

SECTION – 2

QUESTION-2.

ANSWER:-

Capital Structure:-

Capital structure refers to a company's outstanding debt and equity. It allows a firm to understand what kind of funding the company uses to finance its overall activities and growth. In other words, it shows the proportions of senior debt, subordinated debt and equity (common or preferred) in the funding. The purpose of capital structure is to provide an overview of the level of the company's risk. As a rule of thumb, the higher the proportion of debt financing a company has, the higher its exposure to risk will be.

Theory of Capital Structure:-

Theory # 1. Net Income Approach:

According to this approach, a firm can minimise the weighted average cost of capital and increase the value of the firm as well as market price of equity shares by using debt financing to the maximum possible extent. The theory propounds that a company can increase its value and decrease the overall cost of capital by increasing the proportion of debt in its capital structure.

This approach is based upon the following assumptions:

- (i) The cost of debt is less than the cost of equity.
- (ii) There are no taxes.
- (iii) The risk perception of investors is not changed by the use of debt.

Theory # 2. Net Operating Income Approach:

This theory as suggested by Durand is another extreme of the effect of leverage on the value of the firm. It is diametrically opposite to the net income approach. According to this approach, change in the capital structure of a company does not affect the market value of the firm and the overall cost of capital remains constant irrespective of the method of financing.

It implies that the overall cost of capital remains the same whether the debt-equity mix is 50:50 or 20:80 or 0:100. Thus, there is nothing as an optimal capital structure and every capital structure is the optimum capital structure.

Theory # 3. Traditional Approach:

The traditional approach, also known as Intermediate approach, is a compromise between the two extremes of net income approach and net operating income approach. According to this theory, the value of the firm can be increased initially or the cost of capital can be decreased by using more debt as the debt is a cheaper source of funds than equity.

Thus, optimum capital structure can be reached by a proper debt-equity mix. Beyond a particular point, the cost of equity increases because increased debt increases the financial risk of the equity shareholders. The advantage of cheaper debt at this point of capital structure is offset by increased cost of equity. After this there comes a stage, when the increased cost of equity cannot be offset by the advantage of low-cost debt.

Thus, overall cost of capital, according to this theory, decreases up to a certain point, remains more or less unchanged for moderate increase in debt thereafter; and increases or rises beyond a certain point. Even the cost of debt may increase at this stage due to increased financial risk.

The traditional view point on the relationship between the leverage, cost of capital and the value of firm has been shown in the figures below:

Theory # 4. Modigliani and Miller Approach:

M&M hypothesis is identical with the Net Operating Income approach if taxes are ignored. However, when corporate taxes are assumed to exist, their hypothesis is similar to the Net Income Approach.

(a) In the absence of taxes. (Theory of Irrelevance):

The theory proves that the costs of capital is not affected by changes in the capital structure or say that the debt-equity mix is irrelevant in the determination of the total value of a firm. The reason argued is that though debt is cheaper to equity, with increased use of debt as a source of finance, the cost of equity increases.

Gordon Model:-

The Gordon's Model, given by Myron Gordon, also supports the doctrine that dividends are relevant to the share prices of a firm. Here the Dividend Capitalization Model is used to study the effects of dividend policy on a stock price of the firm.

Gordon's Model assumes that the investors are risk averse i.e. not willing to take risks and prefers certain returns to uncertain returns. Therefore, they put a premium on a certain return and a discount on the uncertain returns. The investors prefer current dividends to avoid risk; here the risk is the possibility of not getting the returns from the investments.

But in case, the company retains the earnings; then the investors can expect a dividend in future. But the future dividends are uncertain with respect to the amount as well as the time, i.e. how much and when the dividends will be received. Thus, an investor would discount the future dividends, i.e. puts less importance on it as compared to the current dividends.

According to the Gordon's Model, the market value of the share is equal to the present value of future dividends. It is represented as:

$$P = [E (1-b)] / Ke-br$$

Where, P = price of a share

E = Earnings per share

b = retention ratio

1-b = proportion of earnings distributed as dividends

Ke = capitalization rate

Br = growth rate

Assumptions of Gordon's Model:-

The firm is an all-equity firm; only the retained earnings are used to finance the investments, no external source of financing is used.

The rate of return (r) and cost of capital (K) are constant.

The life of a firm is indefinite.

Retention ratio once decided remains constant.

Growth rate is constant ($g = br$)

Cost of Capital is greater than br