Capital structure

The term 'structure' means the arrangement of the various parts. So capital structure mean the arrangement of capital from different sources so that the long term funds needed for the business are raised. The capital structure refers to the proportion or combination of equity share capital, preference share capital, retained and earning and other long term sources of funds. in the total amount ~~of funds in the total~~ which a firm should be raise to run its business.

Theories of capital structure

(1) Net income (NI) Approach

Acc. to NI approach a firm may increase the total value of the firm by lowering its cost of capital.

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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.

② (Net operating Income NOI) Approach

NOI approach which was advocated by David durand based on certain assumption.

(i) The overall capitilisation rate of the firm Kw is constant for all degree of leverages.

(ii) Net operating income is capitalised at an overall capitalisation rate in order to have the total market value of the firm

$$(S - V - T)$$

$$\left(Ke = EBIT - I/S\right)$$

(3) Traditional Theory approach

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.

(a) The cost of debt capital (K_d).

(b) The cost of equity capital (K_e)

(c) The average cost of capital (K_w).

(4) Modigliani - Miller (M-M) Approach

(MM) advocated that the relationship b/w the cost of capital, capital structure and the valuation of the firm should be explained by (NOI).

Gordon Model

The Gordon growth model (GGM) is used to determine the intrinsic value of a stock based on a future series of dividends that grow at a constant rate. It is popular and straightforward variant of a dividend discount Model (DDM).

The formula of (GGM)

$$P = \frac{D_1}{r - g}$$

where

P = Current stock price

g = constant growth rate expected dividends, in perpetuity.

r = Constant cost of equity capital company. (or rate of return)

D_1 = Value of next years dividend.