Subject: Management

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Paper: 09, Entrepreneurship Development & Project Management

Module: 33, Planning of Capital Structure

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Items	Description of Module
Subject Name	Management
Paper Name	Entrepreneurship Development & Project Management
Module Title	Planning of Capital Structure
Module Id	Module no-33
Pre- Requisites	Basic knowledge about the capital structure of an enterprise
Objectives	▪ To study the concept of capital structure and factors affecting capital structure of an enterprise
Keywords	Capital Structure, Optimal Capital Structure, Factors affecting capital structure

QUADRANT-I

Module : Planning of Capital Structure
1. Learning Outcome
2. Introduction
3. Meaning of capital structure
4. Capital Gearing
5. Planning of Capital Structure
6. Optimal Capital Structure
7. Determinants of Capital Structure
8. Summary

1. Learning Outcome

After completing this module students will be able to:

i. Understand the meaning of Capital Structure
ii. Know about the Optimal Capital Structure
iii. Understand the planning of Capital Structure
iv. Know the concept of Capital Gearing
v. Understand the determinant of Capital Structure

PLANNING OF CAPITAL STRUCTURE

2. Introduction

Every entrepreneur needs finance to carry out business activities smoothly and to achieve his targets. It is an important input for any type of business, whether big, medium or small and is needed for working capital as well as investment in permanent assets. Funds invested in a business are obtained from various sources. The capital invested in a business may be owners' capital or borrowed capital or both. While some of the funds are held in business on permanent basis such as share capital and reserves, some others are held for a long term basis such as debentures, bonds, public deposits etc. and still some other funds are in the nature of short-term borrowings. The entire composition of these funds constitutes the overall financial structure of an enterprise. The short term funds keep on shifting quite often. Therefore the proportion of various sources for short-term funds cannot rigidly be laid down. An entrepreneur has to follow a flexible approach. A policy has to be laid down for the composition of long-term funds, known as capital structure**.** The most important aspects of the policy are the debt equity ratio and the dividend decision. Dividend decisions affect the building up of retained earnings, which is an important component of owned capital. The long-term funds occupy a large portion of total funds and involve long-term policy decision about the proportion of various kinds of securities which is often used to mean the capital structure of the firm.

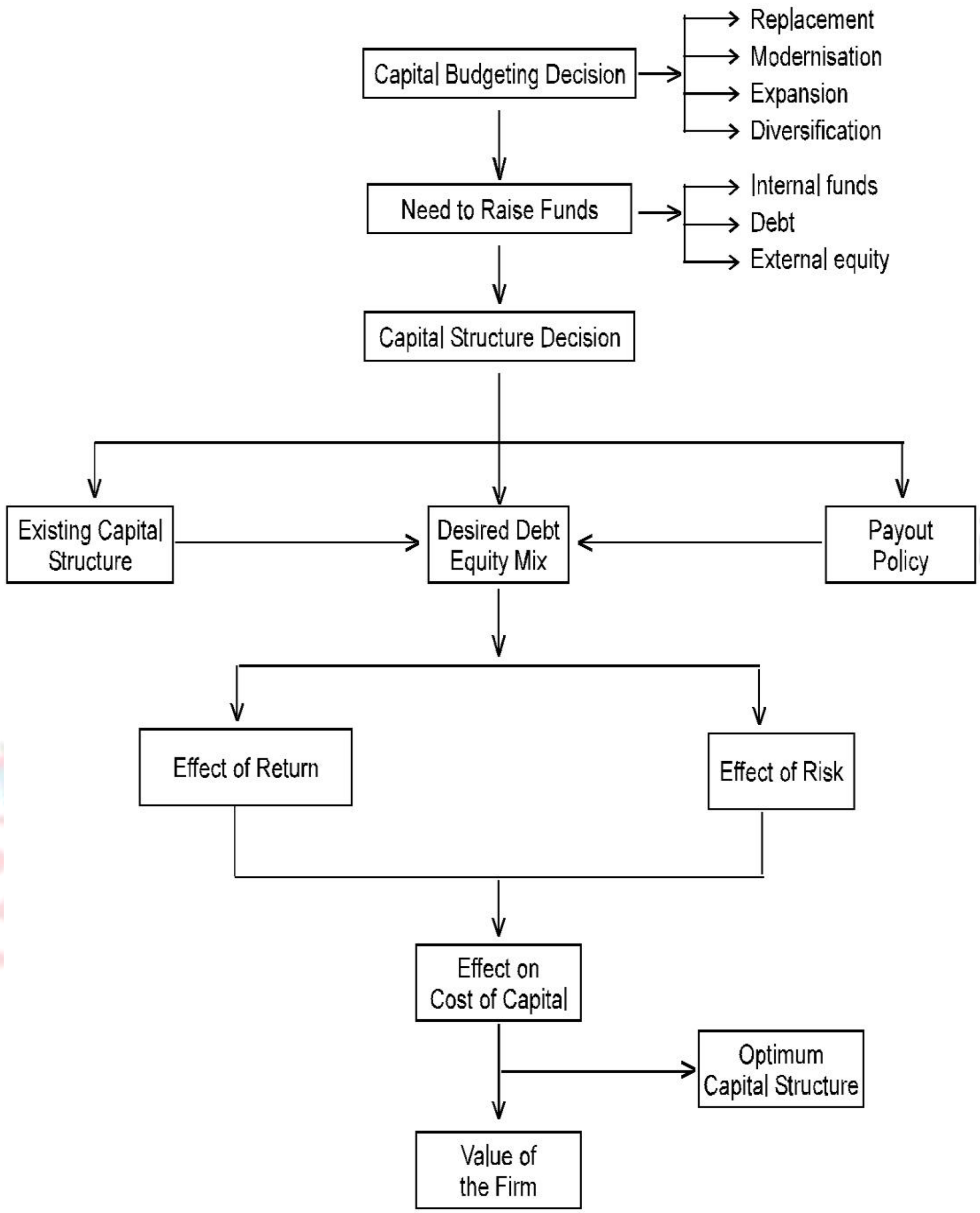
3. Meaning of Capital Structure: The term capital structure refers to the relationship between various forms of financing such as equity share capital, preference share capital and debentures. It is the decision making process which determines the proportion among various types of securities to total capitalisation. Gerstenberg defines *Capital Structure as the types of securities issued by a company and the proportionate amount that make up capitalisation*. In other words, it refers to the composition or make up or mix of capital i.e. in what proportion equity capital, preference share capital, debentures etc. have been issued. But the question arises how this proportion is to be determined.

Gerstenberg has laid down the following two general principles:

1. The greater the stability of earnings, the higher may be the ratio of bonds to stock in the capital structure.

2. The capital structure should be balanced with a sufficient equity cushion to absorb the shocks of business cycle and to afford flexibility.

A capital structure decision refers to deciding the forms of financing i.e. which sources to be tapped, their actual requirement and the relative proportion in total capitalisation. Thus, whenever funds are to be raised for long term perspective to finance investment, capital structure decision is involved. The form or quality of financing in capital structure depends upon the nature of requirement of finance. The process of financing or capital structure decision is shown in the figure below:



So, every capital structure decision affects the value of the firm and the optimal capital structure is one which increases the value of the firm and decreases its cost of capital. As shown in the figure every capital expenditure requires a huge amount of funds which can be raised through debt capital or equity capital. Both the modes of financing have their own features and limitations but generally a finance manager prefers to raise the funds by using appropriate ratio of debt equity mix to yield a maximum return and minimize the cost of capital.

4. Capital Gearing: The concept of Capital Gearing is closely related to the pattern of the capital structure of a company. It refers to the ratio between various types of securities of a company. That is the ratio between equity capital, preference capital plus debentures. It can be written as:

Capital Gearing = Equity Capital : [Preference Share Capital + Debentures]

- A company is said to be highly geared if the proportion of preference shares and debentures is higher than equity share capital (including reserves and surpluses belonging to equity share holders)
- A company is said to be low geared if the proportion of preference shares and debentures is low as compared to equity share capital.

5. Planning of Capital Structure: Planning the capital structure of a company has a great importance because of its prospective impact on profitability and solvency. Small organisations often do not plan their capital structure rather allowed to develop it without any formal planning. They may do well in the short run, however, sooner or later they face considerable difficulties. Without proper planning of capital structure, an economical use of funds for the company is not possible. An enterprise should therefore plan its capital structure in such a way that it derives maximum benefits out of it and is able to adjust it with the change in economic conditions.

Theoretically, optimum capital structure should be planned by the company in such a way that the market value of its shares is maximum. The value of the firm will be maximized when the marginal real cost of each source of funds is the same. The discussion on the issue of optimum capital structure is highly theoretical. But in order to determine an optimum capital structure we have to go beyond the theory. That is why capital structure is found different from company to company even within the same industry. A number of factors influence the capital structure decision of a company. Finance manager plays a crucial role in making the capital structure of a company. Two similar companies can have different capital structures if the decision makers differ in their approach. There are many factors affecting the role of decision maker. These factors are qualitative, complex and highly psychological and do not always follow the accepted theory. Security markets are not always perfect and the decision has to be taken with imperfect knowledge and consequent risk.

6. Optimal Capital Structure: Optimal capital structure is one that maximizes value of business, minimizes overall cost of capital i.e. flexible, simple and futuristic that ensures adequate control on affairs of the business by the owners and so on. Capital structure is usually planned keeping in view the interests of the ordinary shareholders. The ordinary shareholders are the ultimate owners of the company and have the right to elect the directors. While developing an optimal capital structure for the company, the financial manager should aim at maximizing the long-term market price of equity shares. The optimum capital structure may be defined as "that capital structure or a debt-equity mix that leads to the maximise value of the firm". It maximizes the value of the company and hence the wealth of its owners and minimises the company's cost of capital. Thus, every business enterprise should aim at achieving the optimal capital structure and also tries to maintain it. The following considerations should be kept in mind while maximising the value of the firm:

- The capital structure of the firm should be simple. Simplicity means that minimum number of securities should be used in the capital structure. If capital structure becomes complicated in the beginning, it can be difficult to maintain it in future.
- The capital structure should bear the minimum cost of capital. The cost of capital takes the form of interest or dividend. Different sources have different costs. Certain securities have lower cost as compared to others. By obtaining funds at less costs, a company can avail the new opportunities of

investment in future. Therefore it should determine a capital structure in which weighted average cost of capital is minimum.

- An enterprise should not use financial leverage beyond a certain limit because it will increase financial risk. If the shareholders perceive high risk in using further debt capital, it will negatively affect the market price of the shares.
- Capital structure of the firm affects the level of risk also. The use of borrowed funds in capitalisation increases the level of risk because interest on such funds has to be paid before paying the claims of shareholders. Greater use of borrowed funds can result in availability of future funds at high cost. Therefore, while determining capital structure, efforts should be made to minimise the risk.
- The capital structure of the firm should be flexible so that it can be easily altered at the time of need. Whenever there is increase in the size of the business, new sources of capital could be added to it and at the time of reduction of the size, surplus sources could be repaid easily.

7. Determinants of Capital Structure: Capital structure plan is to be prepared very carefully, initially at the time of promotion of company. First of all, the objective of the capital structure should be determined and then the financing decisions should be taken accordingly. Company has to arrange funds for its business activities continuously. Every time when the funds are to be procured, project manager has to choose the most profitable source of finance after considering the merits and limitations of different sources of finance. Therefore, capital structure decisions have to be taken on continuous basis. Generally, the factors to be considered whenever a capital structure decision is taken are:

1. **Trading on Equity/Financial Leverage:** Trading on equity is an arrangement under which an enterprise uses long term debts carrying a fixed rate of interest in such a manner so as to increase the rate of return on equity shares. It refers to the additional profit that equity shares earn because of issuing other type of securities such as preference share capital, debentures, bonds etc. It is based on the theory that if the rate of interest on debentures and rate of dividend on preference shares, which is fixed, is lower than the general rate of company's earnings, equity shareholders will get the advantage of higher dividend per share. While planning the capital structure of a company, financial leverage is considered as one of the important considerations due to its effect on the earnings per share. The greater the Earnings Per Share (EPS), more profitable it will be for the ordinary shareholders.

2. **Cost of Capital:** The cost of a source of finance is the minimum rate of return expected by its suppliers. The expected rate will depend upon the risk borne by the investors. Ordinary shareholders bear the maximum risk because no rate of dividend is fixed for them and the dividend is paid after the payment of interest and preference dividend. The payment of interest on debentures is a statutory liability of the company whether the company earns profits or not. Therefore, debt is cheaper as compared to ordinary share capital. Cost of debt becomes lesser because interest on debt is a charge against the taxable income. But debt is cheaper only upto a particular point and the company cannot always decrease the overall cost of capital by using debt. Later, debt can be costly because use of more debt raises the risk for both the creditors and the shareholders.

3. **Regular & Stable Cash Flows:** The sale and stability of cash flows affect the quantum of leverage. The companies which have stability in income and sales, can use more amount of debt in their capital structure. They can easily pay their fixed financing charges. The industries producing consumer goods face more fluctuations in their sales and, therefore, use lesser amount of debt. On the other hand, income and sales of public utility institutions are more stable and therefore, they can use more debts in financing their assets. Expected increase in sales also affects the amount of leverage. This is the reason that developing companies

use more debt in their capital structure. The companies, whose sales are decreasing, should not use debt or preference share capital because they can face difficulty in the payment of interest and preference dividend, as result of which the company could be liquidated.

4. **Control:** In present times, management wants to maintain its existence continuously and does not want any outside interference. Ordinary shareholders have got legal right to appoint directors. If the company is paying interest and instalment of loan in time, the creditors of company can't interfere in managerial decisions. Similarly, preference shareholders do not have voting rights. But in case the company is unable to pay dividend to the preference shareholders for certain period of time, the preference shareholders get a right to participate in the meetings of the company. Thus, in most of the circumstances, ordinary shareholders get a right to appoint directors. If the main objective of the management is to keep control in the existing hands, it will raise additional finance from debt and preference shares because it will not adversely affect its control.

5. **Flexibility:** Flexibility means the firm's ability to make adjustment in the sources of finance at the time of change in needs of funds. Capital structure of a company is called flexible when it does not face any difficulty to change its capitalisation or the sources of finance. Therefore, the management should take into account the future effects on the present capital structure. Whenever a company needs finance for profitable investment, it must be able to raise necessary funds without delay and at reasonable cost. If less amount of funds is required, company must be in a position to redeem the debentures and preference share capital. Flexibility in the capital structure depends on flexibility in fixed expenses, restrictive conditions in the debt agreement, terms of redemption and debt capacity.

6. **Size of the Business:** Small businesses have to face great difficulty in raising long-term finance. For procuring long term loan, it has to accept unreasonable conditions and high rate of interest. Such restrictive conditions make the capital structure inflexible for small companies and management cannot freely run the business. Therefore, small businesses rely on share capital and retained earnings to meet their requirement of long-term funds. Small companies have to bear greater cost of raising long term funds as compared to large companies. Moreover small companies do not allow expanding their business much and managing their funds out of retained earnings. Large companies are able to raise their long term loans comparatively at flexible terms and can issue ordinary shares and preference shares to the public. Therefore, while preparing capital structure plan, company should make proper use of its size.

7. **Floatation Costs:** Floatation costs are incurred at the time of issue of securities. These costs include commission, brokerage, stationery and other expenses. Normally the cost of debt is less than cost of issuing shares. Therefore, the company can be attracted towards the loan funds. In case of retained earnings, no such issue expenses need to be incurred. But flotation costs are not the most important factor in capital structure decisions. If the amount of issue is increased, the percentage of floatation costs can decrease.

8. **Capital Market Conditions:** While taking decision on the capital structure, tendencies of the capital market should be taken into account because these affect the cost of capital and availability of funds from different sources. Sometimes, company wants to issue ordinary shares but the investors do not want to invest in that company due to high risk. In such a situation, company should not issue shares and necessary funds should be raised from other sources. Therefore, timing of the issuance of securities to the public is an important factor affecting the capital structure of a company.

9. **Gestation Period:** Gestation period refers the period between starting of project construction and first commercial operation of the project. If the gestation period is longer, more equity financing will be advised as there will not be need for servicing of capital in the initial times.

10. **Forms of Business Organisations:** Control is much significant in case of private companies, sole traders and partnership firms because in such businesses, ownership is limited to a few hands. In public limited companies, ownership is widely spread. Therefore, control can't be restricted.

11. **General Economic Conditions:** If an economy is recovering from depression, the business activities in the country will expand. The possibilities of development of business will increase due to it. As a result, company may require additional funds in the future. In such cases, management should give more importance to the flexibility of capital structure so that it may be able to raise funds from alternate sources to meet its need. The company, in such situation, should issue ordinary share capital rather than debt.

12. **Statutory Restrictions:** Capital structure decisions of the company are also affected by the government regulations. The statutory restrictions prescribed by the Government and various statutes are required to be taken into consideration before the capital structure is planned.

13. **Corporate Taxation:** Due to current provisions of tax, the use of debt in the capital structure is cheaper as compared to the ordinary share capital or preference share capital. Interest is chargeable expense from the taxable income, whereas dividend is paid out of earnings available after tax. Hence, level of tax affects the cost of capital. Therefore, to take the advantages of trading on equity, management uses more debt capital in the capital structure which helps in increasing the income of the shareholders.

8. Summary: At the time of preparing financial plan for the business, not only the capitalisation is determined but the form of financing or type of capital is also decided. In the capital structure decisions, it is determined from which sources and how much finance should be raised. Thus, under the capital structure, we determine the proportion in which capital should be raised from different securities. In this way, capital structure decisions are related to the mutual proportion of the long term sources of capital. In the long term sources, we include the owned funds and borrowed funds. Owned funds include share capital and reserve and surplus, whereas in the borrowed funds we include debentures and long term loans from financial institutions. While determining the capital structure, management should use proper proportion of borrowed funds and owned funds because it affects the cost of capital and total value of firm. Management also has to consider a number of factors. Capital structure should be determined in such a manner in which cost of capital of the firm is minimum and the value of the firm for shareholders is maximum.