Chapter 4

Overview of Capital Structure Dimensions and Importance to Organisation

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Concept of Capital Structure

Theoretical literature has documented a number of definitions of the term capital structure. Like most other terms in finance, no consensus exists on any of the definitions. According to Aliu (2010), a firm"s capital structure refers to the combination of its financial liabilities and its equities. It is the way a corporation finances its assets through some mix of equity and debt. In line with this, Abdul (2010), Saad (2010), Shehu (2011), Michael (2012) and Ishaya and Abduljaleel (2014) referred to it as a mix of different types of securities (long-term debt, common stock) which are issued by a firm to finance its assets. Semiu and Collins (2011) also referred to it as the proportions of capital at work in a business by type, namely, equity capital and debt capital, each of which having its own benefits and drawbacks. From the foregoing, capital structure is simply a firm"s financial framework, which comprises of a firms retain earnings, debt financing and equity financing in order to maintain the business entity in financing its operations.

The theory and concept of capital structure and its relationship with firm's performance has been a very serious controversy as such have become an issue of great concern/interest in corporate finance and accounting literature since after the seminar work presented by Modigliani and Miller (1958). By definition, capital structure is the combination of debt and equity securities that compromise firm's financing of assets (John J. Hamptom). Modigliani and Miller (1958) in their seminar raised an argument under certain conditions that the choice of debt and equity does not affect the firms value, thus capital structure being irrelevant proposition includes a situation where there are no taxes, no transaction costs in the capital market and no information cost among players; but in a reverse notion, their position changed when they considered the involvement of corporate tax, transaction cost and that in real practice, no economy is tax-free. Ever since, financial theorists have strived severally to give possible explanation for the financing decisions of firms (Harris and Raviv, 1991; Myers, 1984 etc).

Capital structure has been defined as the appropriate mix of debt and equity. Myers and Brealey (2003) in their opinion assert that in terms of the appropriate mix, it will

be improper to say that more debt is always better or equity better. However debt may be better than equity in some cases and worse in some cases vice versa. In clear terms, many financial policies are associated with their own peculiar risk pattern and character. In today's business world where rapid development has led to series of discourse, argument and confusion, yet most of the worries are still not provided with solutions. Harries and Raviv (1991), states that dynamic use of debt has received little attention in the vast theoretical literature on capital mix. Nonetheless, Pandey (1999) states that capital structure gives an appropriate relationship between long-term debt and equity.

More so, it was observed in literature that high-growth firms typically with large financing needs will end up with high debt ratios due to manager's reluctant issue of equity (Harris and Raviv, 1991). This assertion was however criticized by Smith and Natts (1992), Barclay et al (2006), where they states that high-growth firms consistently use less debts in their capital structure. Again Myers (2001) found out that in general, industry debt ratios are low or negative when profitability and business risk are high.

Meanwhile current financial theories argues that in a situation where there is no bankruptcy cost, the appropriate capital structure for a firm would be composed almost entirely with debt diminishing returns are linked with further debt in the capital structure (Kwansa and Cho, 1995). Therefore, an appropriate capital structure beyond which increases in bankruptcy costs are higher than the marginal tax-shield benefit associated with further substitution of debt for equity in the capital mix. Managers who are willing to recognize and maintain this appropriate capital structure minimize financing costs to free-cash flow theory, very high levels will increase a firm's value, despite the threat of financial distress, when the firm's operating cash-flow significantly exceed its profitable investment opportunities (Myers, 2001).

Meanwhile Graham and Harvey (2001) observed that firms issue equity rather than debt when their stock prices are high. Baker and Wurgler (2002) also find out that the level of a firm's stock price is a major determinant of which security to issue. Welch (2004) establishes that firms let their capital structure change with their stock prices rather than issuing securities to counter the mechanical effect of stock returns on capital structure.

The concept of capital structure is said to be closely related to the firm's cost of capital. It was said to be so due to the argument of whether or not there is an existence of optimal capital structure and its effect on the overall cost of capital and the value of the firm. This view brought out a lot of controversy among famous scholars in the field of account and finance. However, those that agreed on optimal capital structure are said to be supporters of the traditional theory approach while those not in agreement are supporters of Modigliani and Miller (MM) hypothesis on capital structure. Modigliani and Miller (MM) (1958) investigated and lay a foundation of modem theory of capital structure. They established that there is independence of investment and financing decisions. To buttress their point, they develop a defense of the net operating income approach to the effect of leverage on the cost of capital and the value of the firm which

asserts that the firm's value and the overall cost of capital are independent of the firm capital structure; which the theory states that behaviorally investors would use arbitrage to keep the weighted average cost of capital (WACC) constant when changes in firm's earnings occur.

In the Net Income Approach Theory, it was said that, if a firm increases the debt in its capital formation (mix), the value of the firm will increase while the weighted average cost of capital (overall cost of capital) will reduce. Under the NI approach, the firm will have the maximum value and minimum WACC when it is 100 percent debt finance in its capital structure. This approach is known as dependent hypothesis, because the cost of capital value of the firms depends on the use of debts. However, in real sense of operation, the hypothesis is considered to be artificial and incomplete because no firm in reality operates with 100% debts (Pandey).

Capital structure is essential to how a firm finances its overall operations and growth by using different sources of funds. Modigliani & Miller (M&M) theorem is the broadly accepted capital structure theory because it is the foundation of capital structure theory which has been used by many researchers. It is recognized as a sort of structure with which firms receive direction and orientation concerning their business activities. It is also the heart of both a market economy and a democratic society. It is said to be the financing performance of a firm (Simon & Afolabi, 2011). In addition, capital structure represents a means for decision making of business firms and facilitates maximization of return on investment, as well as boosting the efficiency of financing and dividend decisions (Chandrasekharan, 2012). Financing decisions generally facilitate the survival and growth of a business enterprise, which calls for the need to channel efforts of business towards realizing efficient decision, which will protect the shareholders interest. Capital structure decision is thus considered as one of the effective tools of management to manage the cost of capital. A substantial part of wise corporate stewardship and management attempts to find the appropriate capital structure in term of risks and return payoff for shareholders. The capital structure of a firm consists of debt and equity. Debt is further classified into short and long term. Accounting and finance literature often discuss these components as ratio of total assets and of equity. The components are discussed hereunder.

Dimensions of Capital Structure

Debt Capital

Debt capital measure the proportion of creditors fund in relation to shareholders fund. Creditors would like this ratio to be lower; because the lower the ratio the higher the level a of firm's financing that is being provided by shareholders and the larger the cushion (margin of protection) in the event of shrinking asset values or outright losses. This a measure of how much suppliers, lenders, creditors and obligors have committed to the company versus what shareholders have committed (Kurfi, 2003). Total debt to total equity refers to the ratio of debt to equity capital of a company. As a result of the payment of interest and repayment of principal amount of the debt, a large part of the firm's cash flow would decrease (Magpayo,

2011).

The debt to equity ratio shows the percentage of a company's financing that comes from creditors and investors. A higher debt to equity ratio indicates that more creditors financing (bank loans) is used than investors financing (shareholders). The debt to equity ratio is considered a balance sheet because all of the elements are reported on the statement of financial position. Each industry has different debt to equity ratio bench marks, as some industries tend to use more debt financing than others. A debt ratio of 0.5 means that there are half as many liabilities as there is equity. In order words, the assets of the company are funded 2 to 1 by investors to creditors. This means that investors own 66.6 cents on the dollar (Erasmus, 2008).

Companies with a higher debt to equity ratio are considered more risky to creditors and investors than companies with a lower ratio. Unlike equity financing, debt must be repaid to the lenders. Since debt financing also requires debt servicing or regular interest payments, debt can be a far cheaper form of financing than equity financing. Creditors view a higher debt to equity ratio as risky because it shows that investors have not funded the operations as much as creditors have. In other words, investors do not have as much skin in the game as the creditors do. This could mean that investors do not want to fund the business operations because the company is not performing well. Lack of performance might also be the reason why the company is seeking for extra debt financing (Stanford,2009).

Equity Capital

Equity is the difference between the values of the assets/interest and the cost of the liabilities of something owned. In accounting context, shareholders equity (stock holders equity, shareholders funds, share holders capital or similar terms) represents the equity of a company as divided among individual shareholders of common or preferred stock (Kurfi, 2003). Accounting shareholders are the cheapest risk bearers as they deal with the public. In financial accounting, owners" equity consists of the net asset which is the difference between the total assets of the entity and all its liabilities. Equity usually appears on the statement of financial position which is one of the four primary financial statements. The assets of an entity can be in tangible and intangible items. Intangible assets include items such as brand names, copy rights or goodwill. Tangible assets include land, equipment and cash (Akinsulire, 2014).

Equity is the residual interest in the assts of the entity after deducting all the liabilities (IASB frame work). Equity is what the owners of an entity have invested in an enterprise. It represents what the business owes to its owners. It is also a reflection of the capital left in the business after assets of the entity are used to pay off any outstanding liabilities. This is what the owners take home in the event of liquidation of the entity (Erasmus, 2008). Equity is the owners" value in an asset or group of assets. It is also refers to the value of the assets contributed by the owners. This is added to the total income earned and retained by the company to give the company's total equity value. This description of equity is correct but very

simplistic. A more profound description is really that used by home owner, that is, owners" value in an asset or group of assets. It is calculated by total assets minus total liabilities.

According to Onaolapo and Kajola (2010), equity capital involves not just the sale of common equity, but also the sale of other equity or quasi-equity instruments such as preferred stock, convertible preferred stock and equity units that include common shares and warrants. A start up that grows into a successful company will have several rounds of equity financing as it evolves. Since a start-up typically attracts different types of investors at various stages of its evolution, it may use different equity instruments for its financing needs.

The equity ratio refers to a financial ratio indicative of the relative proportion of equity applied to finance the assets of a company. This ratio is a variant of the debt-to-equity-ratio and is also, sometimes, referred as net worth to total assets ratio. The equity ratio communicates the shareholder's funds to total assets in addition to indicating the long-term or prospective solvency position of the business. The equity or proprietary ratio is calculated by dividing the shareholders' funds by the total assets. Equity Ratio = Shareholders funds / Total assets .For instance, a company has shareholders' funds worth N1,800,000 and total assets, worth N3,000,000. The equity is, therefore, calculated as: Equity Ratio = 1,800,000 / 3,000,000. Which is 6.00. This implies that of every N1 employed in the business, the contribution of shareholders is about 60 kobo. The creditors' contribution, therefore, would be 40 kobo.

Mahira (2011), stated that the equity ratio is an investment leverage or solvency ratio that measures the amount of assets that are financed by owners' investments by comparing the total equity in the company to the total assets. The Equity Ratio is a good indicator of the level of leverage used by a company. The Equity Ratio measures the proportion of the total assets that are financed by stockholders, as opposed to creditors. A low equity ratio will produce good results for stockholders as long as the company earns a rate of return on assets that is greater than the interest rate paid to creditors.

Importance of Capital Structure

Financing decisions are reactive and evolve response to the operating decisions of a firm. It may be appropriate to say that, some companies do not plan their capital structure, it spring-up as a result of the financial decisions taken by the financial manager without formal policy and planning. Though these companies may prosper in the short-run, but ultimately may be confronted with some considerate difficulties in raising funds to finance activities. Again with unplanned capital structure, firms may also fail to economize the use of their funds. Apparently, its being increasingly realized that a company should plan its capital structure to maximize the use of funds and to be able to adapt more easily to the changing conditions of the economy. The optimal capital structure is one that maximizes the market value of the firm. See below the following as some importance of capital structure.

i. **Increase in value of the firm:** A sound capital structure (mix) of a firm helps to increase the market price of shares and securities which in turn lead to increase in value of the firm.

ii. **Utilization of available funds:** A good capital structure aids business enterprises to utilize their available fund fully. It properly protects the business from over- capitalization and under-capitalization. Appropriate capital mixes ensures the determination of the financial requirements of the firm and raise the funds in such proportions from various sources for the best possible utilization.

iii. **Maximization of returns:** A sound capital mix enables management to increase the profits of a company in form of higher return to equity holders.

iv. **Minimization of cost of capital:** A sound capital mix of any firm maximizes shareholders wealth through minimization of the overall cost of capital. This can be done by adding long term debt capital in the capital mix as the cost of debt capital.

v. **Solvency or Liquidity Position:** A well calculated structure does not allow firms to raise excess debt in her capital mix because at the time of poor earnings, the solvency is disrupted for compulsory payment of interest to debt-owners.

vi. **Flexibility:** A sound capital structure provides room for expansion or reduction of debt capital so that during a changing condition, an adjustment of capital can be made.

Factors Determining Capital Structure:

The determination of capital structure in practice involves additional considerations with regards to EPS, value and cash-flow. A firm may have enough debt servicing ability but it may not have assets to offer as charge (collateral). Ways of firms with regards to financing decision may also be quite often influenced by their desire of not losing control, maintaining operating flexibility and have convenient timing and cheaper means of raising funds. Some of the related factors of determining capital structure can be considered as follows:

Risk in variation of earnings: the higher the debt content in the capital structure of a firm, the higher will be the risk of variation in the expected earnings available to equity holders. If return on investment on total capital employed (i.e. shareholders fund plus long-term debt) exceeds the interest rate, the shareholders get a higher return. But if the interest rate exceeds return on investment, shareholder may not have any return.

Cost of Capital: This refers to the amount or cost of raising fund to finance firm's activities. A firm needs to generate fund (capital) enough to meet its cost of capital and project the future growth of the firm. Therefore, it is pertinent for the financial manager to consider the cost of each alternative sources of fund while designing the capital mix of the firm.

Size of the firm: Size of a firm is another factor to determine the capital structure of a firm. This is because availability of fund is greatly influenced by the size of company. Undoubtedly, a small firm may find it difficult to raise debt capital and even if it does has limit of debt to be raised. The terms of debentures and long-term loans are less

favourable to small firms. Small firms depend more on equity shares and retained earnings on the other hand, large firms issue various kind of securities despite the fact that they pay less interest because they are considered less risky than small firms by investors

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