Basic Capital Structure Theory Overview and Learning Objectives

Overview and Learning Objectives

Overview

We begin this unit by examining the effect of debt financing on earnings per share (EPS). Next we broaden our focus by looking at capital structure theory and what it says about the capital structure that maximizes firm value. Our study of capital structure theory examines several of the most influential papers ever written in Corporate Finance. After becoming familiar with the ideas in these papers, we look at how they can help us make decisions about capital structure in the firm.

Learning Objectives

Upon completion of this unit, students are expected to be able to:

- Explain the effects of leverage on EPS and perform related calculations.
- Draw a graph of levered versus unlevered capital structures and the relation between EBIT and EPS.
- Explain the EBIT breakeven or indifference point and perform related calculations.
- Conduct and explain **Homemade Leverage and Unleverage** and perform related calculations.
- State the four Modigliani and Miller (MM) propositions.
- Explain the MM no tax world (1958) and its conclusions about capital structure.
- Explain the MM with taxes world (1963) and its conclusions about capital structure.
- Calculate the value of the unlevered and levered firm, using Proposition I, MM without taxes.
- Conduct and explain the **Capital Structure Arbitrage**, and use it to show Capital Structure Irrelevance in the MM no tax world (1958) with numerical illustration.
- Calculate the value of the unlevered and levered firm, using proposition I, MM with taxes.
- Calculate the cost of unlevered equity, the cost of levered equity, and the WACC for firms in a "no tax" world and in a world with taxes.