

Relationship of Cost of Capital, Cost of Equity Capital, Value of Firm & other Financial Variables : Panel Data & Simultaneous Equation Analysis of Indian Companies

PARMJIT KAUR*
NEETI KHULLAR**

Abstract

Cost of capital plays an important role in the economy. There is tremendous change in the financial environment after 1990, due to globalization and liberalization processes taking place in India. This paper is an attempt to empirically examine whether cost of capital is the function of capital structure or remains invariant to the same and also to investigate the relationship between cost of capital, cost of equity capital, value of firm and other financial variables based on Secondary sources of top 500 companies of India on the basis of market capitalization, during the period 2008-2010. Study indicates that the relationship of cost of capital, cost of equity capital, value of firm and other financial variables in some industries supports the Traditional view and in other industries supports the Modigliani and Miller view. While taking decisions for financial variables in various companies one has to consider number of factors, which lead to increase strategic efficiency and effectiveness of companies.

I. Introduction

COST OF CAPITAL is the minimum required rates of return a project must be earn in order to cover the cost of raising fund being used by the firm in financing of the proposal. It may be defined in two phase i.e. operational term and economic term. In the first operational term, it refers to the discount rate that would be used in determining the present value of the estimated future cash proceeds and eventually deciding whether the project is worth undertaking or not. In the second economic term, it further divided into two categories. In the first cost of capital is the cost of acquiring the fund required to finance the proposed project i.e. the borrowing rate of the firm. In second the term of lending rate it refers to the opportunity cost of funds to the firm i.e. what the firm could have earned by investing funds elsewhere. In both cases cost of capital connotes rate of return prevailing in the market and

* Professor, Panjab University, University Business School, Panjab University Campus, Arts Block III, Sector 14, Chandigarh 160014, INDIA

** Assistant Professor, Desh Bhagat College Bardwal, Malerkotla Road, Dhuri District Sangrur, District Sangrur, Punjab 148024, INDIA

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variables in various companies one has to consider number of factors influencing above mentioned parameters. Measuring and reporting these variables along with appropriate models and also after considering multiple factors will influence the companies to adapt more easily to changing conditions, in changing business financial environment which lead to increase strategic efficiency and effectiveness of companies.

VI. Managerial Implications And Scope For Future Research

Based on the finding of the study, certain recommendations are being suggested to Managers of different industries. It is suggested that the companies' executive should consider cost of capital more gravely while taking business decision based on the nature of particular industry, which lead to helps the managers to take financial decision of the company to run the firm profitably. It is helpful for financial managers to know the importance of other financial variables like size, growth, tangibility, earning per share, dividend payout ratio and value of firm that directly affects the capital structure of the company. It is helpful for managers to formulate the policies to make the optimal financial mix so that the cost of capital is minimum. Because the companies can no longer depend solely on equity or on extreme leverage that will leads to increase the cost of capital. The present study helps the financial executives to assess the current scenario on the cost of capital in different selected companies. Our study opens wider scope for further research particularly in the following directions : With effect of this competitive environment, the long term future survival and growth of the organization is difficult to achieve. So, it would be interesting to study the relationship between cost of capital, value of firm and other financial variables in future research. This study is conducted for top 500 companies on the basis of market capitalization. Small scale industries may be studied to know the significant determinants of capital structure. Some other variables like, management style, corporate governance, origin of companies, Govt. policies may be included as determinants of capital structure. Future research should be done including financial institutions, insurance and Investment Companies. In the current scenario the financial markets is not good because the financial markets are not stable in these days. So, continuation research is required in this area.

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