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COST OF CAPITAL DERIVED FROM LONG TERM DEBT

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Abstract

Company capital that is used from debt has a greater risk than the capital owned by the company itself. The company's capital used must be done optimally in order to minimize financial risks that can occur. The capital structure determines the use of debt by financial managers to fund company activities. Decisions on capital structure (capital structure) include the selection of sources of funds both from own capital and foreign capital in the form of debt. In this case, capital becomes an important element for the running of a strategic business where the company needs to conduct a study and determine the size of the company's needs and ability to provide capital to support the work or business that will be carried out.

***Keywords**: Company capital*

INTRODUCTION

Research on company capital structure has become an interesting and relevant topic in the field of corporate finance. The crucial question that arises is how companies can choose the optimal capital structure to achieve their goals, such as maximizing firm value or reducing the cost of capital. Capital structure is the topicwhich has received a great deal of attention in the financial management arena (Harris and Raviv, 1991). According to Fama and French (1998), that the optimization of corporate value which is the goal of the company can be achieved through the implementation of the financial management function. Fama (1978) states that the value of the company will be reflected in the market price of its shares. The higher the stock price, the higher the company value. Companies in achieving their main goal, maximizing the value of the company, are sometimes not matched by using the right company capital, especially capital that comes from debt. Company capital that is used from debt has a greater risk than the capital owned by the company itself. The company's capital used must be carried outoptimally in order to minimize financial risks that may occur.

The capital structure determines the use of debt by financial managers to fund company activities. Decisions on capital structure (capital structure) include the selection of sources of funds both from own capital and foreign capital in the form of debt, both of these funds are external funds that can affect the value of the company. Brigham and Houston (2011: 171) state that the optimal capital structure of a company is a structure that will maximize the company's stock price. Capital structure can be expressed in debt to equity ratio (DER). Zainar Inayah "ANALYSIS OF CAPITAL STRUCTURE, PROFITABILITY AND FINANCIAL PERFORMANCE ON COMPANY VALUE (FINANCIAL MANAGEMENT LITERATURE REVIEW RESEARCH)" Volume 3, Issue 2, July 2022

DEFINITION OF CAPITAL STRUCTURE

Definition of Capital Structure Capital structure is a collection of funds that can be used and allocated by companies where the funds are obtained from long-term debt and equity (Gitman, 2006). Capital structure is a combination or balance between debt and equity (preferred stock and common stock) used by companies to plan capital gains (Ambarwati, 2010). According to Fahmi (2014) states that the capital structure is a picture of the form of the company's financial proportions, namely between owned capital that comes from long-term debt (long-term liabilities) and equity (shareholders equity). Capital structure is a company's long-term expenditure as measured by a comparison of long-term debt with its own capital (Sudana, 2011).

CAPITAL STRUCTURE THEORY

The theory of capital structure is very closely related to the cost of capital in a company. The capital structure is a combination of long-term funding sources used by a company. The main objective of making decisions on capital structure is to maximize the market value of the company by means of the right combination of the company's long-term funding sources. This combination of long-term funding sources, called the optimal capital structure, will minimize the overall cost of capital for the company. Here are some theories about capital structure, including:

1. NI & NOI Approach

   The approaches used in analyzing Capital Structure can be explained as follows:

   a. Net Income (NI) Approach In this approach, a portion of the return on shareholders is capitalized at a constant capitalization rate, namely to (cost of own capital). The assumptions underlying the Net Income approach are: a. The cost of debt (kl) and the cost of own capital (ke) are constant even though the capital structure changes. b. The cost of debt before tax (kd) is lower than the cost of own capital.
   b. Net Operating Income (NOI) Approach In the Net Operating Income (NOI) approach, the level of the weighted average cost of capital (ko) is constant. The assumption underlying this approach is that the cost of debt (cl) and the overall cost of capital (ko) are constant. In the NOI approach, changes in capital structure do not affect the total value of the company.

2. Traditional Approach

The Traditional Approach argues that there is an optimal capital structure. This means that the Capital structure has an influence on Firm Value, where the Capital Structure can change in order to obtain optimal company value. Those who adhere to the traditional approach argue that in perfect capital markets and no taxes, firm value (corporate cost of capital)can be changed by changing the capital structure (ie B/S). The traditional approach is one of the theories of capital structure, which in this theory explains that there is an optimal capital structure that companies can use. The position of the traditional approach shows that the cost of capital is not independent of the company's capital structure. So this approach believes that companies can optimize the capital structure. The optimal capital structure occurs when the cost of capital margin of real debt is explicitly and implicitly equal to the cost of capital margin itself in an equilibrium position. The traditional approach also explains that a company can increase the total value of the company by using a certain amount of debt (financial leverage), where the additional use of debt at a certain point will save the cost of capital (co). Additional debt can also increase value the company, because of the increase in debt it has cheaper cost of capital (Solikhadi, 2016)

3. Modligani Theory Approach – Miller (MM)

   Modligani Theory – Miller (MM) No Taxes

   a. Based on the theory put forward by 2 financial management experts, namely Franco Modigliani and Merton Miller in 1958 which stated that there was no relationship between company value and the cost of capital with its capital structure. This statement is supported by the existence of an arbitration process. Going through the arbitration process will make the stock price or value of the company either not using debt or using debt, ultimately the same. This arbitrage process arises because investors are rational, meaning that investors prefer the same investment but produce greater profits or with smaller investments produce the same profit (Sutrisno: 2013). Several assumptions underlie the MM-No Tax theory: A company's business risk is measured by Ơ EBIT (standard deviation of Earning Before Interest and Tax);
   b. Investors have the same appreciation of a company's future EBIT;
   c. Stocks and bonds are traded in a perfect capital market The debt is risk free so the interest rate on debt is risk free;
   d. All cash flows are perpetuities (the same amount each period to infinity). In other words, the company's growth is zero or EBIT is always the same;
   e. There are no corporate taxes or personal taxes (Nidar, 2016).

The three approaches in the capital structure theory use an assumption to simplify and refine the problem, as follows:

a) No profit tax is taken into account
b) The company determines a dividend payout ratio of 100%

c) There are no transaction fees
d) The company has a constant operating profit
e) The company has constant operational risk

Capital structure theory explains whether a company's long-term spending policy can affect a company's value, the cost of capital to the company and also the market price of the company's shares. If a company's spending policy can affect these three factors, what is the combination of long-term debt and company's own capital that can maximize a company's value, or minimize a cost of capital for the company or maximize the market price of the company's shares. The stock market price really reflects a value in the company, thus if the value of a company increases enough, then the market price of a company's stock will also increase or increase. Syarinah Sianipar, "The effect of capital structure and profitability on firm value in the listed food and beverage sector on the Indonesian stock exchange", JOM FISIP. Vol. 4 No.1, 2017. 1.

COMPANY CAPITAL STRUCTURE

According to Frank J. Fabozzi and Pamela Peterson (2000), the company's capital structure is the combination of debt and equity used to finance the company's projects. Based on this, it can be seen that the company's capital structure is part of the finance or financial structure that exists in a company and the relationship of this financial structure to the way the company takes strategic steps in procuring capital to fund existing work in the company, where the capital can be in the form of debt. long-term or shareholder capital. In this case, the selection of sources of capital is an important element for realizing a business strategy where the company needs to conduct a study and determine the size of the needs and the ability of the company itself to provide capital to support the core business that will be carried out.

CONCLUSION

One important part of a company is having a source of capital that can support operations. In this case, the capital structure will affect the financial condition of a company, where the application of the theory of capital structure as a company foundation can be used as a reference in determining the business strategy that will be taken by stakeholders in the company. A management set about. The capital structure will really help the company to be able to allocate funds appropriately. Management of the capital structure will also help the effectiveness of the use of debt as capital that can be used to ensure decision making by company management and shareholders. In the capital structure, applying long-term debt by calculating the right cost of capital will be a good start for running a business. This is inseparable from how the company can develop its assets.

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