# Capital structure and dividend policy essay

Business, Company

Event studies are statistical tests used to examine financial market reaction and the impact of certain events of interest on the value of financial assets such as stock prices, bond prices and exchange rates. Events that may affect the market value of financial assets include; stock split, merger or takeover announcements, earning announcement and regulatory changes .

Par Value determines the minimum price that a Corporation can price its common stock. Several states do not permit a corporation to sell their common stock below the par Value. Corporations therefore set relatively low par value for their shares so that it does not constraint them when they price their shares. Corporations in states that base certain taxes on the par value of share, might also assign low par value to their shares to minimize their tax burden .

According to the Signaling theory, managers have perfect information concerning the firm’s future cash flows since they are insiders whereas investors do not. This model argues that managers can use higher financial leverage to signal greater optimism in the firm’s future. This is because debt imposes a contractual obligation on the firm to repay both the interest and principal as and when they fall due. The firm will be liquidated and the managers will lose their jobs if they fail to honor debt agreement. Increasing debt to a firm’s capital structure will be interpreted by investors as a signal of managers’ optimistic outlook of the future. Investors will therefore attach a high value to the debt issuance.

Pecking order model is also based on the concept of asymmetry of information between managers and investors. Managers have perfect

information concerning the firm’s future cash flows, riskiness and true worth of the firm whereas investors do not. Managers utilize this asymmetry in information while prioritizing the sources of finance to minimize financing cost. Firms prefer internal sources of finance to debt. On the other hand, firms will prefer debt over equity. Therefore, adding equity to a firm’s capital structure will be interpreted by investors that the managers think the firm is overvalued and they are trying to take advantage of it. Investors will therefore attach a lower value to the equity issuance.

Dividend yield is the dividend per share divided by the market share price; it is an indicator of the current rate of return. Dividend payout ratio is dividend per share divided by the earning per share; it is an indicator of future rate of return. Therefore, current dividend payout ratio will affect the dividend yield in future .

## Exercise

There are three forms of informational efficiency; weak form, semistrong form and strong from of informational efficiency. Weak level of informational efficiency hypothesizes that the market price of shares reflects only past or historical information and historical movement of the share price. It therefore implies that the future market price of shares can be predicted from historical price movement patterns. If the share price of corporation steadily increased, the next change in price can either be upward, constant or downward with equal chances since the current share price reflects all information about the company. Therefore, investors cannot make arbitrage profits by technical analysis .

Semi-strong form of informational efficiency hypothesizes that market price of shares reflect both present and past information that is available to the public. Investors in markets that have achieved this level of informational efficiency can consistently make higher returns through technical analysis. Such markets have the ability to anticipate new information before it is publicly released which is then reflected in the price. If two corporations were to merge, the share price will change prior to the merger plans being announced. Investors can therefore use technical analysis to anticipate future movement of the share prices .

Strong form of informational efficiency hypothesizes that the market price of shares reflects past, present and future information. It also reflects all public and private information. Insider trading is impossible since investors have perfect information. Publication of previously confidential information will not affect the market share price. The share price movements therefore tend to be consistent with a clear pattern rather than arbitrary. Investors can therefore maximize their returns by technical analysis .

Bankruptcy laws are legislation that provides a regulatory framework for any corporation or person who is unable to meet their debt contractual obligation to pay the principal amount and interest when it is due. Bankruptcy laws determine how much debt managers are willing to take to finance their investments. When the bankruptcy laws are stringent, managers will be less willing to finance their projects using debt. This is because there is a higher likelihood that a firm will be liquidated and the managers will lose their jobs if they fail to honor debt agreement .

Bankruptcy laws in U. S are well developed. However, they are less stringent compared to bankruptcy laws in other jurisdictions. This provides U. S managers an incentive to finance their firms' investment projects with debt. In Europe, managers face severe consequences for bankruptcy filing delays. For example, whereas bankruptcy laws in France impose a fine for failure to file for bankruptcy within fifteen days and managers may be held personally liable, U. S bankruptcy laws do not hold managers personally liable neither do they impose any fines for filing delays.

Another difference emanates from the party that initiates the bankruptcy process. Voluntary bankruptcy is initiated by insiders, mostly managers, whereas involuntary bankruptcy is initiated by outsiders, mostly creditors. Involuntary bankruptcy is discouraged in the U. S since it can only be filed by at least three creditors together. On the other hand, in most European jurisdictions any party can petition for involuntary winding up. European firms therefore face a higher risk of involuntary bankruptcy.

Lastly, under the U. S bankruptcy laws, when a corporation files for bankruptcy, it has an option of choosing to restructure. If a corporation decides to restructure, managers may file for bankruptcy protection which permits them to remain in control. On the other hand, courts appoint another party to manage the firm after filing for bankruptcy in European jurisdictions. This curtails the control that current managers have on the bankruptcy process. Therefore, U. S managers have better prospects of restructuring their corporations and re-emerging from bankruptcy . This makes U. S

managers more willing to finance their firms' investment projects with debt than European managers.

The best method to evaluate the investment project would be the weighted average cost of capital. Since the project will not affect the firm's target debt-to-equity ratio, economic feasibility of the investment project will be most logical factor to consider. The fact that the debt-to-equity ratio will not be affected implies that the investment is funded by both debt and equity in the target ratio. Therefore, both debt and equity will contribute to the cost of financing .

Weighted average cost of capital abbreviated as WACC can be defined as the average cost of financing. It is computed by taking in consideration the relative weights contributed by each source of finance to the capital structure. The cost of capital varies for different sources of capital depending on their risk. WACC factors in these differences to determine the cost of capital. Different source of capital have different tax treatment. Interest paid on debt is a tax allowable expense whereas dividends paid are not allowable for tax purposes. WACC unifies this difference in cost of capital caused by the different tax treatments by capturing the interest tax shield benefit on debt. The expected rate of return from the investment project that involved modernizing the existing plant is then determined basing on the incremental cash flows. The rate of return is then compared with the computed WACC. If the rate of return is greater than the WACC, the investment was economically viable. If the rate of return is less than the WACC, the

investment was not economically viable and was therefore not worth undertaking .

Higher dividends paid by corporations with diverse shareholder bases can also be explained by the agency theory of dividend payment. According to this theory, managements pay higher dividends primarily to meet agency costs that arise when a publicly traded corporation’s ownership structure become diffuse. Privately owned corporations and public corporations with a concentrated ownership structure have little divergence between control and ownership hence they have fewer agency problems and costs to meet. As corporations continue to diversify their shareholder bases, agency problems between management and shareholders who are outsiders became more significant.

Managers are forced to start paying higher dividends to solve the agency problem. Therefore, managers of firms with diverse shareholder bases pay fixed dividends as a commitment mechanism to shareholders so that in future they will payout free cash flow as dividends instead of making excessive investments .

Higher dividends paid by corporations with diverse shareholder bases can also be explained by signaling theory of dividend payment. Managers have access to inside information concerning the firm future cash flows and level of risk that is not available to outside investors.

Managers of corporations with diverse shareholder bases may use dividend payment to convey certain information. Managers tend to avoid paying

higher dividends unless such dividend payout can be maintained in future. Paying higher dividends will be interpreted by investors as a signal of managers' optimistic outlook of the future profitability of the firm. Investors will therefore attach a high value to the shares of the firm. Therefore, corporations with diverse shareholder bases will pay higher dividends so that their shares remain attractive.

## References

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