Capital Structure Decisions

How can capital structure affect value?

\[
V = \sum_{t=1}^{\infty} \frac{FCF_t}{(1 + WACC)^t}
\]

\[
WACC = w_d (1-T) r_d + w_ce r_s
\]
A Preview of Capital Structure Effects

- The impact of capital structure on value depends upon the effect of debt on
  - WACC
  - FCF

The Effect of Additional Debt on WACC

- Debtholders have a prior claim on cash flows relative to stockholders
  - Debtholders’ “fixed” claim increases risk of stockholders’ “residual” claim
  - Cost of stock, $r_s$, goes up
- Firms can deduct interest expenses
  - Reduces the taxes paid
  - Frees up more cash for payments to investors
  - Reduces after-tax cost of debt
- In sum, the cost of doing business will change!

The Effect of Additional Debt on WACC

- Additional debt can affect the behavior of managers
  - Reductions in agency costs
  - Increases in agency costs
Factors That Influence Business Risk

- Uncertainty about demand (unit sales)
- Uncertainty about output prices
- Uncertainty about input costs
- Product and other types of liability
- Degree of operating leverage (DOL)

Operating Leverage and How it Affects Business Risk

- Operating leverage is the change in EBIT caused by a change in quantity sold
- The higher the proportion of fixed costs within a firm's overall cost structure, the greater the operating leverage

Pecking Order Theory

- Internal generating of funds
- Issuing of debt
- Issuing of equity