Presentation on

Capital Structure

Part-I

For the students

of

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B.Com.(Hons. & General)

By

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Meaning and Concept of Capital Structure:

For any business (investment) project, it is essential to estimate the amount of capital likely to be required for the business. After having determined the finance required for a project to be undertaken, the question arises what shall be the sources of finance, i.e., what are the securities to be issued and what shall be the proportion of various securities.

The main types of securities are

1. Ordinary shares (or Equity shares),
2. Preference shares, and
3. Debentures.

Capital structure refers to the mix or proportion of different sources of financing to the total capitalization. In other words, capital structure refers to the proportion of Equity capital, Preference capital, Reserves, Debentures and other long-term debts to the total capitalization. So, capital structure signifies the kind and proportion of different securities for raising long-term finance. Capital structure involves the decision about the form of capitalization i.e. the types of securities to be issued and the relative proportion of each type. Capital structure refers to the makeup of the capitalization.

Pattern of Capital Structure

A new company cannot collect sufficient funds as per their requirements as it has yet to establish its **creditworthiness** in the market; consequently they have to depend only on equity shares, which is the simple type of capital structure. After establishing its creditworthiness in the market, its capital structure gradually becomes complex.

A complex capital structure pattern may be of following forms:

i. Equity Shares and Debentures (i.e. long term debt including Bonds etc.),

ii. Equity Shares and Preference Shares,

iii. Equity Shares, Preference Shares and Debentures (i.e. long term debt including Bonds etc.).

However, irrespective of the pattern of the capital structure, a firm must try to maximize the earnings per share for the equity shareholders and also the value of the firm.

Modes of Finance:

While devising a sound capital structure, we have to lay more emphasis on the pattern of the capital structure, i.e., the relative importance to be given to the ownership resources or creditor ship resources.

In general the determinants of mode of finance are:

1. The volume of earnings expected.
2. Stability of earnings.
3. Predictability of earnings.

When is Loan Finance (or Debenture Capital) Desirable?

If anticipated earnings are well above interest and the earnings are stable, certain and regular and the success of the enterprise is assured, the business enterprise can certainly resort to loan or bond finance.

But for a new enterprise bond or debenture capital is undesirable because earnings are irregular or uncertain, goodwill is absent and borrowing may involve considerable financial burden.

A new company also is unable to pledge or mortgage its assets right from the beginning. Bonds are preferred when future earnings are certain, stable and regular.

When is Preference Share Capital Welcome in the Capital Structure?

If the success of the enterprise is reasonably assured and certainty of earnings is not too high, a company can secure preference share capital. Preference shares are suitable when the earnings are irregular but on an average we have a fair margin over the preference dividends.

Redeemable preference share capital is always welcome in the capital structure of a corporation and it is considered better than that of debenture capital, because there is no problem, of mortgage of assets and payment of dividends is not compulsory. Redeemable shares are considered good substitutes of debenture capital.

When is Equity Share Capital Desirable?

If earnings of the corporation are highly unpredictable, irregular, uncertain and fluctuating, equity share capital is always desirable. For a speculative business, risk of loss is considerable we have no immediate prospects of profitability.

Hence, such business can raise only equity share capital. An equity share of a prosperous company is better than a preference share of a doubtful company or a debenture of a bad company. Hence, in the final analysis much depends upon the financial position of a company and its earning power.

Overall analysis

Preference shares depend upon financial position, and earning power of the company.

Bonds and debentures depend upon financial position, earning power and security offered by the corporation.

Equity shares are usually in demand during an inflationary or prosperous period because we have rising dividends and rising market value of shares. Equity shares alone are entitled to participate in the prosperity of business and equity shares of a growing company are always sold in the market at a considerable premium.

Thus, the choice of securities depends upon the volume, stability and predictability of earnings and the management on the basis of these three criteria will have to evolve a suitable proportion of variable income securities (equity shares) and fixed income securities (debenture and preference shares).

For a new corporation we must have 70 per cent equity share capital, and the balance, i.e., 30 per cent, may be in the form of preference share capital and loan capital.

In the case of an established corporation, demanding growth capital for further expansion, we have risk capital, i.e., equity share capital plus free reserves near about 50 per cent and the remaining capital, i.e., preference shares, debentures and loans about 50 per. cent of the total capital. The pattern of capital structure is usually the optimum combination of share capital and loan capital.

Factors Determining Capital Structure

Trading on Equity- The word "equity" denotes the ownership of the company. Trading on equity means taking advantage of equity share capital to borrowed funds on reasonable basis. It refers to additional profits that equity shareholders earn because of issuance of debentures and preference shares. It is based on the thought that if the rate of dividend on preference capital and the rate of interest on borrowed capital is lower than the general rate of company's earnings, equity shareholders are at advantage which means a company should go for a judicious blend of preference shares, equity shares as well as debentures. Trading on equity becomes more important when expectations of shareholders are high.

Degree of control- In a company, it is the directors who are so called elected representatives of equity shareholders. These members have got maximum voting rights in a concern as compared to the preference shareholders and debenture holders. Preference shareholders have reasonably less voting rights while debenture holders have no voting rights. If the company's management policies are such that they want to retain their voting rights in their hands, the capital structure consists of debenture holders and loans rather than equity shares.

Flexibility of financial plan- In an enterprise, the capital structure should be such that there are both contractions as well as relaxation in plans. Debentures and loans can be refunded back as the time requires. While equity capital cannot be refunded at any point which provides rigidity to plans. Therefore, in order to make the capital structure possible, the company should go for issue of debentures and other loans.

Choice of investors- The company's policy generally is to have different categories of investors for securities. Therefore, a capital structure should give enough choice to all kind of investors to invest. Bold and adventurous investors generally go for equity shares and loans and debentures are generally raised keeping into mind conscious investors.

Capital market condition- In the lifetime of the company, the market price of the shares has got an important influence. During the depression period, the company's capital structure generally consists of debentures and loans. While in period of boons and inflation, the company's capital should consist of share capital generally equity shares.

Period of financing- When company wants to raise finance for short period, it goes for loans from banks and other institutions; while for long period it goes for issue of shares and debentures.

Cost of financing- In a capital structure, the company has to look to the factor of cost when securities are raised. It is seen that debentures at the time of profit earning of company prove to be a cheaper source of finance as compared to equity shares where equity shareholders demand an extra share in profits.

Stability of sales- An established business which has a growing market and high sales turnover, the company is in position to meet fixed commitments. Interest on debentures has to be paid regardless of profit. Therefore, when sales are high, thereby the profits are high and company is in better position to meet such fixed commitments like interest on debentures and dividends on preference shares. If company is having unstable sales, then the company is not in position to meet fixed obligations. So, equity capital proves to be safe in such cases.

Sizes of a company- Small size business firms capital structure generally consists of loans from banks and retained profits. While on the other hand, big companies having goodwill, stability and an established profit can easily go for issuance of shares and debentures as well as loans and borrowings from financial institutions. The bigger the size, the wider is total capitalization.

A sound/ideal optimum structure is one which:

(1) Maximises the worth or value of the concern.

(2) Minimizes the cost of funds.

(3) Maximizes the benefit to the shareholders, by giving best earning per share and maximum market price of the shares in the long run.

(4) Is fair to employees, creditors and others.

Objectives of Optimum Capital Structure:

(A) Economic Objectives:

(1) Minimisation of Costs:

Funds should be raised at the lowest possible cost in terms of interest, dividend and the relationship of earnings to the prices of shares.

(2) Minimisation of Risks:

Business risks, management risks, tax risks, trade cycle risks, purchase risks, interest rate risks, etc., should be minimized by making suitable adjustments.

(3) Maximisation of Return:

Equity shareholders should get maximum return. It may be achieved by minimizing the cost of issue and the cost of financing.

(4) Preservation of Control:

The control of equity shareholders on company’s affairs should be preserved by proper balance between voting right capital (equity capital) and limited voting (or non-voting) right capital (preference shares and debentures).

(5) Proper Liquidity:

Liquidity is necessary for the solvency of the company, therefore, a proper balance between fixed assets and the liquid assets should be maintained.

(6) Full Utilisation:

Full utilisation of available capital should be made at minimum cost. For this, there should be a proper coordination between the quantum of capital and the financial requirements of the business.

(B) Other Objectives:

(1) Simplicity:

The capital structure should be simple. In the beginning a company should raise only the ownership capital i.e., equity share capital that will enhance the credit of the company.

(2) Flexibility:

The capital structure (design) should be flexible so that it can be altered as per the requirements or need of the company.

In short:

The safety ratios to be maintained for sound capital structure are:

1. Equity-debt ratio 1:2.
2. Earnings-interest ratio 2:1.
3. Total loan capital on mortgage not exceeding 50 per cent of the depreciated value of assets covered by mortgage.
4. Total long-term debts under normal circumstances shall not exceed the net working capital, i.e., excess of current assets over current liabilities.
5. Current ratio, i.e., current assets divided by current liability should be: 2:1.
6. Acid-test ratio, i.e., quick ratio, is determined by dividing 'quick assets,' i.e., cash marketable investments and book debts, by current liabilities. It is a better measure of liquidity and it should be 1: 1.

DESIRABLE CAPITAL STRUCTURE

Desirable Capital Structure

New Company	*Initial Capital*	
Equity Capital	70%	Rs. 140M.
Preference Capital	20%	Rs. 40M.
Loan Capital	10%	Rs. 20. 4
Total	**100%,**	**200 M.**
Later Stage		
Existing Comnuny	Growth Capital	
Equity Capital	30%	Rs. 120 M.
Free Reserves	20%,	Rs. 80 M.
Preference Capital	20%	Rs. 80 M.
Loans and Bonds	30%	Rs. 120 M
Total	**100%**	**Rs. 400 M**


Thank
You