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CAPITAL STRUCTURE: A CONCEPTUAL FRAMEWORK

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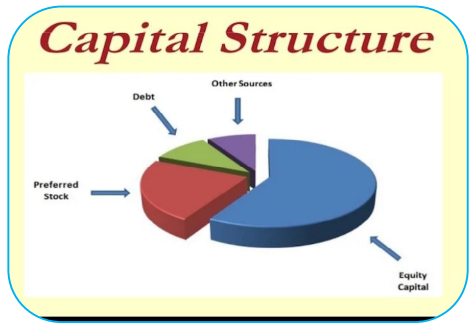
ABSTRACT

The debt-to-equity ratio used to finance the company's operations is just one of the variables taken into account by the capital structure approach. In order to maximize wealth for the organization, it is vital to make the choice to develop an effective capital structure. The choice of the capital structure affects both the market value of the stock and the equity of the owners. Any modification to the capital structure has an impact on the weighted average cost of capital, debt-to-equity ratio, and valuation of the company. Capital structure and dividend strategy are interlinked and, as a result, re-linked to a company's funding decisions, much like capital structure and dividend strategy. The quantity of money that can be reinvested is impacted by the dividend policy. Retaining earnings for reinvestment raises shareholders' equity status. The cost of capital, net income, earnings per share (EPS), dividend payout ratio, and liquidity situation of the company are all impacted by the capital structure. The value of a firm is determined by these elements as well as others.



KEYWORDS : *Capital Structure Element, Capital Structure Planning, EBIT-EPS.*

INTRODUCTION

Finance managers need to be more watchful when it comes to business funding and capital structure because of the heightened competitive pressure that business organizations are under during and after the globalization transition. Capital components of businesses are impacted by capital structure decisions, which increase their significance in terms of reducing capital expenses and boosting the value of the company. The elements that affect a company's financing and capital structure decisions must be examined in order to comprehend how a company finances its operations. Decisions for corporate finance are based on a wide range of policy variables.

MEANING AND CONCEPT OF CAPITAL STRUCTURE

Long-term debt, short-term debt, common equity, and preferred equity make up the capital structure. A company's capital structure illustrates how it finances its entire operations and growth by combining several financial sources. The organization, structure, or division of a company's capital is referred to as its capital structure. The capital used includes both owner's capital and debt capital issued by lenders. Debt capital refers to long-term debt that has been used to build long-term assets. In addition to the components of equity and debt in the capital structure, a corporation or firm could also have quasi-equity in the form of convertible debt. A company's value rises while its cost of capital is reduced with the ideal capital structure. Increasing leverage is a key component of this strategy because it lowers the company's cost of capital and increases total value.

The best capital structure for the company should, in theory, be prepared by the financial management. The ideal capital structure is identified at the highest market value per share. Sectors and individual enterprises within a sector vary substantially in terms of capital structure. The decision-judgment maker's is crucial because many different elements influence a company's capital structure choice. Two similar businesses may have differing capital structures if the importance of certain criteria is judged by decision-makers to be of varying importance. It is impossible for a theoretical model to take into account all the factors that affect capital structure choices. These variables are psychologically complicated, qualitative, and do not always adhere to pre-established theory since capital markets are flawed and decisions must be made with perfect knowledge and risk. Financial management primarily concerns how the company divides its cash flows into two broad components: a fixed component destined for debt capital commitments and a residual component earmarked for equity owners. Financial management seeks to optimize shareholder value.

There are various ways to look at how capital structure impacts corporate value. Some contend that there is no connection between the capital structure and the firm's value. Others contend that, once it crosses a certain point, financial leverage has a negative effect on a firm's worth. Still others draw the conclusion that, all other things being equal, the higher the leverage, the higher the firm's value. For almost 50 years, capital structure has been the subject of intense discussion in the financial management community. Since the groundbreaking work of Modigliani and Miller (1958), there has been considerable discussion in the capital structure literature on whether a particular mix of debt and equity capital enhances business value and, if so, what variables might influence a firm's optimal capital structure.

DEFINITIONS OF CAPITAL STRUCTURE

Long-term sources are represented by the capital structure, which is a component of the financial structure. The capital structure is typically solely thought to consist of long-term debt and total stockholder investment1. In addition to debentures, long-term financing from outside sources, and preference share capital, it combines long-term funding sources such as equity share capital, savings, and surplus.

"A capital structure may be as simple as one class of stock or as complex as several issues of bonds and preferred stock, each with its own set of features," according to the definition.

2. In other words, capital structure refers to the capitalization's composition, or the ratio of debt to equity that constitutes capitalization.

Peterson claims that the capital structure, which is utilized to fund business endeavors, is a blend of debt and equity capital. However, since choosing the ideal capital structure depends on a number of circumstances, a proper mix of equity and borrowing capital is required. The interest rate would be greater if the business chose to borrow money to fund its operations.

The assets and debt of a company's shareholders make up its capital structure. The source of an entity's finances affects its intrinsic financial stability, the risk of insolvency to which it is exposed, the kinds and relative sizes of the assets it owns, and other factors. The ideal capital structure is the debt-to-equity ratio with the highest market value per share and the lowest cost of capital.

THEORETICAL BASE OF CAPITAL STRUCTURE

The claim is that in an effort to raise their overall market worth, businesses choose a variety of capital structures. As a result, numerous capital structure theories have been put out to try and account for this cross-sectional variation. These studies analyze the factors influencing capital structure from various angles and reach various findings when determining the level of financial leverage. While this is going on, empirical research has been shown to be incompatible with the studies they are looking at.

The most obvious instance is empirical research on the pecking order theory, which has produced a range of contradictory results from numerous academics5.

A company's capital structure is a topic that has given rise to a number of theories, although Modigliani and Miller have dominated the world of finance. According to Miller and Modigliani (1958), a company's worth is determined by its capital structure in the absence of acquisition and other fixed expenditures. To put it another way, the capital structure can be modified whenever it is necessary because it has no bearing on the company's worth. Modigliani and Miller created the widely recognized idea of "capital structure irrelevance," which contends that financial leverage has no impact on a company's market value. Their hypothesis, however, was founded on irrational presumptions, including ideal capital markets, uniform goals, a lack of taxes, and a lack of transaction costs. An ideal capital structure is one that optimizes the firm's value or reduces its overall cost of capital due to bankruptcy costs and the favorable tax treatment of interest payments. Research on how taxes affect a company's capital structure is extensive. Interest is a crucial element of the tax code and is a tax-deductible item. A tax-paying business benefits from a partial "tax-shield" in the form of reduced taxes. As a result, enterprises should borrow as much money as they can to increase their worth, as stated by Modigliani and Miller (1963). Researchers also considered the issue of personal income taxes in addition to corporation taxation. Three tax rates that are based on US tax law determine the company's overall value. These are the rates for company taxes, dividend taxes, and interest inflow taxes.

Other ways, outside the tax-related features of capital structure, often help to explain how it is determined. These techniques examine how agency costs and asymmetric knowledge are used to influence debt levels. The study has thus far come to the conclusion that the funding choices made by the financial managers are in the best interests of the shareholders. Corporate executives frequently have their sights set on attaining goals that may or may not be consistent with maximizing the value of the company. In order to get better pay, perks, job stability, and in certain cases, direct manipulation of the company's financial flows, they would act in their own best interests. As a result, there will inevitably be a conflict of interest between shareholders and executives. In order to stop these value transfers, investors-shareholders will employ a variety of monitoring and control measures, such as independent director oversight and the threat of acquisition; as a result, agency costs will develop. On the other side, perfect power is unaffordable. In order to monitor and regulate the managers' actions, shareholders are searching for choices that would not significantly reduce the value of the company. Leverage's position would need managers to generate and distribute cash. Debt capital reduces the amount of potential after-investment cash flows at the managers' discretion because debt involves mandated interest payments, which cause cash outflows. As a result, the department can use debt to save money. In this situation, the balance between the costs and advantages of debt would be used to determine the best capital structure.

The level of debt that will save the company money over the long run will be chosen. Agency expenses of debt are incurred if a default is possible. Debt holders are not concerned with the company's profitability, value, or risk if the debt is not subject to default risk. However, stockholders may benefit at the expense of the debt holders if a default is likely. A business may elect to reorganize its assets after raising debt, for instance, by selling low-risk assets and buying riskier ones that carry a larger risk of default but higher expected profits. If everything goes as planned, stockholders will benefit the most; if not, bondholders will suffer the most because they had agreed to be compensated with an interest rate that is lower than the firm's risk level demands. Managers may be inclined to make actions that benefit shareholders if the danger of default is significant. For instance, managers could increase their debt and distribute dividends to shareholders. As a result, debt investors have three options: enforce restrictive covenants, ask for additional information about the company's genuine investment prospects, and offer capital in exchange for high returns.

These are two pricey choices that incur expenses for the agencies involved. But at this point, the firm's ideal capital structure would be developed, allowing shareholders to benefit from debt while keeping debt holders' costs in check. In conclusion, the debt-equity option idea is not absolute. Many practical conditional theories attempt to determine the capital structure from diverse perspectives.

Financial Management should create a capital structure that is best for their company. It has the finest capital structure when earnings per share and market value per share are at their highest. Sectors and individual enterprises within a sector vary substantially in terms of capital structure. The decision-judgment maker's is crucial since many different factors influence how a company chooses its capital structure. Two similar businesses may have different capital structures if the decision-makers' evaluations of the different elements differ. It is impossible for a theoretical model to take into account all the factors that affect capital structure choices.

FACTORS DETERMINING CAPITAL STRUCTURE

There are several factors that affect a company's capital structure, some of which are covered below:

(a) Trading on Equity: The term "equity" describes a company's ownership. It is acceptable to use stock share capital rather than borrowed money. It alludes to the extra money stockholders make via the issue of debentures and preferred shares. It is founded on the idea that equity shareholders benefit if the rate of preferred capital dividends and the rate of interest on borrowed capital are both lower than the overall rate of company earnings. This allows a business to use a smart combination of preferred stock, equity shares, and debentures. When stockholders have strong expectations, equity trading becomes more significant.

(b) Level of Control: The directors are the 'chosen officers' of the stockholders who own the company. Comparatively speaking to preference owners and debenture holders, these members have the highest voting rights. Debt investors do not have any voting rights, although holders of preferred securities do. The capital structure of the company consists of debenture holders and loans rather than equity shares if the management actions are such that they desire to maintain control over their voting rights.

(c) The Financial Plan's Flexibility: A company's financial structure needs to be flexible enough to accommodate both timetable contractions and relaxations. Debentures and loans will be paid back when the time comes. Plans are more rigorous as a result of the fact that equity capital cannot ever be repaid. In order to achieve the capital structure, the corporation should issue debentures and other loans.

(d) Investor Selection: The Company's stock policy is to draw in a broad spectrum of investors. A capital structure should therefore present enough investment options for a wide variety of investors. While conservative investors like debentures, ambitious and risk-taking investors favor equity shares and bonds.

(e) Capital Market Situation: A company's stock price has a significant impact on how long it will last. During the Great Depression, debentures and loans typically made up a company's financing plan. During times of booms and inflation, the company's capital should consist of share capital, which is typically equity stock.

(f) Length of Financing: Businesses that require cash for a brief length of time look for loans from banks and other lending organizations; those who require funds for a longer time frame issue shares and debentures.

(g) Cost of Financing: The organization must take into account the cost component on its capital structure while raising shares. Debentures are discovered to be a less expensive source of financing when a corporation makes money than equity shares, which take home an additional portion of profits.

(h) Sales Stability: As a well-established firm with a growing market and healthy profitability, the corporation is able to meet its set obligations. Whatever the advantage, debtenture interest must be paid. Because of this, the corporation is better able to satisfy fixed obligations like debenture interest and preference share distributions when sales are strong and profits are high. A corporation wouldn't be able to fulfill its contractual obligations if its earnings fluctuated wildly. Because of this, equity money appears secure in these situations.

(i) Company Sizes: Bank loans and retained earnings often make up the capital structure of small enterprises. Large corporations, on the other hand, can readily borrow money from financial institutions and issue shares and debentures because of their solid reputation, profitability, and track record of making a profit. The overall capitalisation is wider the larger the size.

Principal Capital Structure Elements

There are several qualities that make up the ideal capital structure. Some of the most significant traits are listed below.

- It ought to have a strong return on equity and a cheap cost of capital.
- The debt load shouldn't be greater than the company's full capability; the capital structure should enable the company to raise money anytime it is needed.
- The danger of losing or diluting ownership of the business should be maintained to a minimal; there should be no risk of loss or dilution of money, and
- The capital structure should prevent the company from going bankrupt.

Approaches to Determining Appropriate Capital Structure

The methods for determining a company's capital structure are as follows.

- **EBIT-EPS Approach:** This method is useful for determining the effect of debt on Earnings per Share.
- **Valuation Approach:** This method assesses the effect of debt on the valuation of a company's stock.
- **Cash Flow Approach:** This method assesses a company's debt service capability and helps it escape financial distress.

Considerations in Capital Structure Planning

The six essential aspects of capital structure planning are risk, cost, control, flexibility, income, and tax. This varies for various forms of capital, such as own funds and loan funds.

a) Risk: The equity of the company is only marginally at risk. because repayment of the funds is not required until the business is liquidated. Even though the dividend payout is based on earnings, preference capital carries a slightly higher risk than stock share capital because the principle is redeemable after a set period. Loan capital involves a lot of risk. Capital must be returned in accordance with the agreement's conditions. No matter how well or how much money you make, interest should be levied.

b) Price: Equity capital is the priciest type of capital. This is due to the fact that investors expect bigger dividends than interest rates. The dividend is also not tax deductible. Although preference capital is more expensive than debt funds, it is only slightly more expensive than equity. Therefore, preference distributions are not tax deductible. In contrast, loan money are less expensive. This benefit limits the consideration of current interest rates to the extent of their after-tax impact.

c) Control: Distributions of preferences, however, are not tax deductible. A loan is cheaper to obtain than a deposit is. Current interest rates are only taken into account after taxes due to this benefit. On the other side, institutional lenders can insist that the Board of Directors include one of their representatives. In addition to corporate taxation, government regulations, legal requirements, marketability, maneuverability, flexibility, timing, business size, purpose and timing of financing, investor nature, and provision for future development are other factors to be taken into account when planning capital structure.

d) Flexibility: The capital structure must fit within the debt capacity, which must be established. It should not be surpassed at any cost and at any time. The company's capacity to produce potential cash flows determines its debt capacity. Free cash flow on its own might aid in making regular interest payments to creditors and timely principle repayments. Additionally, there should be room in the cash flow for unforeseen circumstances. Therefore, in the event of unforeseen situations, the capital structure should be flexible enough to allow it to modify its structure with little cost and delay.

e) Income: The debt that the company takes on to create a capital structure must maximize assets and provide the owners with the highest possible returns at the lowest possible cost of capital.

f) Tax: A lot of research has been done on how taxes affect a company's capital structure. An essential component of taxation is interest, which is a tax-deductible expense. Reduced taxes are supplied as a partial interest "tax-shield" to a corporation that pays taxes. The businesses can employ as much loan money as necessary to maximize their worth.

Impact of Capital Structure

The impact of changes in internal and market capitalization on ROI can be used to assess capital structure effects. The capital structure of the company may have an effect on its valuation, which may affect, among other things, predicted profitability, Return on Investment (ROI), and overall Cost of Capital. The value share of earnings made available to shareholders may vary depending on the form of finance utilised.

The capital structure ratio is a group of financial measures that evaluates the structure and long-term viability of an organization. Capital structure ratios are also known as leverage ratios. The following is a list of the capital structure ratios:

a) Shareholders‟ equity ratio
b) Debt equity ratio
c) Owner's ratio
d) Fixed assets ratio
e) Proprietary ratio
f) Current assets to net worth ratio
g) Long term debt to capital employed ratio
h) Fixed assets to net worth ratio

Capital Structure Determinants Impact

The capital structure of a company is decided by a number of qualitative and quantitative factors, as well as the author's subjective interpretation of the literature. Theoretical viewpoints are presented below; numerous empirical research have identified firm-level traits that affect company capital structure. Some of the key factors that determine capital structure include,

i) Sales Size,
ii) Growth,
iii) Profitability,
iv) Interest Coverage Ratio,
v) Tangibility,
vi) Non-Debt Tax Shield,
vii) Assets Size,
viii) Income Variability,
ix) Liquidity.

CONCLUSION

Capital structure relates to how much money—or capital—is supporting a business, financing its assets, and funding its operations. It can also show company acquisitions and capital expenditures that can influence the business's bottom line. Although it can vary by industry, capital structure is important to businesses of all kinds, from small businesses managing their start-up finances, to large international companies managing their funds with an eye on expansion. Each business should make sure that they're using the optimal capital structure for their business and industry.

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