Cost of Capital

Meaning of Cost of capital

Cost of capital refers to the opportunity cost of making a specific investment. It is the rate of return that could have been earned by putting the same money into a different investment with equal risk. Thus, the cost of capital is the rate of return required to persuade the investor to make a given investment.

An investor provides long-term funds (i.e., Equity shares, Preference Shares, Retained earnings, Debentures etc.) to a company and quite naturally he expects a good return on his investment.

In order to satisfy the investor's expectations the company should be able to earn enough revenue.

Thus, to the company, the cost of capital is the minimum rate of return that the company must earn on its investments to fulfill the expectations of the investors.

Definition of Cost of Capital

- According to Khan and Jain, cost of capital means "the minimum rate of return that a firm must earn on its investment for the market value of the firm to remain unchanged".

- According to Mittal and Agarwal "the cost of capital is the minimum rate of return which a company is expected to earn from a proposed project so as to make no reduction in the earning per share to equity shareholders and its market price".

Significance of Cost of Capital

The significance or importance of cost of capital may be stated in the following ways:

1. Maximization of the Value of the Firm:

For the purpose of maximization of value of the firm, a firm tries to minimize the average cost of capital. There should be judicious mix of debt and equity in the capital structure of a firm so that the business does not to bear undue financial risk.

2. Capital Budgeting Decisions:

Proper estimate of cost of capital is important for a firm in taking capital budgeting decisions. Generally cost of capital is the discount rate used in evaluating the desirability of the investment project. In the internal rate of return method, the project will be accepted if it has a rate of return greater than the cost of capital.

In calculating the net present value of the expected future cash flows from the project, the cost of capital is used as the rate of discounting. Therefore, cost of capital acts as a standard for allocating the firm's investible funds in the most optimum manner. For this reason, cost of capital is also referred to as cut-off rate, target rate, hurdle rate, minimum required rate of return etc.

3. Decisions Regarding Leasing:

Estimation of cost of capital is necessary in taking leasing decisions of business concern.

4. Management of Working Capital:

In management of working capital the cost of capital may be used to calculate the cost of carrying investment in receivables and to evaluate alternative policies regarding receivables. It is also used in inventory management also.

5. Dividend Decisions:

Cost of capital is significant factor in taking dividend decisions. The dividend policy of a firm should be formulated according to the nature of the firm— whether it is a growth firm, normal firm or declining firm. However, the nature of the firm is determined by comparing the internal rate of return (r) and the cost of capital (k) i.e., $r > k$, $r = k$, or $r < k$ which indicate growth firm, normal firm and decline firm, respectively.

6. Determination of Capital Structure:

Cost of capital influences the capital structure of a firm. In designing optimum capital structure that is the proportion of debt and equity, due importance is given to the overall or weighted average cost of capital of the firm. The objective of the firm should be to choose such a mix of debt and equity so that the overall cost of capital is minimized.

7. Evaluation of Financial Performance:

The concept of cost of capital can be used to evaluate the financial performance of top management. This can be done by comparing the actual profitability of the investment project undertaken by the firm with the overall cost of capital.

Classification of Cost of Capital

The cost of capital defines as the minimum rate of return a firm must earn on its investment in order to satisfy investors and to maintain its market value. It is the investors required rate of return. Cost of capital also refers to the discount rate which is used while determining the present value of estimated future cash flows. The major classification of cost of capital are:

1. **Historical Cost and future Cost**: Historical Cost represents the cost which has already been incurred for financing a project. It is calculated on the basis of the past data. Future cost refers to the expected cost of funds to be raised for financing a project. Historical costs help in predicting the future costs and provide an evaluation of the past performance when compared with standard costs. In financial decisions future costs are more relevant than historical costs.

2. **Specific Costs and Composite Cost**: Specific costs refer to the cost of a specific source of capital such as equity shares, Preference shares, debentures, retained earnings etc. Composite cost of capital refers to the combined cost of various sources of finance. In other words, it is a weighted average cost of capital. It is also termed as 'overall costs of capital'. While evaluating a capital expenditure proposal, the composite cost of capital should be as an acceptance/ rejection criterion. When capital from more than one source is employed in the business, it is the composite cost which should be considered for decision-making and not the

specific cost. But where capital from only one source is employed in the business, the specific cost of those sources of capital alone must be considered.

3. **Average Cost and Marginal Cost**: Average cost of capital refers to the weighted average cost of capital calculated on the basis of cost of each source of capital and weights are assigned to the ratio of their share to total capital funds. Marginal cost of capital may be defined as the 'Cost of obtaining another dollar of new capital.' When a firm raises additional capital from only one sources (not different sources), than marginal cost is the specific or explicit cost. Marginal cost is considered more important in capital budgeting and financing decisions. Marginal cost tends to increase proportionately as the amount of debt increase.

4. **Explicit Cost and Implicit Cost**: Explicit cost refers to the discount rate which equates the present value of cash outflows or value of investment. Thus, the explicit cost of capital is the internal rate of return which a firm pays for procuring the finances. If a firm takes interest free loan, its explicit cost will be zero percent as no cash outflow in the form of interest are involved. On the other hand, the implicit cost represents the rate of return which can be earned by investing the funds in the alternative investments. In other words, the opportunity cost of the funds is the implicit cost. Implicit cost is the rate of return with the best investment opportunity for the firm and its shareholders that will be forgone if the project presently under consideration by the firm were accepted. Thus implicit cost arises only when funds are invested somewhere, otherwise not. For example, the implicit cost of retained earnings is the rate of return which the shareholder could have earn by investing these funds, if the company would have distributed these earning to them as dividends. Therefore, explicit cost will arise only when funds are raised whereas implicit cost arises when they are used.