Financial Management MS109

UNIT VII COST OF CAPITAL

MBA Second Semester

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- The cost of capital is the minimum rate of return that is expected by the company to earn to meet the expectations of the equity shareholders or various categories of investors. The various sources of funds through which company raises funds are equity shares, debentures, term loans, bonds, retained earnings etc.

- "Cost of capital is the minimum required rate of earnings or the cut-off rate of capital expenditures." —Solomon Ezra
- "A cut-off rate for the allocation of capital to investments of projects. It is the rate of return on a project that will leave unchanged the market price of the stock." —James C. Van Horne
- "The rate of return the firm requires, from investment in order to increase the value of the firm in the market place." —Hampton, John J
- "Cost of raising funds is the minimum required rate of return of the firm i.e., the cost of capital is the minimum return which the firm must earn on the proposals in order to break even."- Rustagi R.P

Importance of Cost of Capital

- Evaluation of Investment decisions
- Designing Debt-Equity mix of the Company
- Evaluating Financial Performance of the Company

Methods of Computation of Cost of Capital

Measurement of specific cost of capital for different sources of funds (Cost of Specific Sources)

Cost of debt financing (Debentures, bonds etc)

- Cost of Irredeemable Debt/Perpetual Debt
- Cost of Redeemable Debt
  - Debt or debentures issued at par
  - Debt or debentures issued at premium or discount

Cost of Debt

- The Company can raise Debt in various ways say by raising funds from debentures, bonds, borrowing funds from banks and financial institutions, etc. Now, this debt can be issued at par, at premium and at a discount..

Cost of Irredeemable Debt/Perpetual Debt

The cost of debt is equal to the interest rate if the debenture is given at the same rate and without tax being taken into account. It provides long term funds to the company or in other words it is permanent source of raising funds. The interest rate on debt is assessed a representation of cost of debt in approximate terms. The debentures can be issued at par/face value or at discount or at premium.

Cost of Redeemable Debt

- When the debentures or bonds or term loans are redeemable after a definite time period then the cost of debt shall be computed differently.
- These debenture or bonds are repayable after a definite period. Such debentures have legal binding or obligation to redeem the amount to the debenture holders either at some predefined time period during the lifetime of the debt or as a lump sum at the end of its maturity.
- In other words, cost of debt is the discount rate which equates the net realization from the issue of debentures to the interest and principal repayments.

- The cost of the preferred share capital is the dividend paid and accrued by the company. The preference share shall be given at the fixed rate of the dividend on the face value of the shares.

- Generally, dividends are paid on a fixed rate but it is not the legal biding on the management to pay dividends. But it is generally paid when company makes adequate profits. Therefore, it is sometimes inferred that since it is not legal binding on the company to pay dividend on preference shares hence, it does not have a cost.

COST OF PREFERENCE SHARES

- Preference share capital issued at par
- Preference share capital issued at premium or discount
- Cost of redeemable preference share capital

COST OF EQUITY

- Cost of Equity is the rate of return that company pays to the equity shareholders for funds supplied by them. This payment is made in lieu of their expectation for dividends and capital gains and also for the returns which they could have received by investing the funds somewhere else. Company estimates cost of equity also to assess the relative value of investments both for internal projects and opportunities for external acquisitions or proposals.

CAPITAL ASSET PRICING MODEL

The Capital Asset Pricing Model (CAPM) is a model of equilibrium that calculates the relationship between risk and expected return of an asset based on the sensitivity of the asset to general stock market movements.

- According to this method, the cost of equity is calculated by the following equation;
- K_e=R_f+Bi(Rm-Rf)
- Where;
- R_fRisk free rate of return
- =Beta of the Investment
- =Rate of Return on market portfolio

Cost of Retained Earning

- The cost of retained earnings is the rate of return which the existing shareholders can avail if they invest after tax dividends in various other alternatives available. Accordingly, the cost of retained earnings is the opportunity cost of dividends foregone by shareholders.

Weighted Average Cost of Capital

- Weighted average cost of capital is the rate that a firm on an average pays to all its securities holders to finance its financial structure. The weighted average cost of capital serve as a benchmark or a parameter in appraising profitability of the company or a firm.

Overall Cost of Capital(Ko)

The computation of over-all cost of capital involves following steps

1. Assigning weights to specific costs
2. Multiplying the cost of each of the sources by the appropriate weights
3. Dividing the total weighted cost by the total weights

Thank You !

References

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