GOVT. DEGREE COLLEGE FOR MEN SRIKAKULAM

Dept. of Commerce & Management
N.Pavani, MBA., M.Com., M.Phil., APSET.

CAPITAL STRUCTURE THEORIES

INTRODUCTION

The capital structure theory is the approach to determine the value proportion of the capital share to the overall cost of capital for a company to thrive.

Though there are many theories advocated by the noted economists, the two different views have been drawn regarding capital structure of the firm. One view states that the value of the firm depends on the capital structure in-turn it emphasizes on the cost of capital. It advocates that optimal capital structure of the firm at which the overall cost of capital (ko) will be minimum and thereby the value of the firm increases.

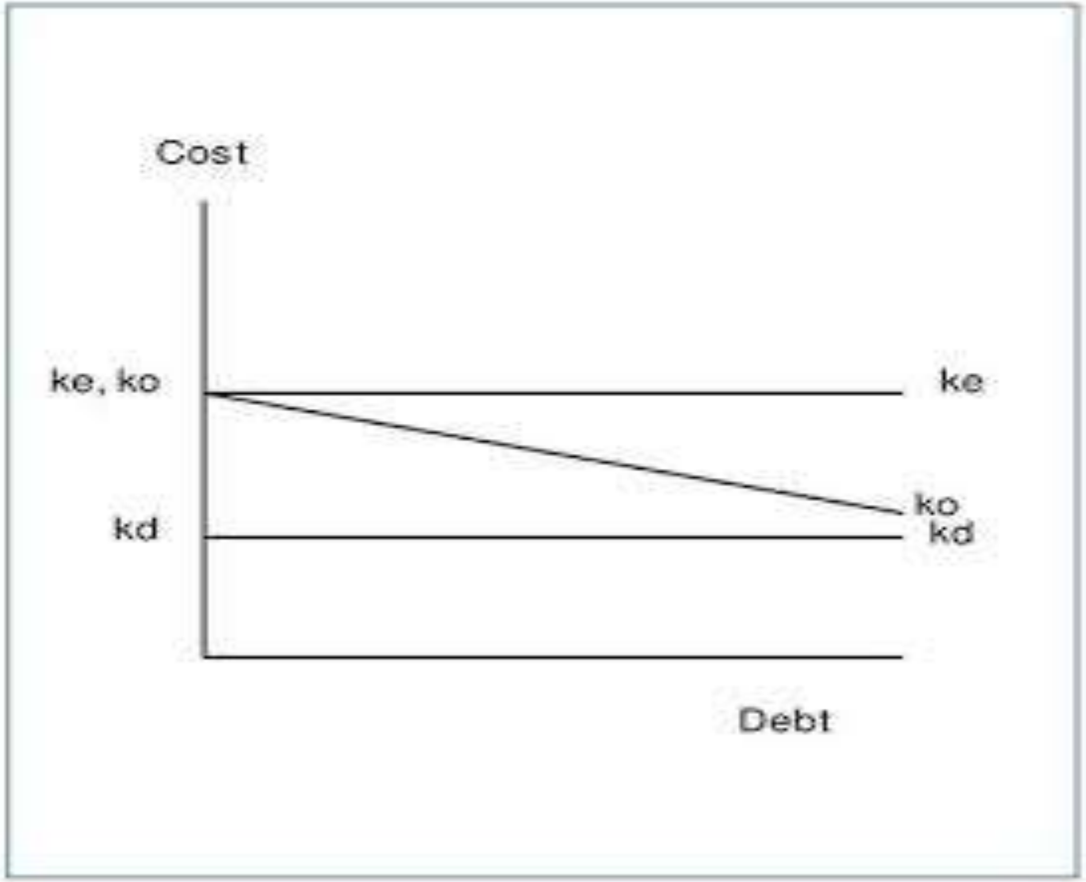
Types

1. Net Income Approach (NI)
2. Net Operating Income Approach(NOI)

1. Net Income Approach(NI)

The capital structure theory known as the net income approach says there is a direct relationship between the capital structure and the value of the business. That is, lowering the cost of capital can increase the value of a company.

Net Income (NI) Approach



- **This method is suggested by Durand**
- Kd and Ke are constant.
- As the debt proposition increases, Ko decreases (Kd is lesser than Ke)
- This result in the increase in value of the firm.

According to this approach, the cost of equity capital and cost of debt capital are assumed to be independent to the capital structure. The value of the firm rises by the use of more and more leverage and the weighted average cost of capital declines.

Assumptions

1. The use of debt does not change the risk perception of investors, as a result, the equity capitalization rate and the debt capitalization rate remain constant with changes in leverages.

2. The debt capitalization rate is less than the equity capitalization rate.

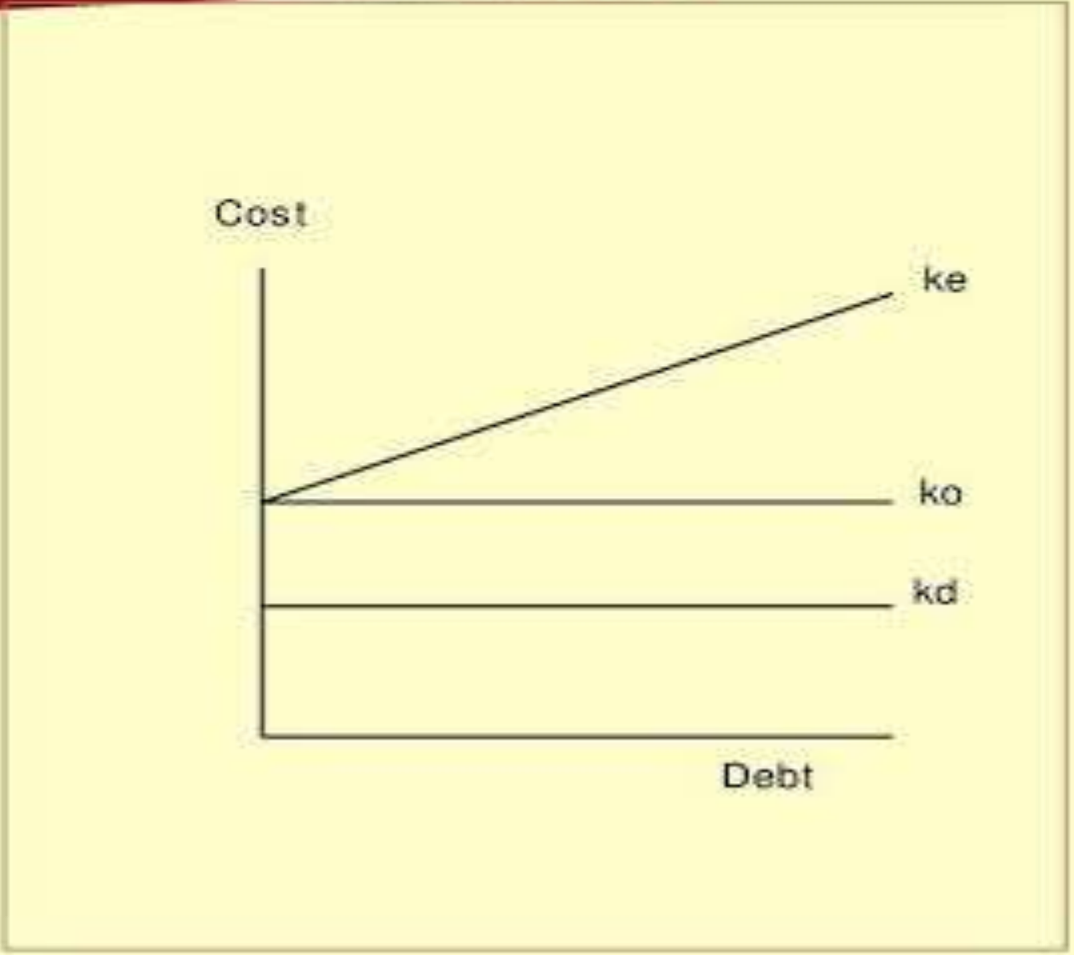
3. Corporate income tax does not exist.

2. Net Operating Income Approach (NOI)

The net operating income approach proposes that the capital structure decisions of a business are irrelevant to the company's value. That is, this capital structure theory says there is no relationship between the capital structure and the value of a business.

Net Operating Income Approach (NoI)

- **According to NOI approach the value of the firm and the weighted average cost of capital are independent of the firm's capital structure., Therefore value of the company is the same.**



According to the net operating approach, the cost of equity increases in accordance with leverage. Due to which the weighted average cost of capital remains constant and the value of the firm also remains constant as leverage is changed.

Assumptions

1. The market capitalise the value of the firm as a whole. Thus the split between debt and equity is not important.
2. The use of the costly debt funds Increases the risk of shareholders. This causes the equity capitalisation rate to increase. There the advantage of debt is offset exactly by the increase in equity capitalisation rate.
3. The debt capitalisation rate is a constant.
4. Corporate income taxes do not exist.

Advantages

- A firm having a sound capital structure has a higher chance of increasing the market price of the shares and securities that it possesses. It will lead to a higher valuation in the market.
- A good capital structure ensures that the available funds are used effectively. It prevents over or under capitalisation.
- It helps the company in increasing its profits in the form of higher returns to stakeholders.

Disadvantages

- **Costs of capital:** It is the cost that is incurred in raising capital from different fund sources. A firm or a business should generate sufficient revenue so that the cost of capital can be met and growth can be financed.
- **Degree of Control:** The equity shareholders have more rights in a company than the preference shareholders or the debenture shareholders. The capital structure of a firm will be determined by the type of shareholders and the limit of their voting rights.

- **Trading on Equity:** For a firm which uses more equity as a source of finance to borrow new funds to increase returns. Trading on equity is said to occur when the rate of return on total capital is more than the rate of interest paid on debentures or rate of interest on the new debt borrowed.
- **Government Policies:** The capital structure is also impacted by the rules and policies set by the government. Changes in monetary and fiscal policies result in bringing about changes in capital structure decisions.

Thank you