TYPES OF CAPITAL STRUCTURE THEORIES pdf

1: What Are the Different Types of Capital Structure Theory?

Capital Structure. Capital structure is the proportion of all types of capital viz. equity, debt, preference etc. It is synonymously used as financial leverage or financing mix. Capital structure is also referred as the degree of debts in the financing or capital of a business firm.

History[edit] Pecking order theory was first suggested by Donaldson in and it was modified by Stewart C. Myers and Nicolas Majluf in Hence, internal funds are used first, and when that is depleted, debt is issued, and when it is not sensible to issue any more debt, equity is issued. Asymmetric information affects the choice between internal and external financing and between the issue of debt or equity. Therefore, there exists a pecking order for the financing of new projects. The issue of equity would signal a lack of confidence in the board and that they feel the share price is over-valued. An issue of equity would therefore lead to a drop in share price. This does not however apply to high-tech industries where the issue of equity is preferable due to the high cost of debt issue as assets are intangible. However, several authors have found that there are instances where it is a good approximation of reality. On the one hand, Fama and French,. Goyal and Frank show, among other things, that pecking order theory fails where it should hold, namely for small firms where information asymmetry is presumably an important problem. Firms prefer internal financing. They adapt their target dividend payout ratios to their investment opportunities, while trying to avoid sudden changes in dividends. Sticky dividend policies, plus unpredictable fluctuations in profits and investment opportunities, mean that internally generated cash flow is sometimes more than capital expenditures and at other times less. If it is more, the firm pays off the debt or invests in marketable securities. If it is less, the firm first draws down its cash balance or sells its marketable securities, rather than reduce dividends. If external financing is required, firms issue the safest security first. That is, they start with debt, then possibly hybrid securities such as convertible bonds, then perhaps equity as a last resort. In addition, issue costs are least for internal funds, low for debt and highest for equity. There is also the negative signaling to the stock market associated with issuing equity, positive signaling associated with debt.

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2: Top 4 Theories of Capital Structure (With Calculations)

Optimal capital structure theory is unique to each business, so different businesses subscribe to different theories. Financial analysts use a number of elements when determining capital structure. These often include common stock values, expected cash dividends, equity, debt, and earnings.

Various theories have attempted to answer the question: Taxation is ignored in thetraditional view. At low levels of gearing: Equity holders perceive risk as unchanged so the increase in the proportion of cheaper debt will lower the WACC At higher levels of gearing: Equity holders see increased volatility of returns as debt interest must be paid first. At very high levels of gearing: This can be shown diagrammatically: At point X theoverall return required by investors debt and equity is minimised. Assumptions underpinning the traditional view No taxation The company pays out all its earnings as dividends The earnings of the company are expected to remain constant in perpetuity Business risk is constant The gearing of a company can be changed immediately by issuing debt to repurchase shares or vice versa. That is to say the capital employed in the business is constant. The are no transaction costs for issues Implication for finance Company should gear up until it reaches optimal point and then raise a mix of finance to maintain this level of gearing. Problem There is no method, apart from trial and error,available to locate the optimal point. The traditional view of capital structure As an organisation introduces debt into its capital structure, theWACC will fall because initially the benefit of cheap debt finance morethan outweighs any increases in the cost of equity required tocompensate equity holders for higher financial risk. As gearing continues to increase the equity holders will ask forincreasingly higher returns and eventually this increase will start tooutweigh the benefit of cheap debt finance, and the WACC will rise. At extreme levels of gearing the cost of debt will also start torise as debt holders become worried about the security of their loans ,shareholders will continue to increase their required return and thiswill contribute to a sharply increasing WACC. Key staff leave to avoid beingtainted by a failed company. Uncertainties are placed in the minds ofcustomers and suppliers, which may result in lost sales and moreexpensive trading terms. If a bankruptcy situation finally occurs, the assets may be soldoff quickly and cheaply. The traditional view therefore claims that there is an optimalcapital structure where WACC is at a minimum. This is represented bypoint X on the above diagram. At point X the overall return required by investors debt andequity is minimised. To address this problem two economists attempted to find the optimal point in Conclusion The WACC and therefore the value of the firm are unaffected by changes in gearing levels and gearing is irrelevant. Ensure you can discuss them. Their view is based on the belief that the value of a companydepends upon the future operating income generated by its assets. Theway in which this income is split between returns to debt holders andreturns to equity should make no difference to the total value of thefirm equity plus debt. Thus, the total value of the firm will notchange with gearing, and therefore neither will its WACC. Their view is represented in the above diagrams. If the WACC is to remain constant at all levels of gearing itfollows that any benefit from the use of cheaper debt finance must beexactly offset by the increase in the cost of equity. This is at oddswith the beliefs of the traditionalists. This proof is outside the syllabus. Since debt interest is tax-deductible the impact of taxcould not be ignored. The starting point for the theory is, as before, that: However this is adjusted to reflect the fact that: The optimal capital structure is The company should use as much debt as possible. This is demonstrated in the following diagrams: In they amended their model to include corporation tax. This alterationchanges the implication of their analysis significantly. Previously they argued that companies that differ only in theircapital structure should have the same total value of debt plus equity. However, the corporation tax system carries a distortion underwhich returns to debt holders interest are tax deductible to the firm,whereas returns to equity holders are not. Once again they were able to produce a proof to support theirarguments and show that as gearing increases, the WACC steadilydecreases. The logicalconclusion is that companies should choose a The problems of high gearing In practice firms are rarely found with very high levels of gearing. This is because of:

3: Modigliani And Miller's Capital Structure Theories

In financial management, capital structure theory refers to a systematic approach to financing business activities through a combination of equities and liabilities.

Top 4 Theories of Capital Structure Article shared by: This article throws light upon the top four theories of capital structure. Net Income Approach 2. Net Operating Income Approach 3. Net Income NI Approach: According to NI approach a firm may increase the total value of the firm by lowering its cost of capital. When cost of capital is lowest and the value of the firm is greatest, we call it the optimum capital structure for the firms and at this point, the market price per share is maximised. The same is possible continuously by lowering its cost of capital by the use of debt capital. In other words, using more debt capital with a corresponding reduction in cost of capital, the value of the firm will increase. The same is possible only when: There are no taxes, and iii. The use of debt does not change the risk perception of the investors since the degree of leverage is increased to that extent. Since the amount of debt in the capital structure increases, weighted average cost of capital decreases which leads to increase the total value of the firm. So, the increased amount of debt with constant amount of cost of equity and cost of debt will highlight the earnings of the shareholders. Average Cost of Capital is computed as under under various financing plans: From the above table it is quite clear that the value of the firm V will be increased if there is a proportionate increase in debt capital but there will be a reduction in overall cost of capital. It is interesting to note that the NI approach can also be graphically presented as under with the help of the above illustration: It reveals that when the cheaper debt capital in the capital structure is proportionally increased, the weighted average cost of capital Kw, decreases and consequently the cost of debt Kd. Thus, it is needless to say that the optimal capital structure is the minimum cost of capital, if financial leverage is one, in other words, the maximum application of debt capital. The value of the firm V will also be the maximum at this point. Net Operating Income Approach: Thus, the value of the firm, V, is ascertained at overall cost of capital Kw: Under this approach, the most significant assumption is that the Ku is constant irrespective of the degree of leverage. The segregation of debt and equity is not important here and the market capitalizes the value of the firm as a whole. Thus, an increase in the use of apparently cheaper debt funds is offset exactly by the corresponding increase in the equity-capitalisation rate. So, the weighted average Cost of Capital Kw and Kd remain unchanged for all degrees of leverage. Although the value of the firm Rs. Thus, if the cheaper debt capital is used, that will be offset by the increase in the total cost of equity, Ks and as such, both Ke and Kd remain unchanged for all degrees of leverage i. It is accepted by all that the judicious use of debt will increase the value of the firm and reduce the cost of capital. So, the optimum capital structure is the point at which the value of the firm is highest and the cost of capital is at its lowest point. Practically, this approach encompasses all the ground between the net income approach and the net operating income approach i. The traditional approach explains that up to a certain point, debt-equity mix will cause the market value of the firm to rise and the cost of capital to decline. But after attaining the optimum level, any additional debt will cause to decrease the market value and to increase the cost of capital. In other words, after attaining the optimum level, any additional debt taken, will offset the use of cheaper debt capital since the average cost of capital will increase along with a corresponding increase in the average cost of debt capital. Thus, the basic, proposition of this approach are enumerated below: The traditional approach can graphically be represented as under taking the data from the previous illustration. It is found from the above, the average cost curve is U-shaped. If we draw a perpendicular to the X-axis, the same will indicate the optimum capital structure for the firm. Thus, the traditional position implies that the cost of capital is not independent of the capital structure of the firm and that there is an optimal capital structure. At that optimal structure, the marginal real cost of debt explicit and implicit is the same as the marginal Real cost of equity in equilibrium. For degree of leverage before that point, the marginal real cost of debt is less than of equity, beyond that point the marginal real cost of debt excess that of equity. Hence, optimum capital structure in this case is considered as Equity Capital Rs. Variations on the Traditional Theory: Thus, there are some distinct variations in this theory. Some followers of

the traditional school of thought suggest that Ke does not practically rise till some critical conditions arise. After attaining that level only, the investors apprehend the increasing financial risk and penalize the market price of the shares. This variation expresses that a firm can have lower cost of capital with the initial use of leverage significantly. This variation in Traditional Approach is depicted as under: It explains that optimum capital structure has a range where the cost of capital is rather minimised and where the total value of the firm is maximised. So, this approach grants some sorts of variation in the optimal capital structure for various firms under debt-equity mix. Modigliani-Miller MM advocated that the relationship between the cost of capital, capital structure and the valuation of the firm, should be explained by NOI Net Income Operating Approach by making an attack on the Traditional Approach. The Net Income Operating Approach, we know, supply proper justification for the irrelevance of the capital structure. In this context, MM support the NOI approach on the principle that the cost of capital is not dependent on the degree of leverage irrespective of the debt-equity mix. In other words, according to their thesis, the total market value of the firm and the cost of capital are independent of the capital structure. They advocated that the weighted average cost of capital does not make any change with a proportionate change in debt-equity mix in the total capital structure of the firm. The same can be shown with the help of the following diagram:

The above equations are used by all capital structure theories, the controversy only lies in relation to the degree of leverage of the variable cost of equity (K e), weighted average cost of capital (K w), and total firm's value (V).

This section does not cite any sources. Please help improve this section by adding citations to reliable sources. Unsourced material may be challenged and removed. July Learn how and when to remove this template message Consider a perfect capital market no transaction or bankruptcy costs; perfect information ; firms and individuals can borrow at the same interest rate; no taxes ; and investment returns are not affected by financial uncertainty. Modigliani and Miller made two findings under these conditions. That is, as leverage increases, risk is shifted between different investor classes, while total firm risk is constant, and hence no extra value created. Their analysis was extended to include the effect of taxes and risky debt. Under a classical tax system , the tax-deductibility of interest makes debt financing valuable; that is, the cost of capital decreases as the proportion of debt in the capital structure increases. The optimal structure would be to have virtually no equity at all, i. In the real world[edit] If capital structure is irrelevant in a perfect market, then imperfections which exist in the real world must be the cause of its relevance. Trade-off theory[edit] Trade-off theory of capital structure allows bankruptcy cost to exist as an offset to the benefit of using debt as tax shield. It states that there is an advantage to financing with debt, namely, the tax benefits of debt and that there is a cost of financing with debt the bankruptcy costs and the financial distress costs of debt. This theory also refers to the idea that a company chooses how much equity finance and how much debt finance to use by considering both costs and benefits. The marginal benefit of further increases in debt declines as debt increases, while the marginal cost increases, so that a firm optimizing its overall value will focus on this trade-off when choosing how much debt and equity to use for financing. It states that companies prioritize their sources of financing from internal financing to equity according to the law of least effort, or of least resistance, preferring to raise equity as a financing means "of last resort". Thus, the form of debt a firm chooses can act as a signal of its need for external finance. As a result, investors may place a lower value to the new equity issuance. Capital structure substitution theory[edit] The capital structure substitution theory is based on the hypothesis that company management may manipulate capital structure such that earnings per share EPS are maximized. The SEC rule 10b allowed public companies open-market repurchases of their own stock and made it easier to manipulate capital structure. First, it has been deducted[by whom? The second prediction has been that companies with a high valuation ratio, or low earnings yield, will have little or no debt, whereas companies with low valuation ratios will be more leveraged. This contradicts Hamada who used the work of Modigliani and Miller to derive a positive relationship between these two variables. Agency costs[edit] Three types of agency costs can help explain the relevance of capital structure. As debt-to-equity ratio increases, management has an incentive to undertake risky, even negative Net present value NPV projects. This is because if the project is successful, share holders earn the benefit, whereas if it is unsuccessful, debtors experience the downside. If debt is risky e. Thus, management have an incentive to reject positive NPV projects, even though they have the potential to increase firm value. Increasing leverage imposes financial discipline on management. Managerial contracts, debt contracts, equity contracts, investment returns, all have long lived, multi-period implications. Therefore, it is hard to think through what the implications of the basic models above are for the real world if they are not embedded in a dynamic structure that approximates reality. A similar type of research is performed under the guise of credit risk research in which the modeling of the likelihood of default and its pricing is undertaken under different assumptions about investors and about the incentives of management, shareholders and debt holders. Capital not bearing risk Capital bearing risk includes debentures risk is to pay interest and preference capital risk to pay dividend at fixed rate. Consider, for example, traditional bonds, and convertible bonds. The latter are bonds that are, under contracted-for conditions, convertible into shares of equity. The stock-option component of a convertible bond has a calculable value in itself. The value of the whole instrument should be the value of the traditional bonds plus the extra value of the option feature. If the spread the difference between the convertible and the

non-convertible bonds grows excessively, then the capital-structure arbitrageur will bet that it will converge.

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Capital Structure Theories - D) Traditional Approach The NI approach and NOI approach hold extreme views on the relationship between capital structure, cost of capital and the value of a firm. Traditional approach ('intermediate approach') is a compromise between these two extreme approaches. Traditional approach confirms the existence of.

It is synonymously used as financial leverage or financing mix. Capital structure is also referred as the degree of debts in the financing or capital of a business firm. Financial leverage is the extent to which a business firm employs borrowed money or debts. In financial management , it is a significant term and an important decision in a business. In the capital structure of a company, broadly, there are mainly two types of capital i. Out of the two, debt is considered a cheaper source of finance because the interest payments are a tax-deductible expense. Capital structure or financial leverage deals with a very important financial management question. The other question which hits the mind in the first place is whether a change in the financing mix would have any impact on the value of the firm or not. The question is a valid question as there are some theories which believe that financial mix has an impact on the value and others believe it to be not connected. How can financial leverage affect the value? One thing is sure that wherever and whatever way one sources the finance from, it cannot change the operating income levels. The reason is explained further. Changing the financing mix means changing the level of debts and change in levels of debt can impact the interest payable by that firm. The decrease in interest would increase the net income and thereby the EPS and it is a general belief that the increase in EPS leads to increase in the value of the firm. Apparently, under this view, financial leverage is a useful tool to increase value but, at the same time, nothing comes without a cost. Financial leverage increases the risk of bankruptcy. It is because higher the level of debt, higher would be the fixed obligation to honor the interest payments to the debts providers. Discussion of financial leverage has an obvious objective of finding an optimum capital structure leading to maximization of the value of the firm. If the cost of capital is high Important theories or approaches to financial leverage or capital structure or financing mix are as follows: Net Income Approach This approach was suggested by Durand and he was in the favor of financial leverage decision. According to him, change in financial leverage would lead to a change in the cost of capital. In short, if the ratio of debt in the capital structure increases, the weighted average cost of capital decreases and hence the value of the firm. It says that the weighted average cost of capital remains constant. It believes in the fact that the market analyses firm as a whole which discounts at a particular rate which is not related to debt-equity ratio. Traditional Approach This approach is not defined hard and fast facts but it says that cost of capital is a function of the capital structure. The special thing about this approach is that it believes an optimal capital structure. Optimal capital structure implies that at a particular ratio of debt and equity, the cost of capital is minimum and value of the firm is maximum. MM theory proposed two propositions. It says that the capital structure is irrelevant to the value of a firm. The value of two identical firms would be same and it would not be affected by the mode of finance adopted to finance the assets. The value of a firm is dependent on the expected future earnings. It says that the financial leverage boosts the expected earnings but it does not increase the value of the firm because the increase in earnings is compensated by the change in the required rate of return. To summarize, it is essential for finance professionals to know about the nitty-gritty of capital structure they have suggested to the management. Accurate analysis of capital structure can help a company save on the part of their cost of capital and hence improve profitability for the shareholders.

Modigliani and Miller's Tradeoff Theory of Leverage The tradeoff theory assumes that there are benefits to leverage within a capital structure up until the optimal capital structure is reached.

Meaning, Assumptions and Classification Accounting Article shared by: Let us make an in-depth study of the meaning, assumptions and classification of the capital structure. In other words, it includes all long-term funds invested in the business in the form of Long-term Loans, Preference Shares and Debentures, including Equity Capital and Reserves. As regards capital structure, the significant point to be noted is the proportion of owned capital and borrowed capital by way of different securities to the total capitalisation for raising finance. Long-term funds can be raised either by the issue of a Shares, or b Debentures or long-term loans and borrowings. However, there is an important difference between the two. If funds are raised by the issue of equity shares, it requires dividends only if there is sufficient profits, whereas, in the latter case, it requires a fixed rate of interest irrespective of the profit or loss. Thus, the question of capital gearing arises relating to which fund a fixed rate of interest or dividend is paid. From a theoretical point of view, capital structure affects either cost of capital or expected yield, or both, of a firm. On the contrary, financing-mix affects the yield per share which belongs to the equity shareholders but do not affect the total earnings, since they are determined by investment decisions of a firm. In other words, the decisions of capital structure affects the value of the firm by the returns that are made available for the equity shareholders. On the other hand, leverage affects the value of the firm by the cost of capital. The relationship between the Capital Structure and the Cost of Capital can better be understood if we assume: In order to explain the theories of capital structure we are to use the following systems in addition to the above assumptions: In order to ascertain the total value of the firm, the Equity S and Debt T may be summed up as: Financial Structure and Capital Structure: The financial structure of a firm comprises of the various ways and means of raising funds. In other words, financial structure includes all long-term and short-term liabilities. But if short- term i. Thus, instead of exclusion of current liabilities, if they are included—which is quite justified in a broader sense of the term—there will be no difference between the two. Classification of Capital Structure: We know that a firm obtains its requirement from various sources and invests the same also in various forms of assets. In other words, a firm has to perform a two-fold aspect for its capital structure application, viz. Thus, the classification of capital structure can be represented as:

7: Corporate Capital Structure Definition from Financial Times Lexicon

Net Income Theory. According to this theory, the cost of debt is recognized as cheaper source of financing than equity capital. The more use of debt in the capital structure lowers the total cost of capital.

Khan3 Abstract Capital structure is the important part of the business performance. Here paper investigates the theories of the capital structure on the basis of review, from the start-up point. There are various studies which have examined capital structure determinants also in the corporate finance literature. As per these theories there are various determinants such as assets structure, profitability, growth opportunities, liquidity, company size, and dividend policywhich affect the leverage of the firm, these are possibly responsible for decision making of the capital Structure, and find that pecking theory in capital structure decision prevails in the market, but some time moderate support for the trade-off theory. Miller and Modigliani Theory of Irrelevance The theory of business finance in a modern sense starts with the Modigliani and Miller capital structure irrelevance proposition. Before them, there was no generally accepted theory of capital structure. Modigliani and Miller start by assuming that the firm has a particular set of expected cash flows. They argue that there would be arbitrage opportunities in the perfect capital market if the value of the firm depends on its capital structure. Furthermore, investor can avail any capital structure decision of the firms if both investor and firms can be borrowed at the same rate of interest. Though this theory is based on many unrealistic assumptions, yet it provides the basics theoretical background for further research. The investor can create any leverage that was wanted but not offered, or the investor can get rid of any leverage that the firm took on but was not wanted. So, as a result, the leverage of the firm does notaffect the market value of the firm. In the matter of theory, capital structure irrelevance can be proved under a range of circumstances. On the basis of theory, there are two fundamentally different types of capital structure irrelevance propositions. Classic arbitrage-based irrelevance propositions provide settings in which arbitrage to the investors, keeps the value of the firm independent of its leverage. In addition to the original Modigliani and Miller paper, important contributions include by Hirshleifer , and Stiglitz In other word, in the perfect market, neither capital structure choices nor dividend policy decisions matters. This research has shown that the MM theorem fails under a various circumstances. Given that so many different ingredients are available, it is not surprising that many different theories have been proposed. Covering all of these would go well beyond the scope of this paper. Harris and Raviv provided a survey of the development of this theory. As an empirical proposition, the MM irrelevance proposition is not easy to test. A popular argue as follows: Accordingly, it influenced the early development of others, trade-off theory and the pecking order theory and etc. Interest, being a tax deductible expense, decreases the tax liability and increases the after tax cash flows. Firms in their attempt to increase cash flows and market value will remark on higher level of debt if the tax rate is high. Thus tax rate and leverage have positive relationship. The costs of monitoring he managers so that they act in the interests of the shareholders are referred as Agency Costs. The higher the need to monitor the managers, the higher the agency costs will be. All cash inflows in profit should be returned to the shareholders, forexample though dividend payouts Jensen, In detail we will discuss in agency theory. The possibility of default on debts increases with the increase in level of debt beyond the optimal point. Should the firm default on repayment of loans; the control of the firm will be shifted from shareholders to debt holders who will try to repossess their investment through the process of bankruptcy. Because of the possible financial distress caused by the higher level of leverage, a firm may face two types of bankruptcy costs. They are direct costs and indirect costs. Direct costs include the administrative costs of the bankruptcy process. The indirect costs arise because of change in investment policies of the firm encase the firm foresees possible financial distress. One of the disadvantages of debt is the cost of potential financial distress, especially when the firm relies on too much debt. Already, this leads to a trade-off between the tax benefit and the disadvantage of higher risk of financial distress. But there are more cost and benefits involved with the use of debt and equity. One other major cost factor consists of agency costs. Agency costs stem from conflicts of interest between the different stakeholders of the firm and because of ex post asymmetric information Jensen and Meckling and Jensen Hence, incorporating agency

costs into the static trade-off theory means that a firm determines its capital structure by trading off the tax advantage of debt against the costs of financial distress of too much debt and the agency costs of debt against the agency cost of equity. Many other cost factors have been suggested under the trade-off theory, and it would lead to far to discuss them all. Therefore, this discussion ends with the assertion that an important prediction of the static trade-off theory is that firms target their capital structures, i. On the basis of determinants of capital structure in static trade-off theory are Non-debt tax shield and Business Risk having negative, Profitability, Firm size, and Asset tangibility having positive effect on the debt-to-capitalratio Dynamic Trade-off Theory: This Constructing models that recognize the role of time requires specifying a number of aspects that are typically ignored in a single-period model. Of particular importance are the roles of expectations and adjustment costs. In a dynamic model, the correct financing decision typically depends on the financing margin that the firm anticipates in the next period. Some firms expect to pay out funds in the next period, while others expect to raise funds. If funds are to be raised, they may take the form of debt or equity. More generally, a firm undertakes a combination of these actions. An important precursor to modern dynamic trade-off theories was Stiglitz , who examines the effects of taxation from a public finance perspective. The first dynamic models to consider the tax savings versus bankruptcy cost trade-off, Brennan and Schwartz They Analyzed continuous time models with uncertainty, taxes, and bankruptcy costs, but no transaction costs. Dynamic trade-off models can also be used to consider the option values embedded in deferring leverage decisions to the next period. Under their assumptions, the option to increase leverage in the future serves to reduce the otherwise optimal level of leverage today. Again, if firms optimally finance only periodically because of transaction costs, then the debt ratios of most firms will deviate from the optimum most of the time. Much of the work on dynamic trade-off models is fairly recent and so any judgments on their results must be somewhat tentative. Agency Theory Berle and Means initially developed the agency theory and they argued that there is an increase in the gap between ownership and control largeorganisations arising from a decrease in equity ownership. Furthermore, acting as agents to shareholders, managers try to appropriate wealth away from bondholders to shareholders by taking more debt and investing in risky projects. To be more specific, the following summary points are presented. Free cash flow refers to cash flow available after funding all projects with positive cash flows. Managers having less than percent stake in business may try to use the free cash flows sub- optimally or use them to their own advantage rather than to increase value of the firm. Here the reduction in cash flow because of debt financing is considered to be the benefit of debt financing. The bondholder expropriation hypothesis says that shareholders try to gain advantage at the cost of bondholders. If investment yields high returns, the extra or additional benefits go to shareholders and if the firm fails, the bondholders International Research Journal of Commerce Arts and Science http: So bondholders share extra risks for no reward. Being agents to shareholders, management tries to invest even in projects that may not have good chances of viability. On the other hand, the underinvestment problem refers to the tendency of managers to avoid safe net present value projects in which value of equity may decrease a little, however, increase in value of debt maybe high. This happens because management, being primarily responsible to shareholders, does not concern itself with the overall increase in value of the firm rather it tries to increase the value of equity only Myers and Majluf Jenson and Meckling propose that optimal capital structure is reached by trading off the agency costs of debt against the benefits of debt. This particular situation provides a platform for managers to pursue their own interest instead of maximizing returns to the shareholders. In other words, the duty of top managers is to manage the company in such a way that returns to shareholders are maximized thereby increasing the profit figures and cash flows Elliot, However, Jensen and Meckling explained that managers do not always run the firm to maximise returns to the shareholders. Their agency theory was developed from this explanation and the principal-agent problem was taken into consideration as a key factor to determine the performance of the firm. Jensen and Meckling , p. The problem is that the interest of managers and shareholders is not always the same and in this case, the manager who is responsible of running the firm tend to achieve his personal goals rather than maximising returns to the shareholders. This means that managers will use the excess free cash flow available to fulfil his personal interests instead of increasing returns to the shareholders Jensen and Ruback, Hence, the main problem that

shareholders face is to make sure that managers do not use up the free cash flow by investing in unprofitable or negative net present value NPV projects. Instead these cash flows should be returned to the shareholders, for example though dividend payouts Jensen, The costs of monitoring the managers so that they act in the interests of the shareholders International Research Journal of Commerce Arts and Science http: Pinegar and Wilbricht discovered that principal-agent problem can be dealt with to some extent through the capital structure by increasing the debt level and without causing any radical increase in agency costs. Similarly, Lubatkin and Chatterjee argue that increasing the debt to equity ratio will help firms ensure that managers are running the business more efficiently. Hence, managers will return excess cash flow to the shareholders rather than investing in negative NPV projects since the managers will have to make sure that the debt obligations of the firm are repaid. Hence, with an increase on debt level, the lenders and shareholders become the main parties in the corporate governance structure. Thus, managers that are not able to meet the debt obligations can be replaced by more efficient managers who can better serve the shareholders. This mean that leverages firms are better for shareholders as debt level can be used for monitoring the managers. In this case, it can be said that debt financed firms are more appropriate for investors but with a high debt levels increases the cost of capital as well as bankruptcy costs. Moreover, there is more risks in investing in firms with high debt levels as these firms tend to have a bad or low rating by rating agencies. Obviously a low rating will in most cases not attract investors. Pecking Order Theory The pecking order theory does not take an optimal capital structure as a starting point, but instead asserts the empirical fact that firms show a distinct preference for using internal finance as retained earnings or excess liquid assets over external finance. If internal funds are not enough to finance investment opportunities, firms may or may not acquire external financing, and if they do, they will choose among the different external finance sources in such a way as to minimize additional costs of asymmetric information. The resulting pecking order of financing is as follows: To avoid this discount, managers avoid equity whenever possible. In the absence of investment opportunities, firms retain profits and build up financial slack to avoid having to raise external finance in the future. The pecking order theory regards the market-to-book ratio as a measure of investment opportunities. With this interpretation in mind, both Myers and Fama and French note that a contemporaneous relationship between the market-to-book ratio and capital structure is difficult to reconcile with the static pecking order model. Iteration of the static version also suggests that periods of high investment opportunities will tend to push leverage higher toward a debt capacity.

The following points will highlight the top four theories of capital structure. Capital Structure Theory # 1. Net Income (NI) Approach: According to NI approach a firm may increase the total value of the firm by lowering its cost of capital. When cost of capital is lowest and the value of the firm.

The following points will highlight the top four theories of capital structure. Capital Structure Theory 1. Net Income NI Approach: According to NI approach a firm may increase the total value of the firm by lowering its cost of capital. When cost of capital is lowest and the value of the firm is greatest, we call it the optimum capital structure for the firm and, at this point, the market price per share is maximised. The same is possible continuously by lowering its cost of capital by the use of debt capital. In other words, using more debt capital with a corresponding reduction in cost of capital, the value of the firm will increase. The same is possible only when: Since the amount of debt in the capital structure increases, weighted average cost of capital decreases which leads to increase the total value of the firm. So, the increased amount of debt with constant amount of cost of equity and cost of debt will highlight the earnings of the shareholders. Calculate the cost of capital and the value of the firm for each of the following alternative leverage after applying the NI approach. From the above table it is quite clear that the value of the firm V will be increased if there is a proportionate increase in debt capital but there will be a reduction in overall cost of capital. It is interesting to note the NI approach can also be graphically presented as under with the help of the above illustration: It reveals that when the cheaper debt capital in the capital structure is proportionately increased, the weighted average cost of capital, Kw, decreases and consequently the cost of debt is Kd. Thus, it is needless to say that the optimal capital structure is the minimum cost of capital if financial leverage is one; in other words, the maximum application of debt capital. The value of the firm V will also be the maximum at this point. Capital Structure Theory 2. Thus, the value of the firm, V, is ascertained at overall cost of capital Kw: Under this approach, the most significant assumption is that the Kw is constant irrespective of the degree of leverage. The segregation of debt and equity is not important here and the market capitalises the value of the firm as a whole. Thus, an increase in the use of apparently cheaper debt funds is offset exactly by the corresponding increase in the equity- capitalisation rate. So, the weighted average Cost of Capital Kw and Kd remain unchanged for all degrees of leverage. Thus, if the cheaper debt capital is used, that will be offset by the increase in the total cost of equity Ke, and, as such, both Ke and Kd remain unchanged for all degrees of leverage, i. Capital Structure Theory 3. It is accepted by all that the judicious use of debt will increase the value of the firm and reduce the cost of capital. So, the optimum capital structure is the point at which the value of the firm is highest and the cost of capital is at its lowest point. The traditional approach explains that up to a certain point, debt-equity mix will cause the market value of the firm to rise and the cost of capital to decline. But after attaining the optimum level, any additional debt will cause to decrease the market value and to increase the cost of capital. In other words, after attaining the optimum level, any additional debt taken will offset the use of cheaper debt capital since the average cost of capital will increase along with a corresponding increase in the average cost of debt capital. Thus, the basic proposition of this approach are: The traditional approach can graphically be represented under taking the data from the previous illustration: It is found from the above that the average cost curve is U-shaped. If we draw a perpendicular to the X-axis, the same will indicate the optimum capital structure for the firm. Thus, the traditional position implies that the cost of capital is not independent of the capital structure of the firm and that there is an optimal capital structure. At that optimal structure, the marginal real cost of debt explicit and implicit is the same as the marginal real cost of equity in equilibrium. For degree of leverage before that point, the marginal real cost of debt is less than that of equity beyond that point the marginal real cost of debt exceeds that of equity. Calculate the cost of capital and the value of the firm under each of the following alternative degrees of leverage and comment on them: Hence, optimum capital structure in this case is considered as Equity Capital Rs. Variations on the Traditional Theory: Thus, there are some distinct variations in this theory. Some followers of the traditional school of thought suggest that Ke does not practically rise till some critical conditions arise. Only after attaining that level the investors apprehend the

increasing financial risk and penalise the market price of the shares. This variation expresses that a firm can have lower cost of capital with the initial use of leverage significantly. This variation in Traditional Approach is depicted as: It explains that optimum capital structure has a range where the cost of capital is rather minimised and where the total value of the firm is maximised. So, this approach grants some sort of variation in the optimal capital structure for various firms under debt-equity mix. Such variation can be depicted in the form of graphical representation: Capital Structure Theory 4. The Net Operating Income Approach, supplies proper justification for the irrelevance of the capital structure. In Income Approach, supplies proper justification for the irrelevance of the capital structure. In this context, MM support the NOI approach on the principle that the cost of capital is not dependent on the degree of leverage irrespective of the debt-equity mix. In the words, according to their thesis, the total market value of the firm and the cost of capital are independent of the capital structure. They advocated that the weighted average cost of capital does not make any change with a proportionate change in debt-equity mix in the total capital structure of the firm. The same can be shown with the help of the following diagram: The following propositions outline the MM argument about the relationship between cost of capital, capital structure and the total value of the firm: The cost of capital is equal to the capitalisation rate of equity stream of operating earnings for its class, and the market is determined by capitalising its expected return at an appropriate rate of discount for its risk class. In short, increased Ke is offset exactly by the use of cheaper debt. The MM proposition is based on the following assumptions: All the investors should have identical estimate about the future rate of earnings of each firm. That is, there will be no corporate tax effect although this was removed at a subsequent date. Interpretation of MM Hypothesis: The MM Hypothesis reveals that if more debt is included in the capital structure of a firm, the same will not increase its value as the benefits of cheaper debt capital are exactly set-off by the corresponding increase in the cost of equity, although debt capital is less expensive than the equity capital. So, according to MM, the total value of a firm is absolutely unaffected by the capital structure debt-equity mix when corporate tax is ignored. MM have suggested an arbitrage mechanism in order to prove their argument. They argued that if two firms differ only in two points viz. Naturally, this process will be going on till both attain the same market value. As such, as soon as the firms will reach the identical position, the average cost of capital and the value of the firm will be equal. It can be explained with the help of the following illustration: They are similar in all respects except in the composition of capital structure. The following particulars are presented: This process will be continued till both the firms have same market value. He will do the following: By this, his net income will be increased as: Obviously, this net income of Rs. We know that the value of the levered firm cannot be higher than that of the unlevered firm other things being equal due to that arbitrage process. We will now highlight the reverse direction of the arbitrage process. Consider the following illustration: Criticisms of the MM Hypothesis: There are some authorities who do not recognise such assumptions as they are quite unrealistic, viz. We also know that most significant element in this approach is the arbitrage process forming the behavioural foundation of the MM Hypothesis. As the imperfect market exists, the arbitrage process will be of no use and as such, the discrepancy will arise between the market value of the unlevered and levered firms. The shortcomings for which arbitrage process fails to bring the equilibrium condition are: The arbitrage process is affected by the transaction cost. While buying securities, this cost is involved in the form of brokerage or commission etc. As such, the levered firm will enjoy a higher market value than the unlevered firm. The above proposition that the firms and the individuals can borrow or lend at the same rate of interest, does not hold good in reality. Since a firm holds more assets and credit reputation in the open market in comparison with an individual, the former will always enjoy a better position than the latter. As such, cost of borrowing will be higher in case of an individual than a firm. As a result, the market value of both the firms will not be equal. The arbitrage process is retarded by the institutional investors e. At present these institutional investors dominate the capital market. For this purpose, both of them have different footing in the capital market. If corporate taxes are considered which should be taken into consideration the MM approach will be unable to discuss the relationship between the value of the firm and the financing decision. For example, we know that interest charges are deducted from profit available for dividend, i. In other words, the cost of borrowing funds is comparatively less than the contractual rate of interest which

allows the firm regarding tax advantage. Ultimately, the benefit is being enjoyed by the equity-holders and debt-holders. According to some critics the arguments which were advocated by MM, are not valued in the practical world. We know that cost of capital and the value of the firm are practically the product of financial leverage. The MM Hypothesis is valid if there is perfect market condition.

9: What is Capital Structure? - Definition from Divestopedia

Hence, optimum capital structure in this case is considered as Equity Capital Rs. 1,00, and Debt Capital Rs. 1,00, which bring the lowest overall cost of capital followed by the highest value of the firm.

TYPES OF CAPITAL STRUCTURE THEORIES pdf

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