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A Study on Market Structure and Cost of Capital

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INTRODUCTION

Cost of capital is the expenditure what a company faces while raising a particular type of capital With the point of view of the company. The cost of capital is calculating the expenditure occurred by the company while raising a particular type of capital with the perspective of the company. The rising of capital should always be With the aim of maximising the wealth of the shareholders of the company. Usually while raising the capital the company has to analyse various cost of capital that is going to incur and which world would have the least cost for rising the capital.

From the investors perspective the cost of capital is the minimum amount of return the investor must get in return to surpass the break even point that is the amount of minimum return he should get for the investment that he has committed for the firm. It should be the justification for the investor for the amount that he is committing to the company and the risk that he is bearing. In the beginning stages of the company the company will not be owning any of the major assets which it could pledge in return for the debt that they can raise so equity stands as the only option that a company can raise in the initial stages. From the companies point of you the cost of capital is the minimum earning that it should get for the investment that it is raising from various sources, and from the investors perspective the cost of capital is what the minimum earnings that he should get for the investment committed by him.

The rising of the capital there are various types of cause that occurs while raising the capital such as specific cost, weighted cost. These are the 2 types of costs that occur while rising the capital for a company Specific cost measures the cost occurred to a company will raising a specific type of capital such as equity or debt, wherein weighted capital gives way to multiple kinds of capital raised in the company such as debt capital, equity capital, preference capita, in this method of weighted average cost we assign weight to every kind of capital that we raise according to its contribution to the whole capital and calculate the cost of capital accordingly.

The various types of costs of capital that a company might face are cost of equity capital, cost of debt capital, cost of preference share capital, cost incurred by utilising retained earnings. These are the major 4 types of capital that a company rises. equity capital is known as most expensive type of capital a company can raise, raising of the equity capital dilutes the ownership of the business because there are Various numbers of people getting the ownership of the company in exchange to the contribution they had made for the capital raising. on the other hand, debt is known as the cheapest source of capital as interest rate what we pay to the debtors is lower when compared to what we pay to the equity shareholders preference shareholders. Usually it is preferred that the company does a thorough analysis of its working capital before raising a long Term capital .

In this research we will try to narrow down the cost of capital of a company limited to only equity capital.

REVIEW OF LITERATURE

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INDUSTRY ANALYSIS

In India the cost of raising equity is quite high sas there is high expectancy of return by the investors, and this causes the cost of raising equity capital quite high for the companies, there are many other charges related to raising equity capital such as the Commission paid. the risk return analysis theory says that the risk is directly proportional to the return that one expects from the investment, so more the stock is speculative the more is the return that is expected by the investors and so this the cost of raising the equity capital increases from the point of view of the company.

PESTEL analysis

- **Political factor**

the politics of a country has a major role on deciding the economy performance of the country. The policy is that the government rules out and interest rate that is fixed by the government and many other factors have major impact on that companies cost of raising equity share capital. the cost of the legal proceedings and all the regulation charges also add upon for the cost of raising the equity share capital.

- **Economical factor**

the economic factor also has the higher impact on the performance of the company as well as the cost of raising the capital for the short term as economical factors are the responsible factors for the systematic risks in the market and the systematic risk are responsible for the the overall economy performance which in turn is responsible for the factors like interest rates the market performance EC…

- **Social factors**

The performance of the company is also dependent on the social factors because apart from the performance of the company economically the social sentiments of the public also plays a major role in the performance of the stock of the company these are known as ripples the market performance theories, which are caused by the public and these are usually short term in nature.

- **Technological factors**

the rise of the technology the cost of raising the capital has reduced to some extent, s the technology has improvised the more and more people can invest into the equity of the company without a broker being present between the company and the investor and charging higher Commission rates that would eventually add up to the cost of capital of the company.

- **Environmental factors**

while starting a company the proprietor has 2 clear up all the legal regulatory formats that is required for the registration of the company an environmental factor is one of the required factors that a company has to clear up in terms to have a smooth functioning in the company.

- **Legal factors**

legally the company has a lot of obligations towards the investors of the company, and on the other hand even the investors have legal obligations towards the company depending on the liability to shareholders gets with the share he buys in the company. there are many legal obligations for both the parties to adhere to and meet them obligations as per the demand of the other party.

METHODOLOGY

We would conduct this research based on the data collected from the Secondary sources of data available.

For an investor 2 major important factor that one considers while investing are the WACC and the beta value of the stock. these 2 factors play a major and critical role in the stock performance of the company. beta is the most important factor that an investor considers while investing because the higher the beta value the higher the volatile the stock is because higher beta value shows that stock is most speculative and with this the investor decides upon whether to invest or not into the particular stock and this has major impact on rising of the equity capital of the company.

The WACC is one of the important factor that a company has to consider while raising the capital because each aspect of the capital should be given the optimum weight intern to cut down the cost of capital raising from the companies point of view, with the WACC value the company comes up with the total cost of capital that a company is going to have and how much return it has to earn for the investment made for the company to get past the break even point and give the maximum return to the investors of the company.

Now , we see how the market structure has the affect on the cost of capital of a company The market structure has a huge impact on the cost of capital as the external factors such as industry standards, play a high role in the selection of the type of the capital to allocate for the company and how well the company should perform in order to meet the Industry norms , the whole market in the picture also plays an important role with respect to the cost of capital , as the macro economic conditions are responsible for the performance of the economy in whole, and the factors like :

- Country’s growth rate
- Government subsidies towards the Industry
- Industry standards
- Company’s past growth trends
- Type of capital raised by the company
- Market sentiments about the company

These factors are the key elements in the performance of a company, while other factors are the external factors but the cost of capital of the company is the internal factor for the performance of the company. To raise any type of capital factors like:

- Cost of capital of the raised funds
- The break even point
- Shareholders acceptance rate for the proposed capital structure.

How does beta affect the capital structure of a company?

Beta value determines the sensitivity rate of the stock selected, it shows how many time will the market change per one unit change in the market index. Beta value shows the sensitivity and fluctuation related to the market's fluctuation. Beta with higher beta value are considered to be more speculative and those with lower beta value have less affect of market crash or macro economic depression on the stock performance.

Beta>1 High volatility, preferred by risk takers

Beta <1 Low volatility , preferred by the risk transferrer

Beta = 1 change is perfectly correlated with the market changes

From the beta value we can consider the number of the investors and their nature towards the risk taking is dependent on the market structure and this has direct affect on the capital structure raised.

Risk averse people would choose the preference share , where the risk takers would go for the equity Shares even when the beta value is higher sometimes. The risk taking nature of the investors and the market conditions and the economic performance are the major factors that are external to the company and they have major impact on determining the type of capital a company can raise and how much of it has affect on the capital structure of the company.

CONCLUSION

At final we would conclude that the market structure has a positive correlation with the cost of capital of a company , it not only external factors such as market structure that determines the cost of capital of the company but the internal factors also plays an important role in the selection of the capital structure of the company, these internal factors include: company's past performance, current debt equity ratio, industry norms etc… The structure of the company is also one of the most important factor that a company considers while allocating the resources to the capital of the company. But the market structure has a higher impact on the growth rate and choices that the company has to make in term to achieve the objectives of having corporate finance that the wealth maximization of the shareholders.