

## **UNIT 2 FINANCING DECISION**

### **Capital structure**

Capital structure is the permanent long term financing that is represented by long term debt, preference share capital, equity share capital and retained earnings.

### **Definition**

Capital structure of a company refers to the composition or make up of its capitalization and it includes long term capital resources like shares, bonds, reserves.

Capital Structure is referred to as the ratio of different kinds of securities raised by a firm as long-term finance.

### **Patterns of Capital Structure**

1. Capital structure with equity shares only.
2. Capital structure with both equity shares and preference shares.
3. Capital structure with equity shares and debentures.
4. Capital structure with equity shares, preference shares and debentures.

### **Optimum Capital Structure**

The optimal capital structure indicates the best debt-to-equity ratio for a firm that maximizes its value.

### **Capitalization**

Capitalization refers to the combination of different types of securities of a business concern.

### **Factors influencing Capital Structure**

1. Trading on Equity

Trading on equity means taking advantage of equity share capital to borrowed funds on reasonable basis. It refers to additional profits that equity shareholders earn because of issuance of debentures and preference shares.

2. Degree of control

The attitude of the management in retaining control has direct impact on the capital structure. If the company's management policies are such that

they want to retain their voting rights in their hands, the capital structure consists of debenture holders and loans rather than equity shares.

### 3. Flexibility of financial plan

It is the ability to adopt its capital structure to the needs of changing conditions. Its capital structure should be flexible, so that the firm can make change the securities in the capital structure. Therefore, in order to make the capital structure possible, the company should go for issue of debentures and other loans.

### 4. Capital market condition

In the lifetime of the company, the market price of the shares has got an important influence. During the depression period, the company's capital structure generally consists of debentures and loans and vice versa.

### 5. Period of financing- When company wants to raise finance for short period, it goes for loans from banks and other institutions; while for long period it goes for issue of shares and debentures.

### 6. Cost of financing

In a capital structure, the company has to look to the factor of cost when securities are raised. It is seen that debentures at the time of profit earning of company prove to be a cheaper source of finance as compared to equity shares where equity shareholders demand an extra share in profits.

### 7. Stability of sales

When sales are high, thereby the profits are high and company is in better position to meet such fixed commitments like interest on debentures and dividends on preference shares. If company is having unstable sales, then the company is not in position to meet fixed obligations. So, equity capital proves to be safe in such cases.

### 8. Sizes of a company

Small size business firm capital structure generally consists of loans from banks and retained profits. While on the other hand, big companies having goodwill, stability and an established profit can easily go for issuance of shares and debentures as well as loans and borrowings from financial institutions. The bigger the size, the wider is total capitalization.

## **LEVERAGE**

The term leverage is used to describe the firm's ability to use fixed assets or funds to increase the returns to its owners; i.e, equity shareholders.

It must be noted that higher is the degree of leverage higher is the risk as well as return to the owners.

There are basically types of leverages. They are:-

- 1) Operating leverage.
- 2) Financial leverage.
- 3) Combined leverage.

### **1) Operating leverage**

It may be defined as the ability of a concern to use fixed operating costs to magnify (to increase) the effect of change in sales on its operating profits.

$$\text{Operating leverage} = \frac{\text{Contribution}}{\text{Operating profit/EBIT}}$$

### **Degree of operating leverage**

It refers to the percentage change in operating profit, resulting from a percentage change in sales. It can be expressed with following formula:-

$$\text{Therefore, Degree of operating leverage} = \frac{\% \text{ Change in EBIT}}{\% \text{ Change in Sales}}$$

### **2) Financial leverage or Trading on Equity**

The use of long term fixed interest bearing debt and preference share along with equity share capital is called as financial leverage or trading on equity.

$$\text{Financial leverage} = \frac{\text{EBIT}}{\text{EBT}}$$

### **Degree of financial leverage**

The degree of financial leverage measures the impact of a change in EBIT on change in Earning per share

$$\text{Degree of Financial leverage} = \frac{\% \text{ Change in EPS}}{\% \text{ Change in EBIT}}$$

### **3) Combined leverage**

It is the Combination of operating and financial leverage. It called as combined leverage.

$$\text{Combined leverage} = \text{Operating leverage} \times \text{Financial leverage}$$

### **Degree of Combined Leverage**

$$\text{Degree of Combined Leverage} = \frac{\% \text{ Change in EPS}}{\% \text{ Change in SALES}}$$

1. Calculate operating leverage from the following data:

Sales: 1, 50,000 units at Rs 4 per unit.

Variable cost per unit Rs 2

Fixed cost Rs 1, 50,000

<b>Particulars</b>	<b>Amt (Rs.)</b>
<b>Sales</b>	<b>6,00,000</b>
<b>Less Variable Cost</b>	<b>3,00,000</b>
<b>Contribution</b>	<b>3,00,000</b>
<b>Less Fixed Cost</b>	<b>1,50,000</b>
<b>EBIT</b>	<b>1,50,000</b>

Operating leverage =  $\frac{\text{Contribution}}{\text{Operating profit/EBIT}}$

Operating leverage =  $\frac{3,00,000}{1,50,000}$

= 2 times

### **Earnings per Share (EPS)**

EPS is a financial ratio, which divides net earnings available to common shareholders by the total outstanding shares over a certain period of time. The EPS formula indicates a company's ability to produce net profits for common shareholders.

EPS =  $\frac{\text{Earnings available to equity shareholders}}{\text{Number of Equity Shares}}$

### **Master table to calculate EPS**

<b>Particulars</b>	<b>Amt (Rs.)</b>
<b>Sales</b>	<b>****</b>
<b>Less Variable Cost</b>	<b>****</b>
<b>Contribution</b>	<b>****</b>
<b>Less Fixed Cost</b>	<b>****</b>
<b>EBIT</b>	<b>****</b>

<b>Less Interest</b>	<b>****</b>
<b>EBT</b>	<b>****</b>
<b>Less Tax</b>	<b>****</b>
<b>EAT</b>	<b>****</b>
<b>Less Preference Dividend</b>	<b>****</b>
<b>Earnings Available to Equity Shareholders</b>	<b>****</b>

**EBIT=Earnings before interest and tax**

**EBT=Earnings before tax**

**EAT=Earnings after tax**