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Capital Structure and Its Determinants

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Abstract - Financing decisions is one of the important areas in financial management to increase shareholder's wealth. Firms can use either debt or equity capital to finance their assets. The best choice is a mix of debt and equity. The determination of a company's capital structure constitutes a difficult decision, one that involves several and influencing factors, such as risk and profitability. That decision becomes even more difficult, in times when the economic environment is volatile in which the company operates. Therefore, the choice among the ideal proportion of debt and equity can affect the value of the company, as much as the return rates can. Although there have been many prior studies of the determinants of capital structure, the question of what determines the best financing mix that maximizes a firm's value is still the most debatable issue in corporate finance.

Keywords: Financial management, Shareholder's wealth, Profitability, Economic environment, Corporate finance

I. INTRODUCTION

The basic aim of starting a business is earning profit for which the proprietor has to sacrifice or invest some amount of money in the business. Money invested helps in acquiring resources i.e. assets. The assets of the business are used in process of production, distribution and in the operation of the business. The funds to be invested are procured from various sources. The source can be promoter himself or outsiders to the business. Those funds are the input to business which will provide the expected output. This input is termed as capital/financial capital. The source of financial capital can be of two types- owned capital and borrowed capital. Owned capital is raised from owners (promoters/shareholders) also known as owner's equity and borrowed capital is raised from lenders or investors known as debt fund or outsider's equity. The finance capital can be of various types on the basis of time such as long term capital, medium term capital & short term capital. Long term capital basically obtained by issuing share capital, debenture capital, venture capital mortgage, retained earnings etc. The term loan, leasing, Bank overdraft, trade credit, factoring etc. are the sources of Medium and short term capital. All these mix of sources of funds is known as financial structure. The portion of finance structure consisting of long term capital can be said as capital structure.

The capital structure is the combination of equity capital and debt capital. The proportion of debt and equity in capital structure varies from firm to firm and time to time. A firm can adopt a capital mix of either 100% equity and zero debt or 100% debt with zero equity or any combination of both. Equity financing is less risky in the sense of cash flow commitments, but results in a dilution of ownership and earnings where as debt capital creates an obligation or liability with low-cost and high risk. It is a very important component of corporate finance. Long before 50 years financial management has not got that much importance and deals with only procurement of funds but at present it has taken the basics of any business including procurement, utilization and control of finance. So it is directly affects the performance of business organization. That's why finance manager should take a decision of optimal capital mix which will increase the profitability.

II. REVIEW OF LITERATURE

Jensen and Meckling (1976), said that the optimal capital structure is obtained by trading off the agency cost of debt against the benefit of debt. They first identified disputes between shareholders and managers because of management's ownership being less than 100% of the equity. Jensen proposed that this problem could be reduced by increasing the percentage of shares owned by the manager or by increasing debt in the capital structure. This would result in the reduction of the amount of unused cash available to managers.

Harris and Raviv (1990), in their research state that the optimal structure is obtained through a trade-off between liquidation decisions and higher investigation costs. They concluded that high leverage can be an outcome with large firm value, lower probability of reorganization following default, and higher debt level.

Stulz (1990), stated that the optimal capital structure can be designed by a trade-off between benefit of debt and cost of debt. His arguments were based on the fact that managers issue debt only if they fear a takeover.

Diamond (1989), argued that as a firm gets older, it chooses less risky projects, thereby reducing its defaults which would lead to a lower cost of debt. This theory suggests that younger firms will have less debt than older ones.

Myers and Majluf (1984), emphasized that if investors were less well informed than company insiders while equity was being issued, it would result in mis-pricing. Mis-pricing can be avoided if firms use external funds followed by low risk debt, and finally, equity to finance new investment. This is called the "pecking order theory" of financing.

III. STATEMENT OF THE PROBLEM

An appropriate capital structure is a critical decision for any business organization. The decision is important not only because of the need to maximize returns to various organizational constituencies, but also because of the impact such a decision will have on an organization's ability to deal with its competitive environment. The difficulties are associated with designing optimum capital structure policies to enhance profitability. So, the study sought to assess the determinants of capital structure of the firms.

IV. OBJECTIVES OF THE STUDY

The objectives of the study are:

1. To study the conceptual aspect of capital structure.
2. To identify the determinants of capital structure..

V. RESEARCH METHODOLOGY

The entire study is based on secondary data. The relevant data has been collected from the newspaper, journals, and research papers.

CONCEPT OF CAPITAL STRUCTURE

A firm needs capital to grow and acquire additional assets. Firms usually finance for purchase of long-term assets with long-term capital. Retained earnings are one source of long-term capital. But when capital requirements exceed the firm's ability to generate cash internally, it must raise funds externally. The mix of different securities in firm's finance structure is known as capital structure**.** Capital structure is essentially concerned with how the firm decides to divide its cash flows into two broad components, a fixed component that is earmarked to meet the obligations towards debt capital and a residual component that belongs to equity shareholders. The relative proportion of various sources of funds used in a business is termed as financial structure. Capital structure refers to the proportion of the various long-term sources of financing. The capital structure of a company is made up of debt and equity securities that comprise a firm's financing of its assets. It is the permanent financing of a firm represented by long-term debt, preferred stock and net worth. So it relates to the arrangement of capital and excludes short-term borrowings. It denotes some degree of permanency as it excludes short-term sources of financing. Again, each component of capital structure has a different cost to the firm. In case of companies, it is financed from various sources. In proprietary concerns, usually the capital employed is wholly contributed by its owners. In this context, capital refers to the total of funds supplied by both—owners and long-term creditors. The question arises: What should be the appropriate proportion between owned and borrowed capital? It depends on the financial policy of individual firm. In one company debt capital may be nil while in another such capital may even be greater than the owned capital. The proportion between the two, usually expressed in terms of a ratio, denotes the capital structure of a company.

Capital plays a significant role in any business. In any organization sufficient capital is required to carry out its business activity. The success of a business depends upon the efficient selection of capital mix and its utilization. During the last 50 years, the role of financial management has undergone a tremendous change. The finance manager is expected to maximize the shareholders wealth which is measured by the market value of the firm. To achieve this objective, the finance personnel have to take a number of decisions, the most significant decisions are the investment, financing and dividend decisions. The financing capital structure decision is a significant managerial decision which influences the shareholders return and risk. Therefore, the market value of the share can be affected by the capital structure decisions. Sound financing decisions of a firm basically should lead to an optimal capital structure. Finance is to play a vital role in all organizations and it directs the finance department to be a team player which is constructively involved in all the operations of the firm. Firm's capital structure refers to the mix of liabilities and owners' equity. The main objective of financial management is to minimize cost and maximize the shareholders wealth. It can be achieved through the proper mix of debt and equity i.e. capital structure. An optimal capital structure is reached where the overall cost of capital is at minimum. The finance manager should make proper decision to meet the investment needs of the firm. Hence, he has to determine the suitable proportion of equity and debt considering the effects of the financial and operating risk factors. The finance personnel have to acquire the best choice of capital mix which helps to obtain the optimum capital structure of the firm.

Example:

A company is very eager to determine its optimal capital structure.

From the following information, determine the optimal capital structure of the company

Situations	Debt Capital(RS)	Equity Capital(Rs)	After tax cost of debt	Cost of equity

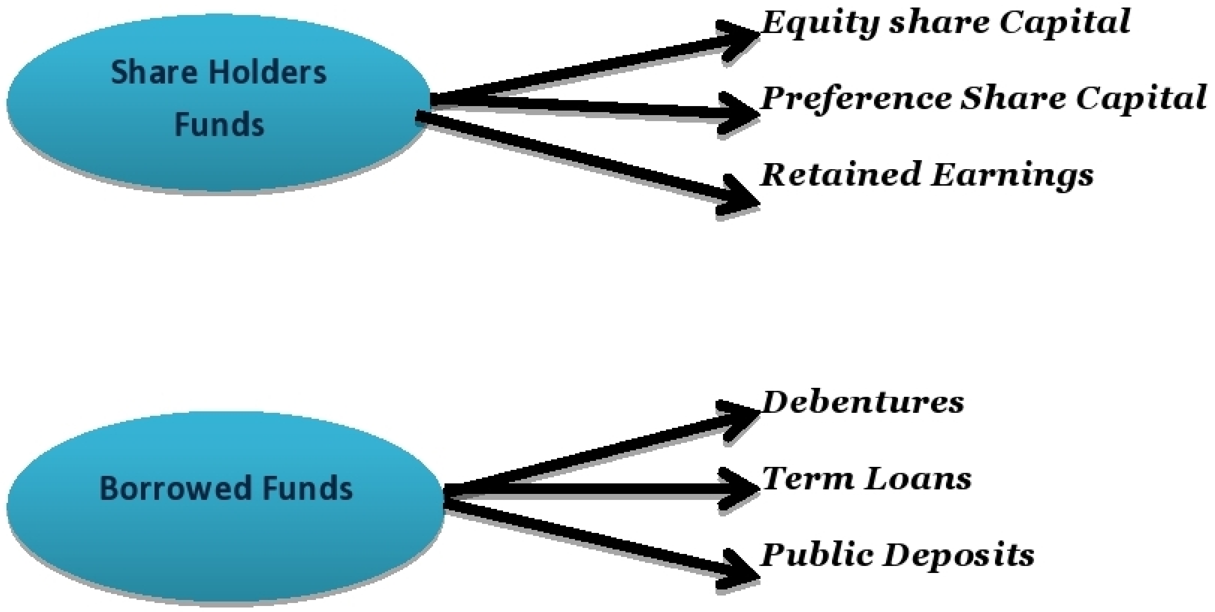
1	4,00,000	1,00,000	9	12
2	2,50,000	2,50,000	6	10
3	1,00,000	4,00,000	5	15

Source: Self Compiled

Solution: So the optimal capital structure for the company is Situation 2, where it uses 50% debt and 50% equity. At this level its combined average cost of capital is the minimum.

Situations	Percentage of		Cost of		Average Total Cost (in %)
	Debt	Equity	Debt	Equity	
1	80	20	9	12	7.20+2.40=9.60
2	50	50	6	10	3.00+5.00=8.00
3	20	80	5	15	1.00 + 12.00 = 13.00

VI. COMPONENTS OF CAPITAL STRUCTURE



Source – www.google.com/image

DETERMINANTS

Financial Leverage or Trading on Equity: The use of long term fixed interest bearing debt and preference share capital along with equity share capital is called financial leverage or trading on equity. If the assets financed by debt yield a return greater than the cost of the debt, the earnings per share will increase without an increase in the owners' investment. Similarly, the earnings per share will also increase if preference share capital is used to acquire assets.

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 of growth in sales also affects the capital structure decision.

Cost of Capital: Cost of capital refers to the minimum return expected by its suppliers. The expected return depends on the degree of risk assumed by investors. A high degree of risk is assumed by shareholders than debt-holders. The capital structure should provide for the minimum cost of capital. The main sources of finance for a firm are equity share capital, preference share capital and debt capital.

Risk: There are two types of risk that are to be considered while planning the capital structure of a firm (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 its 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.

Cash Flow: One of the features of a sound capital structure is conservation. Conservation does not mean employing no debt or a small amount of debt. Conservatism is related to the assessment of the liability for fixed charges, created by the use of debt or preference capital in the capital structure in the context of the firm's ability to generate cash to meet these fixed charges. The fixed charges of a company include payment of interest, preference dividend and principal. The amount of fixed charges will be high if the company employs a large amount of debt or preference capital. Whenever a company thinks of raising additional debt, it should analyze its expected future cash flows to meet the fixed charges. It is obligatory to pay interest and return the principal amount of debt. 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.

Nature and Size of a Firm: Nature and size of a firm also influence its capital structure. All public utility concern has different capital structure as compared to other manufacturing concern. Public utility concerns may employ more of debt because of stability and regularity of their earnings. On the other hand, a concern which cannot provide stable earnings due to the nature of its business will have to rely mainly on equity capital. The size of a company also greatly influences the availability of funds from different sources.

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 debt and preference share capital.

Flexibility: Flexibility means the firm's ability to adopt its capital structure to the needs of the changing conditions. The capital structure of a firm is flexible if it has no difficulty in changing its capitalization or sources of funds. Whenever needed the company should be able to raise funds without undue delay and cost to finance the profitable investments.

Requirement of Investors: The requirements of investors are another factor that influences the capital structure of a firm. It is necessary to meet the requirements of both institutional as well as private investors when debt financing is used. Investors are generally classified under three kinds, i.e. bold investors, cautions investors and less cautions investor.

Capital Market Conditions: Capital Market Conditions do not remain the same forever, sometimes there may be depression while at other times there may be boom in the market and there are pessimistic business conditions, the company should not issue equity shares as investors would prefer safety.

Marketability: Marketability here means the ability of the company to sell or market particular type of security in a particular period of time which in turn depends upon the readiness of the investors to buy that security. Marketability may not influence the initial capital structure very much but it is an important consideration in deciding the appropriate timing of security issues.

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 rupees 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.

Floatation Costs: Floatation costs are incurred when the funds are raised. Generally, the cost of floating a debt is less than the cost of floating an equity issue. This may encourage a company to use debt rather than issue ordinary shares. If the owner's capital is increased by retaining the earnings, no floatation costs are incurred. Floatation cost generally is not a very important factor influencing the capital structure of a company except in the case of small companies.

Legal Considerations: At the time of evaluation of different proposed capital structure, 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 whereas; no such approval is required if the firm avails loans from financial institutions. All these and other regulatory provisions must be taken into account at the time of deciding and selecting a capital structure for the firm.

VII. CONCLUSION

The capital structure decision is crucial for any business organization. The capital structure of a concern depends upon a large number of factors such as leverage or trading on equity, growth of the company, nature and size of business, the idea of retaining control, flexibility of capital structure, requirements of investors, cost of floatation of new securities, timing of issue, corporate tax rate and the legal requirements. So it is very difficult on the part of a human being to decide a best mix by considering all these factors.

Previous theories have viewed that in case the funds are raised though the issue of equity shares, the control of the existing shareholder is diluted. Hence, from the point of view of control, debt financing is recommended. But, depending largely upon debt financing may create other problems, such as, too much restrictions imposed upon by the lenders or suppliers of finance and a complete loss of control by way of liquidation of the company. Considering the changing market sentiments, the company has to decide whether to raise funds through common shares or debt. If the share market is depressed, the company should not issue ordinary shares but issue debt and wait to issue ordinary shares till the share market revives. During boom period in the share market, it may not be possible for the company to issue debentures successfully. Therefore, it should keep its debt capacity unutilized and issue ordinary shares to raise finances.

The size of a company also greatly influences the availability of funds from different sources. A small company may often find it difficult to raise long-term loans. If somehow it manages to obtain a long-term loan, it is available at a high rate of interest and on inconvenient terms. The highly restrictive covenants in loans agreements of small companies make their capital structure quite inflexible. The management thus cannot run business freely. Small companies, therefore, have to depend on owned capital and retained earnings for their long-term funds.

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