

CAPITAL STRUCTURE

Capital is the major part of all kinds of business activities, which are decided by the size, and nature of the business concern. Capital may be raised with the help of various sources. If the company maintains proper and adequate level of capital, it will earn high profit and they can provide more dividends to its shareholders.

Meaning of Capital Structure

The term capital structure refers to the relationship between the various long-term source financing such as equity capital, preference share capital and debt capital.

Deciding the suitable capital structure is the important decision of the financial management because it is closely related to the value of the firm.

OPTIMUM CAPITAL STRUCTURE

Optimum capital structure is the capital structure at which the weighted average cost of capital is minimum and thereby the value of the firm is maximum.

Optimum capital structure may be defined as the capital structure or combination of debt and equity that leads to the maximum value of the firm.

Decision of capital structure aims at the following two important objectives:

1. Maximize the value of the firm.
2. Minimize the overall cost of capital.

Capital structure pattern varies from company to company and the availability of finance. Normally the following forms of capital structure are popular in practice.

- Equity shares only.
- Equity and preference shares only.
- Equity and Debentures only.
- Equity shares, preference shares and debentures.

CAPITAL STRUCTURE THEORIES

There are two major theories explaining the relationship between capital structure, cost of capital and value of the firm.

1. Traditional Approach
2. Modern Approach

Traditional Approach

It is the mix of Net Income approach and Net Operating Income approach. Hence, it is also called as intermediate approach. According to the traditional approach, mix of debt and equity capital can increase the value of the firm by reducing overall cost of capital up to certain level of debt.

Assumptions

Capital structure theories are based on certain assumption to analysis in a single and convenient manner:

- There are only two sources of funds used by a firm; debt and shares.
- The firm pays 100% of its earning as dividend.
- The total assets are given and do not change.
- The total finance remains constant.
- The operating profits (EBIT) are not expected to grow.
- The business risk remains constant.
- The firm has a perpetual life.
- The investors behave rationally.

Net Income (NI) Approach

Net income approach suggested by the Durand. According to this approach, the capital structure decision is relevant to the valuation of the firm. In other words, a change in the capital structure leads to a corresponding change in the overall cost of capital as well as the total value of the firm.

According to this approach, use more debt finance to reduce the overall cost of capital and increase the value of firm.

Net income approach is based on the following three important assumptions:

1. There are no corporate taxes.
2. The cost debt is less than the cost of equity.
3. The use of debt does not change the risk perception of the investor.

Net Operating Income (NOI) Approach

Another modern theory of capital structure, suggested by Durand. This is just the opposite to the Net Income approach. According to this approach, Capital Structure decision is irrelevant to the valuation of the firm. The market value of the firm is not at all affected by the capital structure changes.

According to this approach, the change in capital structure will not lead to any change in the total value of the firm and market price of shares as well as the overall cost of capital.

NOI approach is based on the following important assumptions;

1. The overall cost of capital remains constant,
2. There are no corporate taxes.

Modigliani and Miller Approach

Modigliani and Miller approach states that the financing decision of a firm does not affect the market value of a firm in a perfect capital market. In other words MM approach maintains that the average cost of capital does not change with change in the debt weighted equity mix or capital structures of the firm.

Modigliani and Miller approach is based on the following important assumptions:

- There is a perfect capital market.
- There are no retained earnings.
- There are no corporate taxes.
- The investors act rationally.
- The dividend payout ratio is 100%.
- The business consists of the same level of business risk.