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Cost of capital and value of a firm

Rahul Singh Gautam [1*], **Aashi Rawal** [2]
[1-2] PhD, Symbiosis Institute of Business Management, Pune, Symbiosis International (Deemed) University, Pune, India

* Corresponding Author: **Rahul Singh Gautam**

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Abstract
Cost of capital is one essential corporate tool in the world of finance. The importance of the cost of capital is very high as it is directly linked to the valuation of the business. At a time when businesses are keen to get involved in anything and everything that adds value to the firms, the concept of cost of capital is the cynosure. There are numerous activities in which a firm generally gets involved. All such activities can be classified as operational and non-operational. The operational activities are supposed to influence the valuation by design. However, the non-operational activities, namely transparency and valuation, ESG (environmental, social and governance) related initiatives, shareholders activism and corporate governance, all are aimed at adding value to the firm. The ultimate influence of all the operational and non-operation activities fall on the cost of capital (either directly or indirectly) and reflects on its linkages with the valuation of the businesses.

Keywords: Cost of capital; Valuation; Firms; Governance; Disclosures

1. Introduction

The reason for having a business is a question that is asked out of context. Nevertheless, it is important to answer this query at least once. There will always be some people with needs, and those needs generally inspire others to take action to meet those needs. This straightforward drive to meet that need can eventually be transformed into a phenomenon we call business. This outcome makes it clear that anyone fulfils the qualifications would undoubtedly desire to gain in some way from suffering the agony and danger to achieve something that may not have existed in the past.

As the processes expand up and the size of everything increases over time, the entire activity becomes increasingly challenging. The business owners discover that the resources, principally financial, with which they had begun the straightforward endeavour of satisfying the objectives may not be sufficient to advance the venture. They begin hunting for additional individuals to give them the most important and dangerous input-funds. The business owners have two alternatives for obtaining more cash or capital: take out a loan (debt) or borrow by giving up ownership in the company (equity or ownership stakes). However, in order to supply the services to the entrepreneurs, both sorts of capital providers require something.

Debt capital has a clear-cut deal of fixed tenure and a fixed interest rate. However, equity capital does not provide such a condition for fixing anything. Instead, it claims that the equity provider becomes the part-owner of the organization and therefore has to share everything, including profit and losses. Therefore, it can be interpreted that the debt capital providers take less risk than the equity fund providers.

There are no free lunches in this world. The same applies to capital providers of both types. The terms of the transaction of the debt capital providers are defined and detailed in the covenant of debt agreement, but equity capital providers cannot be left in the lurch. They may share in profit and loss equally even without getting a promise of regular income, but still they expect some return for sharing their hard-earned money with the entrepreneurs. However, capturing this expectation is abstract and cannot be as simple as in the case of their debt provider counterparts. This collective expectation of debt fund providers can be termed cost of debt (The minimum acceptable rate of return expected by all the debt providers can be termed as cost of debt). Similarly, the minimum acceptable rate of return expected by all the equity providers is called the cost of equity).

Moreover, a weighted average of the cost of debt and equity is termed as cost of capital. The cost of capital is entirely abstract but can be mathematically calculated for every organization (*in percentages as the rate of return per annum*). A good number of novice entrepreneurs do not understand the nitty-gritty of the cost of capital and think that part of the capital is free (equity capital). The only part of the capital that is to be paid back is debt capital. They think that they can easily survive for long even if they make losses or do poor business and continue to repay their interests to the debt capital providers in time. Businesses are meant to create value for those who are party to run the show. The capital providers provide funds to organizations with certain expectations (cost of capital). Suppose a business can create wealth (rate of return/ return over investment/return over capital employed/return on capital) more than the cost. In that case, we know that the organization is creating VALUE for the fund providers, depleting the value and losing on the funds provided to the organization.
Therefore, the business may be of any type, in any industry or sector, in any country. The basic tenet remains the same: a company adds value only when it creates returns (e.g. Return on Capital) more than its **cost of capital**.

2. Review of Literature

Many instances in the literature reveal the importance of valuation in the business (Shingade *et al*., 2022a, Rawal *et al*., 2022, Bhimavarapu and Rastogi, 2020) [29, 8, 4]. In the inclusive growth of the nation, valuation has its significant role to play (Rastogi *et al*., 2020, Rastogi *et al*., 2021b, Rastogi and Ragabiruntha, 2018, Rastogi *et al*., 2017) [1, 4, 12, 21, 23, 28, 31, 20, 14, 22]. Studies investigating valuation in the banks are also quite frequently seen (Sidhu *et al*., 2022, Rawal *et al*., 2022, RASTOGI *et al*., 2022, Rastogi and Kanoujiya, 2022a, Bhimavarapu *et al*., 2022, Kuknor and Rastogi, 2021, Kanoujiya *et al*., 2021) [2, 3, 8, 16, 25, 33, 34,17, 29, 10, 6].
There are several papers where valuation is part of literature review papers (Shingade and Rastogi, 2020, Bhimavarapu and Rastogi, 2020, Athaley *et al*., 2020, Shingade and Rastogi, 2019, Patil and Rastogi, 2019, Verma and Gautam, 2022, Gautam and Kanoujiya, 2022) [31, 4, 1]. A relatively newer concept, Shareholder Activism (SHA), also covers the valuation aspects as an impact of SHA (Shingade *et al*., 2022b, Shingade *et al*., 2022a, Shingade and Rastogi, 2020, Shingade and Rastogi, 2019, Gautam *et al*., 2021, Gautam *et al*., 2022) [30, 32, 29, 31, 32, 6, 7]. Valuation in SMEs is witnessed (Singh and Rastogi, 2022a, Singh and Rastogi, 2022b) [15] in various ways. The involvement of valuation is the same for a concept known as transparency and disclosures (TD) (Rawal *et al*., 2022, Rastogi and Kanoujiya, 2022a, Bhimavarapu *et al*., 2022, Sharma and Rastogi, 2021, Gautam *et al*., 2021) [8, 4, 6]. Valuation also finds its role in the measurement of volatility and its impact on different securities markets (Rastogi and Kanoujiya, 2022b, Rastogi *et al*., 2021c, Rastogi *et al*., 2021a, Sharma and Rastogi, 2020, Rastogi and Agarwal, 2020, Rastogi and Athaley, 2019, Rastogi *et al*., 2018, Rastogi, 2014, Sarkar and Rastogi, 2011) [30, [1, 4, 12, 21, 23, 28, 31, 20, 14, 22, 13, 14, 24, 26].

3. Issues to be solved

1. What is value, and why it is so essential in business?
2. What is the capital, and what is the cost of this capital? Is the capital free, or part of it is free?
3. What is Return Over Capital?
4. Describe
   a) Find capital in a firm and calculate the amount? Use the enclosed Balance Sheet and estimate the capital.
   b) What is Return Over Capital in the firm
   c) Use the enclosed Balance Sheet and estimate the Return on Capital (RoC)

Company 1: Reliance Industries Limited
Company 2: Avenue Supermarket Limited
Company 3: HDFC Bank Limited
Company 4: Tata Consultancy Services

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