



MERCER CAPITAL

# Capital Structure in 5 Minutes

**Travis W. Harms, CFA, CPA/ABV**

Leader, Family Business Advisory Group

[harmst@mercercapital.com](mailto:harmst@mercercapital.com)

901.685.2120



BUSINESS VALUATION &  
FINANCIAL ADVISORY SERVICES  
[WWW.MERCERCAPITAL.COM](http://WWW.MERCERCAPITAL.COM)

# What Does Capital Structure Mean?

---

Capital structure describes how your family business pays for assets



# The Weighted Average Cost of Capital

Different capital sources have different costs

Market Value of Debt + Equity	
\$125 million	
Interest-Bearing Debt	Shareholders' Equity
\$40 million	\$85 million
32% of total	68% of total
4.0% after-tax cost	15% after-tax cost
<b>Weighted Average Cost of Capital = 11.5%</b>	

## After-tax cost of debt

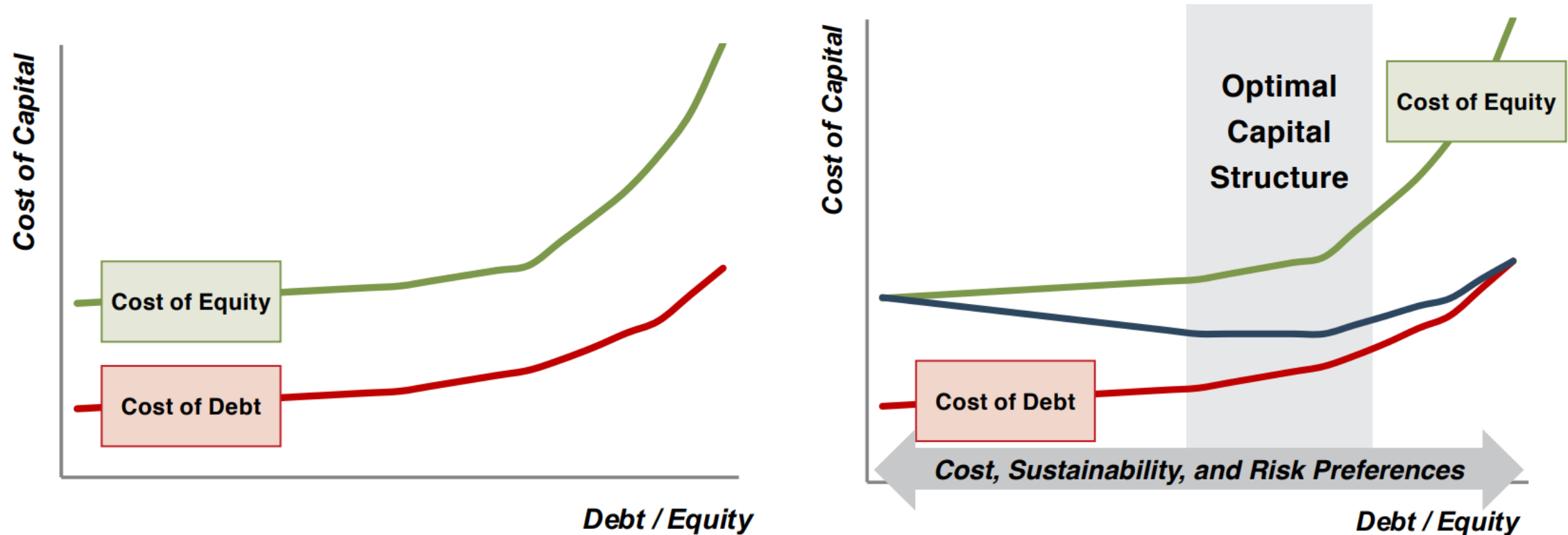
- Cost of debt is explicit (interest rate)
- Since interest is typically deductible for taxes, the net cost of debt to the borrowing company is calculated on an after-tax basis

## After-tax cost of equity

- Not directly observable – you don't "owe" shareholders a fixed return
- Typically estimated by comparing to historical and/or projected returns for investments having comparable risk
- Regardless of estimation technique, always a matter of judgment

# Capital Structure and the WACC

The optimal capital structure is a range rather than a single point



# Setting a Capital Structure Target

The optimal capital structure is a range rather than a single point

Factor	Considerations
<b>Capital Intensity</b>	To what extent is the value of the enterprise attributable to assets that have value outside the operations of the business? Or, is value primarily attributable to company-specific intangible assets that are difficult to use as collateral?
<b>Life Cycle</b>	Has the family business reached a point of maturity at which cash flows are predictable and sufficient for debt service? Or, is the family business in a rapid growth phase in which reinvestment needs are high?
<b>Size</b>	Does the company have sufficient scale to borrow funds at attractive rates and on desirable terms? Or, is the family business too small to generate competition among multiple lenders?
<b>Operating Risk</b>	Is the company's operating expense base primarily variable, such that operating margins can be preserved during a period of soft revenues? Or, are the family business's operating expenses primarily fixed, leading to more dramatic swings in period-to-period earnings?



## Travis W. Harms, CFA, CPA/ABV

harmst@mercercapital.com

901.322.9760

Travis W. Harms leads Mercer Capital's Family Business Advisory Services Group. Travis's practice focuses on providing financial education, valuation, and other strategic financial consulting to multi-generation family businesses. The Family Business Advisory Services Group helps family shareholders, boards, and management teams align their perspectives on the financial realities, needs, and opportunities of the business. Additionally, Travis is a regular contributor to Mercer Capital's blog, *Family Business Director*.

[>> Click here to learn more about Travis](#)

# Mercer Capital's Family Business Advisory Services

Mercer Capital provides financial education services and other strategic financial consulting to family businesses.

## Services

---

- Customized Board Advisory Services
- Management Consulting
- Independent Valuation Opinions
- Transaction Advisory Services
- Confidential Shareholder Surveys
- Benchmarking / Business Intelligence
- Shareholder Engagement
- Shareholder Communication Support

We help family ownership groups, boards, and management teams align their perspectives on the financial realities, needs, and opportunities of the business.

We also help family business boards and management teams explain strategic financial decisions to shareholders and help shareholders communicate preferences to boards and management teams.

We have had the privilege of working with successful family and closely held businesses for the past 35 years. Given our experience, we are convinced that an engaged and informed shareholder base is essential for the long-term health and success of a family or closely held business. Yet, cultivating an engaged and informed shareholder base is often difficult. We can help.

[>> Click here to learn more](#)



**MERCER  
CAPITAL**

[www.mercercapital.com](http://www.mercercapital.com)

Want more resources on this topic?

[CLICK HERE](#)