

## **1. Determinants of Capital Structure of a Firm**

There are numerous factors, both qualitative and quantitative, including the subjective judgment, of financial managers which conjointly determine a firm's capital structure.

The main factors are the following:

### **1. Profitability:**

The key word in capital structure is leverage. It can be defined as the employment of an asset or sources of funds for which the firm has to incur a fixed cost or pay a fixed sum (as the return per period).

Operating v. Financial Leverages:

Leverage is of two types 'operating' and 'financial'. The leverage associated with investment (or acquisition of assets) activities is referred to as operating leverage, while leverage associated with financing activities is called financial leverage. In general, the higher the level of (EBIT) and the lower the chance of downward fluctuation the larger the amount of debt that can be employed.

### **2. Liquidity:**

The analysis of the cash flow ability of the firm to service fixed charges is of considerable importance to carry out capital structure planning.

The Coverage Ratio:

In assessing the liquidity position of a firm in terms of its cash flow analysis, we use a ratio called the coverage ratio. It is the ratio of fixed charges to net cash inflows. It measures the coverage of fixed financial charges (interest plus repayment of principal, if any) to net cash inflows. In other words, it indicates the number of times the fixed financial requirements are covered by the net cash inflows. The higher the coverage ratio the larger the amount of debt (and other sources of funds carrying a fixed rate of interest) that a firm can use.

### **3. Control:**

Another consideration in planning the types of funds to use is the attitude of existing management towards control. Lenders have no direct voice in the management of a company. In most cases, the power to choose the management team rests with the equity holders. Accordingly, if the main objective of management is to maintain control, they may like to have a greater weight-age for debt and preference share in additional capital requirements. This is so because by obtaining funds through them the management sacrifices little or no control.

### **4. Competitive Parity:**

Another factor determining a company's optimal capital structure is the debt-equity ratios of other companies belonging to the same industry and facing a similar business risk. The rationale here is that the debt-equity ratios appropriate for other firms in a similar line of business should be appropriate for the company (under consideration) as well. The use of industry standards provides a benchmark.

If a firm is deviating from its optimal capital structure, the market will give a red signal to the management that there is something wrong in the company's debt-equity mix. If the firm is out

of line, it should identify the causes of such deviation and be satisfied that the reasons are genuine.

### **5. The Nature of Industry:**

The fifth determinant of a firm's optimal capital structure is the nature of the industry to which it belongs. The nature of industry largely determines the degree of financial leverage the firm can carry safely without any risk of bankruptcy. If an industry's sales are subject to periodic fluctuations, the firm should have a low degree of financial leverage. Such firms will always have high operating leverage.

### **6. Timing of Issue:**

The question of timing of issue is also of considerable importance in determining a company's capital structure. It is often possible to make substantial savings through proper timing of security issues. It is in the Tightness of things to make public offering at a time when the state of the economy as well as the capital market is ideal for providing the required funds.

However, timing should not be the only consideration. "Timing analysis, for example, may suggest use of debt. But the company cannot go in for debt if its existing capital structure is already overloaded with debt.

### **7. Characteristics of the Company:**

The nature and characteristics of the company in terms of its size, capital structure and goodwill (credit-standing) also play a very important role in determining the share of old securities and equity in its capital structure.

In general, firms enjoying a higher credit-standing among investors and lenders in the capital market are in a better position to get funds from their choicest sources. If the credit-standing is poor, the firm has limited choice regarding acquisition of funds.

## **2. Essentials of a good capital structure**

A company's capital structure is said to be optimum when the proportion of debt and equity is such that it results in maximizing the return for the equity shareholders. Such a structure would vary from company to company depending upon the nature and size of operations, availability of funds from different sources, efficiency of management, etc.

A sound capital structure should possess the following features:

#### **(i) Maximum Return:**

The financial structure of a company should be guided by clear-cut objective. Its objective can be maximization of the wealth of the shareholders or maximization of return to the shareholders.

#### **(ii) Less Risky:**

The capital structure should represent a balance between different types of ownership and debt securities. This is essential to reduce risk on the use of debt capital.

#### **(iii) Safety:**

A sound capital structure should ensure safety of investment. It should be so determined that fluctuations in the earnings of the company do not have heavy strain on its financial structure.

(iv) Flexibility:

A sound capital structure should facilitate expansion and contraction of funds. The company should be able to procure more capital in times of need and should be able to pay all its debts when it does not require funds.

(v) Economy:

The capital structure should ensure the minimum costs of capital which in turn would increase its ability to generate more wealth for the company.

(vi) Capacity:

The financial structure of a company should be dynamic. It should be revised periodically depending upon the changes in the business conditions. If it has surplus funds, the company should have the capacity to repay its debt and reduce interest obligations.

(vii) Control:

The capital structure of a company should not dilute the control of equity shareholders of the company. That is why; convertible debentures should be issued with great caution.

### 3. Efficient Market Hypothesis

The Efficient Market Hypothesis (EMH) essentially says that all known information about investment securities, such as stocks, is already factored into the prices of those securities.

Therefore, assuming this is true, no amount of analysis can give an investor an edge over other investors. EMH does not require that investors be rational; it says that individual investors will act randomly but, as a whole, the market is always "right." In simple terms, "efficient" implies "normal." For example, an unusual reaction to unusual information is normal.

Defining the Forms of EMH

There are three forms of EMH: Weak, Semi-strong and Strong. Here's what each says about the market.

**Weak Form EMH:** Suggests that all past information is priced into securities. Fundamental analysis of securities can provide an investor with information to produce returns above market averages in the short term but there are no "patterns" that exist. Therefore fundamental analysis does not provide long-term advantage and technical analysis will not work.

**Semi-Strong Form EMH:** Implies that neither fundamental analysis nor technical analysis can provide an advantage for an investor and that new information is instantly priced in to securities.

**Strong Form EMH:** Says that all information, both public and private, is priced into stocks and that no investor can gain advantage over the market as a whole. Strong Form EMH does not say some investors or money managers are incapable of capturing abnormally high returns but that there are always outliers included in the averages.

## 4. Business risk and its types

Business risks are broadly categorized into two types as follows:

**Systematic risk** is due to the influence of external factors on an organization. Such factors are normally uncontrollable from an organization's point of view. It is a macro in nature as it affects a large number of organizations operating under a similar stream or same domain. It cannot be planned by the organization. The following are the examples of systematic risk:

- Interest rate risk,
  - Market risk
  - Purchasing power or inflationary risk.
  - Interest rate risk
1. **Interest-rate** risk arises due to variability in the interest rates from time to time. It particularly affects debt securities as they carry the fixed rate of interest.

The types of interest-rate risk are depicted and listed below.

- Price risk and
  - Reinvestment rate risk.
- a. **Price risk** arises due to the possibility that the price of the shares, commodity, investment, etc. may decline or fall in the future.
  - b. **Reinvestment rate risk** results from fact that the interest or dividend earned from an investment can't be reinvested with the same rate of return as it was acquiring earlier.

### 2. Market risk

Market risk is associated with consistent fluctuations seen in the trading price of any particular shares or securities. That is, it arises due to rise or fall in the trading price of listed shares or securities in the stock market.

The types of market risk are depicted and listed below.

- Absolute risk,
- Relative risk,
- Directional risk,
- Non-directional risk,
- Basis risk and
- Volatility risk.

The meaning of different types of market risk is as follows:

- a. **Absolute risk** is without any content. For e.g., if a coin is tossed, there is fifty percentage chance of getting a head and vice-versa.

- b. **Relative risk** is the assessment or evaluation of risk at different levels of business functions. For e.g. a relative-risk from a foreign exchange fluctuation may be higher if the maximum sales accounted by an organization are of export sales.
- c. **Directional risks** are those risks where the loss arises from an exposure to the particular assets of a market. For e.g. an investor holding some shares experience a loss when the market price of those shares falls down.
- d. **Non-Directional risk** arises where the method of trading is not consistently followed by the trader. For e.g. the dealer will buy and sell the share simultaneously to mitigate the risk.
- e. **Basis risk** is due to the possibility of loss arising from imperfectly matched risks. For e.g. the risks which are in offsetting positions in two related but non-identical markets.
- f. **Volatility risk** is of a change in the price of securities as a result of changes in the volatility of a risk-factor. For e.g. it applies to the portfolios of derivative instruments, where the volatility of its underlying is a major influence of prices.

### 3. Purchasing power or inflationary risk

Purchasing power risk is also known as inflation risk. It is so, since it emanates (originates) from the fact that it affects a purchasing power adversely. It is not desirable to invest in securities during an inflationary period.

The types of power or inflationary risk are depicted and listed below.

- Demand inflation risk and
- Cost inflation risk.

The meaning of demand and cost inflation risk is as follows:

- a. **Demand inflation risk** arises due to increase in price, which result from an excess of demand over supply. It occurs when supply fails to cope with the demand and hence cannot expand anymore. In other words, demand inflation occurs when production factors are under maximum utilization.
- b. **Cost inflation risk** arises due to sustained increase in the prices of goods and services. It is actually caused by higher production cost. A high cost of production inflates the final price of finished goods consumed by people.

### Unsystematic Risk

Unsystematic risk is due to the influence of internal factors prevailing within an organization. Such factors are normally controllable from an organization's point of view.

It is a micro in nature as it affects only a particular organization. It can be planned, so that necessary actions can be taken by the organization to mitigate (reduce the effect of) the risk.

The types of unsystematic risk are depicted and listed below.

- Business or liquidity risk,

- Financial or credit risk and
- Operational risk.

## 1. Business or liquidity risk

Business risk is also known as liquidity risk. It is so, since it emanates (originates) from the sale and purchase of securities affected by business cycles, technological changes, etc.

The types of business or liquidity risk are depicted and listed below.

- Asset liquidity risk and
  - Funding liquidity risk.
- Asset liquidity risk** is due to losses arising from an inability to sell or pledge assets at, or near, their carrying value when needed. For e.g. assets sold at a lesser value than their book value.
  - Funding liquidity risk** exists for not having an access to the sufficient-funds to make a payment on time. For e.g. when commitments made to customers are not fulfilled as discussed in the SLA (service level agreements).

## 2. Financial or credit risk

Financial risk is also known as credit risk. It arises due to change in the capital structure of the organization. The capital structure mainly comprises of three ways by which funds are sourced for the projects. These are as follows:

Owned funds. For e.g. share capital.

Borrowed funds. For e.g. loan funds.

Retained earnings. For e.g. reserve and surplus.

The types of financial or credit risk are depicted and listed below.

- Exchange rate risk,
  - Recovery rate risk,
  - Credit event risk,
  - Non-Directional risk,
  - Sovereign risk and
  - Settlement risk.
- Exchange rate risk** is also called as exposure rate risk. It is a form of financial risk that arises from a potential change seen in the exchange rate of one country's currency in relation to another country's currency and vice-versa. For e.g. investors or businesses face it either when they have assets or operations across national borders, or if they have loans or borrowings in a foreign currency.
  - Recovery rate risk** is an often neglected aspect of a credit-risk analysis. The recovery rate is normally needed to be evaluated. For e.g. the expected recovery rate of the funds

tendered (given) as a loan to the customers by banks, non-banking financial companies (NBFC), etc.

- c. **Sovereign risk** is associated with the government. Here, a government is unable to meet its loan obligations, renege (to break a promise) on loans it guarantees, etc.
- d. **Settlement risk** exists when counterparty does not deliver a security or its value in cash as per the agreement of trade or business.

### 3. Operational risk

Operational risks are the business process risks failing due to human errors. This risk will change from industry to industry. It occurs due to breakdowns in the internal procedures, people, policies and systems.

The types of operational risk are depicted and listed below.

- Model risk
  - People risk
  - Legal risk and
  - Political risk.
- a. **Model risk** is involved in using various models to value financial securities. It is due to probability of loss resulting from the weaknesses in the financial-model used in assessing and managing a risk.
  - b. **People risk** arises when people do not follow the organization's procedures, practices and/or rules. That is, they deviate from their expected behavior.
  - c. **Legal risk** arises when parties are not lawfully competent to enter an agreement among themselves. Furthermore, this relates to the regulatory-risk, where a transaction could conflict with a government policy or particular legislation (law) might be amended in the future with retrospective effect.
  - d. **Political risk** occurs due to changes in government policies. Such changes may have an unfavorable impact on an investor. It is especially prevalent in the third-world countries.