

CAPITAL STRUCTURE AND ITS THEORIES

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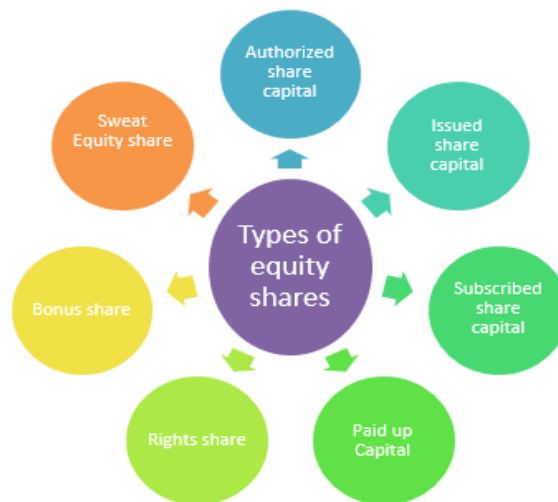
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Abstract

The phrase capital structure refers to the sum of all long-term funding sources. These long-term sources of funding include equity share capital, reserves and surplus, preference share capital, loans, and debentures. A corporation must decide how much of its own funds and outside funds, particularly debt financing, it should have. WACC and a firm's value are impacted by the amount of finance. There are four capital structure theories for this, including the traditional, M&M approach, net income, and net operating income.

EQUITY SHARE:

They fall under the category of long-term sources of financing since they are legally irredeemable in nature. These shares serve as an investor's proof of ownership in the company, entitling them to a portion of the net profits and a residual claim on the company's assets in the event of liquidation (Mostafa & Boregowda, 2014).



Types of Equity Shares

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Different classes of shares (equity) depend on different factors. Let's talk about them.

We list the equity shares on the liability side of the balance sheet in a company's financial statements. The following categories are used to classify them:

Authorized Share Capital

It represents the maximum capital a firm may issue. It may occasionally be increased by the companies. We must follow some procedures and pay some fees to the authorities in order to do it.

Issued Share Capital

It is that portion of the company's authorized capital that it makes available to investors.

Subscribed Share Capital

It is that part of issued capital which an investor accepts and agrees upon.

Paid Up Capital

It is the amount that investors pay as a portion of the subscribed capital. Typically, all businesses take the full amount at once, making the issued, subscribed, and paid capital into a single sum. Paid-up capital, in theory, refers to the sum of money that a corporation really puts in the business.

Apart from the above, there are other types of shares (equity) also.

Rights Shares

These shares are the ones that a business issues to its current stockholders. Such shares are issued by the corporation in an effort to safeguard the ownership rights of current investors.

Bonus Shares

We will refer to bonus shares when a corporation distributes shares to its owners in the form of a dividend. Bonus shares include both advantages and disadvantages, such as dividends, capital gains, limited liability, high risk, market volatility, etc.

Sweat Equity Share

Sweat equity shares are awarded to outstanding firm employees or directors in recognition of their exceptional contributions in the form of know-how or intellectual property rights.

VARIOUS PRICES OF EQUITY SHARES

Par or Face Value

Par or face value is the value of shares which we record in the books of accounts.

Issue Price

This pricing represents what a business truly offers to investors. In the case of new corporations, the issue price and face value of a share are often the same.

Share/Security Premium and Share at Discount

When shares are issued at a price above face value, the excess is referred to as a premium. In contrast, we will refer to this deficiency amount as a discount when shares are issued at a price below face value.

Book Value

The calculation of the book value will be:

$$\text{Paid up Capital} + \text{Reserves and Surplus} - \text{Any Loss} / \text{The total number of equity shares of the company}$$

Market Value

The market value of a share, in the case of businesses listed on stock exchanges, is the price at which it is currently traded. Additionally, known as stock market value. It is possible for stock market value and value determined by fundamental principles to diverge, because a variety of emotions have an impact on the value of the stock market.

Fundamental Value

The number of times the fundamental value of the security is calculated for the purpose of the Merger or valuation. Its calculation is as per (i) Dividend Discount Model (ii) Price Earning Ratio Method (iii) Earning Capitalization Method (iii) Chop Shop method.

Preference shares are a long term source of finance for a company. They have elements of both equity shares and debts.

Debentures are one of the common long term sources of finance. It carries fixed interest rate and certain maturity date.

Preference Shares and its Features

Preference shares are one of the special types of share capital having fixed rate of dividend and they carry preferential rights over ordinary equity shares in sharing of profits and also claims over assets of the firm. It is ranked between equity and debt as far as priority of repayment of capital is concerned.

Definition of Preference Share

A corporation can obtain long-term financing through preference shares. They are neither exactly the same as equity nor are they the same as debt. Although they have aspects of both equity shares and debt, the law treats them as shares. They are also known as "hybrid finance instruments" for this reason. In some parts of the world, these are also referred to as preferred shares, preferred stock, or simply preferred. Preference shares come in a variety of forms and are used as a financing tool.

Gives us a detailed understanding of the preference share's unique qualities. Both debt and equity have some of the same characteristics. It makes sense to talk separately about the characteristics that are similar to debt and equity.

Features of Preference Shares Similar to Debt

Fixed Dividends

Preference shares have fixed dividends tied to them, similar to how debt has a fixed interest rate.

But unlike debt, the responsibility to pay a dividend is not as rigorous. In the event of a preference share, the failure to pay a dividend does not constitute insolvency.

Preference over Equity

These shares receive preference over equity shares in the distribution of income and claims on assets, as the word preference suggests. As an alternative, the dividend on preference shares must be paid before the dividend on common equity shares. These shares would likewise be paid before equity shares at the time of liquidation.

No Voting Rights

Voting rights are typically not given to preference share capital. They are comparable to debt holders and have no influence over how the company is run.

No Share in Earnings

Shareholders of Preferences are limited to two claims. Both the amount of capital deposited and the dividend percentage that was mutually agreed upon. In the event of liquidation, equity shares are entitled to a portion of the residual earnings and residual assets while preference shares are not.

Fixed Maturity

Preference shares have a predetermined maturity date, just like debt. The preferred capital must be returned to the preference owners on the date of maturity. The exception to this rule is a particular class of shares called irredeemable preference shares. They lack a set level of maturity.

CAPITAL STRUCTURE

The ratio of each sort of capital—equity, debt, preference, etc.—makes up the capital structure. It is sometimes referred to as finance mix or financial leverage. The degree of debt in a business firm's capital financing is known as the capital structure.

Financial leverage refers to how much borrowed money or debt a company is using. It is a fundamental term in financial management and a crucial business choice. Generally speaking, equity and debt are the two primary types of capital in a company's capital structure. Because the cost of debt is lower than the cost of equity and the interest payments are tax deductible, debt is the more affordable of the two sources of capital (Javed & Jahanzeb, 2012).

A very significant financial management issue is addressed by capital structure or financial leverage. What the debt-to-equity ratio should be is the question. We should be aware of the goal before racking our brains to try and come up with an answer. Any financial choice made in the framework of financial management must aim to maximise shareholder wealth or boost the company's worth. The second thought that comes to mind is whether or not the value of the company would be affected by a change in the financing mix. The question is legitimate given that some theories hold that the financial mix has an effect on value while others hold that there is no connection.

How can Financial Leverage affect the Value?

One thing is certain: no matter where or how one obtains funding, the operating income levels remain unaffected. Maximum financial leverage may have an influence on net income or EPS (Earning per Share). The cause will be discussed later. The amount of debt must change if the financing mix is altered. The interest the firm must pay may alter when debt levels change. It is generally accepted that an increase in EPS results in an increase in the value of the company. The decrease in interest would raise the net income and hence the EPS.

Financial leverage appears to be an effective technique to increase value in this perspective, but nothing is free. Leveraged finances raise the possibility of bankruptcy. The reason for this is that the fixed responsibility to honour the interest payments to the debt providers would be bigger the higher the degree of debt.

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Important theories or approaches to financial leverage or capital structure or financing mix are as follows:

Finding the ideal capital structure that will maximise a company's value is the clear goal of discussions of financial leverage. If the cost of capital is high, the following important theories or approaches to capital structure, financing mix, or financial leverage include:

Net Income Approach

Durand proposed this strategy and supported the use of financial leverage in the choice. He believed that altering financial leverage would modify the cost of capital. In other words, if the capital structure's debt to equity ratio rises, the weighted average cost of capital falls, raising the firm's value in the process. Net Income Approach is additional information.

Net Operating Income Approach

Durand also provides this strategy. If there are no taxes, it is the opposite of the Net Income Approach. According to this strategy, the weighted average cost of capital stays the same. It holds that the market evaluates a company as a whole and discounts at a specific rate that is unrelated to the debt-to-equity ratio. If tax information is provided, it suggests that as debt financing increases, WACC decreases and the firm's value begins to rise. Net Operating Income Approach is additional information.

Traditional Approach

Hard and fast facts are not defined by this method. It claims that the capital structure affects the cost of capital. This approach is unique in that it thinks there is an ideal capital structure. The idea behind an optimal capital structure is that at a specific debt-to-equity ratio, the cost of capital is lowest and the firm's value is highest. Visit Traditional Approach for more.

Modigliani and Miller Approach (MM Approach)

It is a capital structure theory named after Franco Modigliani and Merton Miller. MM theory proposed two propositions.

- Proposition I: It says that the capital structure is irrelevant to the value of a firm. The value of two identical firms would remain the same and value would not be affected by the choice of finance adopted to finance the assets. The value of a firm is dependent on the expected future earnings. It is when there are no taxes.
- Proposition II: It says that the financial leverage boosts the value of a firm and reduces WACC. It is when tax information is available.

Capital Structure Theory – Traditional Approach

According to the conventional view of capital structure, there is a perfect debt-to-equity ratio where the total cost of capital is lowest and the market value of the company is highest. Changes in the financing mix have the potential to increase the firm's worth on either side of this line. The marginal cost of debt is lower before this point than the cost of equity, and after this point it is the opposite.

Importance and Use of Weighted Average Cost of Capital (WACC)

A corporation is raising money from various sources of funding and using that money to conduct operations. The business has an obligation to pay back its funding sources. If a business only has one source of funding, that source is the required rate of business revenue. WACC (Weighted Average Cost of Capital), which specifies the minimal rate at which the firm should earn from the business in order to give a return to its finance sources, as per their expectations, must be found in cases where the company has raised money from more than one source of financing.

Financial analysts generally agree on the significance and value of the weighted average cost of capital (WACC) as a tool for investors and businesses. It's crucial for businesses to consider both similar and different risks when making investment decisions and evaluating projects. The WACC is necessary for the computation of significant metrics like net present values and economic value added. It is similarly crucial for investors who are valuing businesses (Javed & Jahanzeb, 2012).

WACC analysis can be viewed from the perspectives of the company and the investor. It can be described as the combined cost of capital that the company must pay utilising funds from both owners and debt holders from the perspective of the company. In other words, it is the lowest rate of return that a business must achieve in order to add value for investors. It is the opportunity cost of the investor's capital, seen from their perspective. If the company offers a return that is less than its WACC, value is being lost. As a result, investors may decide to stop funding the business and go elsewhere for a higher return.

Introduction to Capital Structure Theory

A corporation can finance its operations primarily through two methods: debt and equity. The percentage of each of these, however, may differ from firm to business. A corporation can opt for a structure that has a 50/50 split between debt and equity, or it can choose to have more of one and less of the other. Financial leverage, another name for capital structure, refers to the percentage of debt or borrowed money in a company's funding mix (Chen & Hammes, 2004).

Due to the fact that interest paid on loans is tax deductible, debt structuring might be a practical choice (deductible from net profit before tax). Therefore, debt is a less expensive form of funding. However, growing debt has a number of negative consequences, including a higher risk of bankruptcy and more fixed interest obligations etc.

Different theories (approaches) have developed for determining the ideal capital structure to maximise shareholder wealth or the firm's worth. Let's now examine the first strategy.

Explaining the Net Income Approach

Durand gave his Net Income Approach presentation. According to the notion, a company's value can be increased by lowering its weighted average cost of capital, which represents the total cost of capital. This can be accomplished by using more debt, which is a less expensive source of funding than stock financing.

WACC, or weighted average cost of capital, is the cost of equity and debt divided by the total amount of capital raised from all sources.

$$\text{WACC} = \left(\frac{E}{V} \times Re\right) + \left(\frac{D}{V} \times Rd \times (1 - Tc)\right)$$

Where: E =Market value of the firm's equity

D =Market value of the firm's debt

$V = E + D$

Re =Cost of equity

Rd =Cost of debt

Tc =Corporate tax rate

The Weighted Average Cost of Capital (WACC) and the value of the company will both fluctuate in response to changes in a firm's financial leverage, according to the Net Income Approach. According to the Net Income Approach, as leverage (the percentage of debt) increases, the WACC lowers and the firm's value rises. On the other hand, if the leverage is reduced, the WACC rises and the firm's value consequently declines (Ardalan, 2017).

When compared to a 50:50 equity-debt mix, for instance, a 20:80 equity-debt mix would have a beneficial effect on the business' worth and raise the value per share.

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