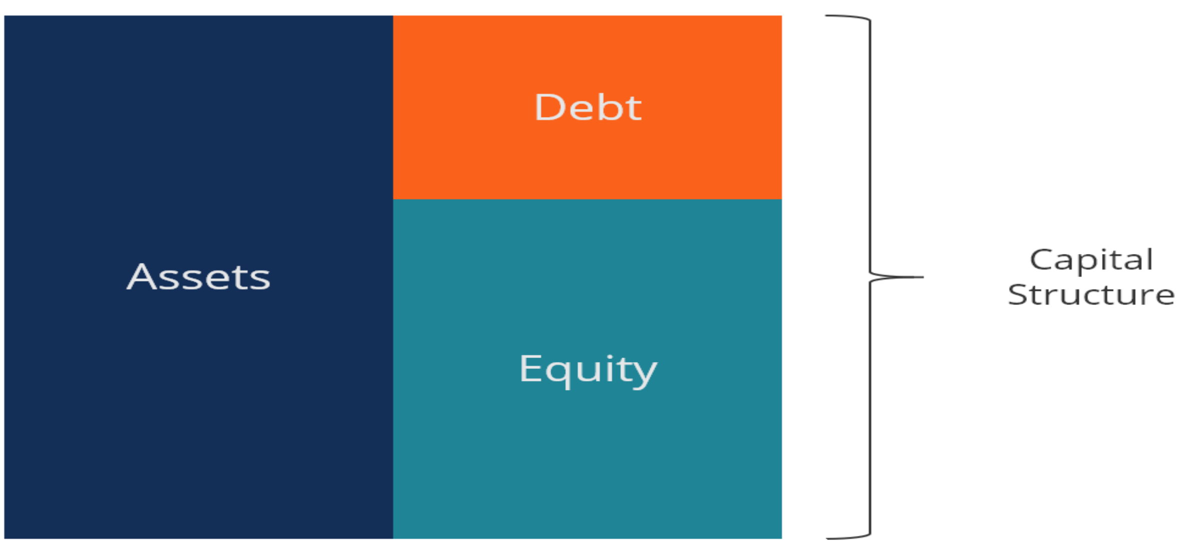
Capital Structure

Meaning

The term ‘structure’ means the arrangement of the various parts. So capital structure means the arrangement of capital from different sources so that the long-term funds needed for the business are raised.

Capital Structure refers to the amount of debt and/or equity employed by a firm to fund its operations and finance its assets. The structure is typically expressed as a debt-to-equity or debt-to-capital ratio.

Debt and equity capital are used to fund a business’s operations, capital expenditures, acquisitions, and other investments. There are tradeoffs firms have to make when they decide whether to use debt or equity to finance operations, and managers will balance the two to find the optimal capital structure.



Definitions of capital structure

- “Capital structure refers to the mix of long-term sources of funds, such as, debentures, long-term debts, preference share capital and equity share capital including reserves and surplus.”—I. M. Pandey.

- "Capital structure of a company refers to the make-up of its capitalisation and it includes all long-term capital resources viz., loans, reserves, shares and bonds."—Gerstenberg.
- "Capital structure is the combination of debt and equity securities that comprise a firm's financing of its assets."—John J. Hampton.

Factors Determining the Capital Structure

1. Financial Leverage:

The use of long-term fixed interest bearing debt and preference share capital along with equity share capital is called financial leverage or trading on equity. The use of long-term debt increases magnifies the earnings per share if the firm yields a return higher than the cost of debt.

The earnings per share also increase with the use of preference share capital but due to the fact that interest is allowed to be deducted while computing tax, the leverage impact of debt is much more. However, leverage can operate adversely also if the rate of interest on long-term loans is more than the expected rate of earnings of the firm. Therefore, it needs caution to plan the capital structure of a firm.

2. Growth and Stability of Sales:

The capital structure of a firm is highly influenced by the growth and stability of its sales. If the sales of a firm are expected to remain fairly stable, it can raise a higher level of debt. Stability of sales ensures that the firm will not face any difficulty in meeting its fixed commitments of interest payment and repayments of debt.

Similarly, the rate of growth in sales also affects the capital structure decision. Usually greater the rate of growth of 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.

3. Cost of Capital:

Every rupee invested in a firm has a cost. Cost of capital refers to the minimum return expected by its suppliers. The capital structure should provide for the minimum cost of capital. The main sources of finance for a firm are equity, preference share capital and debt capital.

The return expected by the suppliers of capital depends upon the risk they have to undertake.

Usually, debt is a cheaper source of finance compared to preference and equity capital due to:

(i) Fixed rate of interest on debt;

(ii) Legal obligation to pay interest;

(iii) Repayment of loan and priority in payment at the time of winding up of the company.

4. Risk:

There are two types of risk that are to be considered while planning the capital structure of a firm viz.:

(i) Business risk and

(ii) Financial risk.

Business risk refers to the variability of earnings before interest and taxes. Business risk can be internal as well as external. Internal risk is caused due to improper product mix, non-availability of raw materials, incompetence to face competition, absence of strategic management etc.

Internal risk is associated with the efficiency with which a firm conducts its operations within the broader environment thrust upon it. External business risk arises due to change in operating conditions caused by conditions thrust upon the firm which are beyond its control e.g., business cycles, governmental controls, changes in business laws, international market conditions etc.

Financial risk refers to the risk of a firm that may not be able to cover its fixed financial costs. Financial risk is associated with the capital structure of a company. A company with no debt financing has no financial risk. The extent of financial risk depends on the leverage of the firm's capital structure.

When a firm uses more and more of debt in its capital mix the financial risk of the firm increases. It may not be able to pay the fixed interest charges to the suppliers of debt and they may force to liquidate. Thus, a firm has to reach a balance between the financial risk and the risk of non-employment of debt capital to increase its market value.

5. Nature and Size of a Firm:

Nature and size of a firm also influence its capital structure. All public utility concern has different capital structure as compared to other manufacturing concern. Public utility concerns may employ more of debt because of stability and 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; similarly, small companies have to depend mainly upon owned capital as it is very difficult for them to raise long-term loans on reasonable terms and also cannot issue equity and preference shares at ease to the public.

6. Flexibility:

Capital structure of a firm should be flexible, i.e., it should be such as to be capable of being adjusted according to the needs of the changing conditions. It should be possible to raise additional funds, whenever the need be, without much of difficulty and delay.

A firm should arrange its capital structure in such a manner, that it can substitute one form of financing by another. Redeemable preference shares and convertible debentures may be preferred on account of flexibility. Preference shares and debentures which can be redeemed at the discretion of the firm offer the highest flexibility in the capital structure.

7. Capital Market Conditions:

Capital market conditions do not remain the same forever. 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 and 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. Proper timing of issue of securities also saves in costs of raising funds.

8. Purpose of Financing:

If funds are required for a productive purpose, debt financing is suitable and 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.

9. Period of Finance:

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, say, 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.

10. Costs of Floatation:

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 and 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.

11. 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.

12. Personal Considerations:

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

13. Legal Requirements:

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

For example, the controller of capital issues, now SEBI grants his consent for capital issue when:

(i) The debt-equity ratio does not exceed 2:1 (for capital intensive projects a higher debt- equity ratio may be allowed,

(ii) The ratio of preference capital to equity does not exceed 1:3 and

(iii) Promoters hold at least 25% of the equity capital.

Importance of Capital Structure

The importance or significance of Capital Structure:

1. Increase in value of the firm:

A sound capital structure of a company helps to increase the market price of shares and securities which, in turn, lead to increase in the value of the firm.

2. Utilization of available funds:

A good capital structure enables a business enterprise to utilize the available funds fully. A properly designed capital structure ensures the determination of the financial requirements of the firm and raises the funds in such proportions from various sources for their best possible utilization. A sound capital structure protects the business enterprise from over-capitalization and under-capitalization.

3. Maximization of return:

A sound capital structure enables management to increase the profits of a company in the form of higher return to the equity shareholders i.e., increase in earnings per share. This can be done by the mechanism of trading on equity i.e., it refers to increase in the proportion of debt capital in the capital structure which is the cheapest source of capital. If the rate of return on capital employed (i.e., shareholders' fund + long- term borrowings) exceeds the fixed rate of interest paid to debt-holders, the company is said to be trading on equity.

4. Minimization of cost of capital:

A sound capital structure of any business enterprise maximizes shareholders' wealth through minimization of the overall cost of capital. This can also be done by incorporating long-term debt capital in the capital structure as the cost of debt capital is lower than the cost of equity or preference share capital since the interest on debt is tax deductible.

5. Solvency or liquidity position:

A sound capital structure never allows a business enterprise to go for too much raising of debt capital because, at the time of poor earning, the solvency is disturbed for compulsory payment of interest to .the debt-supplier.

6. Flexibility:

A sound capital structure provides a room for expansion or reduction of debt capital so that, according to changing conditions, adjustment of capital can be made.

7. Undisturbed controlling:

A good capital structure does not allow the equity shareholders control on business to be diluted.

8. Minimization of financial risk:

If debt component increases in the capital structure of a company, the financial risk (i.e., payment of fixed interest charges and repayment of principal amount of debt in time) will also increase. A sound capital structure protects a business enterprise from such financial risk through a judicious mix of debt and equity in the capital structure.