

Optimal Capital Structure: Balancing the Trade-offs

This lecture explores how companies decide on the best mix of debt and equity financing. We'll cover the potential benefits and drawbacks of each, and why companies don't just choose whatever is easiest.

The Costs of Debt: Facing the Music

Debt financing is like borrowing money. It can be a good thing! It can get you more money to invest, but there's a catch: you have to pay it back with interest. If you don't pay it back on time, things can get really bad. This is called *financial distress*. The worst case scenario is *bankruptcy*, where you legally lose control of your company's assets.

Thinking Like a Bank: Why Leverage Isn't Always Great

Imagine a company wants to launch a risky new product. They could use only their own money (equity) or take out a loan (debt). If the product fails, they lose money either way. However, with debt, they have to pay back the loan, even if they're losing money. This makes the situation more stressful.

Perfect World vs. Real World

In a perfect world, the total value of a company wouldn't change based on how much debt they use. But the real world isn't perfect. The risk of bankruptcy and the costs associated with it are real. These costs can include legal fees, lost customers, and even employees quitting.

The Tradeoff Theory: Finding the Sweet Spot

The *Tradeoff Theory* says that companies aim for a balance between the benefits of debt (like tax breaks on interest payments) and the costs (like the risk of financial distress). It's like finding the perfect amount of spice in a dish – too little and it's bland, too much and it's too hot.

Agency Costs: The Conflict of Interest

Imagine a company in trouble. The owners (shareholders) might want to take a risky gamble, hoping to save the company. But the lenders (debt holders) might not like this risky move. This is a *conflict of interest* called an *agency cost*. The owners may take actions that hurt the lenders because they have more to gain and less to lose.

Under-Investment: A Missed Opportunity

Another agency cost is *under-investment*. This happens when a company has debt and avoids taking on profitable projects because most of the benefit would go to the lenders, not the owners. It's like having a great investment opportunity but not being able to take advantage of it because you're already burdened with debt.

Signaling with Debt: Showing You're Good

Sometimes a company can use debt as a *signal* to potential investors. If a company takes on a lot of debt, it might be saying, "We're confident we can handle this debt, so we must be doing well!" This can make investors more likely to invest in the company.

The Pecking Order Theory: From Internal Funds to Equity

The *Pecking Order Theory* says that companies prefer to use their own money first, then debt, and only resort to selling new stock (equity) as a last option. This is because selling stock can be seen as a bad sign, signaling that the company is in trouble.

The Bottom Line: The Real World is Messy

In the real world, companies use a combination of debt and equity, considering many factors. There's no single "optimal" capital structure, but companies try to find a balance that works best for them. It's all about balancing the benefits and costs, and recognizing the different perspectives of owners, lenders, and investors.