SOS POLITICAL SCIENCE AND PUBLIC ADMINISTRATION

MBA FA 202

SUBJECT NAME: FUNDAMENTALS OF FINANCIAL MANAGEMENT

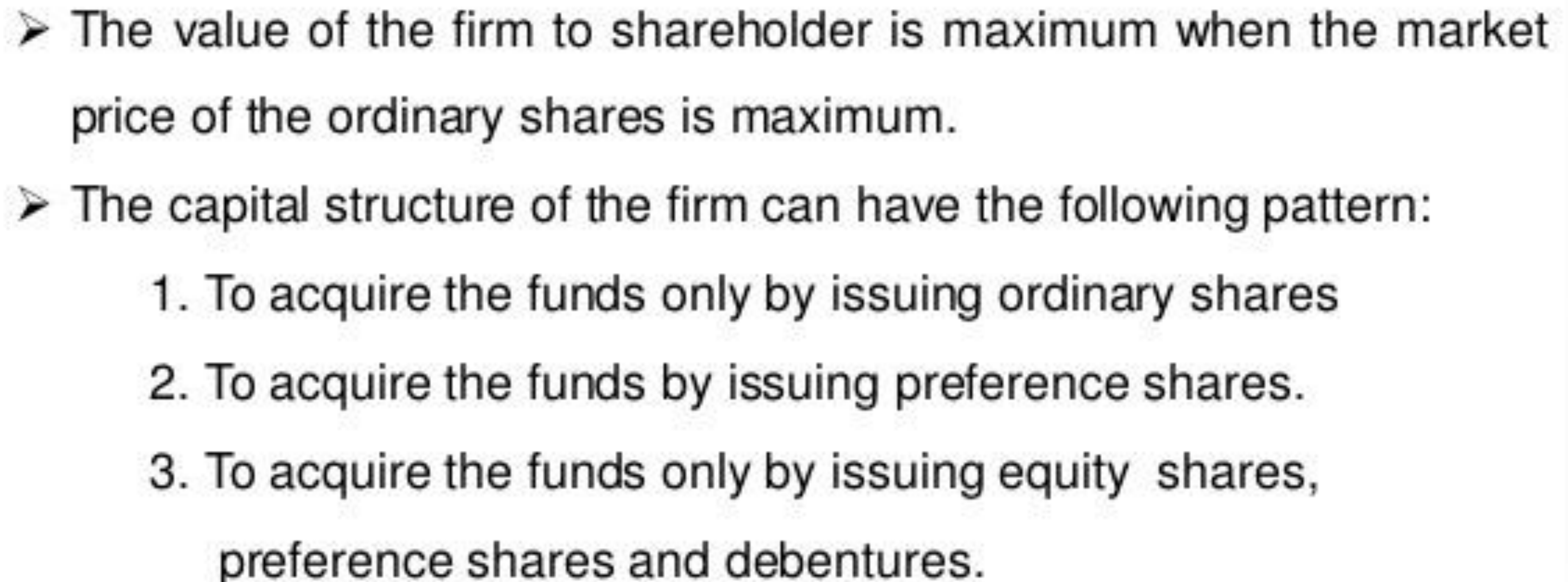
CAPITAL
STRUCTURE

At the time of preparing financial plan, not only the capitalization is determined but the nature and type of the capital is also decided. In the capital structure decision, it is determined from which sources and how much finance should be raised. Thus, under capital structure we determine the proportion in which capital should be raised from different securities.

MEANING

Capital structure is that part of financial structure that represents long term sources. Or in other words it refers to the mix of long term sources of funds such as debentures, long term debt, preference share capital , equity share capital including reserve and surplus.

- Management should determine the capital structure in such a manner that the cost of capital of the firm is minimum and the value to the shareholder is maximum.



➢ The value of the firm to shareholder is maximum when the market price of the ordinary shares is maximum.
➢ The capital structure of the firm can have the following pattern:
1. To acquire the funds only by issuing ordinary shares
2. To acquire the funds by issuing preference shares.
3. To acquire the funds only by issuing equity shares, preference shares and debentures.

The optimum capital structure may be defined as that capital structure or combination of debt plus equity which leads to maximum value of firm.

-According to M.Y. Khan and P.K.Jain

1. Simplicity
2. Flexibility
3. Minimum cost of capital
4. Adequate liquidity
5. Minimum risk
6. Legal requirements
7. Maximum returns
8. Control
9. Solvency
10. Conservatism

I. Size of the business
II. Form of business organization
III. Stability of earnings
IV. Degree of competition
V. Credit standing
VI. Stage of life cycle
VII. State regulations
VIII. Attitude of management
IX. Trading on equity
X. Interest coverage ratio
XI. Proper mix of different sources

CAPITAL STRUCTURE CHART

THEORIES OF CAPITAL STRUCTURE

- Net Income Approach
- Net Operating Income Approach
- Modigliani- Miller Approach
- Traditional Approach

1. There are only two sources of funds used by a firm i.e. debt plus equity.
2. There are no corporate taxes.
3. The dividend pay out ratio is 100% and it does not retain the earnings.
4. The investment decision is assumed to be constant.
5. Firms total financing remains constant but the degree of leverage can be changed.
6. EBIT are not expected to grow.
7. Firms business risk is constant over the time and is assumed to be independent of its capital structure and financial risk.
8. Stability of the firm
9. Total assets of the company are given and do not change.

1. Net Income Approach

- This approach was given by DAVID DURAND
- According to this approach capital structure decision is relevant to valuation of the firm.
- In other words, a change in the capital structure will lead to a corresponding change in the overall cost of capital as well as the total value of firm.

ASSUMPTIONS

- There is no corporate taxes.
- Cost of debt is less than the cost of equity.
- Due to change in leverage, cost of equity(K_e) and cost of debt(K_d) do not change.

2.Net Operating Income Approach

- ✓ This theory is diametrically opposite to Net Income Approach.
- ✓ This tells us that capital structure decision is irrelevant to cost of capital and value of firm.
- ✓ Any change in leverage will not lead to any change in total value of firm and market price of shares (Po); as the overall cost of capital is independent of the degree of leverage.
- ✓ In other words, according to this approach change in capital structure of a company, does not effect the market value of the firm and the overall cost of capital remains constant.

ASSUMPTION:

1. The net operating income approach argues that overall cost of capital remains constant for all degree of leverage.
2. Residual value of the firm: the value of equity is a residual value which is determined by deducting Total market value of debt from value of the firm.

   i.e. $S = V - B$
3. The cost of debt capital remains unchanged(K_d).
4. Corporate income tax do not exists.
5. Optimum capital structure: there is nothing such as optimum capital structure. According to this approach any capital structure is optimum.

3. Modigliani-Miller Approach

- MM contend that overall cost of capital is irrelevant to capital structure.
- This approach supported the Net Operating Income Approach.
- They argue that Net Income theory of capital structure and valuation is not possible in the perfect capital market, in which their assumption holds.
- MM used the arbitrary process to support their claim, they hold that in the absence of taxes, total market value and the cost of capital remains constant to the capital structure changes.

ASSUMPTIONS

1. Perfect capital market: where there are large no. of. Buyers and seller. And no one buyer or seller can affect the market.
2. Rationality and homogenous expecting of earnings: they further assume that all the investors are rational and have homogenous expectations of a firms earnings.

4. Traditional Approach

- This approach is mid way between the net income and net operating income approach. Therefore also known as intermediate approach.
- It test that a firm can increase its value and reduce its cost of capital up to a point but beyond that point use of future debt will need to a rise in average cost of capital .
- At that point, capital structure is optimum.
- This approach is divided in to three stages:

STAGE 1:

In this stage increase in financial leverage in the capital structure results in the decrease of the overall cost of capital and increase in the values of the firm.

In this cost of equity remains constant. Cost of debt also remains constant. And cost of capital is declining at a faster rate.

STAGE 2:

Once the firm has reached a certain degree of financial leverage, increase in leverage does not affect he overall cost of capital and value of the firm, this is because the increase in the cost of equity within the range or at a particular level of leverage; the overall cost of capital will be minimum and the value of the firm will be maximum. This range or level represents optimal capital structure.

STAGE 3:

In thus the further increase in debt will lead to increase in overall cost of capital.

Thank you