

Basic Capital Structure Theory Introduction

Introduction

Capital structure refers to the way a firm finances its assets. There are two fundamental questions: (1) Does capital structure, i.e., the mix of debt and equity, affect the value of the firm? (2) If it does, then what factors determine the optimal mix of debt and equity? In other words, managers study capital structure because they wish to figure out the amount of debt a firm should have in its capital structure, i.e., the level of debt that maximizes firm value. As we examine this question, we will look at the effect of debt on earnings per share and the effect of debt on firm value. Capital structure theory shows us that firm value is not affected by capital structure, when market frictions and taxes are assumed away. However, when taxes (and market frictions) are added back into the model, capital structure does affect firm value.

As we study capital structure theory, we will assume that the firm is financed using only straight debt and common equity. In other words, more complex forms of financing, such as convertible bonds and preferred stocks, are not considered until later in the semester. The firm may be financed with 100% equity. This is referred to as an unlevered or all equity firm. Alternatively, the firm may be financed with some combination of debt and equity, i.e., a levered firm. The value of the firm is assumed to be the sum of the firm's debt and equity.

$$V = B + S$$

Where:

V = firm value

B = market value of debt

S = market value of equity