ABM 302

Lesson 4: Capitalization & Capital Structure: Concept & Determinants

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CONCEPT OF CAPITALIZATION

- Capitalization refers to the valuation of the total business or the total fund invested in the business.
- According to Guthmami and Dougall, 'Capitalization is the sum of the par value of the outstanding stocks and the bonds'.
- Thus, it includes borrowed funds and owner's funds including surplus earning if any.
- Symbolically:

  Capitalization = Long term Loans + Debentures + Share capital + Retained earnings

  Or,

  Capitalization = Total Assets – Current Liabilities

THEORIES OF CAPITALIZATION

- There are two theories of capitalization:

  (i) Cost theory

  (ii) Earning theory

- **Cost theory:** According to this theory capitalization or the value of firm is arrived by adding:

  (i) Cost of fixed assets,

  (ii) Cost of establishment, and

  (iii) Permanent working capital

- **Earning theory:** According to this theory capitalization or the value of firm depends on the volume of earnings and the fair rate of return or the rate of return of the industry.
- The amount of capitalization is arrived at by following formula:

$$\textbf{Capitalization} = \frac{\text{Estimated Earnings}}{\text{Fair Rate of Return}} \text{ x } 100\text{, or}$$

$$\textbf{Capitalization} = \frac{\text{Average Amount of Profit}}{\text{Fair Rate of Return}} \text{ x } 100$$

- The estimates of earnings and rate of return of the industry (Fair RoR) must be accurate.

  Over and under-estimates of earnings may lead to over and under capitalization.

  Over and under assessment of RoR of the industry may lead to under and over capitalization.

CONCEPT OF CAPITAL STRUCTURE

- Capital structure refers to mix of long-term sources of funds which comprises of borrowed funds and stockholders' investment. Thus, it is the composition of various components of borrowed and owned sources of capital. includes long term debt, debentures, share capital, and reserves & surplus.
- Symbolically:

  Capital structure = Long term debt + Debentures + Preferred stock + Net worth

  Here, Net worth means Equity holder funds (i.e., Equity capital + Reserves & surplus)

Determinants of capital structure

- Nature, size and characteristics of the firm
- Life cycle stage of the firm
- Volume, growth and continuity of sales and earnings
- Interest rates
- Cost of capital
- Tax rates
- Desired degree of flexibility
- Desired degree of control
- Duration of funds requirement
- Investors' preferences and capital market conditions
- Degree of financial leverage
- Availability of funds in money market
- Legal requirements
- Conditions imposed by big financers, Venture Capital Financers, Angle Investors etc.

QUALITIES OF GOOD CAPITAL STRUCTURE

Optimal capital structure consists following qualities.

- Manageable cost of capital
- Manageable degree of risk (adequate financial leverage)
- Adequate flexibility
- Proper control of management
- Maximum return and maximum value of firm
- Simple and easy to understand
- Minimum undue restrictions of lenders and financers
- Safety of investment
- Commensurate to legal requirements

Thank you…