Material & Human Resource Management

CAPITAL STRUCTURE

WHAT IS CAPITAL STRUCTURE?

- Generally, represents the relationship between debt and equity.

- The term capital structure is used to represent the proportionate relationship between debt, preference and equity shares on a firm’s balance sheet.

- **Gerestenbeg** defines Capital Structure as, “ Capital structure of a company refers to the composition or make-up of its capitalisation and it includes all long-term capital resources viz: loans, reserves, shares and bonds.”

WHAT DOES A COMPANY'S CAPITAL STRUCTURE INCLUDE?

- Capital structure includes only long term debt and total stockholder investment.

- Capital Structure = Long Term Debt + Preferred Stock + Net Worth

OR

- Capital Structure = Total Assets – Current Liabilities

WHAT IS CAPITALISATION AND FINANCIAL STRUCTURE?

DO THESE TERMS MEAN SAME AS CAPITAL STRUCTURE?

- **Capitalisation** is a quantitative aspect of the financial planning of an enterprise, where as **Capital Structure** is a qualitative aspect.
- Capitalisation refers to the total amount of securities issued by a company while Capital structure refers to the kinds of securities and the proportionate amounts that make up capitalisation.
- Financial structure refers to all the financial resources marshalled by the firm, short as well as long-term, and all forms of debt as well as equity. “Thus, generally it is composed of a specified percentage of short-term debt, long-term debt & shareholders’ funds.

EXAMPLE:

1. Compute Capitalisation, Capital structure & Financial structure from the following.

LIABILITIES	Rs
Equity share capital	10,00,000
Preference share capital	5,00,000
Long-term loans & Debentures	2,00,000
Retained Earnings	6,00,000
Capital surplus	50,000
Current Liabilities	1,50,000

CAPITALISATION:

Equity share capital	**10,00,000**
Preference share capital	5,00,000
Long-term loans & Debentures	2,00,000
CAPITALISATION →	17,00,000

CAPITAL STRUCTURE:

Equity share capital	**10,00,000**
Preference share capital	5,00,000
Long-term loans & Debentures	2,00,000
Retained Earnings	6,00,000
Capital Surplus	50,000
CAPITAL STRUCTURE →	23,50,000

FINANCIAL STRUCTURE:

Equity share capital	**10,00,000**
Preference share capital	5,00,000
Long-term loans & Debentures	2,00,000
Retained Earnings	6,00,000
Capital Surplus	50,000
Current liabilities	1,50,000
FINANCIAL STRUCTURE→	25,00,000

OPTIMUM CAPITAL STRUCTURE:

OPTIMUM CAPITAL STRUCTURE IS THE CAPITAL STRUCTURE AT WHICH THE MARKET VALUE PER SHARE IS MAXIMUM AND THE COST OF CAPITAL IS MINIMUM.

Why is it important?

- Enables one to “optimize” the value of a firm by finding the “best mix” for the amounts of debt and equity on the balance sheet

- Provides a signal that the firm is following proper rules of corporate finance to “improve” its balance sheet. This signal is central to valuations provided by market investors and analysts

APPROPRIATE CAPITAL STRUCTURE SHOULD HAVE THE FOLLOWING FEATURES:

- Profitability / Return
- Solvency / Risk
- Flexibility
- Conservation / Capacity
- Control

PATTERNS / FORMS OF CAPITAL STRUCTURE:

- Complete equity share capital
- Different proportions of equity and preference share capital
- Different proportions of equity and debenture (debt) capital and
- Different proportions of equity, preference and debenture (debt) capital.

IMPORTANCE OF CAPITAL STRUCTURE

WHAT IS FINANCIAL LEVERAGE OR TRADING ON EQUITY?

Financial Leverage

- Financial leverage is the ability of the firm to use fixed financial charges to magnify the effects of changes in EBIT on the firm’s earnings per share.
- In other words, financial leverage may be defined as the payment of fixed rate of interest for the use of fixed interest bearing securities to magnify the rate of return as equity shares

- The use of the fixed-charges sources of funds, such as debt and preference capital along with the owners' equity in the capital structure, is described as financial leverage or gearing or trading on equity.
- The financial leverage employed by a company is intended to earn more return on the fixed-charge funds than their costs. The surplus (or deficit) will increase (or decrease) the return on the owners' equity. The rate of return on the owners' equity is levered above or below the rate of return on total assets.

Example of Trading on Equity

- Able Company has an Equity capital of 1000 shares of Rs.100/- each fully paid & earns an average profits of Rs.30,000 annually.
- Now it wants to make an expansion & needs another Rs.1,00,000. The company can either issue new shares or raise loans @ 10%p.a{Assuming same rate of profit}.
- It is advisable to raise loans as by doing so earnings per share will magnify.
- The company shall pay only Rs.10,000 as interest & profit expected shall be Rs.60,000[EBIT].
- Profits left for shareholders[EBT] shall be Rs.50,000. It is 50% return on the equity capital against 30% return otherwise.

Measures of Financial Leverage

- *Debt ratio*
- *Debt–equity ratio*
- *Interest* coverage

The first two measures of financial leverage can be expressed either in terms of book values or market values. These two measures are also known as measures of capital gearing.

The third measure of financial leverage, commonly known as coverage ratio. The reciprocal of interest coverage is a measure of the firm's income gearing.

FACTORS DETERMINING THE CAPITAL STRUCTURE:

- Financial Leverage
- Growth & Stability of Sales
- Cost of Capital
- Cash Flow Ability to Service Debt
- Nature & Size of a Firm
- Control
- Flexibility
- Requirements of Investors
- Capital Market Conditions
- Assets Structure
- Purpose of Financing
- Period of Finance
- Costs of Floatation
- Personal Considerations
- Corporate Tax Rate
- Legal Requirements

- <u>Growth and stability of sales</u>

  Stability of sales ensures that the firm will not face any difficulty in meeting its fixed commitments of interest payment & repayment of debt. Usually, greater the rate of growth in sales, greater can be the use of debt in the financing of firm. On the other hand, if the sales of a firm are highly fluctuating or declining, it should not employ, as far as possible, debt financing in its capital structure.

- <u>Cost of Capital</u>

  It refers to the minimum return expected by its suppliers. The return expected by the suppliers of capital depends upon the risk they have to undertake. While formulating a capital structure, an effort must be made to minimize the overall cost of capital.

- Cash flow ability to service debt

  A firm which shall be able to generate larger & stable cash inflows can employ more debt in its capital structure as compared to the one which has unstable & lesser ability to generate cash inflows. Whenever a firm wants to raise additional funds, it should estimate, project its future cash inflows to ensure the coverage of fixed charges. Fixed charges Coverage Ratio & Interest Coverage Ratio may be calculated for this purpose.

- Nature & Size of a Firm

  Public utility concerns may employ more of debt because of stability & regularity of their earnings. On the other hand, a concern which cannot provide stable earnings due to the nature of its business will have to rely mainly on equity capital. Small companies have to depend mainly upon owned capital as it is very difficult for them to raise long-term loans on reasonable terms.

- <u>Control</u>

Whenever additional funds are required by a firm, the management of the firm wants to raise the funds without any loss of control over the firm. In case the funds are raised through the issue of equity shares, the control of the existing shareholders is diluted. Hence, they might raise the additional funds by way of fixed interest bearing debt & preference share capital. Preference shareholders & debentures holders do not have the voting right. Hence, from the point of view of control, debt financing is recommended.

- <u>Flexibility</u>

Capital structure should be as capable of being adjusted according to the needs of the changing conditions. It should be in such a manner that it can substitute one form of financing by another. Redeemable preference shares & convertible debentures may be prefered on account of flexibility.

- Requirements of Investors

It is necessary to meet the requirements of both institutional as well as private investors when debt financing is used. Investors are generally classified under three kinds,i:e. Bold investors, Cautious investors & Less cautious investors.

- Capital market conditions

Capital market conditions do not remain the same for ever. Sometimes there may be depression while at other times there may be boom in the market. The choice of the securities is also influenced by the market conditions. If the share market is depressed & there are pessimistic business conditions, the company should not issue equity shares as investors would prefer safety. But in case there is boom period, it would be advisable to issue equity shares.

- **Assets structure**

The liquidity & the composition of assets should also be kept in mind while selecting the capital structure. If fixed assets constitute a major portion of the total assets of the company, it may be possible for the company to raise more of long term debts.

- **Purpose of financing**

If funds are required for a productive purpose, debt financing is suitable & the company should issue debentures as interest can be paid out of the profits generated from the investment. However, if the funds are required for unproductive purpose or general development on permanent basis, we should prefer equity capital.

- <u>Period of Finance</u>

  The period for which the finances are required is also an important factor to be kept in mind while selecting an appropriate capital mix. If the finances are required for a limited period of, seven years, debentures should be preferred to shares. Redeemable preference shares may also be used for a limited period finance, if found suitable otherwise. However, in case funds are needed on permanent basis, equity share capital is more appropriate.

- <u>Costs of floatations</u>

  Although not very significant, yet costs of floatation of various kinds of securities should also be considered while raising funds. The cost of floating a debt is generally less than the cost of floating an equity & hence it may persuade the management to raise debt financing. The costs of floating as a percentage of total funds decrease with the increase in size of the issue.

- Personal consideration

The personal considerations & abilities of the management will have the final say on the capital structure of a firm. Managements which are experienced & are very enterprising do not hesitate to use more of debt in their financing as compared to the less experienced & conservative management.

- Corporate Tax Rate

High rate of corporate taxes on profits compel the companies to prefer debt financing, because interest is allowed to be deducted while computing taxable profits. On the other hand, dividend on shares is not an allowable expense for that purpose.

- **Legal Requirements**

The government has also issued certain guidelines for the issue of shares & debentures. The legal restrictions are very significant as these lay down a framework within which capital structure decision has to be made.

PRINCIPLES OF CAPITAL STRUCTURE DECISIONS:

1) Cost Principle
2) Risk Principle
3) Control Principle
4) Flexibility Principle
5) Timing Principle

Theories of capital structure:

- Different kinds of theories have been propounded by different authors to explain the relationship between capital structure, cost capital & value of the firm. The main contributors to the theories are David Durand, Ezra Solomon, Modiliani and Miller.

Assumption of Capital Structure Theories

There are only two sources of funds i.e.: debt and equity.

- The total assets of the company are given and do no change.
- The total financing remains constant. The firm can change the degree of leverage either by selling the shares and retiring debt or by issuing debt and redeeming equity.
- Operating profits (EBIT) are not expected to grow.
- All the investors are assumed to have the same expectation about the future profits.
- Business risk is constant over time and assumed to be independent of its capital structure and financial risk.
- Corporate tax does not exit.
- The company has infinite life.
- Dividend payout ratio = 100%.

Capital Structure

Capital Structure

- A decision about the proportion among these type of securities refers to the capital structure of an enterprise.
- The cost of capital is the weighted average cost of the different components in the capital structure.
- The optimum capital structure is that where the firms cost of capital is minimum.

Capitalisation and Capital Structure

Capitalization :- Refers to the total amount of Securities issued by a company.

Capital structure: - Refers to the Kind of Securities and the proportionate amounts that make up Capitalization.

Features of Ideal Capital Structure

- Minimum possible use of leverage.
- The capital structure should be flexible so that it can be easily altered.
- To avoid undue financial/business risk with the increase of debt.
- The debt should be within the capacity of a firm.

Features of Ideal Capital Structure

- It should involve minimum possible risk of loss of control.
- It must avoid undue restrictions in agreement of debt.
- It should be easy to understand and simple to operate to the extent possible.
- It should minimise the cost of financing and maximise earnings per share.

Factors affecting Capital Structure

- Financial leverage or Trading on Equity
- Growth and Stability of Sales
- Cost of Capital
- Risk
- Cash flow ability to service debt
- Nature and size of a firm
- Control
- flexibility

Factors affecting Capital Structure

- Requirements of investors
- Capital market conditions
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- Corporate tax rate
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