



B.Com Honours

Semester VI

Calicut University

FINANCIAL MANAGEMENT

Course Code: COM6EJ302 • Module 4 Notes

Module IV: Capital Structure & Dividend Decisions

Covers capital structure factors, capital structure theories (NI, NOI, MM Hypothesis, Traditional), dividend policies, Walter Model, Gordon Model, MM Dividend Irrelevance theory, and corporate share actions.

Unit 4.1: Capital Structure & Factors Affecting Financial Mix

Capital Structure: Proportional mix of long-term debt and equity capital. Determinants: EBIT-EPS indifference point, financial leverage risk, cost of capital, & cash flow stability.

Unit 4.2: Capital Structure Theories (NI, NOI, MM, Traditional)

1. **Net Income (NI) Approach:** Capital structure affects K_o ; higher debt reduces overall cost.
2. **Net Operating Income (NOI) Approach:** Overall cost K_o remains constant regardless of debt ratio.
3. **Modigliani-Miller (MM) Hypothesis:** Capital structure irrelevance in perfect markets (without tax).

Unit 4.3: Dividend Decisions & Policy Objectives

Dividend Policy: Balancing cash dividend payouts vs retaining earnings for internal growth. Types: Stable dividend, constant payout ratio, & regular plus extra dividend policies.

Unit 4.4: Dividend Valuation Models (Walter & Gordon) & Share Actions

Walter's Model: $P = \frac{D + \frac{r}{k_e} (E - D)}{k_e}$. If $r > k_e$ (Growth firm), optimal payout is 0%. If $r < k_e$, optimal payout is 100%. Share Actions: Stock split, reverse split, & share buybacks.

Practical Solved Problem 1 (Walter Dividend Valuation Model Application): Firm Earnings Per Share $E = ₹10$. Cost of Equity $k_e = 10\%$ (0.10). Calculate Share Price (P) under 2 scenarios for Dividend Payout of ₹4 (40%):

Case A: Growth Firm ($r = 15\%$); Case B: Declining Firm ($r = 8\%$).

Walter Formula: $P = [D + (r / k_e) * (E - D)] / k_e$

Step-by-step Solution:

1. **Case A: Growth Firm ($r = 0.15 > k_e = 0.10$):**

- Retained Earnings per share = $10 - 4 = ₹6$.
- Numerator = $4 + \left(\frac{0.15}{0.10}\right) \times 6 = 4 + (1.5 \times 6) = 4 + 9 = 13$.
- Share Price $P = \frac{13}{0.10} = ₹130.00$.

2. **Case B: Declining Firm ($r = 0.08 < k_e = 0.10$):**

- Numerator = $4 + \left(\frac{0.08}{0.10}\right) \times 6 = 4 + (0.8 \times 6) = 4 + 4.8 = 8.8$.
- Share Price $P = \frac{8.8}{0.10} = ₹88.00$.

Practical Case Framework 2 (Capital Structure Theories Architectural Matrix): Compare capital structure theory, proponent author, impact of debt on WACC (\$K_o\$), and value of firm (\$V\$).

Capital Structure Theories Summary Table:

Theory / Approach	Impact of Higher Debt on WACC (\$K_o\$)	Impact on Total Firm Value (\$V\$)
Net Income (NI) Approach	WACC decreases continuously	Total Firm Value increases continuously
Net Operating Income (NOI)	WACC remains strictly CONSTANT	Total Firm Value remains CONSTANT
Traditional Approach	WACC decreases up to optimal point, then rises	Firm Value reaches MAXIMUM at optimal debt level

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