

Chapter 14

Capital Structure and Leverage

LEARNING OBJECTIVES

After reading this chapter, students should be able to:

- Explain why capital structure policy involves a trade-off between risk and return, and list the four primary factors that influence capital structure decisions.
- Distinguish between a firm's business risk and its financial risk.
- Explain how operating leverage contributes to a firm's business risk and conduct a breakeven analysis, complete with a breakeven chart.
- Define financial leverage and explain its effect on expected ROE, expected EPS, and the risk borne by stockholders.
- Briefly explain what is meant by a firm's optimal capital structure.
- Specify the effect of financial leverage on beta using the Hamada equation, and transform this equation to calculate a firm's unlevered beta, b_U .
- Illustrate through a graph the premiums for financial risk and business risk at different debt levels.
- List the assumptions under which Modigliani and Miller proved that a firm's value is unaffected by its capital structure, then explain trade-off theory, signaling theory, and the effect of taxes and bankruptcy costs on capital structure.
- List a number of factors or practical considerations firms generally consider when making capital structure decisions.
- Briefly explain the extent that capital structure varies across different countries.