Question: What is capital structure? Discuss the features of capital structure.

The term capital structure refers to the relationship between the various long-term sources financing such as equity capital, preference share capital and debt capital. Deciding the suitable capital structure is the important decision of the financial management because it is closely related to the value of the firm. It is the permanent financing of the company represented primarily by long-term debt and equity.

According to James C. Van Horne, "The mix of a firm's permanent long-term financing represented by debt, preferred stock, and common stock equity".

Question: What is Financial Structure? Distinguish between capital structure and financial structure.

The term financial structure is different from the capital structure. Financial structure shows the pattern total financing. It measures the extent to which total funds are available to finance the total assets of the business.

Financial Structure = Total liabilities

Or

Financial Structure = Capital Structure + Current liabilities.

The following points indicate the difference between the financial structure and capital structure.

Financial Structure	Capital Structure
It includes both long-term and short-term sources of funds	It includes only the long-term sources of funds.
It means the entire liabilities side of the balance sheet.	It means only the long-term liabilities of the company.
Financial structures consist of all sources of capital.	It consists of equity, preference and retained earning capital.
It will not be more important while determining the value of the firm.	It is one of the major determinations of the value of the firm.

Question: Discuss the types of Capital Structure.

Depending on the use of various types of securities capital structure of a company basically can be two types:

1. Levered
2. Unlevered

Levered: The capital structure which has both equity shares and debenture is known as levered capital structure. That use of debenture or fixed cost bearing sources creates leverage.

Features:

- ✓ Use of debenture or fixed-income (cost bearing) securities.
- ✓ Increase financial risk.
- ✓ Tax deductibility of interest.
- ✓ Chance of value maximization.
- ✓ Chance of cost minimization.

Unlevered: The capital structure which has no fixed cost bearing security (like, debt or preferred stock) can be labeled as unlevered capital structure. That is an unlevered capital structure uses only equity shares.

Features:

- ✓ No use of fixed cost bearing security
- ✓ Cannot enjoy tax-deductibility
- ✓ Lack of flexibility
- ✓ More sharing of control

Question: Definition of Optimum capital structure.

The word 'optimum' means the best practical solution or the most favorable conditions. In case of the capital structure of a company the most favorable condition can be created by ensuring –

- ✓ Minimum cost of capital
- ✓ Maximum value of share

Optimum capital structure is the capital structure at which the weighted average cost of capital is minimum and thereby the value of the firm is maximum. In other way, structure may be defined as the capital structure or combination of debt and equity, which leads to the maximum value of the firm.

Question: Discuss the factors influencing the capital structure of an enterprise.

Capital structure of a firm is determined by various internal and external factors. Following are the main factors which affect the capital structure decision.

Size of a firm: There is a positive relation between the capital structure and size of a firm. The large firms are more diversified, have easy access to the capital market, receive higher credit ratings for debt issues, and pay lower interest rate on debt capital. Further, larger firms are less prone to bankruptcy and this implies the less probability of bankruptcy and lower bankruptcy costs. Therefore, larger firms tend to use more debt capital than smaller firms.

Growth in Sales: Anticipated growth rate in sales provides a measure of extent to which earning per share (EPS) of a firm are likely to be magnified by leverage. The firm is likely to use debt financing with limited fixed charge only when the return on equity is likely to be magnified. However, the firms with significant growth in sales would have high market price per share as a result of which they might prefer equity financing. The firm should make a relative cost benefit analysis against debt and equity financing in anticipation to growth in sales to determine appropriate capital structure.

Business Risk: There is negative relation between the capital structure and business risk. The chance of business failure is greater if the firm has less stable earnings. Similarly, as the probability of bankruptcy increases the agency problems related to debt become more aggravating. Thus, as business risk increases, the debt level in capital structure of the enterprises should decrease.

Debt Service Capacity: The higher debt level in capital structure increases the probability of bankruptcy and bankruptcy costs of the enterprises. Probability of bankruptcy refers to the chances of cash flows to be less than the amount required for servicing the debt. The debt service ratio measured by the ratio of operating income to total interest charges indicates the firm's ability to meet its interest payment out of its annual operating earnings. Therefore, the higher debt service ratio shows the higher debt capacity of the enterprises. Hence, there is the positive relation between the debt service capacity and capital structure of the firm.

Operating Leverage: The use of fixed cost in production process also affects the capital structure. The high operating leverage; use of higher proportion of fixed cost in the total cost over a period of time; can magnify the variability in future earnings. There is negative relation between operating leverage and debt level in capital structure. Higher the operating leverage, the greater the chance of business failure and the greater will be the weight of bankruptcy costs on enterprise financing decisions.

Stability in Cash Flow: The firm's cash flow stability also affects its capital structure. If firm's cash flows are relatively stable, then it may find no difficulties in meeting its fixed charge obligation. As a result, the firm may attempt to take the benefits by using leverage to some extent.

Nature of Industry: Capital structure of a firm also depends on the nature of industry in which it operates. If there were no barriers in industry for the entry of new competing firms, the profit margin of existing firms in the industry would be adversely affected. As a result, the firm may find a more risky to use fixed charge bearing securities.

Asset Structure: The sources of financing to be used are affected to several ways by the maturity structure of assets to be used by the firm. If a firm has relatively longer term assets with assured demand of their products, the firm attempts to use more long term debt. In

contrast to this, the firms with relatively greater investment in receivables and inventory rather than fixed assets rely heavily on short-term financing.

Lender's Attitude: Lender of any firm permits the use of debt financing only to a limited range. If management seeks to use leverage beyond that permitted by industry norms, this may reduce the credit standing and credit rating of the firm. As a result, lenders do not permit for additional debt financing.