CAPITAL STRUCTURE

Overview

- A company raises funds in debt (bond) and equity (stock) financial markets to finance its business.
- Investors have different risk preferences and companies have investments of varying risk.
- Riskier firms end up paying higher returns or yields on debt securities and are expected to pay a higher rate of return on their equity, thereby raising their average cost of capital.

Benefits of debt (borrowed money)

- ***Financial leverage*** *(i.e., use of debt)* – allows the borrower (i.e., the business) to use lender's money at a fixed rate which can result in higher rates of return.
- Borrowed money is cheaper than equity money. Since interest income is fixed, the borrower is happy with a lower rate when compared to equity investment.
- Interest payments on debt securities are tax deductible expense. Therefore, a firm's tax payments go down if the firm borrows money.
- Borrowing means the company will have fewer ownership shares outstanding. Hence, earnings per share (EPS) will increase.

Drawbacks of borrowed money

- Too much borrowed money or debt makes the company financially risky; the probability of bankruptcy increases with borrowing. The company's ratings fall when it borrows too much money.
- Borrowing results in too many restrictions placed by the lenders, which can hurt the firm.

Pecking Order of Financing a Business

The pecking order hypothesis is based on the notion that firms have a preferred order of raising capital. Accordingly, it states that:

1. Firms prefer internal financing (retained earnings) first, to avoid paying out of pocket fees for new (external) securities to the investment bankers.
   (Note: An investment banker (e.g., Goldman Sachs) helps raise new securities)
2. If external financing is required, firms will choose to issue the cheapest security first, starting with debt financing (because borrowed money is cheaper than equity money and provides tax benefits) and using equity as a last resort.