

Estimates of Cost of Capital to Selected Indian Industries

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1. INTRODUCTION

The estimation of cost of capital to any firm or enterprise is crucial in determining the cut-off point while appraising prospective investment opportunities or for choosing the discount rate for the valuation of cash flows. The term 'cost of capital' may be defined as the minimum prospective yield rate that a proposed investment in real assets has to offer to make it worthwhile from the standpoint of the current owners of the firm. The computation of costs associated with different types of capital such as equity capital, retained earnings of a firm, preference share capital, debenture capital and long-term loans is also necessary, before deciding upon an optimal pattern of financing of any investment project.

Despite the importance of the concept of capital cost both in theory and in actual decision-making, there is no agreement among economists as regards the nature and shape of a firm's cost of capital function. The measurement of cost of capital to an enterprise and the determination of its optimal capital structure have received the attention of a large number of research scholars in economics and finance. The extensive theoretical and empirical work done in the area has not, however, led (till now at least) to any unique method of computing the cost of capital. It is, however, generally accepted that both debt and equity capital costs are influenced by debt ratios and hence the overall cost of capital to a firm or industry should be computed as a form of weighted average of equity and debt costs.

2. THEORETICAL WORK - A BRIEF SURVEY

The cost of any investment project for a firm may be viewed as the opportunity that the firm forgoes to utilise its resources elsewhere. Similarly, the shareholder, by investing funds in the company, sacrifices the rate of return he would have obtained had he invested the funds in an alternative investment outlet. Consequently, opportunity cost could serve as a cut-off point for making investment decisions. In practice, however, it is difficult to compute the