Capital Structure

Meaning of Capital Budgeting

Capital structure means the arrangement of capital from different sources so that the long-term funds needed for the business are raised. Thus, capital structure refers to the proportions or combinations of equity share capital, preference share capital, debentures, long-term loans, retained earnings and other long-term sources of funds in the total amount of capital which a firm should raise to run its business. The purpose of capital structure is to provide an overview of the level of the company's risk. As a rule of thumb, the higher the proportion of debt financing a company has, the higher its exposure to risk will be. Capital structure is commonly known as the debt-to-equity ratio.

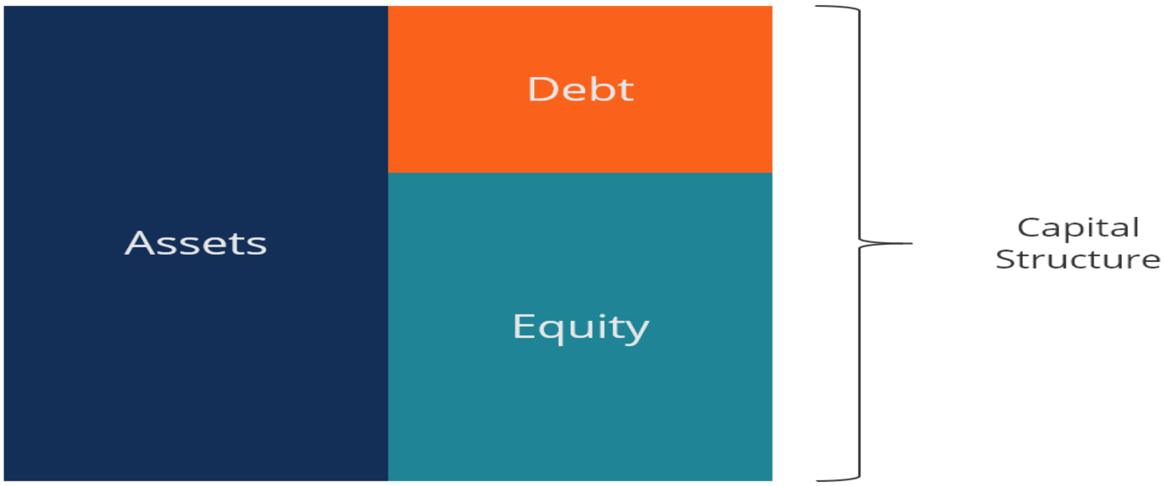
Concept of Capital Structure

The relative proportion of various sources of funds used in a business is termed as financial structure. Capital structure is a part of the financial structure and refers to the proportion of the various long-term sources of financing. It is concerned with making the array of the sources of the funds in a proper manner, which is in relative magnitude and proportion.

The capital structure of a company is made up of debt and equity securities that comprise a firm's financing of its assets. It is the permanent financing of a firm represented by long-term debt, preferred stock and net worth. So it relates to the arrangement of capital and excludes short term borrowings. It denotes some degree of permanency as it excludes short-term sources of financing.

Again, each component of capital structure has a different cost to the firm. In case of companies, it is financed from various sources. In proprietary concerns, usually, the capital employed, is wholly contributed by its owners. In this context, capital refers to the total of funds supplied by both - owners and long-term creditors.

The question arises: What should be the appropriate proportion between owned and debt capital? It depends on the financial policy of individual firms. In one company debt capital may be nil while in another such capital may even be greater than the owned capital. The proportion between the two, usually expressed in terms of a ratio, denotes the capital structure of a company.



Capital structure can be a mixture of a firm's long-term debt, short-term debt, common equity and preferred equity. A company's proportion of short- and long-term debt is considered when analyzing capital structure. When analysts refer to capital structure, they are most likely referring to a firm's debt-to-equity (D/E) ratio, which provides insight into how risky a company is. Usually, a company that is heavily financed by debt has a more aggressive capital structure and therefore poses greater risk to investors. This risk, however, may be the primary source of the firm's growth.

Importance of Capital Structure

Decisions relating to financing the assets of a firm are very crucial in every business and the finance manager is often caught in the dilemma of what the optimum proportion of debt and equity should be. As a general rule there should be a proper mix of debt and equity capital in financing the firm's assets. Capital structure is usually designed to serve the interest of the equity shareholders.

Therefore instead of collecting the entire fund from shareholders a portion of long term fund may be raised as loan in the form of debenture or bond by paying a fixed annual charge. Though these payments are considered as expenses to an entity, such method of financing is adopted to serve the interest of the ordinary shareholders in a better way.

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 raise 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.

Factors Determining Capital Structure

The following factors influence the capital structure decisions:

1. Risk of cash insolvency:

Risk of cash insolvency arises due to failure to pay fixed interest liabilities. Generally, the higher proportion of debt in capital structure compels the company to pay higher rate of interest on debt irrespective of the fact that the fund is available or not. The non-payment of interest charges and principal amount in time call for liquidation of the company.

2. Cost of capital:

Cost of capital means cost of raising the capital from different sources of funds. It is the price paid for using the capital. A business enterprise should generate enough revenue to meet its cost of capital and finance its future growth. The finance manager should consider the cost of each source of fund while designing the capital structure of a company.

3. Control:

The consideration of retaining control of the business is an important factor in capital structure decisions. If the existing equity shareholders do not like to dilute the control, they may prefer debt capital to equity capital, as former has no voting rights.

4. Government policies:

Capital structure is influenced by Government policies, rules and regulations of SEBI and lending policies of financial institutions which change the financial pattern of the company totally. Monetary and fiscal policies of the Government will also affect the capital structure decisions.

5. Size of the company:

Availability of funds is greatly influenced by the size of company. A small company finds it difficult to raise debt capital. The terms of debentures and long-term loans are less favourable to such enterprises. Small companies have to depend more on the equity shares and retained earnings.

On the other hand, large companies issue various types of securities despite the fact that they pay less interest because investors consider large companies less risky.

6. Needs of the investors:

While deciding capital structure the financial conditions and psychology of different types of investors will have to be kept in mind. For example, a poor or middle class investor may only be able to invest in equity or preference shares which are usually of small denominations, only a financially sound investor can afford to invest in debentures of higher denominations.

A cautious investor who wants his capital to grow will prefer equity shares.

7. Flexibility:

The capital structures of a company should be such that it can raise funds as and when required. Flexibility provides room for expansion, both in terms of lower impact on cost and with no significant rise in risk profile.

8. Nature of business:

It has great influence in the capital structure of the business, companies having stable and certain earnings prefer debentures or preference shares and companies having no assured income depends on internal resources.

9. Legal requirements:

The finance manager should comply with the legal provisions while designing the capital structure of a company.

10. Purpose of financing:

Capital structure of a company is also affected by the purpose of financing. If the funds are required for manufacturing purposes, the company may procure it from the issue of long- term sources. When the funds are required for non-manufacturing purposes i.e., welfare facilities to workers, like school, hospital etc. the company may procure it from internal sources.

11. Corporate taxation:

A company has to pay tax on the amount distributed as dividend to the equity shareholders. Due to this, total earnings available for both debt holders and stockholders are more when debt capital is used in capital structure. Therefore, if the corporate tax rate is high enough, it is prudent to raise capital by issuing debentures or taking long-term loans from financial institutions.

12. Cash inflows:

The selection of capital structure is also affected by the capacity of the business to generate cash inflows. It analyses solvency position and the ability of the company to meet its charges.

13. Provision for future:

The provision for future requirement of capital is also to be considered while planning the capital structure of a company.