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PERSPECTIVE ARTICLE

EFFECTS OF CAPITAL STRUCTURE ON COST OF CAPITAL AND ITS SECURITY DESIGN

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ABOUT THE STUDY

The "capital structure" is the mix of securities used to supply funds for the firm's physical asset investments. For nearly six decades, academics have attempted to determine why corporations use debt and when debt is superior to equity as a source of financing. The ultimate goal is to comprehend how the use of debt affects the firm's value. This work has provided significant insight into the problem and has resulted in two Nobel Prizes in economics.

Why is all of this important in a book about the fair return? The cost of equity rises in proportion to the risks investors must bear, and the more debt a company uses, the more risk its shareholders bear. Debt is referred to as "leverage" or "gearing" because it magnifies the volatility of the return on equity. In the absence of financial distress, the variability in a firm's performance is borne by its equity. If operating earnings fluctuate by 5% of asset value but equity accounts for only half of the firm, equity earnings fluctuate by 10% of equity value.

This means that estimating the cost of equity from a sample of firms in a particular industry is impossible unless variations in the sample firms' capital structures are explicitly considered. Alternatively, instead of converting the sample's cost of equity values into the value that corresponds to the equity ratio for the company in question, one could simply look at the overall weighted-average cost of capital.

One branch of the capital structure literature considers the impact of taxes on firm value. One reason for using debt is that corporate interest is tax-deductible. This frees up more of the company's operating earnings for investors (bondholders and shareholders combined). Personal income, on the other hand, is typically taxed more heavily than share returns (dividends and capital gains). After all taxes are paid, this leaves less of the firm's operating earnings in the pockets of investors, raising the required pre-personal tax return on debt relative to equity.

A second thread addresses the importance of making timely interest payments, which helps to discipline corporate executives and keeps them from wasting the corporation's money. However, if interest payments become excessively high, the company may face financial difficulties. Financial distress diverts managers' attention away from future needs and opportunities, and it can lead to actions that reduce the firm's value even further.

In another line of thought, the choice of debt versus equity communicates information about the managers' private views of the firm's prospects to outside investors, who are necessarily less well-informed. For example, if management believes the firm's shares are "overpriced," they will prefer to issue equity rather than debt; conversely, if management believes the firm's shares are "underpriced," they will prefer to issue debt.

Moral hazard and adverse selection issues have been investigated in securitization models by focusing on two non-exclusive features of securitization. One has to do with the securitization design. The term design refers to the problems of pooling and tranching. In theory, assets could be sold individually or in portfolios. How should these portfolios look? Once the pool has been chosen, the SPV will purchase it with proceeds from the issuance of securities of varying seniority in the capital markets. These are known as "tranches," and the originator keeps the most junior, equity-based tranche. The second issue is the concept of "implicit recourse," which refers to the originator's potential incentives to support securitizations in which the portfolio's loans do not perform as expected.

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