Capital structure and dividend decisions

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Chapter preview

Following on from the discussion in the previous chapter, we now discuss three key issues for firms. Firstly, we consider how the overall cost of capital for a firm is determined and why this is important. The combined current, and future, projects of the firm must together earn at least this level of return if the various contributors of capital are to remain satisfied with its financial performance.

This leads into the second major area of discussion, the optimal capital structure debate. Whilst recognising that there can be an advantage to equity investors from having part of a firm's long–term capital needs funded in the form of debt, the question we consider is: to what degree does debt finance provide such a benefit? Much has been written about this debate but, as we will see, there is no magic formula for determining what capital structure best serves the needs of the various stakeholders. Some level of **gearing**, or **leverage**, is advantageous, but at excessive levels these advantages are lost.

Allied to this debate is a related issue, our third main area of discussion – the dividend policy debate. Should firms reinvest all their available earnings in productive opportunities which generate acceptable rates of return, leaving only any residual balance to be distributed in the form of dividends; or should they, as often observed in practice, first determine their dividend distribution policy using only residual internal funds for reinvestment and, if necessary, approaching the capital market for additional funds?