Theories of capital structure

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1.Net Income Approach

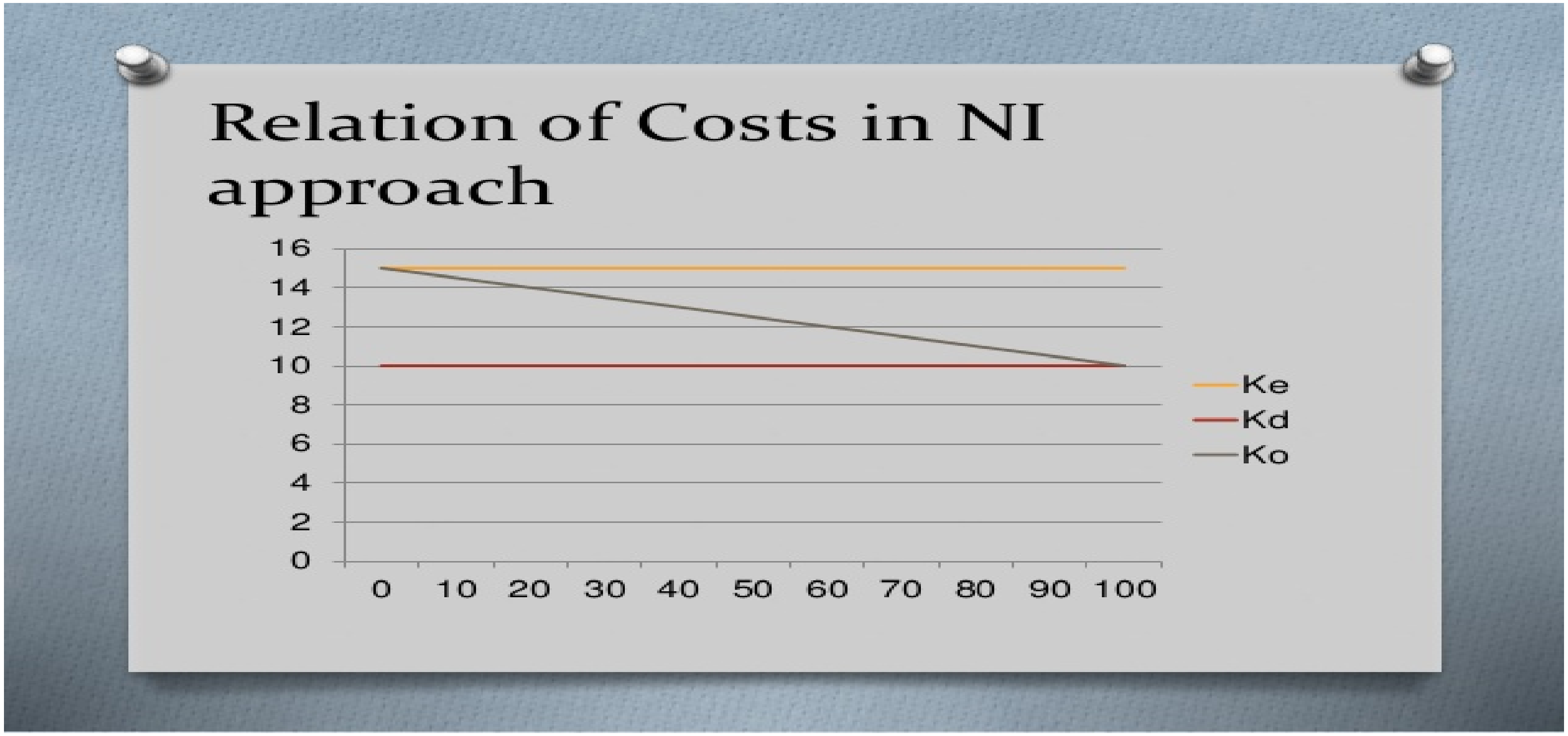
Assumptions to NI approach

- Ke and kd are constant
- Overall cost of capital (ko) > cost of equity (ke) > cost of debt (kd)
- No taxes
- Perception of risk does not change with use of debt

Explanation

Net income approach

- as per this approach average cost of capital can be minimised and value of firm can be increased by using debt to maximum possible extent



2.Net Operating Income Approach

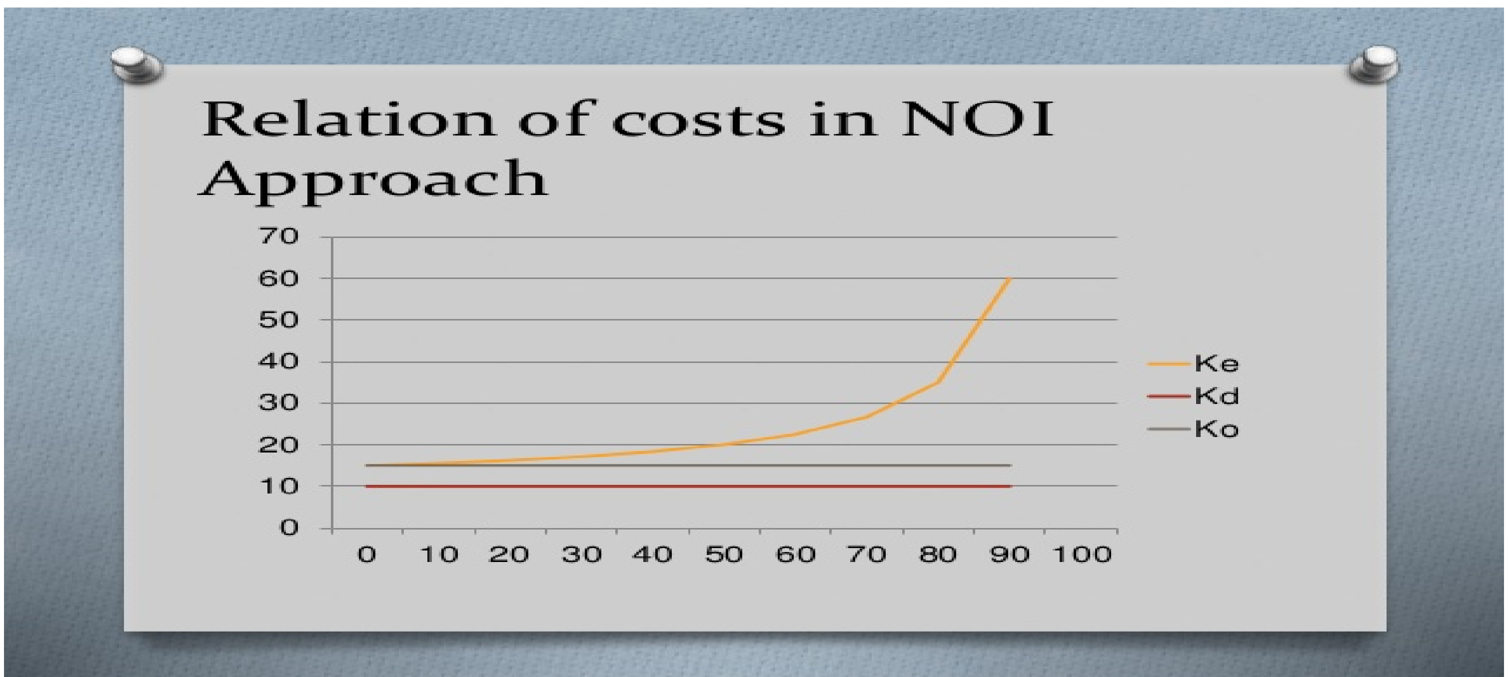
Suggested by Durand

<u>Assumptions</u>

- Value of firm is capitalised on the whole
- No taxes
- Ko remains constant
- Business risk remain constant
- Ke increases due to increase in leverage causing increase in risk

Explanation

- As per this approach any change in the capital structure of the firm will not affect the value of the firm.
- Increase in dept proportion will increase the cost of equity and overall cost of the firm remains contstant



3.MM Approach

Assumptions of MM Approach

- No Taxes
- Perfect Markets
- Dividend payout ratio is 100%
- Investors are purely rational
- Investors are well informed and behave rationally
- Investors free to buy and sell securities
- No Transaction Costs
- Identical expected earnings from all firms.
- Homogeneous risk environment for all the companies

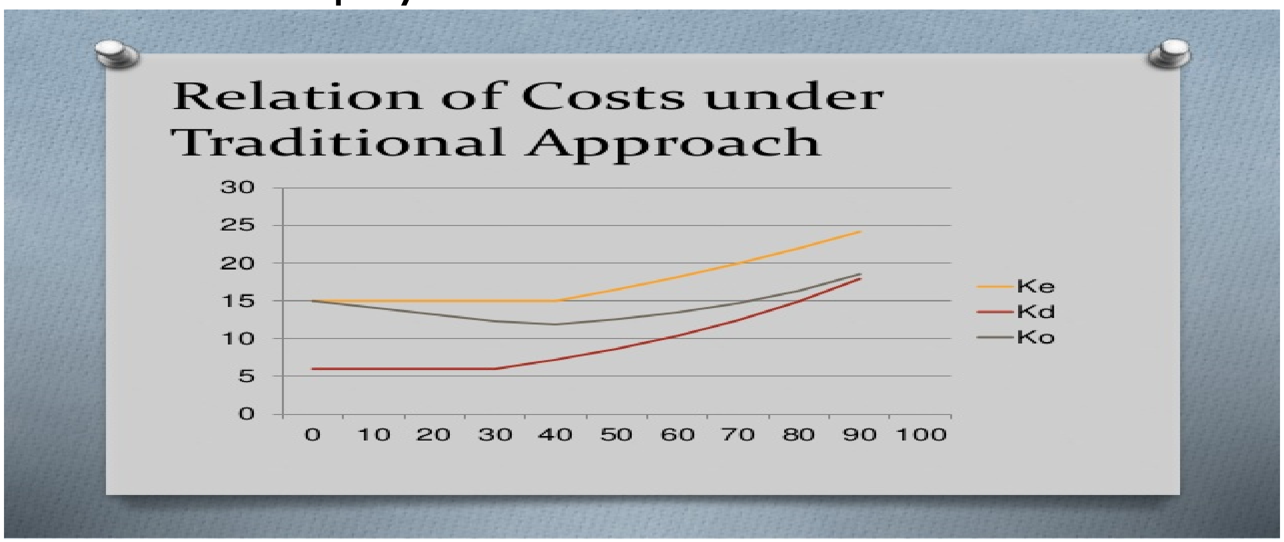
Explanation

- Theory says cost of capital(Ko) is not affected by the change in the capital structure because cost of debt(Kd) are cheaperthan equity cost(Ke)and with the more use of debt, Ke increases. Increase in Ke offset the benifit of low cost of debt.

4. Traditional Approach

It is an mid way approach of NI and NOI approach.

As per this approach cost of capital Ko will decrease as the use of debt increases in capital structure, but after a point the it will start rising and overall cost of capital will also start rising. The benefit of low cost debt will the balanced with increased cost of equity.



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THANKYOU