Capital Structure

Meaning

The term ‘structure’ means the arrangement of the various parts. So capital structure means the arrangement of capital from different sources so that the long-term funds needed for the business are raised.

Thus, capital structure refers to the proportions or combinations of equity share capital, preference share capital, debentures, long-term loans, retained earnings and other long-term sources of funds in the total amount of capital which a firm should raise to run its business.

Capital structure refers to the amount of debt and/or equity employed by a firm to fund its operations and finance its assets. A firm’s capital structure is typically expressed as a debt-to-equity or debt-to-capital ratio.

Debt and equity capital are used to fund a business’s operations, capital expenditures, acquisitions, and other investments. There are trade-offs firms have to make when they decide whether to use debt or equity to finance operations, and managers will balance the two to find the optimal capital structure.

Optimal capital structure

The optimal capital structure of a firm is often defined as the proportion of debt and equity that results in the lowest weighted average cost of capital (WACC) for the firm.

In order to optimize the structure, a firm can issue either more debt or equity. The new capital that’s acquired may be used to invest in new assets or may be used to repurchase debt/equity that’s currently outstanding, as a form of recapitalization.