

## Week 8 discussion 2

Capital structure is the manner in which a firm's assets are financed; that is, the right-hand side of the balance sheet. Capital structure is normally expressed as the percentage of each type of capital used by the firm--debt, preferred stock, and common equity.

Generally, the capital structure theories have the following assumptions:

1. There are no corporate taxes (this assumption has been removed later).
2. The firms use only 2 sources of financing namely perpetual debts and equity shares
3. The firms pay 100% of the earnings as dividend. This means that the dividend pay-out ratio is 100% and there are no earnings that are retained by the firms.
4. The total assets are given which do not change and the investment decisions are assumed to be constant.
5. Business risk is constant over time and it is assumed that it is independent of the capital structure.
6. The firm has a perpetual life.
7. The firm's earnings before interest and taxes are not expected to grow.
8. The firm's total financing remains constant. The firm's degree of leverage can be altered either by selling shares and to retire the debt using the proceeds or by raising more debt and reduce the equity financing.
9. All the investors are assumed to have the same subjective probability distribution of the future expected operating profits for a given firm.

There are 4 basic Capital Structure theories:

1. Net Income Approach- Net Income theory was introduced by David Durand. According to this approach, the capital structure decision is relevant to the valuation of the firm. This means that a change in the financial leverage will automatically lead to a corresponding change in the overall cost of capital as well as the total value of the firm. According to NI approach, if the financial leverage increases, the weighted average cost of capital decreases and the value of the firm and the market price of the equity shares increases. Similarly, if the financial leverage decreases, the weighted

average cost of capital increases and the value of the firm and the market price of the equity shares decreases.

2. Net Operating Income Approach- Net Operating Income Approach was also suggested by Durand. This approach is of the opposite view of Net Income approach. This approach suggests that the capital structure decision of a firm is irrelevant and that any change in the leverage or debt will not result in a change in the total value of the firm as well as the market price of its shares. This approach also says that the overall cost of capital is independent of the degree of leverage.

3. Modigliani-Miller (MM) Approach- Modigliani Millar approach, popularly known as the MM approach is similar to the Net operating income approach. The MM approach favors the Net operating income approach and agrees with the fact that the cost of capital is independent of the degree of leverage and at any mix of debt-equity proportions. The significance of this MM approach is that it provides operational or behavioral justification for constant cost of capital at any degree of leverage. Whereas, the net operating income approach does not provide operational justification for independence of the company's cost of capital.

4. Traditional Approach-Traditional approach stands in the midway between these two theories. This Traditional theory was advocated by financial experts Ezra Solomon and Fred Weston. According to this theory a proper and right combination of debt and equity will always lead to market value enhancement of the firm. This approach accepts that the equity shareholders perceive financial risk and expect premiums for the risks undertaken. This theory also states that after a level of debt in the capital structure, the cost of equity capital increases.

Capital structure theory provides some insights into the value of debt versus equity financing. Modern capital structure theory began in 1958, when Modigliani and Miller proved, under a very restrictive set of assumptions, that a firm's value is unaffected by its capital structure.

MM's work marked the beginning of capital structure research, and subsequent research has focused on relaxing the MM assumptions in order to develop a more realistic theory of capital structure.

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