What is capital structure?

In financial management, capital structure theory refers to a systematic approach to financing business activities through a combination of equities and liabilities. There are several competing capital structure theories, each of which explores the relationship between debt financing, equity financing, and the market value of the firm slightly differently.

Various theories of capital structure

NET INCOME APPROACH

This approach was suggested by Durand and he was in favor of financial leverage decision. According to him, a 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 increases. For more – Net Income Approach.

NET OPERATING INCOME APPROACH

This approach is also provided by Durand. It is opposite of the Net Income Approach if there are no taxes. This approach says that the weighted average cost of capital remains constant. It believes in the fact that the market analyses a firm as a whole and discounts at a particular rate which has no relation to debt-equity ratio. If tax information is given, it recommends that with an increase in debt financing WACC reduces and value of the firm will start increasing. For more – Net Operating Income Approach.

TRADITIONAL APPROACH

This approach does not define hard and fast facts. It says that the 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. For more – Traditional Approach.

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 affect 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.

Motives for Holding Cash:

Transaction Motive: A firm needs cash for making transactions in the day to day operations. ...

Precautionary Motive: ADVERTISEMENTS: ...

Speculative Motive: The speculative motive relates to holding of cash for investing in profitable opportunities

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