

The determinants of capital structure finance essay

[Finance](#)



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عمل الطالبة :

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The capital structureThe capital structure is how a firm finances its overall operations and growth by using different sources of funds. It is a mix of a company's long-term debt, specific short-term debt, common equity and preferred equity. But there are some characteristics of the firms and industries that determine leverage ratios, all the studies agreed that leverage increases with fixed assets, non-debt tax shield, growth opportunities, and firm sizes. Also it decreases with volatility, advertising expenditures, and profitability. Based on the data above. We can identify the determinants of the capital structure: Size, profitability, tangibility, market to book ratio (MB ratio), and non-debt tax shield.

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The size of the firm.

Small size business firm's capital structure generally consists of loans from banks and retained profits. While on the other hand, big companies having goodwill, stability and an established profit can easily go for issuance of shares and debentures as well as loans and borrowings from financial institutions. The bigger the size, the wider is total capitalization. As Titman and Wessels (1988) argued that larger firms, as compared to smaller firms, are more diversified with a little cost of bankruptcy, have stable cash flows and can adopt debt financing in their capital structure. Furthermore, they suggested that larger firms will have lower transaction cost in case of debt financing as compared to equity financing and these firms will also prefer debt financing. Trade-Off theory suggests that large firm should prefer debt financing to obtain target capital structure as they have low financial distress costs than smaller firms. Moreover, it is easy for larger firms to approach the capital market and these firms have low monitoring cost which will reduce agency cost. Similarly, firms with large size are more diversified and have low possibility of bankruptcy; therefore they should be leveraged more. Conversely, pecking order theory suggests inverse relation of size with debt ratio as large firms do not have the issue of information asymmetry and they can issue equity easily. Theoretically, there is an uncertain relationship between the size of the firm and leverage. As Rajan and Zingales (1995, p. 1451) claim: "Larger firms tend to be more diversified and fail less often, so size (computed as the logarithm of net sales) may be an inverse proxy for the probability of bankruptcy. If so, size should have a positive impact on the supply debt. However, size may also be a proxy for the information outside

investors have, which should increase their preference for equity relative to debt". Guney, Li, and Fairchild (2011), Céspedes, González, and Molina (2010) and Cheng and Shiu (2007) found positive relationship of leverage with size in case of nonfinancial firms. So, large firms can generate their own internal capital market in which cash flow generated from one division may be used to finance other division. In this way, a large firm can reduce its external financing. Size of the banks is measured in term of gross advances.

$$SZ1 = \text{LOG}(\text{ADV})$$

Where: SZ1 = Size of the bank
 LOG = natural logarithm
 ADV = Gross Advances

Assets tangibility of the firm (Tangibility).

Tangibility is defined as tangible assets divided by total assets. Tangible assets can be used as collateral. Tangibility is positively related to a firm's leverage as it assures the lender that his loan is backed by some collateral assets. Therefore higher tangibility lowers the risk of a creditor and increases the value of the assets in the case of bankruptcy.

$$\text{TANG} = \text{FA} / \text{TA}$$

Where:
 TANG = Tangibility of banks' assets
 FA = Fixed Assets
 TA = Total Assets

Market to book ratio (MB).

The theory of market to book ratio is a process of deduction of financial distress, it has been discounted shares of the company in financial distress (high pressure) at a high rate, according to the potential risk, if lost reverse Make any to be deducted low price. And show an inverse relationship to be driven by companies with high market by instead of the companies that market's values are low and this was mainly due to (financial missed), That the company's tendency to issue shares at a high price of its shares, the

spectrum-to-earnings ratio, or market values. If the proportion of agents to market a book about the lack of investment costs associated with high leverage and do not look to increase is it internal or external.

Profitability.

There are no consistent theoretical predictions on the effects of profitability on leverage. From the point of view of the trade-off theory, more profitable companies should have higher leverage because they have more income to shield from taxes. Knowing the expected relationship of profitability depends on the theory used. Pecking order theory predicts negative relation of profitability with leverage. According to this theory, more profitable firms generally borrow less because they have adequate internal funds for their capital investment programs, whereas, firms with less profitability generally use debt financing due to less availability of internal funds. Myers (1984) indicated an inverse relationship between leverage and profitability under this theory and research findings of Rajan and Zingales (1995) also support this relationship. Due to the fact that more profitable firms compared to less profitable ones incur more agency in case of increased debt ratios. On the other hand, trade-off theory explains a direct relationship of profitability with leverages. Deangelo and Masulis (1980) argue that the firms with higher profitability can get more benefit of tax shield by increasing their debt financing. Which means a profitable firm may have the probability to pay back the loans, they can borrow more. a positive sign should be expected between financial leverage and profitability. $PROF = ROA$ Where: PROF = Profitability
 $ROA = \frac{\text{Return on Assets}}{\text{Return on Assets}} = \frac{\text{Profit (Loss) After Taxation}}{\text{Total Assets}}$.

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Non-debt tax shield.

There are some items –except the interest expenses- can contribute to decrease the tax payments, which are named as non-debt tax shield which can be identified as a reduction in taxable income for an individual or corporation achieved through claiming allowable deductions. According to Angelo – Masulis (1980, p. 21): " Ceteris paribus, decreases in allowable investment-related tax shields (e. g., depreciation deductions or investment tax credits) due to changes in the corporate tax code or due to changes in inflation which reduce the real value of tax shields will increase the amount of debt that firms employ. firms that have lower investment related tax will employ more debt in their capital structure - in the cross sectional analysis-." So they argue that non-debt tax shields are substitutes for a debt-related tax shield and therefore the relation between non-debt tax shields and leverage should be negative. Also there is some empirical studies confirms this theoretical predictions, for example: Kim and Sorensen (1986, p. 140) declare: " DEPR9 has a significantly negative coefficient. [...] This is consistent with the notion that depreciation is an effective tax shield, and thus offsets the tax shield benefits of leverage." A negative relation between non-debt tax shields and leverage is also found by (Huang – Song, 2002) and (Titman – Wessels, 1988). However, for example Bradley et al. (1984) and Chaplinsky and Niehaus (1993) observe a positive relationship between non-debt tax shields and leverage.

The conclusion:

As a conclusion. We can write the following hypothesis describing the relationship between each variable and the capital structure – leverage- :

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There is a positive relationship between the size of the firm and the capital structure -leverage-. There is a positive relationship between the assets tangibility of the firm and the capital structure. There is a negative relationship between the market to book ratio and the capital structure of the firm. There is a negative relationship between the profitability and the capital structure of the firm. There is a positive relationship between the non-debt tax shield and the capital structure of the firm.