This case is used for classroom discussion.

Identifying Your Opportunity Cost of Capital

The logic in "opportunity cost of capital" is that all resources are limited so that you have to use them in the most efficient way. By investing on one specific project, you give up the opportunity of getting returns from other projects. The highest return among the alternatives, therefore, comprises your "opportunity" cost of capital.

When Harry meets Sally, he suggests maybe they can open a bookshop near the campus. Based on his investigations on the local residents' (mainly university students) population, income and consuming behavior, he believes the shop will be profitable, or simply, "making money".

Sally is just back from her Financial Management class. "Then what's the discount rate of our shop?"

"You mean the cost of capital?" Harry asks. "Well, it's somewhat complicated. My parents will donate $10,000. Since they don't want to get the money back, the cost is actually -100% for us. My friend, Mike, will join our business and invest $5,000. We don't have to pay any interest, so the cost of capital is 0%. Besides, I can also borrow $5,000 from the local bank, which charges an interest rate of 5%. Then the weighted average is……. " He hesitated, "-47.75%? How could it be?"

Sally chuckles. She tells Harry that her classmate, James, is running a bookshop in his hometown, which is very similar to this one. "James earns 15% on his money on average every year." She says.

For some reasons Harry doesn't like James. "James' shop is not my business. Besides, he doesn't have rich parents or good relationship with the bank. We can make more money than he does."

Sally admits that their shop is born with a silver spoon in mouth. But does that mean the discount rate is much lower than 15%? Could it be as low as 5%, 0% or even lower? How should she explain to Harry?

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