Capital strucutre

Debt to book capitalization ratio

Capital strucutre is one of the highly debated issues involving many complex problems related with what should be the optimum capital structure for the company to maximize its value. One such effort was made by Modgigliani and Miller who suggested that the capital strucutre do not have any impact on the value of the firm under certain assumptions.[RHS08] These assumptions were following:

1) No taxes

2) No bankruptcy costs

3) No cost for enforcing debt contracts

4) Investment Opportunities are given

5) Homegeneous expectations about the investment opportunities for the firm

Based on the above assumption, the theory suggest that the firm value is independent of the capital strucutre and there is no fixed combination of the debt and equity which can suggest that it this level the firm has the optimum capital strucutre.

However, in practice it is largely believed that the capital strucutre with 60% of debt and 40% of equity can be optimum for the firm. Higher debt capital may fund the growth of the firm however with increasing debt, it becomes hard for the organisations to keep the financial covenants of their debts intact therefore high debt ratios incur further risk for the organisation therefore there is no such magical relationship between debt to book capitalization ratio.

The debt to book capitalization therefore vary from industry to industry and there Is no solid formula to determine that the debt to book capitalization ratio of 60% therefore there is no capital strucutre theory under which it can be justified that a debt to book capitalization ratio should be 60%.

Lessons from Greenfield projects

A greenfield project is one which is built from scratch and is not constrained by any previous work. These projects are mostly constructed on the unused land where there is no room or need required to remodel the existing piece of land to demolish the existing strucutres. According to the transaction theory of foreign direct investment, the mode of entry into markets especially foreign markets depends upon how efficient the greenfiled projects will be as compared to the domestic facilities. If the greenfield projects are going to give more efficient results than the existing ones than going for greenfield projects can be a good move however if efficiencies are not achieved than in that case greenfield projects may go awry. Therefore one of the most important lesson which can be learned from this is the fact that how good greenfield projects can bring the desire efficiency and effectiveness in the company specially with relation to the operational efficiency.[Hen93]. Apart from that the greenfield projects provide the organisation necessary room to look for better and more efficient resources. If for example, a firm makes an acquisition than it may have to inherit the labor force and all efficient as well as inefficient resources therefore it may be difficult to obtain the desired results initially as the firm may find itself into cleaning up the mess rather than concentrating on its core objectives.

References

RHS08: , (Smith),

Hen93: , (Hennart),