Capital structure case study examples

Business, Company

Introduction

In Finance, Capital Structure means the way a company finances its assets through debt and equity. For example, if a firm is known to have financed 70% of its assets using debt and 30% using equity then the company is said to have a leverage of 70%. The higher the leverage, the more risky is the company from financial and investment perspective. There are different theories on the capital structure. Modigliani and Miller are known to be the founding fathers of the capital structure modeling in a perfect market. In a perfect market as per Modigliani and Miller it does not matter how a company is financed. However, we live in a real world full of follies and not in a perfect world. Parameters like information asymmetry, agency costs, taxes and bankruptcy costs can affect the optimal capital structure of the company. Optimal capital structure is known as that capital ratio between debt and equity which maximizes the value of the firm. This essay will analyze the financial parameters of three companies namely; Clorox, Alaska Air and eBay and then will propose recommendations on optimal capital structure based on the assumptions of current market scenario.

Nature of Business

eBay, an US based multinational company, which is headquartered in San Jose, California is primarily into the business of online auction. Operating in more than 30 countries it is the largest online auction based consumer to consumer company in the world. The main revenue of eBay comes from fees charged to the customers for holding an auction in its website. It also takes 10% fee on the total selling price of each item. Currently, the main business strategy for the company is to expand its business globally to increase its market share as it is not able to do the same in the established markets due to tough competition.

Financial Details

eBay posted a profit of $15 billion for the year 2012. Its revenue per share was $11. 60. Quarterly growth of the company for the quarter which ended on 30th June, 2013 was 14 %, higher than the market expectation. The company has a gross profit margin of $9. 86 billion and operating margin of impressive 20. 75%. It also has a very impressive profit margin of 17. 73%. eBay declared a net profit of $2. 66 billion for the year ended 2012. eBay has current assets worth $21 billion from a total asset of $37 billion. It has a total current liability of $10 billion. The current ratio for the company is around 1. 1. eBay holds a free cash balance of $10. 44 billion. eBay has a market debt of $4. 53 billion and a debt to equity ratio of 20. 94 (Key Financial Parameters#1). This value shows that the company is highly leveraged. Looking at the main competitors of eBay, we can say that eBay is posting average results. The best online shopping and consumer to consumer business model is operated by Google and it is growing at a very fast rate. Amazon is another player growing rapidly. Amazon has a debt to equity ratio of 34 and Google has a debt to equity ratio of 10.

Clorox is an American company operating in the food, chemical and consumer products business segment. Based out of Oakland, California, the company is mainly known for its bleach product ‘ Clorox”. Clorox posted revenue of $5. 6 billion for the year 2012-2013. With a market capitalization of $10. 3 billion, the company has made a profit of $ 574 million for the current year. The growth rate of the company in last few years has stagnated, growing at a rate of only 2-3% YOY. The company being in grocery and consumer products business does not have the operating margin as high as eBay. The operating margin for the company is 17. 34% and net profit margin is 10. 17% (Key Financial Parameters#2). The operating margins for Clorox are lower than its main competitors Colgate Palmolive and Procter and Gamble. Total debt to equity ratio for Clorox is 1624. 66 which is excessively high. The current ratio of Clorox is 1. 25. Alaska Airlines, a Seattle based airline company, is the seventh largest US passenger airline. The company has posted revenue of $4. 6 billion for the year 2012 with an operating profit of $532 million. The company has a good net profit margin of 7. 26% where most of the other airlines are struggling to make money. Growing at a rate of almost 8% YOY for last three years, the company has a small debt base of only $944 million but because of its small equity base the debt to equity ratio is 61 (Key Financial Parameters#3). The company has retained earnings and capital surplus of almost $1. 7 billion

Beta and Riskiness

Beta for eBay is 0. 98. It shows that the riskiness for eBay is almost at par with the systematic risk of the market. The debt to equity ratio for the company is around 20 which is on the higher side. The leverage of eBay is more than the other online auctioneers. The cost of capital for eBay is around 10. 5% (Key Financial Parameters#1). The company has huge short term debt compared to its long term debt. It has taken loan from the market at a higher rate which can be renegotiated to reduce the interest rate as the overall market interest rate is not very high. eBay can restructure its long term and short term debt by having more long term debts and less short term debts but taking more debt from the market will cost eBay a higher percentage as it is already highly leveraged. It can arrange for more capital with the help of equity financing. This way eBay will be able to generate more capital at less cost because investors will be willing to invest if the share price grows on an average 17-20% YOY. However, based on the report of balance sheet, it seems that eBay does not require looking outside for capital as it has huge cash surplus.

Clorox has a debt to equity ratio of 1624 which is extremely high compared to its main competitors Colgate Palmolive and Proctor and Gamble whose debt to equity ratio is in the range of 40 to 300. Clorox has a beta of 0. 42 much lower than the market riskiness mainly because it operates in consumer products segment. The demand for consumer products is more or less stable in all market conditions and hence the beta generally is low for companies which are in the business of consumer products. For example, Colgate Palmolive has a beta of only 0. 24 (Key Financial Parameters#2). Going for debt financing will be costly for Clorox as it is highly leveraged and equity financing will also be a problem for the company as it is not showing huge growth. If the company is in need of capital for making investment then debt financing probably is a better option if the company can offer corporate bonds at a higher rate. If the company tries to gain capital through equity financing then the shares may not be fully subscribed.

Alaska Airline has a beta of 1. 0 which is good compared to its competitors. Airline industry being very susceptible to economic shock or market based changes generally has a beta of more than 1. 0 (Key Financial

Parameters#3). Alaska Airline due to its stable operation and good growth rate has been able to maintain a low beta. The company is less risky for the investors. Although the company has a high debt to equity ratio the total retained earnings for the company is more than the total debt for the company which provides a huge risk reduction for the investors. Alaska Air is also growing its revenue steadily which is reflected in its stock price. The share price went up by 69% in last one year. Alaska Air has the option of going for both debt and equity financing but debt financing option being cheaper, Alaska Air may go ahead, if required, to issue bonds to generate capital.

Advantages and Disadvantages of Debt Financing over Equity Financing

Debt financing is less costly than equity financing in most of the cases. For an aggressive growth strategy debt financing is the perfect instrument. It provides one with the capital to expand his assets without giving away the ownership of the business. The only problem with debt financing is that the business needs to pay the loan and interest on time (Kokemuller). Failure to do so will make the company assets exposed to the financiers.

Equity financing, on the other hand, is good as the company need not repay back anything if it wants. It can just use the capital to drive future growth. However, equity financing leads to sharing of ownership of the business. It provides the shareholders with some level of decision making power (Peavler).

Conclusion and Learning

Capital structure consists of debt and equity. Depending on the growth prospects and market conditions, companies go for either debt or equity financing. As the percentage of debt compared to the total financing increases a company is said to be leveraged on the higher side. However, the right balance between debt and equity varies depending on the industry, market factor, growth prospects and the financial condition of a company. For example, a debt/equity ratio of 20 may not be good sign for eBay but for a consumer goods company like Clorox it is highly acceptable because of the nature of the business. Beta is the measure for defining the riskiness of companies by looking at all those market factors which debt/equity ratio cannot provide us. In this module, the concept of capital structure was discussed. This chapter made it very clear that companies need capital for various reasons and they get capital via two main channel, debt and equity. The concept of debt and equity financing was also clear from the module presentations. Beta is another market parameter that has also been discussed in the module with an elaborate description of how beta defines the riskiness of a company.

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