaluate the cost of using that capital.

What is the cost, though? Well, consider first where capital comes from. There are three general sources of capital for a business: Owners, Lenders, and Customers. Owners' Capital is called equity, and the owners expect a return on their equity or they will pull it out and invest it elsewhere. Lenders' Capital is called debt, and the lender expects an interest payment for the use of their money during the period. Finally, there's Customer Capital. This is called operating capital since the company gets the capital from serving its customers, and in exchange, the customers expect value. To summarize, here's the three sources of capital and their "costs:"

Source of Capital	Costs
Owners (For example, family members, policy owners, shareholders, club members, etc.)	Return on equity and gain on their initial investment (called Paid-In Capital). Many companies refer to this as a Return on Equity target, which ranges from 10% to 15%.
Lenders (For example, banks, credit unions, commercial paper, bond holders, suppliers, the government, etc.)	Interest rates charged for the use of the money during the period.
Customers	In a word, "value." Business is a commercial exchange of money for value, and if a customer perceives more value than the price paid, you are in business!

Businesses will focus on the capital that's been put to work. In an effort to be more precise, a business will manage its "working capital." Working capital is only the current assets on the balance sheet (those that will convert to cash within a year, like accounts receivable and inventory) less the company's current liabilities (debts that are due within a year, like short term loans and accounts payable). If working capital is low, and turns over quickly, the company is considered to be capital efficient.

Business leaders make lots of decisions based upon the cost of capital. It's important for us to know how it's calculated. In short, the business will average the costs of capital from all sources during the period, and calculate the "Average Cost of Capital" from all sources. This is a useful benchmark to compare capital investment decisions (like training and development) and their payoff over the period. For example:

Capital Source	Average Cost per Period
Owners	15%
Lenders	10%
Average Cost of Capital	25% ÷ 2 sources = 12.5%

A company has lots of different types of owners. It also has lots of different lenders. So, it may choose to weight each of these capital sources relative to how much capital it provides and how important it is, resulting in a "weighted average cost of capital."

Any investment of capital in the business must return MORE than the cost of capital, or it's considered a money loser. In other words, "Dan, you should have taken your second choice, because you lost your shirt on the first choice!"

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For many of us in training and development, we focus on training ROI, or Return on Investment of training investments. However, that calculation only compares costs to benefits, in monetary terms. If a training program returns more than its costs, it was worth doing. Well, not so fast! If the return didn't return more than the cost of capital, over the same period of time with the same amount of risk, it was a loser! Further, if the company had a second-best idea with less risk, and a shorter time horizon, the training costs may have returned even less value to the company.

The cost of capital is a vitally important benchmark for our ASTD members' companies. Our training and development efforts must return more value to stakeholders than the 'second best option.' For some of our members' companies, the decision has been to cut training budgets and put that capital elsewhere. For others, the decision has been to re-double the training investments in key growth areas. It's important that we understand the big picture of capital and the cost of capital so that we can position our budgets, business cases, and training initiatives to return exceptional value.

Was this valuable to you? I'm glad you decided to read my column all the way to the end. I trust you got more from this decision than your second option in this case. If not, email me and I'll send you my 128 slides on "Reverse-engineered Dynamic Infrastructure." Good luck!

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