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## Cost of capital: an empirical case study of hindustan unilever limited

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### ABSTRACT

*The cost of capital is simply known as opportunity cost which used for evaluating an investment project as discount rate. The project cost of capital is the minimum required rate of return of funds committed to the project, which depends on the riskiness of its cash flows. The cost of capital is one of the most difficult and disputed topics in the financing theory. It is a concept of vital importance in the financial decision-making. It is useful as a standard for evaluating investment decisions, designing a firm's debt policy and appraising the financial performance of top management. There does exist a methodology to calculate the cost of capital for projects. The objective method of calculating the risk-adjusted cost of capital for projects is to use the capital asset pricing model (CAPM).*

### INTRODUCTION

The term cost of capital refers to the minimum rate of return a firm must earn on its investment so that the market value of the company's equity shares does not fall. This is in consonance with the overall firm's objective of wealth maximization. This is possible only when the firm earns a return on the projects financed by equity shareholders funds at a rate which is at least equal to the rate of return expected by them. If a firm fails to earn return at the expected rate, the market value of the shares would fall and thus result in reduction of overall wealth of the shareholders.

### MEANING

In other word, Cost of Capital of a firm is the minimum rate of return expected by its investors. It is the weighted average cost of various sources of finance used by a firm. It is also referred to as cut-off rate, target cost, hurdle cost, minimum rate of return and standard cost.

According to James C Van Horne, "A cut-off rate for the allocation of capital to investments of project. It is the rate of return on a project that will leave unchanged the market price of the stock".

According to Solomon Ezra, "Cost of capital is the minimum required rate of earning or the cut-off rate of capital expenditures..

According to Hampton, John J, "The rate of return the firm requires from investment in order to increase the value of the firm in the market place".

### CHARACTERISTICS OF COST OF CAPITAL:

1. Note a cash cost: It is not always the cost which the company has to pay in cash for the use of capital. It is, in fact, the reflection of the expectations of the investors of a firm.
2. Minimum rate of return: Cost of capital represents the minimum rate of return required to maintain the value of its equity shares.
3. Consideration of risk premium: Cost of capital takes into account the risk factor also. On account of the presence of various types of risks, the cost of capital goes up.

### FACTORS AFFECTING COST OF CAPITAL:

1. General Economic conditions:
2. Market Conditions:
3. Firm's Operation and Financing Decisions:

### 4. Amount of Financing:

### SIGNIFICANCE OF COST OF CAPITAL:

1. Capital budgeting decision: Cost of capital is used as a rate for discounting cash flows to determine the profitability of a project. The cost of capital being the minimum rate of return desired is used to compare with the actual rate of return (internal rate of return) also. Thus, the concept is very useful for taking investment decisions.
2. Capital restructures decision: While designing an optimal capital structure, the firm has to bear in mind of the objective of minimizing the cost of capital so that the market value of the firm is minimized. The mode of financing is determined on the cost of financing.
3. Other decision: Decisions such as dividend decisions, working capital decisions, etc. are influenced by the cost of capital. Even the financial performance of top management is evaluated in terms of the profitability of the projects undertaken, which depends on the cost of capital.
4. Evaluating financial performance: The actual profitability of the project is compared to the projected overall cost of capital and the actual cost of capital of funds raised to finance the project. If the actual profitability of the project is more than the projected and the actual cost of capital, the performance may be said to be satisfactory.

### CLASSIFICATION OF COST:

- A. FUTURE COST AND HISTORICAL COST: Financial decisions are based on the future costs and not on the historical costs. The decisions relate to the future and hence the costs likely to be incurred in future are more significant than the costs which have already been incurred. Historical costs act simply as guides to estimate the future costs.
- B. SPECIFIC COST AND COMPOSITE COST: The cost of individual source of capital is referred to as the specific cost and the cost of capital of all the sources combined is termed as composite cost or overall cost. It is thus the weighted cost of capital. The cost of debentures, preference shares, equity shares, retained earnings etc. is to be separately calculated first and then only the combined cost can be computed. Since the combined cost considers the quantum of financing through each source, the cost is known as the weighted cost. It is this overall cost

which is important in the evaluation of a firm as an on-going entity. The composite cost of capital is the cost which is to be considered while evaluating capital projects also. In case, only one source of financing is to be used for the investment proposal, the specific cost of that source of funds may be considered. But, in a capital structure decision, it is always the weighted cost of capital that is significant.

C. **AVERAGE COST AND MARGINAL COST:** The average cost of capital is the weighted average of the costs of each component of funds employed by the firm. The weights are in proportion of the share of each component of capital in the total capital structure.

The computation of average cost involves the following problems:

- It requires measurement of costs of each specific source of capital.
- It requires assigning of appropriate weights of each component of capital.
- It raises a question whether the average cost of capital is at all affected by changes in the composite of the capital.

The financing experts differ in their approaches. According to the traditional approach, the firm's cost of capital depends upon the method and level of financing, while according to the modern approach as propounded by Modigliani and Miller, the firm's total cost of capital is independent of the method and level of financing.

Marginal cost of capital, on the other hand, is the weighted average cost of new funds raised by the firm. For capital budgeting and financing decision, the marginal cost of capital is the most important factor to be considered.

D. **IMPLICIT COST AND EXPLICIT COST:** The implicit cost is the rate of return associated with the best investment opportunity for the firm and its shareholders that will be foregone if the projects presently under consideration by the firm were accepted. It is thus the opportunity cost. For example, the implicit cost of retained earnings is the rate of return available to the shareholders had the funds been distributed to them. The explicit cost of any source of capital is the discount rate that equates the present value of the cash inflows that are incremental to the taking of the financial opportunity with present value of the cash inflows that are incremental to the taking of the financial opportunity with present value of its incremental outflows. The cash outflows may be in the form of interest payments, dividends and repayment of the principal sum.

#### **EMPIRICAL CASE STUDY: HINDUSTAN UNILEVER LIMITED**

Hindustan Unilever Limited (HUL) was known as Hindustan Lever Limited (HLL) until 18 May 2007. The company was set up in 1933. It completed 75 years of operations in India on 17 October 2007. It is an important subsidiary of Unilever. Unilever has a large number of subsidiary and associate companies in more than 100 countries. HUL's business areas include home and personal care, foods and beverages, industrial, agricultural and other products. It is one of the largest producers of soaps and detergents in India. The company has grown organically as well as through acquisitions.

HUL places equal focus on serving both the employees and the shareholders, and it is committed to add value to both. Over years, the company has built diversified portfolio of powerful brands, a number of them being household names.

The company requires the cost of capital estimates for evaluating its acquisitions, investment decisions and the performance of its businesses and for determining the value added to shareholders. It needs to develop a methodology of calculating costs of equity and debt and determine the weighted average cost of capital.

#### **HUL's PERFORMANCE;**

**Table 1.1: Hindustan Unilever Limited: EPS, DPS and Share Price**

YEAR	DPS (Rs.)	EPS (Rs.)	SHARE PRICE(Rs.)	MARKET CAP. Rs. (billion)
1997	1.70	2.81	138.35	275.55
1998	2.20	3.67	166.36	365.25
1999	2.90	4.86	225.00	495.13
2000	3.50	5.95	206.35	454.09
2001	5.00	7.46	223.65	492.31
2002	5.16	8.04	181.75	400.08
2003	5.50	8.05	204.70	450.59
2004	5.00	5.44	143.50	315.87
2005	5.00	6.40	197.25	434.19
2006	6.00	8.41	216.55	477.88
2007	9.00	8.73	213.00	465.75

Table 1.1 contains a summary of HUL's EPS, DPS, share price and market capitalization. The company has been paying dividends regularly. HUL's shares have enjoyed high price in the stock market. The company's share price has increased from Rs 138.35 in 1997 to Rs 213.90 in 2007. The company's sales and assets have shown significant growth, and company's profitability has also increased over years (Table 1.2). The company is conservatively financed (Table 1.2).

**Table 1.2: HUL's financial Performance (Rs. Millions)**

Particulars	2005	2006	2007
Net sales	110606	121034	137178
Total income	112130	122949	139426
PBDIT	15958	18395	21105
Interest expense	192	107	255
PBT	16045	18617	21845
PAT (before exceptional items)	13545	15397	17691
Net profit	14081	18554	19255
Share capital	2201	2207	2177
Reserves & Surplus	20855	25028	12215
Loan Funds	569	736	885

#### **COST OF CAPITAL ASSUMPTIONS AT HUL:**

The company considers cost of its debt as the effective rate of interest applicable to an 'AAA' rated company. It thinks that considering the trends over years, this rate is 9.5 per cent in 2007. The risk-free rate is assumed as the yield on long-term government bonds, which the company regards as about 8 per cent. HUL regards the market-risk premium to be equal to 11 per cent. The company uses CAPM to calculate its cost of equity. The alternative method is the constant growth model.



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