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CAPITAL STRUCTURE, LEVERAGE AND SOURCES OF DELEVERAGING

Mr. ASHOK VASANT MAHADIK
[M.COM, M.PHIL, PGDFM, PGDBM]
ASST. PROF. AT LALA LAJJPATRAI
COLLEGE MAHALAXMI, MUMBAI

ABSTRACT:

This paper throws light on some of the important concepts of financial management. In this paper I have discussed concepts like capital structure, equity, debt, leverage and different ways of deleveraging.

Capital structure: it means the mix of different sources of funds in the composition of the capital of the company i.e. own fund and borrowed fund. The company as per its assessment of the business environment decides about the debt component in its capital structure.

WHAT ARE THE SOURCES OF FINANCE

1. Own fund Debt

2. Loan / Debt fund

1. **OWN FUND / EQUITY** : Owned Fund' means amount of the paid-up equity capital and free reserves less fictitious assets as shown in the balance sheet of the company.

Equity financing is where owners contribute their own fund

Equity is especially important for all the industries and kinds of businesses, like technology startups and companies with global aspirations etc

Advantages of equity financing

- You don't have to pay interest on the equity capital, so there's no need to put your business's profits into interest and debt repayments.
- With the good investors, you can get great experience, wisdom, industry connections and much more. These relationships can last you a very long time.
- If your project fails, you are not required to pay back investments.

Disadvantages of equity financing

- Hard to find investors for new projects
- You go on making more owners which can result in change of management.

2. LOAN / DEBT FUND: it is the amount of financed by borrowed funds, secured as well as unsecured. Loan or debt is where you borrow money from a bank or lender with a undertaking to pay back along with interest.

Advantages of debt financing

- Ownership remains intact and you don't add new owners.
- Trading on equity gives higher returns to equity share holders
- Debt financing is a highly flexible.

Disadvantages of debt financing

- Fixed interest burden
- Dangerous if low returns from projects.
- Debt may get converted into equity if repayment is not done, and eventually there can be takeover of management.

Which source of fund should be used by the company

For any company own fund is compulsory. So every company has to have own fund then question arises upto what extent debt is advisable..

The obvious answer is as long as the debt fund is able to earn returns more that its committed cost they are desirable.

Factors affecting capital structure

1. Expected return on investments: if company can expect a handsome ROI it should prefer debt over equity and vice versa

2. Period for which funds are needed: if the funds requirement is permanent then company should prefer equity over debt and vice versa

3. DSCR AND ICR: if debt service coverage ratio and interest coverage ratio is well above satisfactory level even after further borrowing the company can take risk of going for debt.

4 Tax rate: if the prevailing tax rates are high then it will reduce cost of debt and it will be advisable to choose debt over equity

5. Different between cost of debt and cost of equity is high and favorable for debt then it will be better that company chooses debt.

6 Floatation cost: before choosing the option the company should consider cost of floatation.

7. Flexibility: if company wishes to maintain flexibility then debt is a better option.

8. Control: if the management is of strong opinion of keeping control with itself then debt is the best option.

	Full equity & no debt / loan 100crores		**Half Equity and 50 crores**	**Half Debt / loan 50 crores**
Return on Investment 20%	20 cr		10 cr	10 cr
- Paid Interest @ 10%	00		00	5 cr
Profit for Equity share holders [PFESH]	20 cr		10 cr = 15 cr	5 cr
Return on Equity PFESH =------------- x 100 Equity Capital	20 ---- x 100 100 = 20%		15 -----x 100 50 =30%	

Outcome of using excessive debt can be beneficial if ROI is high but it will be dangerous if ROI is low.

Illustration:
TOTAL CAPITAL EMPLOYED 200 CRORES
EQUITY 100 CRORES & DEBT 100 CRORES

	ROI 20%	ROI 30%	ROI 10%
Earning before interest & Tax	40 cr	60 cr	20 cr
(-) Interest @ 15% on 100 cr	15 cr	15 cr	15 cr
Earning before Tax	25 cr	45 cr	5 cr
(-) Tax @ 30%	7.5 cr	13.5 cr	1.5 cr
Profit for equity share holders	17.5 cr	31.5 cr	3.5 cr
Profit % to Equity share holders	17.5%	31.5%	3.5 %

So what if the debt fails to earn its reward what is the remedy.... Deleveraging is the remedy.

But before we discuss about Deleveraging we should know what is leverage.

Leverage: It means the advantage gained due to presence of fixed cost in total cost.

The reasoning behind this is that as the level of production goes up the fixed cost per unit goes on decreasing which ultimately leads to reduction in overall average cost.

TYPES OF LEVERAGES

There are basically two types of leverages, but the combination of these two is considered as overall or combined leverage

1. OPERATING LEVERAGE is the advantage gained due to presence of depreciation cost which is a fixed cost, which will lead to reduction in overall cost of production if the level of output reduces.

2. FINANCIAL LEVERAGE is the advantage gained due to presence of interest cost, which is a fixed cost. Which will lead to reduction in overall operating cost.

3. COMBINED LEVERAGE is the advantage gained due to presence of fixed cost, Which will lead to reduction in overall operating cost when output level increases.

Deleverage: In simple words it means reducing the fixed cost elements from the overall cost. This is because in case of low return on investment the interest cost becomes a burden which can sink the ship. So company should reduce its debt burden to reduce the interest cost, as it is not possible to alter depreciation cost.

THE DELEVERAGE CAN TAKE FOLLOWING ROUTES.

1. Redemption of debt by using cash resources

This is one of the best ways of getting rid of excessive debt. But this route can be used only if company has sufficient cash on hand or short term investments.

2. Converting debt into preference shares

This method is useful if company is short of cash resources but is confident about earning sufficient returns over a period to pay dividend and repay preference capital.

3. Converting debt into equity shares : This method is useful if company is short of cash resources and also not confident enough about earning sufficient returns over a period to pay dividend and repay the capital.