Capital Structure

Meaning of Capital Structure:

Capital structure of a company is the composition of its long-term finance. It is the mix or proportion of a firm's debt and equity. It is related to the long-term financial requirements of the business enterprise. It is determined by the long-term debts and equity capital used by the business enterprise. As a matter of fact, the capital structure of a business enterprise should be ideal i.e. according to the requirements of the business enterprise.

Determinants of Capital Structure/Factors Influencing Capital structure:

The capital structure of a company depends upon a large number of factors. The factors influencing the capital structure of a company are as follows:

1. Financial Leverage or Trading on Equity: The use of long-term fixed interest bearing debts and preference share capital along with equity share capital is called financial leverage or trading on equity. Effects of leverage on the shareholders return or earnings per share have already been discussed in this chapter. The use of long-term debt increases, magnifies the earnings per share if the firm yields a return higher than the cost of debt. The earnings per share also increase with the use of preference share capital but to the act fact that interest is allowed to be deducted while computing tax, the leverage impact of debt is much more.

2. Growth and Stability of Sales: The capital structure of a firm is highly influenced by the growth and stability of its sales. If the sales of a firm are expected to remain fairly stable, it can raise a higher level of debt. Stability

of sales ensures that the firm will not face any difficulty in meeting its fixed commitments of interest payment and repayments of debt. Similarly, the rate f growth in sales also affects the capital structure decision.

3. Cost of Capital: Every rupee invested in a firm has a cost. Cost of capital refers to the minimum return expected by its suppliers. The capital structure should provide for the minimum cost f capital. The main sources of finance for a firm are equity, preference share capital and debt capital. The return expected by the supplier of capital depends upon the risk they have to undertake. Usually, debt is a cheaper source of finance compared to preference and equity capital due to (i) fixed rate of interest on debt. (ii) legal obligation to pay interest.

4. Cash Flow: A firm which shall be able to generate larger and stable cash inflows can employ more debt in its capital structure as compared to the one which has unstable and lesser ability to generate cash inflow. Debt financial implies burden of fixed charge due to the fixed payment of interest and the principal. Whenever a firm wants to raise additional funds, it should estimate, project its future cash inflows to ensure the coverage of fixed charges.

5. Retaining Control: Whenever additional funds are required by a firm, the management of the firm wants to raise the funds without any loss of control over the firm. In case the funds are raised though the issue of equity shares, the control of the existing shareholder is diluted. Hence they might raise the additional funds by way of fixed interest bearing debts and preference share capital in order to retain control over the company. Preference shareholders and debenture holders do not have the voting right. Hence, from the point of view of control, debt financing is recommended.

6. Flexibility: Capital structure of a firm should be flexible, i.e. it should be such as to be capable of being adjusted according to the needs of the

changing conditions. It should be possible to raise additional funds as and when to be required without much difficulty and delay.

7. Size of the Business Enterprise: The capital structure of a business enterprise is also influenced by the size of business enterprise. It may be small, medium or large. A large-sized business enterprise requires much more capital as compared to a small-sized business enterprise.

8. Nature of the Business Organisation: The capital structure of a business enterprise is also influenced by nature of business organisation. It may be manufacturing, financing, trading or public utility type.

9. Period of Finance: The Period of finance, i.e., short, medium or long term is also another factor which determines the capital structure of a business enterprise. For example, short-term finances are raised through borrowings as compared to long-term finance which is raised through issue of shares.

10. Purpose of Financing: The purpose of financing should also be kept in mind in determining the capital structure of a business enterprise. The funds may be required either for betterment expenditure or for some productive purposes. The betterment expenditure, being non- productive, may be incurred out of funds raised by issue of shares or from retained profits. On the contrary, funds for productive purposes may be raised through borrowings.

11. Requirements of the Potential Investors: The capital structure of a business enterprise is also affected by the requirement of the potential investors. Different classes of investors go for different types of securities. It is necessary to meet the requirements of both institutional as well as private investor. Investors who are interested in the stability and safety and

regularity of income prefer debentures and preference shares. On the contrary, investors who want to take more risk so as to have higher income and to take part in the day to day management of the company prefer equity shares.

12. Legal Considerations: At the time of determining the capital structure of a company, the financial manager should also take into account the legal and regulatory framework. For example, in case of the redemption period of debenture is more than 18 months, then credit rating is required as per SEBI guidelines. Moreover, approval from SEBI is required for raising funds from capital market. But no such approval is required if the firm avails loans from financial institutions. Similarly, in India, banking companies are not allowed by the Banking Companies Act to issue any type of securities except shares.

13. Capital Market Conditions: Capital market conditions also influence the capital structure of a business enterprise. Capital Market Conditions do not remain the same for ever. Sometimes there may be depression while at other times there may be boom in the market. In case of boom period, it is advisable to issue shares which can fetch higher premium due to large profits. On the contrary, during the depression period, it is advisable to issue debentures or raise long-term debts as investors would prefer safety.

14. Inflation: Another factor to consider in the financing decision is inflation. By using debt financing during periods of high inflation, we will repay the debt with dollars that are worth less. As expectations of inflation increase, the rate of borrowing will increase since creditors must be compensated for a loss in value. Since inflation is a major driving force behind interest rates, the financing decision should be cognizant of inflationary trends.

15. Risk: There are two types of risk that are to be considered while planning the capital structure of a firm viz (i) business risk and (ii) financial risk. Business risk refers to the variability to earnings before interest and taxes. Business risk can be internal as well as external. Internal risk is caused due to improper products mix non availability of raw materials, incompetence to face competition, absence of strategic management etc. internal risk is associated with efficiency with which a firm conducts it operations within the broader environment thrust upon it. External business risk arises due to change in operating conditions caused by conditions thrust upon the firm which are beyond its control e.g. business cycle.