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A Study of Cost of Capital of ITC Limited

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ABSTRACT

ITC was the first company in India to voluntarily seek a corporate governance rating. ITC's production facilities and hotels have won numerous national and international awards for quality, productivity, safety and environment management systems. This Study is based on the secondary data extracted from the annual reports of the company. The financial statements of ITC have been collected over a period of 5 years from 2013 to 2017. Companies strive to attain optimal financing mix based on the cost of capital for various funding sources. Every company has to chart out its plan for financing the business at an early stage. The cost of capital becomes a critical factor in deciding which financing track to follow – debt, equity or a combination of the two. The breakeven point is the sales volume at which a business earns exactly no money. The company calculate break-even point to determine the amount of remaining capacity after the breakeven point is reached, which tells the maximum amount of profit that can be generated.

Keywords: *Cost of Capital, Cost of Equity, Cost of Debt, Break-Even Point.*

1. INTRODUCTION

ITC Ltd is one of India's foremost private sector companies. ITC has a diversified presence in Cigarettes Hotels Paperboards & Specialty Papers Packaging Agri-Business Packaged Foods & Confectionery Information Technology Branded Apparel Personal Care Stationery Safety Matches and other FMCG products. While ITC is an outstanding market leader in its traditional businesses of Cigarettes Hotels Paperboards Packaging and Agri-Exports it is rapidly gaining market share even in its nascent businesses of Packaged Foods & Confectionery Branded Apparel Personal Care and Stationery. ITC's wholly owned Information Technology subsidiary ITC Infotech India Ltd provides IT services and solutions to leading global customers. ITC Infotech has carved a niche for itself by addressing customer challenges through innovative IT solutions. ITC's production facilities and hotels have won numerous national and international awards for quality productivity safety and environment management systems. ITC was the first company in India to voluntarily seek a corporate governance rating. ITC also entered into lifestyle retailing and the stationery segments through its premium brands Paper craft notebooks and Wills Sport apparel range. Eventually the company launched mass-appeal brands like Classmate: notebooks and John Players: menswear. ITC opened first premium cigar retail store in Delhi. ITC Ltd also acquired the entire shareholding of Russell Credit Ltd. in Wimco Ltd. Consequently Wimco became a direct subsidiary of the Company with effect from September 29 2011. In 2012 ITC Ltd acquired 22606065 Ordinary Shares having no par value of Technico Pty Ltd (TPL) a company incorporated in Australia from Russell Credit Ltd wholly owned subsidiary of the Company. Consequently TPL became a wholly owned Subsidiary of the Company with effect from March 26 2012.

The term cost of capital refers to the minimum rate of return a firm must earn on its investments. The cost of capital is the cost of a firm's debt and equity funds, are the required rate of return on a portfolio of the company's existing securities it is used to evaluate and decide new projects as well as the minimum return investors expect from the invested capital. The break-even point is a point where total costs (expenses) and total sales (revenue) are equal. Break-even point can be described as a point where there is no net profit or loss. It represents the sales amount (in either units or monetary terms) that is required to cover total costs, consisting of both fixed and variable costs to the company. Total profit at the break-even point is zero.

2. OBJECTIVES OF THE STUDY

- To know weighted average cost of various sources of finance of ITC Ltd.
- To study the financial break-even point of ITC Ltd.

3. LIMITATIONS OF THE STUDY

- Data is derived from published annual reports of ITC Ltd.
- The figures taken for the study were only approximate.

4. STATEMENT OF THE PROBLEM

Cost of Capital helps to find the proportion of debt and equity and in which way it affects the shareholders wealth. The cost of capital is needed to identify the particular project that will yield a minimum return to them. If there is high risk, it indicates the management, that the cost of capital will be high for that particular project. For that they need to identify a particular source of financing that is best suited to the company. So that, the risk burden on the shareholders can be reduced. The company calculate break-even point to determine the amount of remaining capacity after the breakeven point is reached, which tells the maximum amount of profit that can be generated. Thus, the study mainly focuses on the Cost of Capital and Break-even point of ITC Limited.

5. REVIEW OF LITERATURE

Richard Lambert, Christian Leuz, and Robert Verrecchia(2006) have made a study on “Cost of Capital”. This paper examine whether and how accounting information about a firm manifests in its cost of capital, despite the forces of diversification. The analysis demonstrate that the quality of accounting information can influence the cost of capital, both directly and indirectly. The direct effect occurs because higher quality disclosures affect the firm’s assessed covariance with other firms’ cash flows, which is nondiversifiable. The indirect effect occurs because higher quality disclosures affect a firm’s real decisions, which likely changes the firm’s ratio of the expected future cash flows to the covariance of these cash flows with the sum of all the cash flows in the market. The study concludes that this effect can go in either direction, but also derive conditions under which an increase in information quality leads to an unambiguous decline in the cost of capital.

Correia C and Cramer P (2008) have made a study on "An analysis of cost of capital, capital structure and capital budgeting practices: a survey of South African listed companies". This study employs a sample survey to determine and analyses the corporate finance practices of South African listed companies in relation to cost of capital, capital structure and capital budgeting decisions. The results of the survey are mostly in line with financial theory and are generally consistent with a number of other studies. This study finds that companies always or almost always employ DCF methods such as NPV and IRR to evaluate projects. Companies almost always use CAPM to determine the cost of equity and most companies employ either a strict or flexible target debt-equity ratio. Furthermore, most practices of the South African corporate sector are in line with practices employed by US companies. This reflects the relatively highly developed state of the South African economy which belies its status as an emerging market.

Mary E Barth , Wayne R Landsman(2013) has made a study on “Cost of capital and earnings transparency”. The study provides evidence that firms with more transparent earnings enjoy a lower cost of capital. It finds a significant negative relation between our transparency measure and subsequent excess and portfolio mean returns, and expected cost of capital, even after controlling for previously documented determinants of cost of capital. This study provides evidence that firms with more transparent earnings enjoy a lower cost of capital. Firms with more transparent earnings are those whose earnings better reflect changes in the economic value of the firm. The analysis signifies that firms with more transparent earnings have a lower cost of capital as reflected in subsequent excess returns and portfolio mean subsequent returns. The study also finds that firms with more transparent earnings have a lower expected cost of capital. This study examines whether firms with more transparent earnings enjoy a lower cost of capital.

Nabil Alnasser (2014) has made a study on “The Effect of Using Break-Even-Point in Planning, Controlling, and Decision Making in the Industrial Jordanian Companies”. The study found out that, the most of the Jordanian industrial companies are using break-even point in the planning, controlling and decision-making, and there is a statistical significant relationship between the use of the break-even point and successful planning, control and decision-making in the Jordanian industrial companies. The study has recommended that, companies should use breakeven point as a main tool of decision-making and planning oversight because of its impact, efficiency and accuracy in the rationalization and control decision. The companies are also performing BEP analysis in the planning process for Human Resources acquisition, also in the planning process for expenditures, Production, and in evaluating auditing performance. The Jordanian industrial companies are performing Breakeven-Point analysis in deciding between alternatives, to make long-term and short-term decisions. The results of this research study may be useful to the industrial companies In a way that it can use the findings to improve the planning and controlling process.

6. PERIOD OF STUDY

The study period is five years i.e., from 2012-2013 to 2016-2017 for the analysis of Cost of Capital and Break Even Point of the company.

7. SOURCE OF DATA

The study is based on secondary data which have been obtained from the audited report of the company , annual report 2012-2013 to 2016-2017 books and journals and website.

8. TOOLS AND TECHNIQUES USED

Cost of Equity Capital, Cost of Debt and Break-even point have been used to analyse the data for ITC Ltd from the period of 2012-2013 to 2016-2017.

• **COST OF CAPITAL**

The cost of capital is the cost of a company's funds (both debt and equity), or, from an investor's point of view, known as the required rate of return on a portfolio company's existing securities .It is used to evaluate new projects of a company. It is the minimum return that investors expect for providing capital to the company, thus setting a benchmark that a new project has to meet. The cost of capital of a business represents the market’s required rate of return on capital invested in that company. It equals the rate of return on a project or investment with similar risk. A company’s cost of capital is the rate of return the company would earn if it invested its capital in a company of equivalent risk.

• **COST OF EQUITY CAPITAL**

Cost of equity refers to the market’s required return on an equity investment. It is the return required to get investors to purchase shares of a company’s equity. The return consists both of dividend and capital gains. Furthermore, investors will demand a specific return for invested capital given the risk of the equity investment. Cost of Equity share capital maybe defined as the minimum rate of return that a company earns on the equity financed portion of an investment in an project in order to leave the market price of such share unchanged. The cost of equity, which compensates investors for time value and a risk premium, is that required rate. From company's perspective the company must earn more than cost of equity capital in order to be unaffected by the market value of the shares of its. The Cost of Equity Share capital, in simple words, refers to the market’s demand for return on the equity instrument for which the company has to earn more than such costs to survive in the market conditions.

$$\text{Cost of Equity Share Capital (Ke)} = \frac{Dp}{Sp} = \frac{\text{Dividend per share}}{\text{Share Price}}$$

Table No. 1 Table of Equity Rs. (in Crores)

YEAR	DIVIDEND PER SHARE (Rs.)	SHARE PRICE PER SHARE (Rs.)	COST OF EQUITY (%)
2017	4.75	280.45	1.69
2016	8.50	328.05	2.59
2015	6.25	325.45	1.92
2014	6.00	352.95	1.69
2013	5.25	268.05	1.96

(Source: computed (profit.ndtv.com/stock/itc-ltd_itc/financials))

From the above table, it is inferred that during the study period 2013 to 2017, the cost of equity capital is high (2.59%) in the year 2016 and low in the years 2014 (1.69%) and 2017(1.69%). In the year 2017, the cost of equity is low and it shows that lower returns have been paid to the equity shareholders by ITC during the year.

• **COST OF DEBT**

Cost of debt is the interest a company pays on its borrowings. The cost of debt is the return that a company provides to its debtholders and creditors. These capital providers need to be compensated for any risk exposure that comes with lending to a company. It is the overall average rate an organization pays on all its debts. These typically consist of bonds and bank loans. It is nothing but the interest payable on the Debt. It measures the discount rate which equates present value of Post-tax interest payment and principle repayment. Cost of Debt maybe calculated by dividing annual interest payment by closing value of Debt. Cost of Debt can be calculated as follows:

$$\text{Cost of Debt (Kd)} = \frac{\text{Interest}}{\text{Cost of Debt}} * 100$$

Table No. 2 Cost of Debt

(Rs. in Crores)

YEAR	INTEREST (Rs.)	DEBT AMOUNT (Rs.)	COST OF DEBT (%)
2017	45.33	25.84	175.43
2016	71.93	42.29	170.09
2015	78.45	53.02	147.96
2014	23.63	66.54	35.51
2013	105.91	77.67	136.36

Source: computed (profit.ndtv.com/stock/itc-ltd_itc/financials)

From the above table, it is inferred that during the study period 2013-2017, the cost of debt is high in the year 2017 and low in the year 2014. It shows that ITC has a higher debt proportion in its capital structure. In the year 2017, the cost of debt is high because it pays more interest to its debtholders. The high payment of interest to its debtholders reduces the profitability of the company which ultimately results in low returns to its shareholders.

FINANCIAL BREAK-EVEN POINT:

The Financial Break-even point (BEP) is the point at which cost or expenses and revenue are equal: there is no net loss or gain. It is the point at which total of fixed and variable costs of a business becomes equal to its total revenue. At this point, a business neither earns any profit nor suffers any loss. Break-even point is therefore also known as no-profit, no-loss point or zero profit point. Calculation of break-even point is important for every business because it tells business owners and managers how much sales are needed to cover all fixed as well as variable expenses of the business or the sales volume after which the business will start generating profit. The computation of sales volume required to break-even is known as break-even analysis. The break-even point is achieved when the generated profits match the total costs accumulated till the date of profit generation. Establishing the break-even point helps businesses in setting plans for the levels of production which it needs to maintain be profitable. Financial Break-even Point is calculated as:

$$\text{Financial Break-even Point} = \frac{\text{Fixed Costs}}{\text{Contribution}}$$

$$(\text{Contribution} = \text{Sales} - \text{Variable Costs})$$

Table No. 3 FINANCIAL BREAK-EVEN POINT

(Rs. in Crores)

YEAR	FIXED COST (Rs.)	CONTRIBUTION (Rs.)	FINANCIAL BREAK-EVEN POINT (Units)
2017	2124.64	17672.93	0.1202
2016	1253.97	15759.97	0.0796
2015	913.80	14989.77	0.0610
2014	1272.74	13955.48	0.0912
2013	969.29	11759.21	0.0824

Source: computed (profit.ndtv.com/stock/itc-ltd_itc/financials)

9. FINDINGS

- ITC shows higher payment of returns to its equity shareholders when the actual composition of equity capital is less in its capital structure.
- It is inferred that ITC has a higher debt proportion in its capital structure. By payment of interest to its debt holders, the company can take advantage of tax benefits.
- ITC Ltd has achieved the financial break-even points where the company earns no profit and no loss. It has a contribution that is fair enough to pay its fixed costs.

10. SUGGESTIONS

- In future, the company can increase its long-term funds in order to avail the benefit of tax. The company can boost its capital in the long run by issuing preference shares.
- The company can reduce the costs of capital and increase the wealth to its shareholders by issuing preference shares.

11. CONCLUSION

The analysis cost of capital highlighted that the company's borrowings and the Equity Finance have fluctuations during the period. The study reveals that the company has a high cost of debt capital and takes maximum advantage of tax. ITC can increase the value of shareholders by issuing preference shares, thus maintaining the balance between Cost of Equity and Cost of Debt.

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