THE THEORY OF CAPITAL STRUCTURE OF FIRMS

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ABSTRACT
The study is undertaken to explore the theory of foundation of capital structure of the firm. Capital structure of a firm includes a mixture of debt and equity securities required to manage the financing of the firms. This study emphasizes on the importance of capital structure in maximizing the market value of the firm and various theories regarding this are discussed herewith. We threw a light on the conflicts between the shareholders and debt holders and how the firm can manage the relations with them and satisfying each of them. The focus was also given on the leverage of the firm, how to calculate it and how it affects the decision of choosing optimal combination of debt and equity for financing the assets of the firm. The optimal capital structure of firm is required for the firm to sustain in the competitive environment.

Keywords: Capital structure, debt, equity, leverage

INTRODUCTION
The capital structure is how a firm finances its overall operations and growth by using different sources of funds. Debt comes in the form of bond issues or long-term notes payable, while equity is classified as common stock, preferred stock or retained earnings. Short-term debt such as working capital requirements is also considered to be part of the capital structure (Source: Investopedia)

A firm’s capital structure is a mix of long-term debt, preferred equity, common equity and net worth. Every type of capital has its one merits and demerits, the firm has to take this into consideration in such a manner that benefits arising out of an optimal capital structure pays the interest and costs attached to the borrowed funds.

It is the permanent financing of a firm as it excludes the short-term sources of financing and includes only the long-term sources. Therefore, the capital structure is a part of financial structure and should not be confused with financial structure as it refers to the permanent sources of financing of a firm. For example: If a firm has 30 lacs in equity and 70 lacs in debit, it is said to have 30% equity-financed and 70% debt-financed. In reality the capital structure of the firm is highly complex and involves huge amount of equity and debt capital. A firm who is borrowing funds from the market must ensure that the earnings from such securities are able to pay off the borrowing costs.

OBJECTIVES
1. The main objective is to study the detailed theory of composition of capital structure of the firm.
2. To emphasize on the factors that influence the capital structure decisions of the firm.
3. To study the importance of capital in maximization of firm’s value.
LITERATURE REVIEW

The mixture of equity and debt in financing of a business firm is called as capital structure. The capital structure of a firm is a part of financial structure as it refers to the permanent sources of financing. The permanent sources include the long-term debt, preference equity and net worth. According to P. Chandra, ‘capital structure is essentially concerned with how the firm decides to divide its cash flows into two broad components, a fixed component that is earmarked to meet the obligations toward debt capital and a residual component that belongs to equity shareholders’. The appropriate proportion of firm’s capital into equity and debt depends upon the financial policy of individual firms. According to Gere Stenberg, ‘capital structure of a company refers to the composition or makeup of its capitalization and it includes all long-term capital resources viz., loans, reserves, shares, and bonds’. The capital structure refers to the total fund provided by both owners i.e. shareholders and long-term creditors. The capital structure should be composed considering how the proportion of debt and equity will have an impact on the market value of the firms. Stulz (1990) gave a statement that the optimal capital structure can be designed by a trade-off between benefit of debt and cost of debt. The firm considers how much of income after taxes can be generated through investments in debt or borrowed fund that trade off the costs of borrowing that fund. The ratio of debt and equity represents the financial leverage of the firm.

COMPONENTS OF CAPITAL STRUCTURE

The capital structure is a mixture of two components: equity capital and debt capital explained as follows:

**Equity Capital**

Equity capital in the capital structure of a company refers to the funds put in by the shareholders (owners of the firm). Equity capital has two types:

1. **Contributed Capital**: It is the original investment made by the shareholders of the company.
2. **Retained Earnings**: It is the profits retained from the past years kept by the firms. Owner’s equity is paid back after all the creditors are paid at the time of liquidation of company.

**Debt Capital**

Debt capital in the capital structure of a firm refers to the borrowed funds required for the business of the firm. Long-term debt is the safest type of borrowed fund as it gives time to the firm to repay back the principal, while they have to pay only interest for the meantime. At the liquidation of the firm these funds are repaid before giving it to preference and equity shareholders.

These two components form the capital structure of the firm. The firm has to decide how much of equity or debt it should employ in its capital structure in order to achieve the maximum value.

IMPORTANCE OF CAPITAL STRUCTURE

Decisions taken for financing the assets of a firm are very critical in every business and the finance manager is always in conundrum of what the optimum proportion of debt and equity should be. As a preferred rule, there ought to be an appropriate mix of debt and equity capital in financing the firm’s assets. The capital structure is generally designed to serve this purpose.

Consequently, in preference to gathering the whole fund from shareholders a part of the long-term fund may be raised as a mortgage in the form of debenture or bond by paying a set annual fee. The importance of creating a proper capital structure is explained below:

**Value maximization**

Capital structure maximizes the marketplace cost of a company, i.e. in a company having a well-designed capital structure the aggregate price of the claims and ownership interests of the shareholders are maximized.
Increased share price
A proper Capital structure maximizes the firm’s market price of a share by increasing earnings per share of the ordinary shareholders. It also increases dividend paid to the shareholders.

Proper balance between risk and return
A upward thrust in debt will boom the company’s risk and the anticipated return. High risk refers to an increase in debt that may cause a lower inventory rate and an increase inside the anticipated return of the inventory price. Therefore, the optimal capital structure makes sure the balance between the risk and return of an enterprise is to maximize the stock(inventory) price.

Cost minimization
A firm should determine an appropriate mix of capital structure of funding the sources, such that it minimizes the cost of financing or cost of capital of the firm.

Investment opportunity
Capital structure increases the capability of the company to find new wealth-growing investment opportunities. In the right capital gearing, it additionally increases the confidence of providers of debt to the company.

THEORIES OF CAPITAL STRUCTURE
The objective of the financial leverage of a firm is to find an optimal capital structure that leads to the maximization of the value of the firm. In this context, there are important theories of capital structure or financial leverage given as below:

Trade off theory
Trade off theory gives an idea of a firm to choose how much of equity financing and debt financing is required by balancing the cost and benefits. The important implication of this theory is that a firm equally financed with debt and equity. A firm considers the main factors such as agency costs, financial distress and taxes while determining the capital structure. The theory states that profitable enterprises will use more of debt as there are tax benefits to debt and less bankruptcy costs.

Pecking order theory
Pecking order theory states that a company has three sources of finance, internal, debt and last raising equity. There is hierarchy involved when a firm chooses a source of financing. In this hierarchy the firm will firstly choose the securities with lower risks and then move on to the other comparatively highly risky securities. The firm prefers internal financing over external financing. This theory assumes that main objective of the firm is the maximization of shareholder’s wealth. The pecking order theory is popularized by Myers and Majluf (1984)[1] where they explained that equity is a less preferred means to raise capital because when managers (who are assumed to know better about true condition of the firm than investors) issue new equity, investors believe that managers think that the firm is overvalued and managers are taking advantage of this over-valuation. As a result, investors will place a lower value to the new equity issuance.

Modigliani Miller theory
It is the modern theorem of capital structure. This theory stated that earning power and the risks involved in underlying asset determines the value of the firm and its value is independent of the way the firm chooses to finance its investments or distribute dividends. It has two propositions explained as: 1) Proposition I: The market value of any firm independent of its capital structure. 2) Proposition II: The cost of capital depends upon the debt. Cost of capital rises as debit increases.

The MM theory is based on the following assumptions:
a) Existence of Perfect Capital Market
b) No transportation costs
c) No taxes
d) The borrowing cost is same for both the companies and investors
e) Investors cannot affect the market price
f) No bankruptcy costs

But in real world, there are taxes involved, transportation costs, inexistence of perfect capital market. MM theory states that the firm should use debt for financing as the interest on debt can be used to reduce taxes. In this theory the optimal capital structure is the one where there is no equity at all.

**Market Timing theory**

The market timing theory of capital structure states that a firm issue the equity securities when they find their shares are overvalued and buy it back when feels that the shares are undervalued. The capital structure of the firm is affected by these fluctuations in the stock prices or value. In this structure the firm does not care about the composition of debt and equity in capital structure, they just choose either equity or finance depending upon which has the more value in financial market.

**FACTORS INFLUENCING THE CAPITAL STRUCTURE OF A FIRM**

The factors that characterize the company such as growth rate, market conditions, management style, cash flow position, business risks have a direct influence on its capital structure. These factors are elaborated and are given underneath:

**Growth rate**

The firm who is in the growth stage requires more of finance through borrowings via debt. But growing with higher debt leads to unstable profits which are usually not appropriate for the firm. The firm who has already achieved higher growth do not opt for debt as a source of financing as it involves higher risks.

**Market conditions**

The capital structure is the firm depends upon the prevailing market conditions. If a firm struggles being in a difficult position in the market then it goes for increased borrowed funds in order to sustain in the market. If the market is in bad condition, the investors are scared to invest as it involves higher risk.

**Management**

The Management style of the firms varies from conservatism to aggression. The aggressive management may tend to go for debt as a source for capital structure. A conservative management avoids raising the funds though debt financing as it adversely affects the profits of the firm.

**Cash flow position**

The firm has to consider the future cash flows while deciding upon its capital structure. If a firm has good cash flow position then it can use the debt capital as it will be in a position to make the interest payment and the capital refund. If a firm is not having good expected cash flows then it lies on internal financing mainly.

**Business risks**

The business risk is the most important factor while determining the capital structure. A firm who has stable earnings has less risk in its business. The lesser the risk, the higher is the debt equity ratio. If the
company has higher risk the investors will feel comfortable to make investments in such capital structure of the firm.

EQUITY-DEBT HOLDER CONFLICTS AND CAPITAL STRUCTURE

Equity holders are the individuals who own the shares of the firm whereas bond holders are the creditors of the firm. The shareholders generally have conflicts in terms of control and ownership. They do not want to transfer wealth to bond holders. They want whole of the investments of the company in order to enjoy maximum ownership and benefits. They aim for the value maximization of the firm. In order to gain the complete ownership, the shareholders can make decisions to shift the wealth from bond holders to shareholders. The shareholders have an incentive in taking risky projects as in comparison to bondholders. This makes an arousal of conflict among the equity and bond holders. The bond holders will demand higher return on their bonds. The shareholders preferences for risky investments will have a negative impact on the debt holders.

LEVERAGE AND CAPITAL STRUCTURE

Leverage refers to borrowing of funds or debt in order to make the purchase of an asset. It depends upon the owners of the firm they can use either debt or equity to finance the buying of assets. If a firm is highly leveraged, it explains that more of debt is there over equity. The borrowed capital increases the risk of bankruptcy. It has been assumed that income earned from the debt and the appreciation in its value will recover the cost of borrowing. There are two types of leverage explained as follows:

Financial Leverage

It refers to the use of debt or borrowed capital to increase the volume of production, thereby increasing sales and earnings. As the firm uses more of debt, the higher is the financial leverage of company. With the increase in the use of debt, the interest payments will increase thereby adversely affecting the earnings per share. A higher ratio will have a negative impact on profits.

Operating Leverage

It refers to the extent to which firm uses both fixed and variable costs, but uses more of fixed costs as in comparison to variable costs. The companies with high ratio of fixed costs to variable costs have high operating leverage with increase in the revenue earned from sales and the companies with high operating leverage have high operating income. A firm with operating leverage tends to have higher break-even. A low operating leverage depicts low fixed costs and high variable cost.

The financial leverage is measure by Debt-Equity ratio of a firm which depicts firm’s borrowing costs and its value to shareholders. It is calculated by dividing total liabilities to total shareholder’s equity. This ratio indicates the amount of debt or borrowed funds a firm is using to finance its assets. A lower debt equity ratio depicts that business is financially stable. A higher debt equity ratio implies financially unstable or volatile earnings.

CONCLUSION

In this paper we described the capital structure as a mixture of debt and equity which aims to maximize the value of the firm. These decisions play a very crucial role in deciding upon the capital structure of the firm. There are various factors such as risks, market conditions, growth that affects the choice of proportion of equity or borrowings which a firm should consider on serious note. The various theories of capital structure were discussed which a firm can follow to determine the optimum capital structure. There are conflicts of interest between the shareholders and bond holders of the firm which the firm’s manager has to consider while choosing the composition of capital structure. The firm creates the capital structure in a manner that do not neglect the interest of the both the creditors and equity holders. The leverage is related to the capital structure of the firm. The financial leverage is measured vie debt equity ratio that depicts the financial stability or earnings of the firm.
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