(3) Nature of Enterprise

Business enterprises which have stability in their earnings or which enjoy monopoly regarding their products may go for debentures or preference shares since they will have adequate profits to meet the recurring cost of interest/fixed dividend. This is true in case of public utility concerns. On the other hand, companies which do not have this advantage should rely on equity share capital to a greater extent for raising their funds. This is, particularly, true in case of manufacturing enterprises.

(4) Stability of earnings

With greater stability in sales and earnings a company can insist on the fixed obligation debt with less risk. But a company with irregular income will not choose to burden itself with fixed charge. Such company should depend upon the sale of stock to raise capital.

(5) Age of Company

Younger companies generally find it difficult to raise capital in the initial years because of greater uncertainty involved in them and also because they are not known to suppliers of funds. It would therefore, be worthwhile for such companies accord to higher weightage to maneuverability factor. In a sharper contrast to this, established companies with good earnings record are always in comfortable position to raise capital from whatever sources they like. Leverage principle should be insisted upon in such concerns.

(6) Purpose of Financing

In case funds are required for some directly productive purposes the company can afford to raise the funds by issue of debentures. On the other hand, if the funds are required for non-productive purposes, providing more welfare facilities to the employees the company should raise the funds by issue of equity shares.

(7) Market Sentiments

Times of boom investors generally want to have absolute safety. In such cases, it will be appropriate to raise funds by issue of debentures. At other periods, people may be interested in earnings high speculative incomes; at such times, it will be appropriate to raise funds by issue of equity shares.

(8) Credit Standing

A company with high credit standing has greater ability to adjust sources of funds upwards or downwards in response to major changes in need for funds than one with poor credit standing. In the former case the management should pay greater attention to maneuverability factor.

(9) Period of Finance

The period for which finance is required also affects the determination of capital structure of companies. In case, funds are required, say, for 5 to 10 years, it will be appropriate to raise them by issue of debentures. However, if the funds are required more or less permanently, it will be appropriate to raise them by issue of equity shares.

(10) Legal Requirements

Companies Act, Banking Co. Act etc. influence the capital structure considerations. The relative weightage assigned to each of these factors will very widely from company to company depending upon the characteristics of the company, the general economic conditions and the circumstances under

which the company is operating. Companies issue debentures and preference shares to enlarge the earnings on equity shares, while equity shares are issued to serve as a cushion to absorb the shocks of business cycles and to afford flexibility. Of course, greater the operating risk, the less debt the firm can use, hence, in spite of the fact that the debt is cheaper the company should use it with caution.

(11) Tax Considerations

The existing taxation provision makes debt more advantageous in relation to stock capital in as much as interest on bonds is a tax deductible expense whereas dividend is subject to tax. In view of prevailing corporate tax rates in India, the management would wish to raise degree of financial leverage by placing greater reliance on borrowing.

13.8 RELEVANCE OF DEBT – EQUITY RATIO IN PUBLIC ENTERPRISES

It is generally argued that the practical significance of the debt-equity ratio is limited in the case of public enterprises in many countries because most of the loans are derived from the government itself or from public sector financial institutions. The government as the owner as well as the lender, has access to all the information it needs about the financial health of the enterprise and does not need to refer to any favourable ratio to derive confidence before making loans to it. Even when the public enterprises are allowed to borrow from private banks or from foreign financial institutions, there is a government guarantee in one from or another that the loans will be removed and lightened by adoption of an appropriate policy measures.

ignou
THE PEOPLE'S
UNIVERSITY

It may, be concluded that the practical significance of the debt-equity ratio is limited in the case of public enterprise is not based on a complete appreciation of all the factors in which these enterprises have to operate in many developing countries. While the private sector analogy in this respect may have to be qualified suitably when applied to the public enterprise situation in a particular country, it will remain a useful indicator, both with the administrative ministers and with the enterprise managements, to assess the strength of their capital structures.

Activity 4

1) Bring out five factors that influence capital structure.

   ....
   ....
   ....
   ....

2) "Debt Equity Ratio is not relevant for public enterprises" Comment.

   ....
   ....
   ....
   ....

ignou
THE PEOPLE'S
UNIVERSITY

13.9 SUMMARY

A firm's capital structure is determined by the mix of long-term debt and equity it uses in financing its operations. Financial structure means the composition of the entire left hand side of the balance sheet. The basic differences in debt (including preference shares) and equity capital are in respect of the voting rights, the claims on income and assets, and the tax treatment. Timing, flexibility, cost, risk and control principles are the criteria for determining patter of capital structure.

A firm's capital structure should be consistent with its business risk and result in an acceptable financial risk. The EBIT-EPS analysis can be used to evaluate various capital structure in the light of the degree of financial risk and the returns to the equity shareholders. The EBIT-EPS analysis shows how the desirable capital structure gives the maximum EPS.

The mathematical relationship between ROI is

[(ROE + ROI – r)   D/E] (1-t)

NI and NOI theories of capital structures are extreme. The MM analysis suggests that the optimal capital structure does not matter and that as much debt as possible should be used because the interest is tax-deductible. The MM hypothesis is criticized because of its unreal assumptions. Tax adjustment makes it more realistic.

The traditional approach to capital structure indicates that the optimal capital structure for the firm is one in which the overall cost of capital is minimized and the share value is maximized.

The cost of debt increases beyong a certain level of leverage.

Certain qualitative considerations such as cash flow, corporate control, contractual obligations, management's risk tolerance, etc. are taken into consideration while determining the capital structure.

The practical significance of Debt-Equity ratio for public enterprises is limited and has different perspectives.

ignou
THE PEOPLE'S
UNIVERSITY

13.10 KEYWORDS

Capital Structure is the proportions of all types of long-term capital. Financial Structure is the proportions of all types of long-term and short-term capital.

EBIT = Earnings before Interest and taxes.
EPS = Earnings per share
NI Approach says more usage of debt will enhance the value of the firm.

NOI Approach says that the total value of the firm remains constant irrespective of the debt-equity mix. Arbitrage refers to an act of buying a security in one market having lower price and selling it in another market at a higher price. The consequence of such action is that the market price of the securities will become the same.

13.11 SELF ASSESSMENT QUESTIONS/EXERCISES

1. What is a firm's capital structure? How is it different from financial structure?
2. Under the traditional approach to capital structure, what happens to the cost of debt and cost of equity as the firm's financial leverage increases?
3. Explain ROI-ROE analysis.
4. Explain the EBIT-EPS approach to the capital structure. Are maximizing value and maximizing EPS the same?
5. Khosla Ltd. had made the following forecast of sales, with the associated probability of occurrence.

Sales Rs.	Probability
2,00,000	0.20
3,00,000	0.60
4,00,000	0.20

The company has fixed operating costs of Rs.1,00,000 per year and variable operating costs represent 40% of sales. The existing capital structure consists of 25,000 equity shares of Rs. 10 each. The market place has assigned the following discount rates to risky earnings per share.

Co-efficient of variation of EPS	Estimated Required Returns %
.43	15
.47	16
.51	17
.56	18
.60	22
.64	24

The company is considering changing its capital structure by increasing debt in the capital structure vis-à-vis capital. Different debt ratios are considered, given here with the estimate of the required interest rate on all debt.

Debt Ratio	Interest on all debt
20%	10%
40%	12%
60%	14%

The tax rate is 40% percent.

a) Calculate the expected earnings per share, the standard deviation of EPS and the co-efficient of variation of EPS for the three proposed capital structures.
b) Determine the optimal capital structure, assuming (i) maximization of ePS and (ii) maximization of share value.
c) Construct a graph showing relationship in (b).

6. Critically examine various theories of capital structure.
7. Narrate the factors influencing capital structure.
8. Explain the criteria for determining pattern of capital structure.
9. Discuss the relevance of debt-equity ratio for Indian Public Enterprises.
10. Assume the figures of an Indian company and examine the relevance of MM's theory of capital structure.

13.12 FURTHER READINGS

Dani, Hemant R. 1973, *Balance Sheets and How to Read Them*. Hemant R. Dani, Bombay,

Gitman Lawerence J. 1985, *Principles of Managerial Finance* Fourth Edition. Haper & Row Publishers, Singapore, New York.

Schall Lawerence D & Haley Charles W. 1986, *Introduction to Financial Management* Fourth (International student) edition, Mc-Graw Hill Book Co., New York.

Srivastava, R,M,, 2002 *Financial Management*, Pragati Prakash, Meerut.

Srivastava R.M. 2003 *Financial Management and Pragati* Himalaya Publishing Housing Mumbai.

Chandra, P., 1995 *Fundamentals of Financial Management* Tata McGraw, New delhi.

Maheshwari, S.N., 1993 *Financial Management* Sultan chand & Sons.

Upadhyaya, K.M., 1985 *Financial Management* Kalyani Publishers, Ludhiana.

Pendey, I.M., 1993 *Financial Management*.