Welcome students.

Course title is financial management.

Title of the unit capital

structure decisions.

Module name capital structure theories.

Outline theories of capital structure.

Under that net income theory,

net operating income theory and

traditional theory learning outcomes.

On completion of the module,

students will be able to state theories of

capital structure that is net income theory,

net operating income theory,

and traditional theory.

Let us see the First

Capital structure theory.

First one is net income approach.

Now there are some

assumptions for this theory.

The first one is no corporate taxes

the company adds for this assumption

as per the net income approach,

there are no taxes that

the company has to pay.

According to this approach.

Secondly,

only two sources of finance

are used by the company,

that is equity and that there are no

other sources of finance which are

used like preferential capital etc.

So only two sources of finances are used,

that is equity and debt.

Thirdly,

dead content does not change the

risk perception of the investors.

So in the capital structure,

even if you are having more

of debt or less of equity or

less of equity or more of that,

it is not going to change the

risk perception of the investors.

4th cost of debt is always

lower than the cost of equity,

so under the net income approach

it is an assumption that costs

of debt is always going to be

lower than the cost of equity.

Now let us see what does this

net income approach say.

According to this approach,

there is a definite relationship

between capital structure

and the value of the form.

The capital structure of the form

influences its cost of capital

that is weighted average cost

of capital and thus directly

affects the value of the firm.

Which means that in the capital

structure your how much content

of debt or how much content

of equity you are having.

That is going to influence

the cost of capital.

So what kind of capital structure

the firm has it is directly going

to influence the cost of capital

or the weighted average cost of

capital and therefore it is directly

going to affect the value of the

form higher debt content in capital

structure will result in the decline

in weighted average cost of capital

which will cause increase in the

value of equity shares of the.

Company,

which means that.

If you're having a higher debt

contend in the capital structure,

how it is going to decline the

weighted average cost of capital

since according to our assumptions,

they are saying that cost of

debt is always going to be lower

than the cost of equity.

That's why even if you're having a higher

debt content in the capital structure,

it will still result and decline in

the weighted average cost of capital.

So if you're having a lower

weighted average cost of capital

or lower cost of capital.

It will definitely increase the

value of the equity shares.

And therefore it will increase

the value of the company.

So the main essence of this approach

is that there is a definite

relationship between capital

structure and value of the firm.

According to NI approach,

value of the form is calculated as market

value of equity plus market value of debt.

And under that,

the market value of equity is

calculated as earnings available

to the equity shareholders

divided by cost of equity,

that is key.

Now this is the second approach that

is net operating income approach.

Now also for this approach

there are different assumptions.

The first assumption is that weighted

average cost of capital is always constant.

So irrespective of what

is your capital structure.

The weighted average cost of capital

is always going to remain same.

The cost of debt is also constant,

and corporate income taxes do not

exist exist, so there is no tax.

So what is the essence of this

net operating income is that it

is directly opposite of North.

I approach this approach is

opposite of NI approach.

The market value of the form is not

dependent upon its capital structure.

Thus there is no optimal capital structure.

So whatever,

maybe the market or whatever

may be your capital structure.

It is not going to affect

the value of the form.

So there is nothing like a proper

capital structure or the optimum

capital structure which will exist

any any capital structure will be

optimum capital structure since there

is no relationship between value of

the form and the capital structure.

Irrespective of debt,

equity mix or degree of leverage

value of the form remains same.

So what is debt equity?

Mix in a capital structure?

What is the debt content and what is

the equity content that you are having?

It is not going to influence what or it is

not going to change the value of the form.

The value of the form is going to

remain constant irrespective of what

kind of debt equity mix you are having.

Market price of equity share will not change

on account of change in debt equity mix.

So if you are changing

your capital structure,

suppose you're having more of

debt and less of equity or more

of equity and less of debt.

It is not going to change the

market price of the equity share.

The market price is not going

to get influenced because of

the capital structure mix.

Therefore there is nothing

like optimum capital structure.

So why there is no why there is?

Not optimum capital structure because

irrespective of the debt equity mix,

the value of the form is remaining same.

There is no change in the value of the form.

Therefore any any capital structure

that you are using will become

the optimum capital structure.

Any capital structure can be considered

optimum according to this approach.

Now under this approach,

value of the form is calculated

as EBIT divided by K.

Oh,

that is earnings before interest

and tax divided by cost of capital

and market value of equity is

calculated as value of the form

minus the market value of debt.

The third approach is

the traditional approach.

Traditional approaches.

A midway between these two approaches,

so traditional approach is not completely

to the side of North Erie or North Erie,

so it is somewhere in between.

Let us see what this

traditional approach is saying.

Traditional approach confirms the

existence of an optimal capital

structure where weighted average cost of

capital is minimum and value of the form is.

Maximum so according to traditional approach,

it confirms that there is

optimum capital structure.

OK, it is not saying that

according to your theory there

is no optimum capital structure

according to traditional theory,

there is a optimum capital structure

and in this optimum capital structure

we know that weighted average cost of

capital is minimum and the value of

the form is maximum which is called

as the optimum capital structure.

As for this approach,

a best possible mix of debt and equity

will maximize the value of the firm.

So traditional approach believes

that the best combination of of.

The best combination of equity and debt is

going to maximize the value of the form.

So if you are having more of debt or less

of debt or more of equity or less of equity,

the best possible mix of debt and equity that

is going to maximize the value of the form.

A forms value increases to a

certain level of debt capital,

after which it tends to remain constant

and eventually begins to decrease.

If there is too much borrowing.

So what happens is a form value

will increase when you're having

a certain level of debt capital.

How will this happen when

you're having debt capital?

Your interest payments that you have to make

on the debt is going to be lower compared to.

Your cost of equity because for debt

there is always a tax advantage.

So when you're having debt capital,

UR value of the form is going to increase

because your cost is going to decrease.

So after a point when a form keeps

on increasing the debt capital and

decreasing the equity capital.

Eventually,

when you're having maximum of debt capital,

it is going to decrease the

value of your form.

How because more and more of debt capital

is going to increase the interest payments

that you will have to make on the debt.

So that's why up to a certain level,

debt capital is good.

But if you're going to

increase more and more,

then your interest payment will increase

and therefore it will eventually begin to.

Lose the firms value,

decrease in value after the tipping point

happens because of over leveraging over

leveraging means use of more and more debt.

So we are dead when you're using debt

across that point after the point,

after which your interest

payment is going to increase,

then your value is going to decrease.

So up to a certain level only

the debt capital is good.

So a sense of this approach or essence

of traditional approach is that a form

through judicious use of debt equity

mix can increase its total value and

thereby reduce its overall cost of capital.

Since debt is cheaper source of

fund because of the tax advantage.

So what the main essence of this traditional

approach is that the best use of death,

the best combination of debt equity mix.

Can increase the value of the form.

And also it can reduce the cost

of capital only if up to a certain

level the debt is being used.

So if you're if you're using more

of that and then after that tipping

point you're using the dead,

then it is going to decrease the value.

But the best you are using the debt up

to a certain point then it is going

to increase the value of the form.

Now why this happens?

Because debt is a cheaper source

of funds because we are getting a.

Tax advantage on debt.

That's why the cost of debt

is lower. But after a certain point

it becomes higher. So that's why.

Uh, in this approach they are saying that.

The best of that equity mix can

increase the total value of the form.

So let us conclude capital structure

theories can be categorized as

firstly net income approach,

whose essence is that change in

proportion and capital structure will

lead to corresponding change in cost

of capital and value of the form.

Secondly, net operating income approach.

The essence is that no relation between

cost of capital and value of the form

and thirdly the essence of traditional.

Approach is that it is somewhere in midway

and believes that the judicious use of

debt can help increase the value of the

form and reduce the cost of capital.

These are the references.

Thank you.