Relevance of ‘Cost of Capital’ in investment decision making

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‘Cost of Capital’ is relevant while structuring the capital requirements of a company, for deciding the right mix of means of financing and for assessing the success or otherwise of any project. It forms the basis of return any investment has to earn so as to maximize shareholder wealth. As the goal of any firm is not only to remain profitable but as well to constantly increase their shareholder wealth, any investment shall not only return at least its cost of capital but aim at getting greater than its cost of capital.

It acts as a benchmark to achieve minimum acceptable rate of return from a project and also helps management in formulating an optimum capital structure. Invariably the funding of a project has to be from out of mix/comination of debt, retained earnings, equity, preference capital, bonds, external borrowings through Special Purpose Vehicles, through Leveraged Buy Outs etc. But, it is helpful to make a distinction between cost of new equity, cost of investing retained earnings including the depreciation provision and cost of debt funds. It is very essential as the ‘economic cost’ of each component has to be measured in terms of the ‘investment value’ of the common stock of the entity.

The ‘Weighted Average Cost of Capital’ is often used as a benchmark, or “hurdle rate” when evaluating new investment opportunities. Therefore, cost of capital is not a cost as such and it is only a ‘hurdle’ rate. ‘Hurdle rate’ is defined as the required rate of return in a discounted cash flow analysis, above which an investment makes sense and below which it does not. Often, this is based on the firm’s cost of capital or weighted average cost of capital, plus or minus a risk premium to reflect the project’s specific risk characteristics, also called ‘required rate of return’.

‘Cost of capital’ is the rate of return to at least maintain the value of shareholders’ holding if not increasing their value through the proposed investments.

Cost of capital and risk assessment

‘Cost of capital’ is necessary not only to assess return at zero risk but more for ascertaining return for the business risks and for the financial risks. ‘Business risk’ means the risk that a business will experience during a period of poor earnings and resultant failure. The risk is greatest for cyclical or relatively new industries. Business risk impacts both the shareholders and the lenders, since the firm may be unable to pay dividends and interest adding to the possibility of repayment defaults. Every company carries the business risk that it will produce insufficient cash flow and the risk can come from a variety of reasons – some systemic and others non-systemic. Financial risk arises on account of mix of debt and equity. Higher the leverage, higher is perceived to be the financial risk in times of down-trend.

Hence, the lenders expect higher return from highly leveraged firms. An investment decision is taken knowing fully well the contingent risks as above but the estimation of ‘cost of capital’ supports decision making as to how much risks can be taken at any given point of time.

Investments are in the nature of greenfield investments, expansion schemes, investments towards modernization of production facilities, diversification projects, and/or by way of inorganic growth strategy. Irrespective of the nature of investment involving capital outlay and the size of such investment, there is always an underlying necessity to mix the capital in proper proportion so as to derive the long term benefits and to maximize shareholder wealth and, in this context, the ‘cost of such capital’ has been relevant.

Implicit vs Explicit cost

‘Cost of capital’ can be either ‘explicit’ or ‘implicit’. Explicit cost of any funding is the discount rate that equals the present value of the funds received when compared to the present value of the expected cash outflows. The outflows as stated above are in the nature of interest, repayment, dividend etc.

It is normally assumed that if a business has large amount of retained earnings or funds at its disposal at any given point of time, the funds are available free of charge as there is no financial obligation attached to usage of these funds. It should, therefore, be remembered that it is not the real cost but the opportunity cost, the cost of forgoing another or many other opportunities in the process. It is called ‘implicit cost’, the rate of return in comparison to the other alternative best investment opportunities forgone if the firm were to decide to go ahead with the proposal under consideration.

It is ‘International cost of capital’ and not domestic any longer

Capital is always a scarce resource and justifiably so. The globalization effect forces one to calculate and compare the returns on capital on an international scale for the most attractive investment opportunities around the globe. Capital allocation considerations are

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becoming increasingly important as both the capital providers and seekers are sensitised to all factors associated with the availability of and return on capital.

Risks associated with raising capital is a growing concern

Gone are the days when analysts were concentrating on whether businesses added or destroyed value. Now, it is more on risks associated with raising capital and their costs so as to mitigate and manage the associated risks. Risk adjusted capital allocation remains a major challenge to many companies, post liberalisation.

Future vs Historical costs

In management decision making on investment decisions, it is relevant to assess the ‘Future costs’ as ‘Historical costs’ have no relevance. Many a times, while doing the capital budgeting estimates, the historical costs with some adjustments are taken not realising that this one single assumption can mislead the entire decision making. For calculating the future costs, the market information taking into account the global level changes have to be factored properly.

It is not fixed all through the investment horizon

It is also ignored that the cost of capital is not the same throughout the lifespan of the investment for two reasons: (1) the composition of the capital keeps changing at very frequent intervals; and (2) the changes in the ‘floating costs’ on borrowings and also the government policies such as tax laws etc. would keep changing either way the cost of capital.

Therefore, the cost of capital is not a fixed cost for the entire duration of the investment horizon.

Traditional approach vs Modigliani and Miller approach

Traditionally it is assumed that with every increase in debt component, the weighted average cost of capital would reduce as the debt component has tax shelter associated with it. But it is to be remembered that when the debt component goes up, the profitability would face adverse consequences and the risk perception of the investors would increase their expectations from equity and this is what the ‘Modigliani and Miller approach’ says.

Cost of capital of Private Equity (PE)

Raising capital is never easier for new enterprises in their initial days and there is uncertainty and difficulty always faced by them in this regard. In such a scenario, PE funding is one of their alternatives and it is not without paying disproportionately higher cost. PE investments are typically sourced from one or more of Strategic investors, High Net worth Individuals (HNIs), PE funds etc. PE is not limited to venture capital, but also capital for leveraged buy-outs, management buy-outs and later stage growth capital. PE is expensive as investors typically require an internal rate of return of approximately 30% p.a. or sometimes even greater. Unless proper evaluation of the profitability of the investment is done, increasing the cost of capital by introducing PE funding as a source of capital would hamper the future prospects of the firm.

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competitive bidding. The tenders would be based on two cover system consisting of technical and price bids. After the issue of tender document, the port may arrange one or more pre-bid conferences for clarifications, if necessary.

The tender document will not give any kind of guarantee for financial returns to the entrepreneur. The tender document should provide that port property, if any, being transferred to the entrepreneur, will be kept insured at the cost of the private entrepreneur. The private entrepreneur would not be permitted to transfer any asset by way of sub-lease, sale, sub-contract or any other method without the previous approval of the Port. The investors will not be allowed to abandon the services abruptly or dispose-off land, machinery and other assets or to convert them partly or fully into non-port use.

All the provisions of the Major Port Trusts Act, 1963, Bye-Laws, Rules and Regulations made thereunder, any administrative or other directions given under the said Act, or the Scale of Rates or a statement of conditions prescribed under the said Act, the Customs Act, and all other statutory enactments in relation to the port including labour laws shall be fully observed and complied with by the Licensee, and the Port shall be fully observed and complied with by the Licensee, and the Port shall be kept indemnified harmless from all claims or demands in this behalf, including any claims from labour.

The Tariff Regulatory Authority (TRY) to be set up may fix a ceiling tariff and leave the private entrepreneur free to charge up to the ceiling at the rates to be notified by the entrepreneur. If the Tariff Regulatory Authority is satisfied, a suitable periodic increase(s) in tariff may be permitted on justified grounds. At the time of revision of tariff, again, the revised tariff would only be a ceiling, with the Port and the entrepreneur having the freedom to charge below that tariff.

Where Central or State Public Sector Undertakings are Port-based industries and wish to create port facilities for their own captive use, they may be treated under the guidelines for port based industries. Other Central or State PSUs who wish to create port facilities as a common user facility and not for their own captive use need to come through the tendering route at par with private entrepreneur. However, Public Sector oil units would be treated as being port specific for the purpose of allowing them captive facilities and captive oil jetties or SBMs without recourse to the tender procedure.