

DETERMINANTS OF CAPITAL STRUCTURE

Capital structure may be determined at the time of formation of the firm or at later stages. But determining optimal capital structure at the time of formation is very important and it should be designed very carefully. Management of any firm should set a target capital structure and the subsequent financing decisions should be made with a view to achieve the target capital structure. Construction of capital structure, is difficult, since it involves a complex trade-off among several factors or considerations. Keeping in view the objective of wealth maximisations in mind capital structure has to be determined. The following are the factors that affect optimal capital structure.

1. Tax benefit of Debt: Debt is the cheapest source of long-term finance, when compared with other source of equity, because the interest on debt finance is a tax-deductible expense. Hence, debt can be accepted as tax-sheltered source of finance, which helps in shareholders' wealth maximisation.

2. Flexibility: Flexibility is the most important and serious factor, which needs to be considered while determining capital structure. Flexibility is the firm's ability to adopt its capital structure to the needs of the changing conditions. Changing conditions may need more funds for investments or no need of having funds that are already raised. Whenever there is a need to have more funds to finance profitable investments, the firm should be able to raise funds at less cost and without delay. On the other hand, whenever there is no need to keep borrowed funds, the firm should be able to repay them. The above two conditions are fulfilled only when there is a flexible capital structure. In other words, the financial plan of a firm should be able to change according to their operating strategy and needs. The flexibility of capital structure depends on the flexibility in fixed charges, covenants and debt capacity of the firm.

3. Control: Equity shareholders have voting rights to elect the directors of the company. Raising funds by way of issue of new equity shares to the public may lead to a loss of control. If the management wants to hold control on the firms then it may require to raise funds through non-voting right instruments that is debt source of finance. But the firm needs to pay interest compulsorily on debt finance. Debt finance is preferred only when the firm's debt service capacity is good. Otherwise, the creditors may seize the assets of the

firm to satisfy their claims (interest). In this situation the management would lose all control. It might be better to sacrifice a measure of control by some additional equity finance rather than run the risk loss of all control to creditors by employing too much debt. Widely held companies can raise funds by way of issue of equity shares, since shares are widely scattered and majority of the shareholders are interested in the returns. At the same time if they are not satisfied with the firm, they will switch over to other firms where they expect higher returns.

4. Industry Leverage Ratios: Industry standards provide a benchmark. Firms can use industry leverage ratio as standard for construction of capital structure. Because industry standard may be appropriate to the firm. But it does not mean that firms in the industry are having optimum capital structure. Put it simply, they may be using more leverage or less leverage, but it suggests that whether the firm is out of line or not, if it is, it should know the reasons why and be satisfied that there are good reasons for it.

5. Seasonal Variations: Use of more or less financial leverage depends on the seasonality of the business. Low degree of financial leverage (less debt) is preferable when a firm's business is seasonal in nature. In other words, more equity finance is preferable when firm's business is the nature of seasonal business. For example, businesses involved in producing and sale of umbrellas, fans, air coolers, require to use less debt capital in their capital structure, Use of more debt may make a firm unable to pay interest obligation in the lean period, which would lead to financial distress. On the other hand, industries involved in business where there is no seasonality, like consumer non-durable products (food items, soaps, etc.) or with items in habitual use (cigarette) or all those products which have an inelastic demand and are not likely to be subjected to wide fluctuations in sales, can use more debt in their capital structure, since they are able to earn regular profit.

6. Degree of Competition: Competition in the industry also determines the capital structure. When there is no or less competition (public utility corporations like gas, electricity, etc.), firms can use less equity or more debt in their capital structure, since they can sell products at higher prices. On the other hand, competitive firms like garment industry, home appliances industry have to use more equity in their capital structure, because of competition; they may not be able to sell more units and cannot earn more profits.

7. Industry Life Cycle: Industry life cycle consists of infancy stage; growth stage, maturity stage and declining stage. When the industry is in infancy stage, a firm should use less debt capital or more equity capital in its capital structure, because the profit earning capacity is less due to less sales whereas when a firm is in growing stage (fast) and having more profits, it can go for more debt or less equity that helps to maximise shareholders' wealth. Therefore, the company has to decide whether to finance infancy stage with equity funds and later stages (except declining) with debt funds or vice versa.

8. Agency Cost: Agency cost is the cost that arises when there is a conflict of interest among owners, debenture holders and management. Conflict may arise due to the transferring of wealth to debt holders in their favour. The agency problem is handled through monitoring and restrictive covenants, which involve costs that are called agency costs. The financing strategy of a firm should seek to maximise the agency cost, by way of employing an external agent who maximises in low-cost monitoring. Management should use debt finance to the extent that it maximises the wealth of shareholders, not beyond that.

9. Company Characteristics: These represent size and credit standing among other companies (within or outside industry). Small firms' ability to raise funds from outside is limited when compared to large firms. Small firms have to depend on owners' funds for financing activities. In other words, investors perceive that investment in small firms is more risky than the large firms. On the other hand, large firms are forced to make use of different sources of funds, because no single source is sufficient to provide for their needs.

When it comes to the credit rating characteristic of a firm enjoying high credit rating it may get funds easily from the capital market, when compared to other firms, which are having low credit rating. Because investors and creditors prefer to invest and grant loans to high credit rating firms, since the risk is less.

10. Timing of Public Issue: Timing of the public offer is also one of the important factors considered while planning capital structure. Public offering should be made at a time when the state of the economy as well as capital market is ideal to provide the funds. For example, 2003 to 2004 period Vijaya Bank, IOB, Union Bank, TCS, IOC, NTPC have come up with IPO is due to the ideal capital market and the economy. Prices as well as yield on

securities depend on the monetary policy pursued by the government. Scarcity of debt money and equity funds leads to high interest rates and low price earnings (P/E) ratios.

11. Requirements of Investors: Before issuing an issue of a particular instrument to the public or investors' to raise funds, there is a need to know the investors' requirements. Investors may be institutional investors (LIC of India, GIC, UTI), as well as individual investors. Some investors are ready to take risk (bold investors), who prefer capital gains and control and hence, equity shares are suitable to them. On the other hand, investors (cautious) who are interested in safety of the investment and stable returns, prefer to invest in debentures, since they satisfy their needs and preference shares are very much suitable to the investors who (less cautious) prefer stable returns and share in profits.

12. Period of Finance: Period of finance also plays a crucial role in determination of capital structure. A firm can issue redeemable debentures or preference shares, when the finance is required for a limited period. For example, for 5 years, the firm can issue 5 years redeemable debentures or preference shares. But equity share capital is the best source when the firm needs finance for unlimited period.

13. Purpose of Finance: Debt source of finance is suitable when a firm is planning to invest in productive purpose. For example, a firm is planning to raise funds for social responsibility (non-productive purpose), it can raise funds from equity source.

14. Legal Requirements: There are some guidelines on the issue of shares and debentures issued by the government that are very important for construction of capital structure. For example., the controller of capital issues, now SEBI grants this consent for capital issue when, (a) debt-equity ratio does not exceed 2:1 (higher ratio may be allowed for capital intensive projects), (b) the ratio of preference capital to equity capital does not exceed 1:3 and (c) promoters hold at least 2.5 per cent of the equity capital.

The above-discussed factors are important and need to be considered while determining capital structure.