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✓ Capital Structure

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Capital Structure

Meaning of Capital Structure :-

"Capital Structure" refers to proportion between various long term sources of finance in the total capital of the firm. The major sources of long term finance include 'Proprietor's funds' and 'Borrowed funds'. These sources differ from each other in terms of risk and their cost to the enterprise.

Optimum Capital Structure :-

Capital Structure is said to be optimum when cost of Capital is minimum and total value of firm is maximum.

Features of optimum Capital Structure :-

☆ Simplicity :→ Simplicity here means that firm should issue minimum type of securities.

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* Flexibility :- Capital Structure should be altered when needed with minimum Cost.

* Minimum Cost of Capital :- Cost of Capital for raising Capital should be minimum. Debt is considered to be cheapest source of finance

* Retaining Control :- Capital Structure should help management in retaining Control. for this purpose, debt is Considered better.

* Sufficient liquidity :- Capital Structure is considered to be liquid when firm is able to pay interest and principal amount under adverse Condition.

* Minimum Risk :- Capital Structure Should ensure minimum risk because more use of debt may effect solvency of firm.

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Factors affecting Capital Structure

* Size of firm :- Capital Structure of firm depends upon its size. Small size firm depend on owned Capital & retained earning. Large Scale firm can raise long term loan and can also issue equity share, preference share and debentures to the public.

* Stability of the Earning :- The Companies with regular Sale and earning may use higher debt. On the other hand, companies with fluctuation in Sales and earning cannot use debt.

* Degree of Competition :- The companies which face keen Competition may use more equity than debt. On the other hand, industries which do not face much competition may use more debt.

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* Cost of Capital :- Capital Structure also depends on cost of Capital. Debt is preferable to equity Capital.

* Retaining Control:- To avoid risk of loss of control, the company prefer to issue preference share or debenture because they donot have voting rights.

* Flexibility:- Capital structure should be flexible i.e the firm should be able to change the proportion of sources of funds.

* Stage of life Cycle of firms:- In the initial stage the firm put more emphasis on equity share capital when it grows then it may use long term debt.

* Credit Standing of the firm:- If the firm enjoy high reputation then it can raise funds on easy terms and from source of their choice

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Capital Structure Theories

Capital Structure

- Relevant Approach
  - Net Income approach
  - Traditional Approach
- Irrelevant Approach
  - Net Operating Income Approach
  - MM Approach

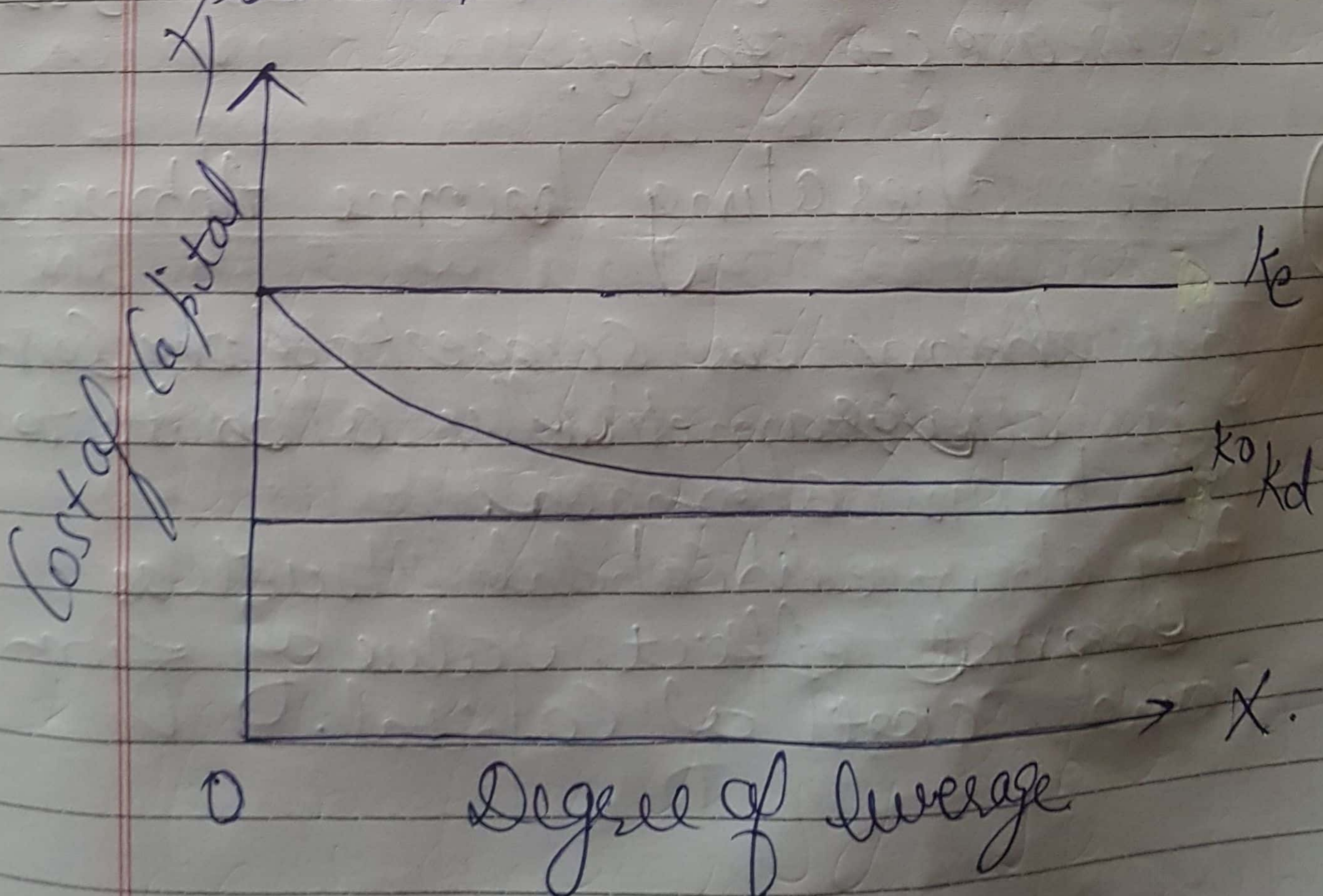
(A) **Net Income Approach:-** This was suggested by Durand. According to this approach capital structure is relevant for valuation of firm i.e change in debt equity ratio will lead to change in value of firm and overall cost of capital.

↑ Debt Equity → ↓ Cost of Capital → ↑ Mkt Price & value of firm

(↓) Debt Equity → (↑) Cost of Capital → (↓) Market Price of share and value of firm.

☆ Assumption of this approach :-

1. The Cost of debt is lower than the Cost of equity.
2. The risk perception of investors is not changed by use of debt.
3. There is no Corporate tax or personal tax.



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Here k_e (Cost of Equity), k_d (cost of debt)
k_0 (Overall cost of capital).

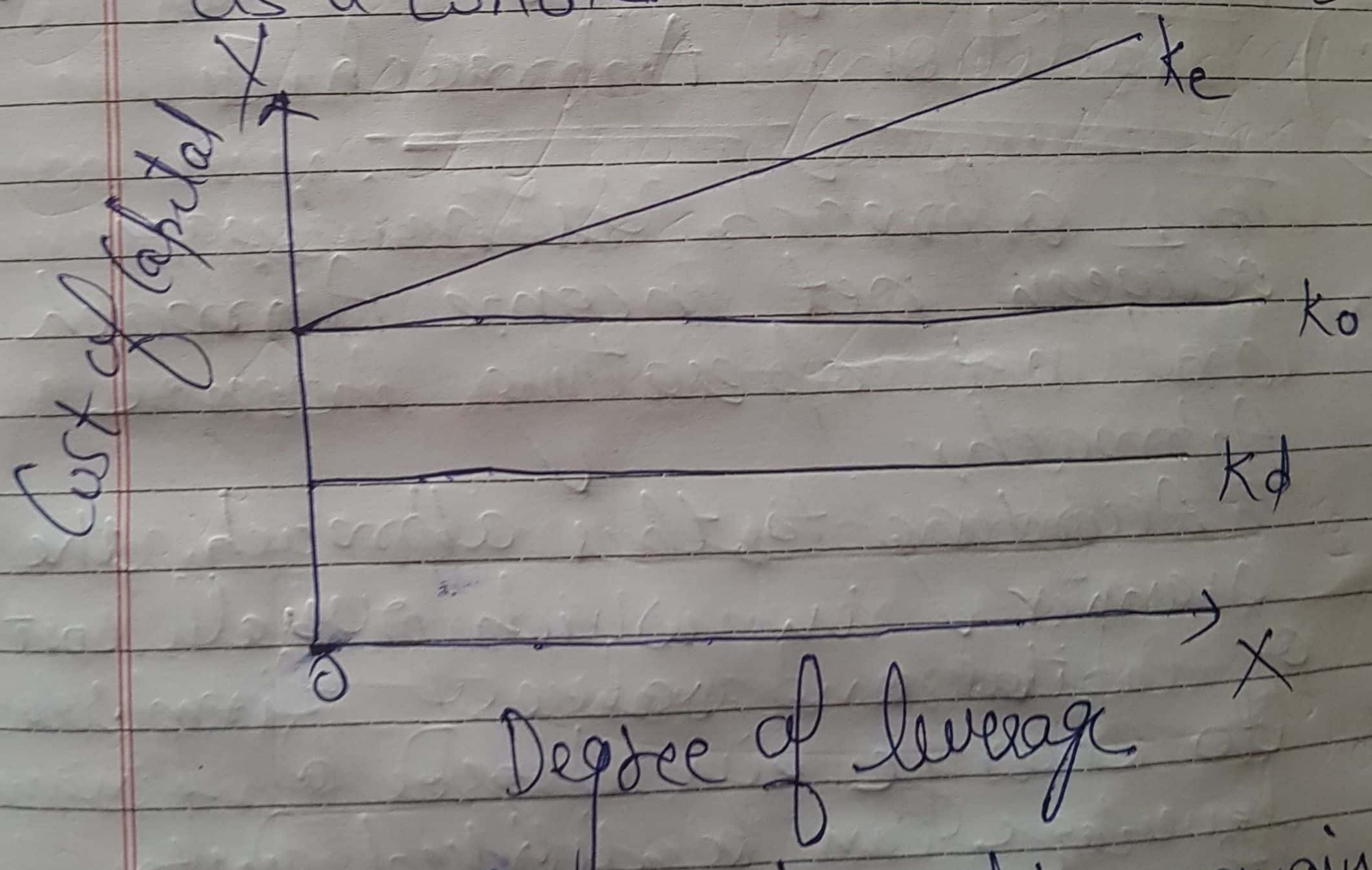
k_e and k_d remain unchange as the degree of leverage is increased. But as degree of leverage is increased, cost of capital (k_0) decrease and approach cost of debt (k_d). however k_0 does not touch k_d because there cannot be all debt in firm. Optimum capital structure is one at which k_0 is nearest to k_d.

(B) Net operating Income Approach:-

This theory is suggested by Durand. His diagrametically opposite to net Income approach.
Any change in capital structure does not effect value of firm and cost of capital.

★ Assumption:-

1. The cost of debt is lower than cost of equity
2. There is no change in risk perception of Investors.
3. There is no corporate and personal tax
4. The market capitalise value of firm as a whole



Degree of leverage

In this figure kd and ko remain constant. as degree of leverage is increased and both curves are parallel to X axis. Ke = Ko wh[en] with leverage is zero.

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increased in leverage ke rise so as to offset advantage of using cheaper source of finance i.e debt. As a result ko and value of firm remain unchange by increase in financial leverage and market price of share donot change with change in leverage

(C) Traditional Approach :-

This approach is midway between net Income Approach and net operating Income Approach.
According to this approach, the manner in which overall cost of Capital and value of firm reacts to change in degree of financial leverage can be divided into three Stages.

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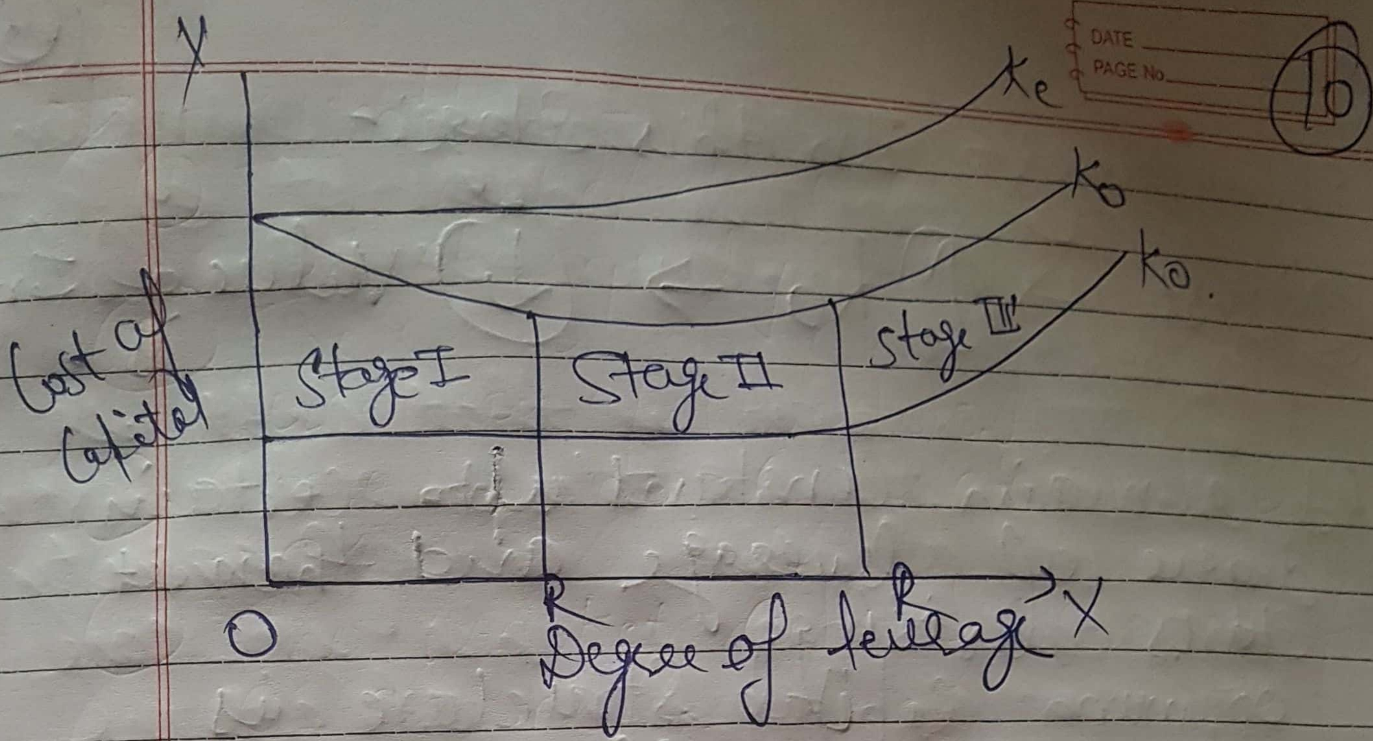
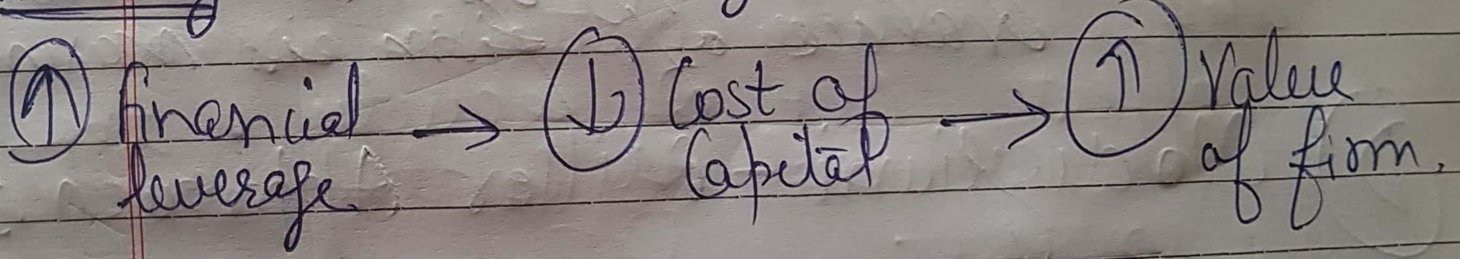


First Stage :- In this Stage



At this Stage, Ke remain constant or rises negligibly.
Kd remain constant or rise negligibly.

Second Stage :- Once firm has reached certain degree of leverage increase in leverage does not affect overall cost of capital and value of firm.

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Third Stage :- In this Stage :-

(↑) Debt → (↑) K_0 → (↓) value of firm

Kd remain constant upto certain degree of leverage and then it starts arising.
optimum capital structure is represented by RR because in this range K_0 is minimum and value of firm is maximum.

(D) Modigliani - Miller Approach :-

This approach is similar to net operating income approach when taxes are ignored. It state that there is no relationship between capital structure decision and value of firm and overall cost of capital

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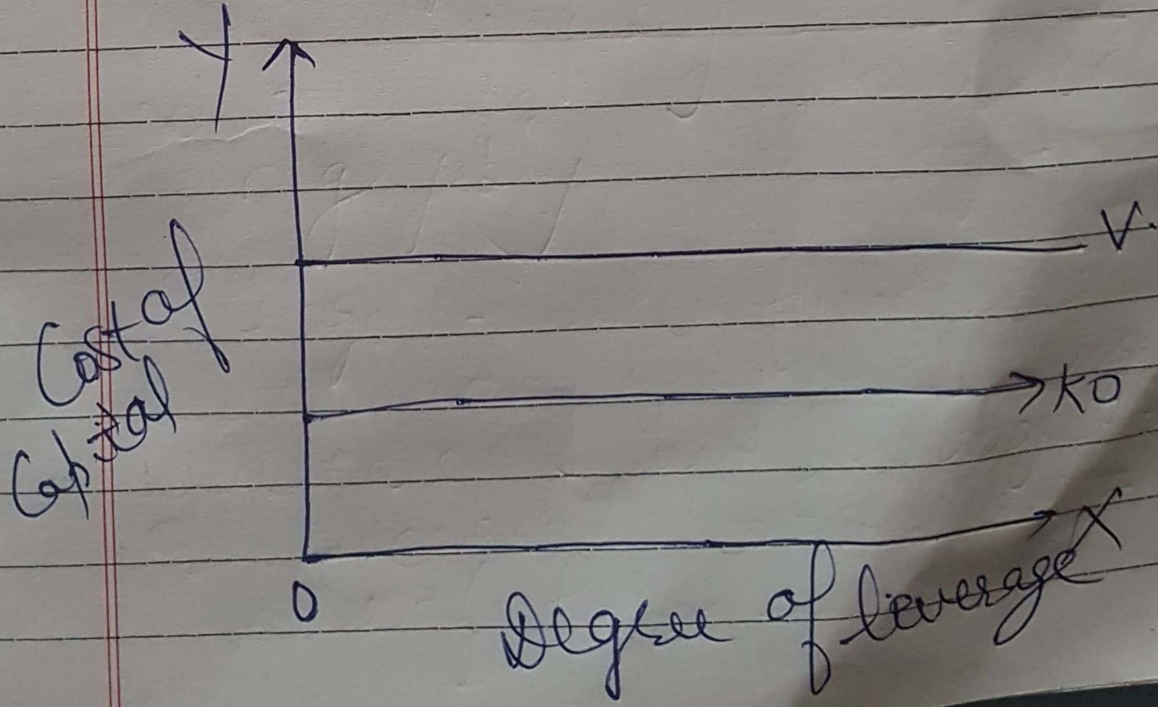
☆ Assumptions:-

1. The dividend payout Ratio is 100%.
2. There is no corporate tax.
3. All investors have same expectation about net operating income of firm.
4. firms can be grouped into homogeneous risk class.
5. Investors behave rationally
6. Securities are infinitely divisible
7. Information is perfect and freely available to investors.
8. The investors are free to buy or sell securities.



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According to this theory, change in capital structure does not affect value of firm and overall cost of capital.

The reason is that debt is cheaper to equity. With increase in use of debt, cost of equity increase and this increase in cost of equity offset the advantage of low cost of debt. Thus, with change in debt equity Ratio although affect cost of equity, the overall cost of capital remain constant

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