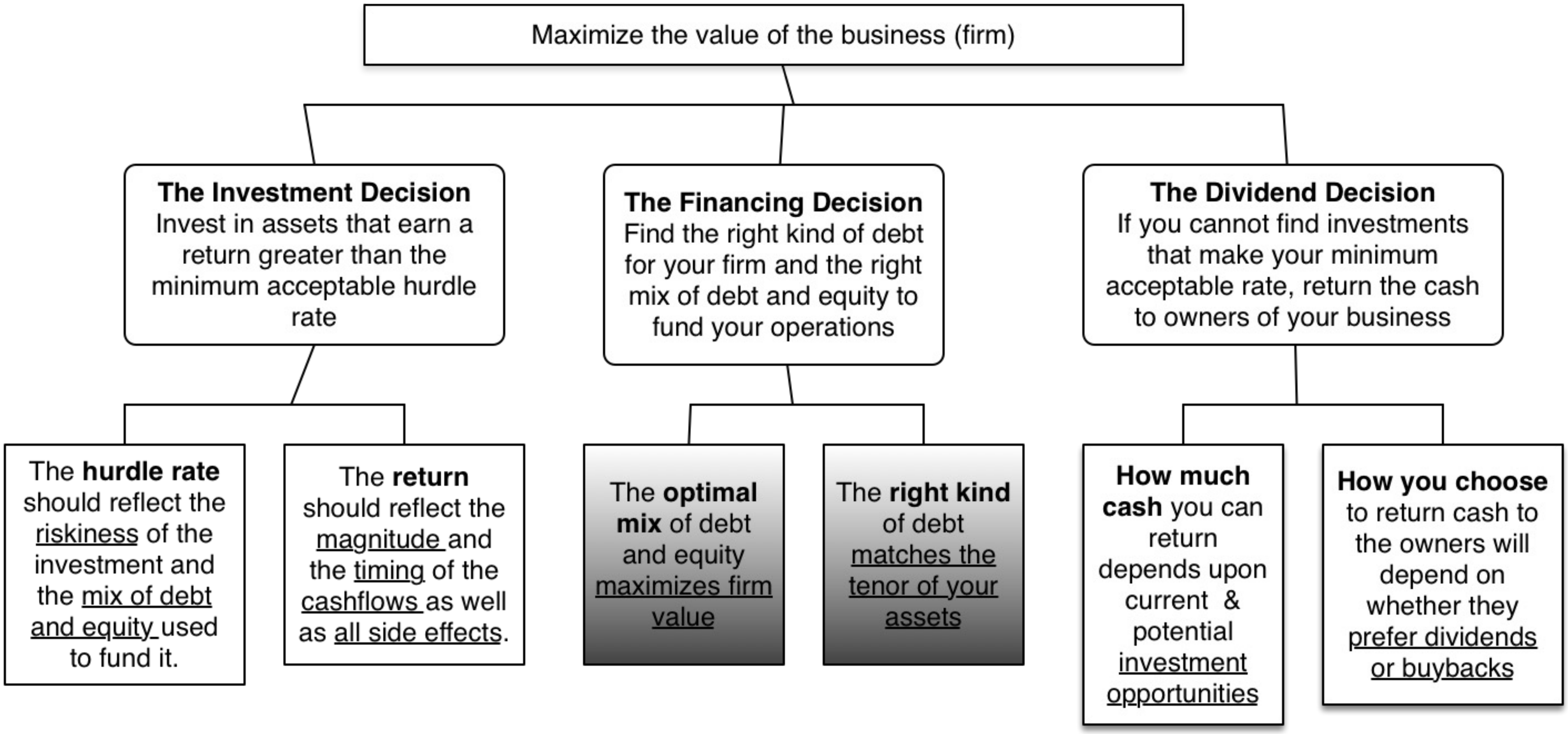
CAPITAL STRUCTURE: THE CHOICES AND THE TRADE OFF

"Neither a borrower nor a lender be"

Someone who obviously hated this part of corporate finance

FIRST PRINCIPLES



THE CHOICES IN FINANCING

Figure 7.1: Debt versus Equity

Fixed Claim
Tax Deductible
High Priority in Financial Trouble
Fixed Maturity
No Management Control

Residual Claim
Not Tax Deductible
Lowest Priority in Financial Trouble
Infinite
Management Control

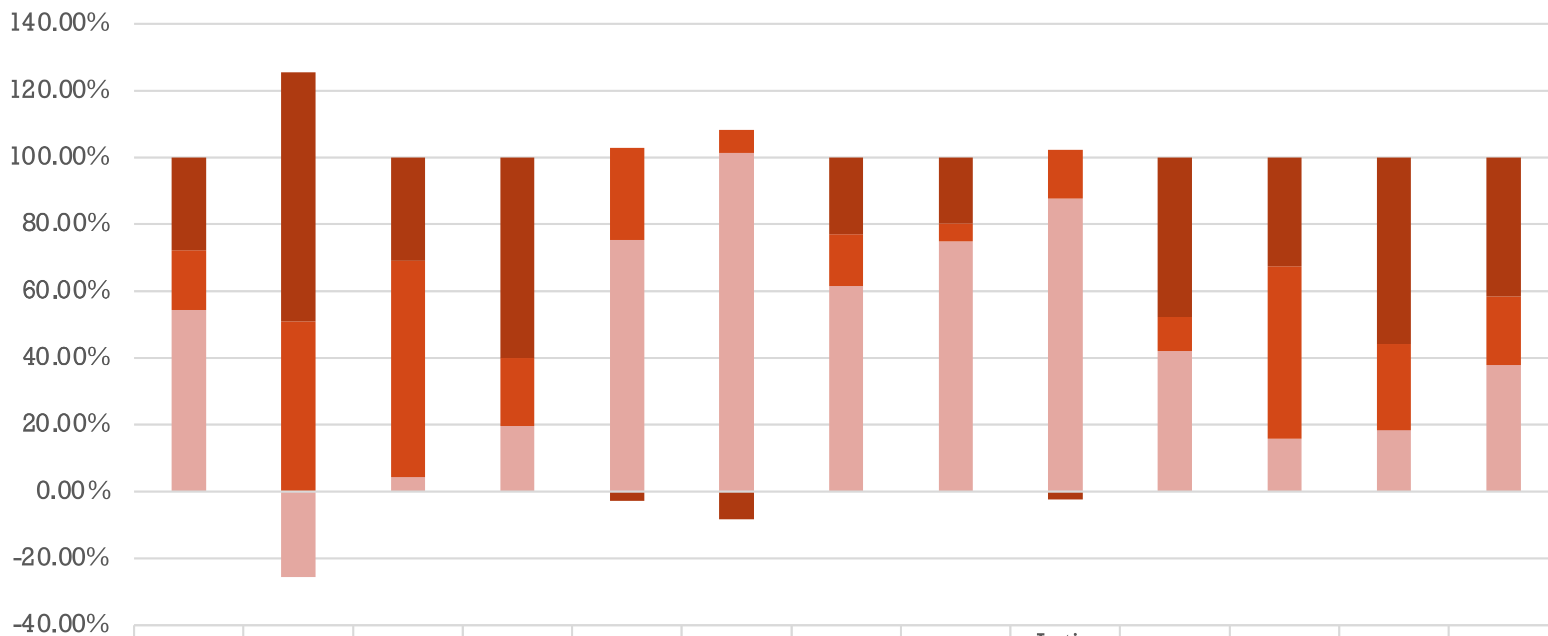
Debt
Bank Debt
Commercial Paper
Corporate Bonds

Hybrid Securities
Convertible Debt
Preferred Stock
Option-linked Bonds

Equity
Owner's Equity
Venture Capital
Common Stock
Warrants

GLOBAL PATTERNS IN FINANCING…

Financing Mix in 2024



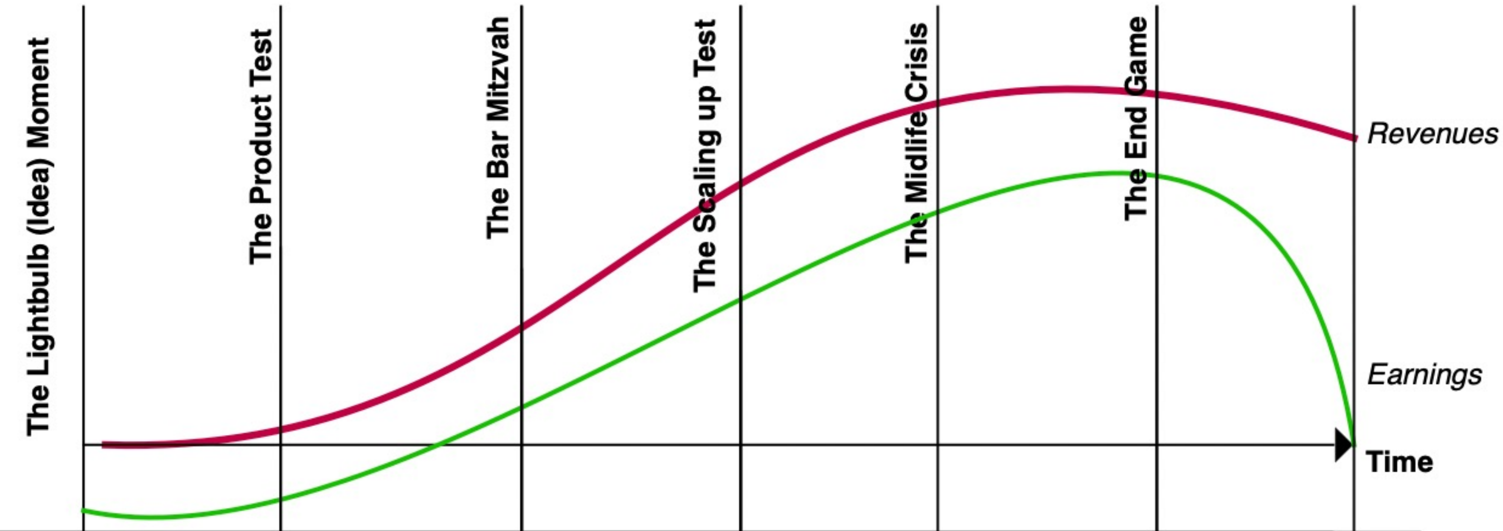
	Africa and Middle East	Australia & NZ	Canada	China	EU & Environs	Eastern Europe & Russia	India	Japan	Latin America & Caribbean	Small Asia	UK	US	Global
Net Debt	27.87%	74.65%	30.86%	60.04%	-2.80%	-8.34%	23.01%	19.66%	-2.35%	47.66%	32.61%	55.72%	41.55%
Equity Issuances	17.80%	50.93%	64.89%	20.32%	27.50%	6.94%	15.59%	5.38%	14.63%	10.15%	51.62%	25.87%	20.63%
Retained Earnings	54.32%	-25.58%	4.25%	19.64%	75.30%	101.40%	61.41%	74.96%	87.72%	42.19%	15.76%	18.40%	37.82%

AND A MUCH GREATER DEPENDENCE ON BANK LOANS OUTSIDE THE US…

- In broad terms, borrowing can come **from banks/lenders** or from issuing corporate bonds.
- In the **United States**, companies **have had more access to corporate bonds** than companies in other markets.
  - That access which initially started for larger companies expanded to cover smaller ones.
  - In the 1980s, **Mike Milken** opened up the bond market to **issuers who had below investment grade ratings** with the junk bond market.
- In the last two or three decades, bond markets have opened up for companies in the rest of the world as well.
- **As a borrower, with a choice of issuing corporate bonds or raising bank loans, why might you pick one over the other?**

ASSESSING THE EXISTING FINANCING CHOICES: DISNEY, VALE, TATA MOTORS, BAIDU & BOOKSCAPE

	Disney	*Vale*	*Tata Motors*	*Baidu*
BV of Interest bearing Debt	$14,288	$48,469	535,914₹	¥17,844
MV of Interest bearing Debt	$13,028	$41,143	477,268₹	¥15,403
Lease Debt	$2,933	$1,248	0.00₹	¥3,051
Type of Debt				
Bank Debt	7.93%	59.97%	62.26%	100.00%
Bonds/Notes	92.07%	40.03%	37.74%	0.00%
Debt Maturity				
<1 year	13.04%	6.08%	0.78%	1.98%
1- 5 years	48.93%	23.12%	30.24%	68.62%
5-10 years	20.31%	29.44%	57.90%	29.41%
10-20 years	4.49%	3.00%	10.18%	0.00%
> 20 years	13.24%	38.37%	0.90%	0.00%
Currency for debt				
Debt in domestic currency	94.51%	34.52%	70.56%	17.90%
Debt in foreign currency	5.49%	65.48%	29.44%	82.10%
Fixed versus Floating rate debt				
Fixed rate debt	94.33%	100.00%	100.00%	94.63%
Floating rate debt	5.67%	0.00%	0.00%	5.37%



Lifecycle Stage	**Start-up**	**Young Growth**	**High Growth**	**Mature Growth**	**Mature Stable**	**Decline**
Operating Profits	Large operating losses	Operating losses narrow	Operating profits turn positive	Operating profits grow quickly	Operating profits level off	Operating profits decline
Reinvestment	Very high	High	Remain large, but scale down as percent of earnings	Continue to decrease, on relative basis.	Mostly maintenance	Divestment
Financing Mix (Debt Capacity)	Non-existent	Very low	Low	Rising	High	Declining
Financing Type	Equity & Equity Hybrids (Warrants, Conv Preferred)		Convertible Debt	Conventional Debt		

THE TRANSITIONAL PHASES..

- The transitions that we see at firms – from fully owned private businesses to venture capital, from private to public and subsequent seasoned offerings are all motivated primarily by the need for capital.
- In each transition, though, there are costs incurred by the existing owners:
  - When **venture capitalists enter the firm**, they will demand their fair share and more of the ownership of the firm to provide equity.
  - When **a firm decides to go public**, it has to trade off the greater access to capital markets against the increased disclosure requirements (that emanate from being publicly lists), loss of control and the transactions costs of going public.
  - When **making seasoned offerings**, firms have to consider issuance costs while managing their relations with equity research analysts and rat

MEASURING A FIRM'S FINANCING MIX …

- The simplest measure of how much debt and equity a firm is using currently is to look at the proportion of debt in the total financing. This ratio is called the debt to capital ratio:

  Debt to Capital Ratio = Debt / (Debt + Equity)

- **Debt**: Debt **includes all interest-bearing liabilities**, short term as well as long term. It should also include other commitments that meet the criteria for debt: **contractually pre-set payments that have to be made**, no matter what the firm's financial standing.
- Equity can be defined either in **accounting terms (as book value of equity) or in market value terms** (based upon the current price). The resulting debt ratios can be very different.