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COST OF CAPITAL DETERMINANTS: CONTEXT IN INDONESIA AND MALAYSIA

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Abstract: The purpose of this paper is to look at the determinants of the cost of capital for a company. This study conducts a literature review to identify the factors that affect the cost of capital for a company. The study shows that profitability, liquidity, tax, growth, size, and age of the company are some of the major determinants that affect the cost of capital of the company. The study further shows a positive correlation between the cost of capital and profitability, liquidity, growth, size, and age of the company. The capital arrangement of the company is determined based on the pecking order theory and the trade-off theory, while keeping in mind the cost elements associated with it. In Indonesia, economic stability and political stability are the major determinants that determine the cost of capital for a company. These determinants affect the availability and cost.

Keywords: Capital Management, Cost of Capital, Profitability, Liquidity, Leverage.

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INTRODUCTION

Cost of capital is an important aspect of any business's financial management as it determines the minimum return a company must earn on its investment to satisfy its investors (Wu et al., 2012). In Indonesia, several factors determine the cost of capital for business development. Extensive research has been conducted to identify the determinants of the cost of capital. The two main sources of capital for a company are debt and equity financing. The source of capital adopted by a company will ultimately be motivated by the shareholders' interest in maximizing profits. Cost of capital is defined as the amount of money a company pays after making a profit to its shareholders, bondholders, or lenders (Jacobs & Vuuren, 2015).

The cost of capital plays a significant role in creating competitive distortions between

developing and developed countries (Esqueda & O'Connor, 2024).

This is due to the assumption that the cost of capital is uniform across countries, which does not take into account country-specific factors that may affect the cost (Jacobs & Vuuren, 2015). The two main calculation methods used in this study are the Weighted Average Cost of Capital (WACC) with and without the addition of country risk premium to the cost of equity component. The results show that when the country risk premium is included, the cost of capital becomes significantly higher, indicating the importance of country-specific risk factors in determining the cost of capital (Radu & Dragomir, 2023). The cost of equity capital has a significant impact on the efficiency of resource allocation in the capital market and can be affected by the quality of information disclosure (Vayas-Ortega et al., 2020). Annual reports, as one of the ways to disclose external company information, are an important channel for investors to understand the company, and help investors predict the company's future performance (Mielcarz & Mlinarič, 2014) and stock prices (Park et al., 2021). The disclosure content of the annual report includes information in digital form and information in text form. The higher the text information content, the greater the value of the information transmitted to the capital market (Carney et al., 2024). The information content referred to in this paper is company-specific information in the annual report that is different from other companies in the same industry or different industries (Shi & Fan, 2024). The cost of equity capital of public companies in Indonesia is higher compared to Malaysia, the Philippines, and Thailand. It is recorded that Indonesia has a cost of equity capital of 34.85 percent. This means that the investment climate in Indonesia is not yet effective and efficient compared to other neighboring countries. In Indonesia itself, the average Weighted Average Cost of Capital (WACC) for listed companies is around 11.6%. This figure reflects the combined cost of equity and debt financing sources, with around 30% of financing typically coming from debt (Kannan-Narasimhan et al., 2023). This composition of capital sources significantly affects the overall cost of capital due to differences in risk and return expectations of investors and lenders. Meanwhile, Malaysia has a different financial landscape. Studies show that Malaysian firms often have a lower cost of equity compared to their counterparts in Indonesia (Bonaccorsi di Patti et al., 2023; Radu & Dragomir, 2023). This can be attributed to several factors, including stronger political connections that may lead to better financing conditions and lower risk perceptions by investors due to these connections. Such political connections can positively affect firm valuations, reducing the cost of equity capital as firms benefit from government support and preferential treatment that may include easier access to credit, subsidies, or a less stringent regulatory environment (Xu et al., 2024). Indonesia has a higher cost of equity capital than Malaysia, at 34.85%. While both countries share some similarities in terms of market dynamics and financial practices, the influence of political relations in Malaysia and the higher reliance on equity financing in Indonesia indicate key differences in how the cost of capital is structured. These differences can affect investment decisions, risk assessments, and ultimately, the financial strategies of firms operating in these two economies. In the context of manufacturing firms, operational risk and financial risk play a significant role in determining the cost of capital (Hamida et al., 2022). The cost of capital is an estimate of the costs a firm must bear to finance its investments and operations, which includes the cost of debt and equity (Radu & Dragomir, 2023). Operational risk relates to the risk of losses arising from the firm's internal operational processes, including system failures, human errors, or disruptions caused by external factors such as natural disasters. In the manufacturing industry, these risks can include machine breakdowns, inefficiencies in the production process, or product quality issues (Rahmawati, 2020).

Higher operational risk can increase the company's perceived risk in the eyes of investors and lenders, which in turn increases the cost of capital (Urbański, 2021). Investors may demand higher rates of return to compensate for this additional risk, while lenders may offer higher interest rates on loans or reduce credit accessibility (Smaga, 2024). Financial risk is related to the company's capital structure and financing decisions, including debt levels, liquidity, and sensitivity to interest rate changes (Smirnov, 2021). In the context of manufacturing companies, this risk can come from a high debt burden or cash flow instability (Quoc et al., 2024). Higher financial risk usually means that the company faces higher costs to access capital because lenders perceive a higher risk of default. This results in higher interest rates on debt and lower stock prices because shareholders anticipate greater risk, which also

increases the cost of equity (Bossauer & Herberger, 2024). The interaction between operational risk and financial risk can complicate the assessment of the cost of capital (Fleta-Asín & Muñoz, 2023). If a manufacturing company faces high operational risk, it can disrupt cash flow, which further increases financial risk if the company relies on debt financing to fund day-to-day operations (Liu et al., 2024). To manage operational risk and financial risk to minimize the cost of capital, companies can balance between debt and equity to minimize the overall cost of capital while maintaining financial flexibility (Khan et al., 2021). Companies can improve operational efficiency by implementing new technologies, improving production processes, and training employees to reduce operational risk (Faozi et al., 2022). Equity financing is usually provided by the company's shareholders or entities, and debt financing is usually provided by bondholders or lenders (Zulfikar et al., 2020). For this reason, the determinants of the cost of capital are heavily influenced by the financing model adopted by the company. Many researchers have identified profitability, liquidity, growth, size, and age of the company among the main determinants that affect the cost of capital. Capital structure refers to the combination of all accessible sources, and this combination depends on the characteristics of a particular firm, industry, and country, where both firm and industry aspects serve as macro-environmental factors for the organization (Fueki et al., 2024). The capital arrangement adopted by a firm is determined by the cost of capital associated with it.

METHODS

This study reviews the literature of journal articles relevant to cost determinants from 2019 to 2024. Literature sources are selected based on their relevance to the research variables and their contribution in providing empirical or theoretical data that supports them. The literature search was conducted using the Scopus and ScienceDirect databases with the keyword "cost of capital". The included literature must meet certain criteria, must be published in a peer-reviewed journal, in English, and focus on the influence of independent variables on the cost of capital in companies. Articles that do not contain empirical analysis, such as opinion pieces or editorials, are excluded from the review. Each article is assessed and screened based on thematic and methodological relevance. Information from each relevant source is summarized and analyzed to identify trends, relationships, and gaps in existing research. Data from the screened literature will be synthesized to assess consensus or differences in previous research. This analysis helps identify patterns or relationships that have been consistently proven and highlights areas that require further investigation. This includes a review of methods for measuring the cost of capital, such as the use of WACC or other methods, and how independent variables affect this measurement in various economic and industrial contexts. A critical evaluation of the selected literature will be conducted to determine the strengths and weaknesses of the existing studies. This study assesses the quality of the methodology, samples, and statistical analyses used in the reviewed literature, as well as the relevance and implications of the findings for management practice and economic theory.

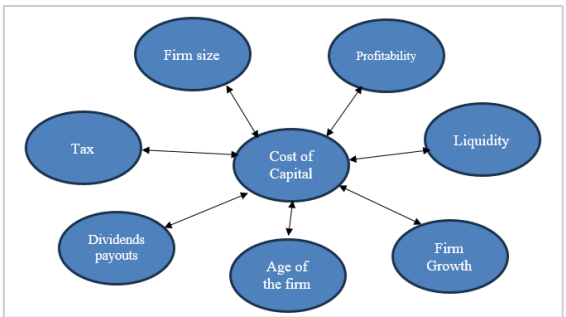

Figure 1. Determinants of Cost of Capital

The company's cost of capital can decrease and become optimal when several key factors are strategically met (Hayder Mohammed Shanshool & Najem Aubdullah Al-Mashhadani, 2024). Companies must achieve an ideal capital structure where the mix of debt and equity is optimized to minimize overall financing costs and maximize company value (Owusu-Ansah et al., 2023). The optimal capital structure takes advantage of the tax benefits of debt interest while keeping

financial risk under control (Meirista & Santoso, 2023). Several factors that can affect the cost of capital include firm size, tax, dividends payout, age of the firm, firm growth, liquidity, and profitability.

Company size is often considered a determining factor in measuring the cost of capital because larger companies usually have better access to capital markets and more favorable lending conditions (Kushermanto & Rohman, 2024). Larger firms tend to have a more established reputation, a more stable financial history, and higher transparency, which attracts investor and creditor trust (Kanapickiene et al., 2021). This encourages firms to issue stocks or bonds with lower interest rates compared to smaller firms with similar risk profiles (Obadire et al., 2023). In addition, large firms often have greater operational and geographic diversification, which reduces their business risk and, as a result, lowers the firm's cost of capital (Koval et al., 2024). With greater resources to invest in risk management and hedging strategies, large firms can more effectively manage their exposure to market fluctuations, which can lower the acceleration of the firm's cost of capital (Bahri et al., 2021). Overall, in this context, the capacity to leverage operational scale and market reputation helps large firms optimize their capital structure, thereby minimizing the overall cost of capital.

In addition, a country's high tax rate can significantly affect a firm's cost of capital (Alexeeva-Alexeev, 2023). Taxes play a significant role in determining investment attractiveness (Đukan et al., 2023), as higher taxes reduce the net income that investors can expect, thus increasing the cost of capital. When companies are faced with high corporate taxes, they must offer higher rates of return to attract investment (Alshirah et al., 2022). This means that companies must generate higher pre-tax earnings to meet investor expectations, which in turn increases the pressure on corporate operations to become more efficient and productive (Vayas-Ortega et al., 2020). Furthermore, in the face of higher taxes, companies prefer to finance operations with debt rather than equity, since interest on debt is tax-deductible, while dividends do not have similar benefits (Diedrich et al., 2022). This can change the capital structure of the company and potentially increase financial risk, which also contributes to an increase in the cost of capital. Therefore, high tax rates can lead to a vicious cycle that worsens the financial condition of companies, forcing companies to seek more complex risk management and financing strategies to optimize the cost of capital (Cifuentes et al., 2024). Dalam kacamata lain, kebijakan pembayaran dividen yang tinggi bisa mempengaruhi biaya modal perusahaan karena refleksi dari prioritas alokasi kas (Lilford, 2023). Ketika perusahaan memilih untuk mendistribusikan sebagian besar labanya sebagai dividen, hal ini menandakan kepada pasar bahwa perusahaan memiliki cukup kas untuk memenuhi kebutuhan operasional dan investasi mereka, serta mampu memberikan pengembalian langsung kepada pemegang saham (Lin, 2020). Namun, pembayaran dividen yang tinggi ini juga bisa meningkatkan biaya modal karena mengurangi dana yang tersedia untuk reinvestasi dalam operasi dan pertumbuhan perusahaan (Markauskas & Saboniene, 2020). Investor mungkin menilai perusahaan dengan pembayaran dividen yang tinggi sebagai lebih stabil dan kurang agresif dalam hal ekspansi dan inovasi, sehingga meminta tingkat pengembalian yang lebih rendah pada ekuitas perusahaan (Clark et al., 2023). Di sisi lain, jika pasar merasa bahwa perusahaan kekurangan dana untuk investasi penting karena pembayaran dividen yang besar, hal ini dapat menyebabkan persepsi risiko yang lebih tinggi dan meningkatkan biaya modal (Zhou, 2024). Oleh karena itu, meskipun pembayaran dividen yang besar dapat menarik bagi pemegang saham saat ini, strategi ini harus diimbangi dengan kebutuhan untuk mempertahankan investasi dalam kapabilitas perusahaan agar tetap kompetitif dan mengoptimalkan struktur modal jangka panjang (Mirzajani et al., 2024).

Company age is often considered an important indicator in assessing risk and, therefore, directly affects a company's cost of capital. Companies that have been in operation for many years are generally considered to have lower risk because they have weathered various economic cycles and proven their adaptability (Lee, 2024). This extensive experience helps in building a solid track record, which increases the confidence of investors and lenders. Over time, such companies can form strong relationships with suppliers, customers, and creditors, and develop a deep understanding of the markets and industries they serve. This not only stabilizes cash flow but also reduces earnings volatility (Im et al., 2020), which is an important factor in assessing risk and, indirectly, the cost of capital (Muslim, 2020). With an established reputation and greater stability, older companies are usually able to access capital at a lower cost compared to newer companies,

which have yet to prove their credibility and operational sustainability in the market (Dhoraisingam Samuel et al., 2022). Therefore, company age can be a crucial determinant in optimizing the cost of capital, allowing older companies to take advantage of this condition for more aggressive expansion and growth (Grigoraş-Ichim et al., 2018).

Company growth characterized by increasing sales can significantly affect the cost of capital, because this growth indicates the potential for future success and expansion (Bayunitri & Malik, 2022). When a company shows an increasing sales trend, this is often seen as an indicator that the company has products or services that are in demand in the market, effective operations, and competent management (Quoc et al., 2024). Increasing sales usually means better cash flow, which reduces the risk of default on debt and makes the company more attractive to lenders and investors (Miglo, 2020). With stronger cash flow and lower risk, companies can obtain more favorable loan conditions and lower debt costs. On the equity side, investors tend to view sales growth as a projection of higher future profits, which can drive stock prices higher and reduce the cost of equity (Esqueda & O'Connor, 2024). Over time, this forms a virtuous circle where the overall cost of capital falls, allowing companies to more easily access capital for further investment, potentially accelerating growth and strengthening their market position. Thus, increasing sales not only signals current financial health but also improves the company's capital conditions for continued growth.

A company's liquidity, which refers to its ability to meet short-term obligations through assets that are easily converted into cash, plays a critical role in determining the cost of capital (Zimon et al., 2022). Companies with high levels of liquidity indicate that they have quick access to cash, which reduces the risk of default on debt payments when due and strengthens investor and lender confidence (Polzin et al., 2021). This directly contributes to a decrease in the company's perceived risk. When firms are seen as safer subjects for investment or borrowing, lenders tend to offer lower interest rates, and investors require lower returns on their equity investments (Kengere et al., 2023). Conversely, firms with low liquidity may face difficulties in meeting their short-term obligations, which may trigger uncertainty among lenders and investors about the firm's ability to manage cash flows in volatile or crisis (Krenz & Živanović, 2024). This increases the cost of debt due to the higher risk of default, and investors may demand higher returns to compensate for the additional risk (Uddin et al., 2022). Therefore, good liquidity not only improves a firm's financial stability but also effectively lowers the cost of capital, facilitating more favorable conditions for growth and expansion (Koval et al., 2024).

Profitability, which measures a company's ability to generate profits from its operations, directly affects the cost of capital (Baule, 2019). Companies that exhibit high profitability are often considered safer investments because they demonstrate effectiveness in managing resources and converting investments into profits (Huq et al., 2022). High profitability implies that the company has good governance and a solid business model, which reduces the risk of financial failure and increases confidence among investors and lenders (Yang et al., 2023). As a result of this lower perceived risk, profitable companies tend to access capital at a lower cost; lenders offer more competitive interest rates, and investors demand lower returns because they perceive less risk in their investments (Smirnov, 2021). In addition, high profitability provides more free cash that can be used to pay down debt faster or to reinvest in operations without the need for additional financing, which can reduce dependence on external capital and thus lower the overall cost of capital (Khalifa et al., 2019). In this case, capital owners can lower the cost of capital by maintaining high levels of profitability through continuous innovation, operational efficiency, and effective strategic management, all contributing to long-term financial stability and growth (Scholze, 2010).

CONCLUSION

The conclusion of this study shows that a company's cost of capital can be influenced by various interrelated factors, including capital structure, dividend policy, tax rate, company size, company age, growth, liquidity, and profitability. These factors, when managed with the right strategy, can significantly lower the cost of capital, thereby maximizing the value of the company and increasing its attractiveness to investors and lenders. An optimal capital structure, which creates a balance between debt and equity, allows companies to take advantage of tax advantages and control financial risks effectively, which ultimately lowers the overall cost of capital.

Company growth and an effective dividend policy also play an important role in managing the cost of capital. Consistent sales growth indicates the company's ability to generate stable cash flows and reduce financial risks, which attracts more favorable lending conditions and lowers the cost of equity. On the other hand, a high dividend policy can affect the market's perception of the company's stability and risk, which can also affect the cost of capital. A balanced dividend policy that considers reinvestment needs and returns to shareholders is a key factor in attracting investment and maintaining company growth.

In addition, factors such as liquidity and profitability show a significant impact on the cost of capital. A high level of liquidity indicates the company's ability to meet short-term obligations, reduces the risk of default, and strengthens investor confidence. High profitability, on the other hand, reflects the effectiveness of the company's management in converting investments into profits, which reduces the perception of risk and allows access to capital at a lower cost. Therefore, efficient management of these aspects can strengthen the company's financial position and support sustainable growth in a competitive market environment.

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