ARTICLE 3: TARGET CAPITAL STRUCTURE

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Target capital structure.

Capital structure is concern with the ratio debt finance in a company's overall financing mix. A company seeking to reach a decision on the mix of financing should consider the following two main issues.

1. The impact capital structure has on shareholder value and
2. The optimal target capital structure for the company

Modigliani and Miller were the first to analyses the theoretical views of the capital structure in the1960s but their conclusion was indeterminable. An alternative theory was developed 'behavioural' or 'managerial' theories of the capital structure/ decision i.e. the **trade-off theory** and the '**pecking order**' theory

1. Trade-off Theory

Trade-off theory of capital structure means offsetting the costs of debt against the benefits of debt. This capital structure will have an impact on the shareholder value. Therefore, companies should identify and maintain the capital structure that is optimal for any particular condition. Meaning that, capital structure will differ from company to company.

Advantages of trade-off theory

i. Cost of debt is lower than the cost of equity

ii. Tax relief on interest payment on the debt finance, means that company can reduce the borrowing cost by the tax rate. For example, interest rate on a £50m loan is 8% and the tax rate 20%. because of the tax relief the company can claim, the net interest the company will pay 6.4% i.e [8% x (1- 0.20)]. this is because interest expense is a "chargeable expense".

iii. Debt is a lower cost source of capital than equity because of risk. Lenders are exposed to a lower risk of default than are equity investors, because of the 'prior charge' nature of interest and debt capital repayment liabilities, and so lenders are willing to take a lower rate of return on their investments than are equity investors.

iv. The greater the level of debt financing, the greater become these two advantages.

Disadvantages of trade-off theory

i. The risk exposure of equity investors - interest payment are paid before corporation tax. Meanwhile, dividend is paid from the reserve after corporation tax. The risk of default on dividend payment to investors are higher as the level of debt finance increase, therefore increasing financial risk.

The risk relates to the company's ability to pay equity investors the amount of dividends expected, since interest liabilities have to be paid, and the risk that shareholder value may be lost if the company's assets have to be sold in order to repay debt capital, if the company defaults on its interest liabilities.

The level of financial risk will certainly increase as the amount of debt financing increases and so the cost of equity capital will rise as a result. It is not that the cost of equity is higher than the cost of debt, but that the cost of equity rises as the level of debt financing increases.

ii. As the company increases its use of debt financing, lenders will also face their own financial risk, as different lenders accept different levels of lending security with the concepts of senior bond holders and subordinated bond holders as well as secured and unsecured lenders and fixed and floating charge lenders. As the level of debt financing increases, the cost of equity capital and the cost of debt will also rises.

The trade-off theory holds that the optimal capital structure for any particular company is that debt-equity financing mix which maximises the net advantages of debt financing and so maximises the beneficial impact of debt financing on shareholder value.

The optimal point in the capital structure mix is not achieved through managerial experience and judgement or following the financial mix decisions of competitors, either is it by increasing gearing gradually over time. This is achieved by continuously increasing gearing until the point is reached where WACC start to rise from a falling WACC. It is at this point where the capital structure minimises the WACC and so maximises the benefit to shareholder value.

2. **Pecking Order Theory**

This theory explains why a spectrum of capital structures are actually observed in practice, from all-equity financed companies to very highly geared companies.

The financing ranking under this theory is as follows:

I. Retained earnings
II. Debt finance
III. Equity finance

The theory states that companies and CFOs prefer to finance first with internally generated cash flow (retained earnings), and only when this provides insufficient funds to satisfy the company's financing requirements does the company start to issue debt.

Where all the issued debt capacity still provides insufficient finance for the company's needs, only then will additional equity be raised either through a rights issue or a placing – as a financing 'last resort'.

The pecking order theory states that the company's internally generated cash flow is the preferred financing choice because the cash is immediately available and have no issue costs and managers do not have to justify their decision making to anyone. If these funds are insufficient for the company's capital needs, then the company will start to use debt financing.

Debt financing has issuing costs are low and can be issued quicker. As long as the company have adequate security, lenders will have little concern about the intended use for the funds. it is only when the company has utilised all internally generated free cash flow and has used all means of raising additional debt capital, will the management consider equity financing.

Equity financing comes last on the pecking order theory because it has higher issue costs, the capital raising process is relatively lengthy and the management will need to justify their investment plans to potential investors. Using equity financing may give out incorrect signals to investors and therefore have an adverse impact on the company's share price in the stock market.

Pike, Neale and Linsley makes the point that often investors believe that management dislike issuing shares when they judge that the share price is low, (to the extent that the shares are undervalued), as new shares would be seen as being sold off too cheaply, and only like to issue new shares when they judge that the share price is overvalued.

When a company's management make an issue of new equity, this may be interpreted as signalling that the management believe that the company's shares are currently overvalued. In such circumstances investors might start to sell their shares and this selling pressure cause the share price to fall. Therefore to avoid this potential scenario, the pecking order theory holds that management will only issue new equity as a source of finance, as a 'last resort' in order to avoid giving an undesirable signal to investors (UoL).

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