CHAPTER II
SIGNIFICANCE OF CAPITAL STRUCTURE, LEVERAGE AND DIVIDEND POLICY
## CHAPTER –II

**SIGNIFICANCE OF CAPITAL STRUCTURE, LEVERAGE AND DIVIDEND POLICY**

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.1</td>
<td>CAPITAL STRUCTURE MEANING AND SCOPE</td>
<td>16</td>
</tr>
<tr>
<td>2.2</td>
<td>SIGNIFICANCE OF CAPITAL STRUCTURE</td>
<td>17</td>
</tr>
<tr>
<td>2.3</td>
<td>OPTIMUM CAPITAL STRUCTURE</td>
<td>17</td>
</tr>
<tr>
<td>2.4</td>
<td>RATIOS FOR ANALYZING THE STRUCTURE</td>
<td>19</td>
</tr>
<tr>
<td>2.5</td>
<td>LEVERAGE MEANING AND SCOPE</td>
<td>22</td>
</tr>
<tr>
<td>2.6</td>
<td>SIGNIFICANCE OF LEVERAGES</td>
<td>25</td>
</tr>
<tr>
<td>2.7</td>
<td>DIVIDEND POLICY MEANING AND SCOPE</td>
<td>26</td>
</tr>
<tr>
<td>2.8</td>
<td>SIGNIFICANCE OF DIVIDEND POLICY</td>
<td>27</td>
</tr>
<tr>
<td>2.9</td>
<td>RATIOS FOR ANALYZING THE DIVIDEND POLICY</td>
<td>28</td>
</tr>
<tr>
<td>2.10</td>
<td>SCOPE OF THE CAPITAL STRUCTURE, LEVERAGE AND DIVIDEND POLICY</td>
<td>28</td>
</tr>
<tr>
<td>2.11</td>
<td>FACTORS AFFECTING CAPITAL STRUCTURE, LEVERAGE AND DIVIDEND POLICY</td>
<td>29</td>
</tr>
</tbody>
</table>
CHAPTER -II

SIGNIFICANCE OF CAPITAL STRUCTURE, LEVERAGE AND DIVIDEND POLICY

2.1 CAPITAL STRUCTURE MEANING AND SCOPE:

   Capital structure is an appropriate mixture of own capital and loan capital as per the tastes of the concerns. A company should plan its capital structure to get maximum advantage.

   The term capital structure differs from financial structure. Capital structure is the permanent financing of the company represented primarily by the long-term debt and shareholders' funds but excluding all short-term credits. Thus, a company's capital structure is only a part of its financial structure.

   According to Gerstenberg, "Capital structure refers to 'the make-up of a firm's capitalization". In other words, it represents the mix of different sources of long-term funds (such as equity shares, preference shares, long-term loans or debts like debentures or bonds, retained earnings, etc.) in the total capitalization of the company.

CAPITAL STRUCTURE DECISION:

   Capital structure is used to represent the proportionate relationship between debt and equity. It is a significant decision as it influences the risk and return of shareholders.

   Capital structure decision also affects the dividend policy of the firm. Because the dividend policy determines what proportion of earnings will be paid-out to shareholders and what proportion will be retained in the business.
2.2 SIGNIFICANCE OF CAPITAL STRUCTURE:

The finance manager should plan the optimal capital structure using leverages. Because the aim of capital structure decision is to increase the profits and market value of the firm with the given funds.

Dr. R. N. Misra and Chinmoy sahu have studied the Indian industries about the debt-equity mix of the company. They have studied the importance of capital structure of Indian companies.

They have intended to find that level of debt which would maximize value of their respective firms. The significant assumption being that Indian industries strive to maximize the wealth of the share holders, which is the ultimate objective of corporate finance.¹

The performance of a firm gets reflected in its valuation by the capital market. The success depends on the desires of the managements and the share holders of the company.

2.3 OPTIMUM CAPITAL STRUCTURE:

A firm should try to have an optimum capital structure to maintain financial stability. It can be reached when market value per share is the maximum.

It may be defined as that relationship of debt and equity securities which maximize the value of company's share in stock exchanges. At optimum capital structure the average cost of capital is the minimum.

Determination of the optimum capital structure:

At optimum capital structure, the value of an equity share is the maximum while the average cost of capital is the minimum. The value of an equity share mainly depends on earning per share. Each rupee of extra borrowing pushes up the earnings per equity share which in turn pushes up the market value of the share. However each extra rupee of borrowings increases the risk and therefore in spite of increase in the earning per equity share, the market value of the equity share may fall due to various reasons.

It is almost impossible to precisely measure the fall in the market value of an equity share on account of increase in risk due to high debt content. Thus, it is not possible to find out the exact debt-equity mix where the capital structure would be optimum. Of course, a range can be determined on the basis of empirical study within which if the company maintains its debt-equity mix, the investors will not discount its shares.

For example:

A company belongs to an industry where the average debt-equity ratio is of 1:1. Empirical studies disclosed that the investors do not discount the value of the company’s shares so long as debt-equity ratio remains within 40% of the industry’s average, i.e., between 0.6:1 and 1.4:1.

In order to have the maximum tax advantage on the interest payable, the company may maintain debt-equity ratio near the top of the range keeping in view the other factors such as profitability, solvency, flexibility, control, etc.
The capital structure so arrived at may not be the optimum but would be the most reasonable under certain circumstances.

The following considerations will greatly help a finance manager in achieving his goal of optimum capital structure:

(i) He should take advantage of favourable financial leverage. In other words, if the ROI is higher than the fixed cost of funds, he may prefer raising funds having a fixed cost to increase the return to equity shareholders.

(ii) He should take advantage of the leverage offered by the corporate taxes. A high corporate income tax also provides some form of leverage with respect to capital structure management. The higher cost of equity financing can be avoided by use of debt which in effect provides a form of income tax leverage to the equity shareholders.

(iii) He should avoid a perceived high risk capital structure. This is because if the equity shareholders perceive an excessive amount of debt in the capital structure of the company, the price of the equity shares will drop.

2.4 RATIOS FOR ANALYZING THE STRUCTURE:

The following ratios are used to analyze the capital structure of a company:

1. Equity Capital Ratio = \( \frac{\text{Equity capital} + \text{Reserves and surplus}}{\text{Net worth} + \text{Debentures}} \) \times 100

2. Preference Share Capital Ratio = \( \frac{\text{Preference share capital}}{\text{Net worth} + \text{Debentures}} \) \times 100
3. Debenture Capital Ratio

\[
\text{Debentures} \times 100
\]
\[
\text{Net worth} + \text{Debentures}
\]

4. D/E ratio

\[
\frac{\text{Total debt}}{\text{Networth}} \times 100
\]

5. Interest Coverage ratio (No. of Times)

\[
\frac{\text{EBIT}}{\text{Interest}} \times 100
\]

The capital structure decision process

The process of the capital structure decision is shown in the form of chart. This flow chart explains the capital structure decision and its related area.

Capital structure decision process first starts with the capital expenditure decision. In this, we decide the most profitable machineries or project to be purchased or undertaken. In the second stage, the funds required to be raised for meeting the capital expenditure are planned in this stage.

In the third stage, debt-equity mix is decided to finance the project or purchase of machinery by giving due weightage to,

(i) Existing capital structure and debt-equity mix.

(ii) Desired debt-equity mix.

(iii) Dividend pay-out policies.

(iv) In deciding the debt-equity mix risk return trade-off are evaluated and then the optimum capital structure is decided so as to increase the value of the firm.

Optimum capital structure is in empirical analysis and it differs from firm to firm.
Chart No.2.1

The capital structure decision process

- Capital Budgeting Decisions
- Need to Raise Funds
- Capital Structure Decision
  - Existing Capital Structure
  - Desired Debt-Equity Mix
  - Payout Policy
- Effect on Return
- Effect on Risk
- Effects on Cost of Capital
- Value of the Firm
- Optimum Capital Structure

Courtesy: I. M. Pandey – Financial Management
2.5 LEVERAGE MEANING AND SCOPE:

The dictionary meaning of the term leverage refers to 'an increased means of accomplishing some purpose'. But in the area of finance, the term leverage has a special meaning. It is used to describe the firm's ability to use fixed cost assets or funds to magnify the return to its owners.

James Horne has defined leverage as 'the employment of an asset of funds for which the firm pays a fixed cost or fixed return'. Thus according to him, leverage results as a result of the firm employing an asset or source of funds, which has a fixed cost or return. The former may be termed as 'fixed operating cost', while the latter may be termed as 'fixed financial cost'.

There are basically **two types** of leverages:

- Operating leverage and financial leverage. The combined effect of the same can be arrived from the combined leverage. Leverages analyze the effects of debt-equity mix on the shareholders' earnings and risk.

2.5.1 OPERATING LEVERAGE:

The operating leverage may be defined as the tendency of the operating profit to vary disproportionately with sales. It is said to exist when a firm has to pay fixed cost regardless of volume of output or sales. This leverage depends on the ratio of fixed operating cost to total operating cost. It is closely related with BUSINESS RISK.

The operating leverage can be calculated by the following formula:

\[
\text{Operating Leverage} = \frac{\text{Contribution (C)}}{\text{Operating Profit (EBIT)}}
\]
Operating profit here means Earning before interest and Tax (EBIT).

**Degree of operating leverage:**

The degree of operating leverage may be defined as percentage change in the profits resulting from a percentage change in the sales.

\[
\text{Degree of Operating Leverage} = \frac{\text{Percentage Change in Profits}}{\text{Percentage Change in Sales}}
\]

**Utility:**

The operating leverage indicates the impact of change in sales on operating income. If a firm has a high degree of operating leverage, small changes in sales will have large effects on operating income. The operating profit of such a firm will suffer a greater loss as compared to reduction in its sales.

**2.5.2 FINANCIAL LEVERAGE.**

The use of the fixed-charges sources of funds, such as debt and preference capital along with the owners' equity in the capital structure, is described as financial leverage or gearing or trading on equity. It refers to the mix of debt and equity in the capitalization of firm. It is closely related to FINANCIAL RISKS.

The Financial leverage can be calculated by the following formula:

\[
\text{Financial leverage} = \frac{\text{Operating Profit (EBIT)}}{\text{Profit before tax (PBT)}}
\]
Degree of Financial Leverage:

Degree of financial leverage may be defined as the percentage change in 'taxable profit' as a result of percentage change in 'operating profit'.

\[
\text{Degree of Financial Leverage (DFL)} = \frac{\text{Percentage Change in Taxable Income}}{\text{Percentage Change in the Operating income}}
\]

Utility:

Financial leverage helps considerably the financial manager while devising the capital structure of the company. A high financial leverage means high fixed financial costs and high financial risk. A financial manager must plan the capital structure in a way that the firm is in a position to meet its fixed financial costs. Increase in fixed financial costs requires necessary increase in EBIT level.

2.5.3 COMBINED LEVERAGE:

Operating leverage explains the degree of operating risk. Financial leverage explains the degree of financial risk. If both the leverages are combined, the result obtained will disclose the effect of change in sales over change in taxable profit (or EPS).

Composite leverage thus expresses the relationship between revenue on account of sales and the taxable income.
Combined leverage = Operative leverage \times \text{Financial leverage}

\[ C = \frac{\text{C}}{\text{PBT}} \]

Where:

\( C = \text{Contribution} \)

\( \text{PBT} = \text{Profit before Tax but after Interest} \)

2.6 SIGNIFICANCE OF LEVERAGES:

The operating leverage and the financial leverage are the two quantitative tools used by the financial experts to measure the return to the owners and the market price of the equity shares. The financial leverage is considered to be superior of these two tools, since it focuses the attention on the market price of the shares which the management always tries to increase by increasing the net worth of the firm.

It may be noted that a right combination of these leverages is a very big challenge for the management. A proper combination of both operating and financial leverages is a blessing for the firm's growth while an improper combination may prove to be a curse.

A high degree of operating leverage together with a high degree of financial leverage makes the position of the firm very risky. This is because on the one hand it is employing excessively assets for which it has to pay fixed costs and at the same time it is also using a large amount of debt capital.
Ideal situation:

Low operating leverage and a high financial leverage is considered to be an ideal situation for the maximization of the profits with minimum of risk.

2.7 DIVIDEND POLICY MEANING AND SCOPE:

The term dividend refers to that part of the profits of a company which is distributed amongst its shareholders. It may, therefore, be defined as the return that a shareholder gets from the company, out of its profits, on his shareholdings.

Any distribution of accumulated profits whether capitalized or not, if such distribution entails a release of the assets or part thereof. Dividends are generally paid in cash.

According to the Institute of Chartered Accountants of India, Dividend is “a distribution to shareholders out of profits or reserves available for this purpose.”

Dividend policy:

The term dividend policy refers to the policy concerning quantum of profits to be distributed as dividend. The concept of dividend policy implies that companies through their Board of Directors evolve a pattern of dividend payments which has a bearing on future action. Of course, in practice many companies do not have a dividend policy in this sense. They rather take each dividend decision independent of every other such decision.
Dividend decision:

The dividend decision of the firm is of crucial importance for the financial manager since it determines the amount of profit to be distributed among shareholders and the amount of profit to be retained in the business for financing its long-term growth. While taking dividend decision, the management will obviously take into account the effect of the decision on the maximization of shareholders’ wealth.

2.8 SIGNIFICANCE OF DIVIDEND POLICY:

Dividend decision should depend on whether the company or the shareholders can make profitable use of funds. The finance manager can use it to maximize the wealth of the equity shareholders.

Bhat and Pandey conducted a survey to show the significance of dividend policy in order to ascertain the perceptions of Indian managers about dividend decisions. The top five determinants of dividend policy, according to the Indian managers are: ²

(i) Current earnings,
(ii) Pattern of past dividends,
(iii) Expected future earnings,
(iv) Increasing equity base,
(v) Liquidity.

---
The firm will have a given amount of cash available for paying dividends given its investment and financing decision. Thus, a dividend decision involves a trade-off between the retained earnings and issuing new shares. This will affect the value of the firm.

2.9 DIVIDEND ANALYSIS RATIOS:

The impact of dividend policy is mostly reflected on the MPS. However the following ratios are employed to know the dividend per share and the dividend payout.

1. Dividend per share:

\[
\text{Dividend per share} = \frac{\text{Earnings paid to shareholders (dividends)}}{\text{Number of equity shares}}
\]

2. Dividend payout ratio:

\[
\text{Payout ratio} = \frac{\text{Dividends per share}}{\text{Earnings per share}}
\]

2.10. SCOPE OF THE CAPITAL STRUCTURE, LEVERAGE AND DIVIDEND POLICY:

There are problems in measuring the financial performance by using conventional methods. There is no proper bench mark for comparing the performances. Most of the times, the bench mark used in the industry average or the nearest
competitor performance but the fact that the industry average or the competitor's performance may be below what is by the investors is ignored so a company may be earning returns better than the others in industry but it might not meet the shareholders minimum expectations.

The capital structure and its impact on the leverage dividend policy are used to measure the financial performance of the company. Optimum capital structure maximizes the market value of the firm. Leverage lifts the company's profit to the high level from the given input of the capital. A high payment of the dividends increases the value of the shares. Objective of the capital structure, leverage and dividend policy to understand with business unit best utilize their debt and equity to generate return and maximize shareholder value.

2.11. FACTORS AFFECTING CAPITAL STRUCTURE, LEVERAGE AND DIVIDEND POLICY:

2.11.1. Factors affecting capital structure:

The capital structure of the company is to be determined initially at the time the company is floated. Great caution is required at this stage. Since, it is not possible to have an ideal capital structure but the management should get a target capital structure and the initial capital structure should be framed and subsequent changes in the capital structure should be done keeping in view of the target capital structure.
Following are the factors which should be kept in view while determining the capital structure of a company.

1. Trading on equity:

A company may raise funds either by issue of shares or debentures. In case return on the total capital employed is more than the debenture interest rate or rate of preference dividend it is said that the company is trading on equity.

2. Retaining Control:

If the company issue new shares there is a risk of loss of control. Due to the fear of loss of control, closely held companies go in for debt or issue preference shares when they require additional funds.

3. Nature of enterprises:

Business enterprises which have stability in their earnings or which enjoy monopoly may go in for debentures as they have adequate profits to meet the fixed charges. Companies which do not have this advantage should rely on equity capital.

4. Size of firm:

Large Companies are in a better position to raise funds by using different types of securities as investors consider them less risky rather than small companies.
5. Flexibility:

Flexibility means the firm's ability to adapt its capital structure to the needs of changing conditions. A considerable degree of flexibility will be introduced in a company's capital structure if it has the right to redeem preference shares and debenture at its discretion.

6. Purpose of financing:

If funds are required for a productive purpose, debt financing is suitable. If funds are required for unproductive purpose equity capital should be preferred.

7. Period of finance:

If funds are required for a limited period then debentures and preference shares should be preferred to equity shares. However, if funds are required more or less permanently it will be appropriate to issue equity shares for raising finance.

8. Market sentiments:

There are periods when people want to have absolute safety. Under such circumstance, funds should be raised by issuing debentures. At other periods they may be interested in speculative incomes. At such times it will be appropriate to issue equity shares.
9. Requirements of investors:

Investors are generally classified under three heads:

(a) Bold investors.
(b) Cautious investors.
(c) Less cautious investors.

The capital structure of the company is also determined by the desires of the investors of the company.

10. Floatation costs:

They are incurred only when the funds are externally raised. The cost of floating a debt is less than the cost of floating an equity issue.

11. Corporate tax rate:

High rate of corporate tax on profits compel the companies to go for debt financing, as debentures interest is an allowable expenditure while computing taxable profits.

12. Legal requirements:

The guidelines issued by our government form time to time regarding issue of shares and debentures is another factor which influences the capital structure of the company.

2.11.2. FACTORS AFFECTING LEVERAGES:

The following factors would affect the leverages.

1. The amount of fixed costs.
2. The contribution margin.
3. The volume of sales.
2.11.3. FACTORS AFFECTING DIVIDEND POLICY

There is a controversy amongst financial analysts regarding impact of dividend on market price of a company’s shares. Some argue that dividends do not have any impact on such price while others hold a different opinion. However, preponderance of evidence suggests that dividend policies do have a significant effect on the value of the firm’s equity shares on the stock exchange. Having accepted this promise, it will now be appropriate to consider those factors which affect the dividend policy of a firm.

Generally the following factors are to be considered while framing the dividend policy:

1. Legal restrictions imposed by the govt. in issuing dividends should be considered.
2. Restrictions by Financial Institutions should also be considered.
3. The amount distribution of dividend depends on the discretion of directors.
4. The amount of distribution depends on the Investment opportunities and Need for expansion
5. Cost of acquiring the Capital for the use in business should also be considered. If the cost of acquiring the capital from outside is greater then it is better to issue lesser dividend.
6. The amount of distribution depends on the management’s Objectives and its attitude.
7. The amount of distribution depends on the liquidity and financial solvency of the concern.
8. Tax on Dividend Should be considered as it may be a burden for the company to pay greater or lesser tax to the govt.

9. Companies following the regular or stable dividend policy and also irregular dividend policy should properly calculate the amount of dividend distribution.

10. The amount of distribution depends on the preference of shareholders to have long term capital gains or Shorterm dividend income.

11. The amount of distribution depends on the accumulated profits, current earnings and estimation of future earnings.

12. Nature of Business and business cycle also considered for the amount of distribution dividend.

13. The Amount of distribution depends on the conventions and customs prevailing.

14. The amount of distribution depends on the contingencies. Contingency means happening or non happening of an event.

15. The amount of distribution depends on the general state of the economy.

16. The amount of distribution depends on the position of capital market and access to capital market for external financing.

17. The amount of distribution depends on the age and growth rate of growth rate of the firm.

18. The amount of distribution depends on the repayment schedule of debt and debentures.

19. The amount of distribution depends on the ownership of the firm i.e., closely held or widely held.