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Subject : Financial Management
Topic : Capital structure Theories

Dear student,

In the Last E-Content related to Financial Management, I discussed what is Capital Structure? and factors affecting Capital structure of a corporate entity.

As we all know that Business Entity frame their Capital structure based on certain theories. So in today's E-Content I will discuss Capital structure Theories.

As you are aware that different experts of the subject developed different theories of Capital structure, I will discuss them one by one, with an example for your better under-standing. Today I am going to discuss in detail the Net income approach.

Net Income approach (N.I)

According to the Net Income Approach, as suggested by Durand, the Capital structure decision is relevant for the valuation of the firm. In other words, a change in the financial leverage i.e the ratio of debt to equity, will lead to a corresponding change in the overall Cost of Capital as well as, the value of the firm. According to this approach, if the ratio of debt to equity is increased, the Cost of Capital will decline, while the value of the firm as well as the market price of the equity shares will increase.

Conversely, a decrease in the ratio of debt to equity will cause an increase in the overall Cost of Capital and a decline, both, in the value of the firm as well as, the market price of the equity shares. Hence, a firm can minimise the Cost of Capital and increase the value of the firm, as well as, market price of its equity shares by using debt financing to the maximum possible extent.

Assumptions

i) The Cost of debt is lower than the Cost of equity.
ii) The risk perception of investors is not changed by the use of debt.
iii) There are no corporate or personal income taxes.

The main contention in favour of N.I. approach is that an increase in the proportion of debt financing in Capital structure results in an increase in the proportion of a cheaper source of funds. This, in return, results in the decrease in overall Cost of Capital leading to an increase in the value of the firm. The main reasons behind the assumption of Cost of debt to be less than the Cost of equity are that, the interest rates are usually lower than dividend rates, due to higher risk on equity shares and also since the interest on debt is a deductible expense, the Company gets the tax benefits on it.

The financial levarage is thus, according to the N.I. Approach, an important variable to the capital structure of the firm, with a judicious mixture of debt and equity, a firm can evolve an optimum capital structure, which will be the one at which the overall cost of capital is lowest and market value of the firm is highest. At the structure, the market price per share would be maximum.

Now I will discuss one example to explain this approach. Consider a fictitious company having following details in INR.

Earning before interest, tax (EBIT) =	Rs 1,00,000
Bonds (Part of debt)	Rs 3,00,000
Cost of Bonds issued	10%
Cost of Equity	14%

Now if value of the company is being calculated on the basis of above information then, it will be —

EBIT	Rs 1,00,000	
Less: Interest Cost $(300000 \times \frac{10}{100})$	Rs 30,000	
Earnings (Since assumption is tax is 0)	Rs 70,000	
Market value of Equity (as Rate of Return on Equity is given 14%)	$= \frac{70000}{14} \times 100$	= Rs 500000
Market value of Debt		Rs 300000
Total Market value		Rs 800000

Overall Cost of Capital $= \frac{\text{EBIT}}{\text{Total value of the firm}} \times 100 = \frac{100000}{800000} \times 100 = 12.5\%$

Now assume that the proportion of the debt increased from Rs 3,00,000 to Rs 4,00,000 and other information remains the same, then the value of the company will be —

EBIT	Rs 100000	
Less Interest Cost $(400000 \times \frac{10}{100})$	Rs 40 000	
Earning (Tax 0)	Rs 60,000	
Market value of Equity	$= \frac{60000}{14} \times 100$	= Rs 4,28,570 (approx)
Market value of Debt		Rs 4,00,000
Total Market Value		Rs 8,28,570

Overall Cost of Capital $= \frac{100000}{828570} \times 100 = 12.06$ or 12% approx.

It can be easily understood by all of you that with increase in debt, the total market value of the company increases and overall cost of capital decreases.

In the next E-Content I will discuss another theory, Net operating Income Approach.

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