

# Growth opportunities essay

[Business](#), [Company](#)



## Abstract

The trade off theory advocates that the management consider the trade off between the benefits resulting from tax shields verses costs, such as bankruptcy costs, interest costs and agency costs among others. The ability of management to obtain external financing is determined by size of company, profitability, opportunities for growth among other factors. The trade off theory indicates that the management gears at obtaining all the benefits associated with external financing. The M and M theory (1963) has the argument that changing the capital structure may not make the share holder any better off. The contradiction of the two theories brings the need to unearth the reasons why different companies opt for different forms of capital structures. These factors influence the debt maturity period and the gearing level.

## Introduction

The gearing ratio indicates the proportion of borrowed capital to share holder's capital. Company with high gearing ratio i. e. above 50% are said to have be aggressive in its form of capital financing. The debt obtained matures overtime and the company is expected to pay both principle amount and interest rate. Shot term debts take few years to mature but long term debts may take over five years to mature. Management of firms considers trade off between marginal costs of obtaining the debts verses the marginal benefits which include tax shields among others.

The M and M theory (1963) indicates that the change of capital structure does not make share holders any better off. This is because when dividends are paid to shareholders it means the firm must obtain external sources to

finance its activities hence incur interest costs. On the other hand if accompany retains profits share holders lose interest but their market value of shares increases.

Management changes the capital structure to suit internal needs of the company. Besides internal factors, the decision of management is influenced by overall industrial moves regarding borrowing. The contradiction of the two theories brings the need to unearth the reasons why different companies opt for different forms of capital structures.

Gearing gives the proportion of entire company debt to equity capital. Gearing ratio of 50% indicates that the company debt equals company capital. Therefore gearing ratio gives instant picture of how much the company has borrowed. Therefore it gives the capital structure of how a company has financed her assets from share holders equity and debt equity. For example the current gearing ratio of BP Company is 0.48. Meaning the company has almost half of its capital financed through debt.

Trade off theory of capital structure is of the idea that a company will determine equity debt ratio by putting into mind costs and benefits. A company gets some benefits if financed by debt e. g. tax shielding gains associated with debt financing. On the other hand the company may face some disadvantages like bankruptcy and non bankruptcy cost of debt. Firm managers are expected to behave rationally therefore they optimize this tradeoff. This indicates that a firm can borrow to extend that the marginal tax shield equals the entire present costs associated with debt financing. Borrowing is associated with financial distress i. e. agency costs that results from putting financial worthiness of firm in doubt, bankruptcy costs. Financial

distress may easily drag the market value of the company down.

The trade off theory has been criticized by ruling out conservative debt ratios associated with taxpaying companies. The correctness of the theory is criticized by the question that, “ should a rational company seeking to optimize the tradeoff between marginal benefits and marginal cost pass up tax shield interest?”

Nowadays many companies are operating at low debt ratios such as Microsoft cooperation. Graham’s (2000) has shown examples of many firms opt to pay full statutory tax. Studies have also shown that most successful companies borrow less despite their credit worthiness which they can maximize on to get enough loans such as Microsoft Corporation. The borrowing habits of companies in United Kingdom are determined by profits. (Wald 1999, cited in George and stulz, 2003). Low profits means high debt and the vice versa is true. According to trade off theory if accompany has low profits then it has low taxable income to shield unlike when it has high profits. This theory practicability is seen to fail in the United Kingdom due to its inability to explain why companies earning high profits are not looking forward to increases their debts so as to shield profits. Furthermore the company’s profits provide adequate cushion against financial distress.

Stohs and Mauer (1996) argue that, there is relationship between gearing of accompanies and growth opportunities but the relationship is different for long term and short term debts. The agency problem mitigates if the firm interchanges long-term debt for a short term debt. Financial institutions worry offering loans to company’s whose worthiness is accounted for in future due to probability of diversion of the aim of the loan. (Myers, 1977).

Studies have shown negative relationship between total debt and growth opportunities. Bevan and Danbolt (2002) studies have shown positive relationship between short term debt and growth opportunities. Further studies done by Stohs and Mauer (1996) showed that firms with high growth prosperity have low levels of debts irrespective of the length of maturity. Generally firms with high growth prosperities have low levels of long term debts but may have high levels of short term debts.

## **Size**

Largeness of firms determines its ability to attract external debt financing. Zingales and Rajan (1995, p. 1451) proposes that “ Larger firms tend to be more diversified and fail less often, so size ... may be an inverse proxy for the probability of bankruptcy”. According to the tradeoff theory if a company has low probability of going bankrupt then the marginal cost of obtaining debt is low. The agency conflict between shareholders and lenders decreases as the size of the company increases. This adds to the marginal cost of obtaining the debt. Lenders on their own view prefers to lend to the small firms which they can easily influence the debt maturity.

Zingales and Rajan (1995, p. 1451) proposes that “ Larger firms tend to be more diversified and fail less often, so size ... may be an inverse proxy for the probability of bankruptcy”. Conversely, Smith and Warner (1979) and Michaelas, et al., (1999) argues that the agency conflict between shareholders and lenders may be particularly severe for small companies. Lenders can manage the risk of lending to small companies by restricting the length of maturity offered.

Studies done by Bennet and Donnelly (1993) have indicated that there is positive correlation between gearing and company size. Stohs and Mauer (1996) have further indicated that there is a positive correlation between maturity of a debt and company size. This is contradicted by, Bevan and Danbolt (2002) who argued that this relationship between debt financing is determined by of the debt elements. Generally, though some contradiction exists short term debts are negatively related to the size of a company.

### **Agency costs**

The gearing of a company is determined by the restrictive conditions imposed by lenders. These conditions prevent reduce decision options available for management. Therefore in accepting the loan the firm trades benefits of being free in decision making with agency costs. Some of the restrictions imposed are: disposition of certain assets required as security, restrictions from tacking loans beyond a stated limit, level of dividends payable among other.

**This makes the management to limit company gearing.**

### **Bankruptcy costs**

The management considers the effect of being termed bankrupt due to inability to pay debts as and when they fall due. The company fore seen bankruptcy costs increases as the gearing ratio increases, this is due to increased loan obligations. The lenders power to proceed into liquidating the company is therefore to be traded off with benefits of income to be earned from the acquired loan. Therefore bankruptcy costs are considered before changing capital structure of a company.

## **Debt capacity**

Debt capacity is determined by assets of company which can act as security for a loan. The lenders would like to get securities of assets which are really valuable and whose expected useful life is longer than the repayment period of the loan.

Therefore if the company lacks the required security then it will not be able to obtain a loan. Hence it cannot alter its gearing ratio.

DeAngelo and Masulis' (1980) had the argument that companies experiencing high depreciation rates have relatively low gearing ratios. This can be attributed to the fact that the company's assets may not provide adequate security requested by lenders. In addition, the company will have already gained from tax exemptions associated with depreciation of fixed assets. The BP Company has adequate assets which can act as security for loan but the gearing ratio has not exceeded 50%.

Modigliani-Miller theorem is of the idea that in absence of taxes, asymmetry of information as well as bankruptcy costs the value of firm is not affected by the mode of financing adopted. Therefore management in an efficient market should not worry on whether they are making the correct decision regarding either issuing stocks or selling debt. The M and M theory has two basics which need to be scrutinized dividend policy and capital structure. Capital structure gives the composition of debt capital versus equity. Equity is owner's capital in the company while debt capital gives the summation of loans that the company has taken. The management determines the proportion of the two sources of capital.

There are advantages associated with debt financing one of them is that the

creditors do not make decisions regarding how the firm is run. The debt can be redeemed unlike in owner's equity (ordinary shares). The interest accruing to the loans is paid before any dividends are issued thus debt financing has less risky than equity financing. Debt interest is tax free because it is considered as an expense to the company. The returns on equity are taxed twice i. e. corporation tax as well as dividends with held tax. Gearing will thus determine capital structure.

The higher the gearing ratio the higher the financial risk to be borne by shareholders. When shareholders accept to face this financial risk they expect higher returns unlike when they adopt low gearing policy. Therefore Modigliani-miller theory argues that it does not matter the mode of funding adopted hence value of unleveraged company is just the same as that of leveraged company. Irrespective of the choice of financing the result evens out.

The weighted cost of capital of a firm does not change according to Modigliani-Miller theorem even when a company changes its gearing policy. This is because when a firm increases its debt financing the financial risk rises hence financial distress has probability of occurring. The increase in debt reduces the return on equity (Brealey et al, 2006).

The dividend policy plays a critical role in providing the financial market with information on the internal working pertaining growth earning opportunities. (University of Leicester, 2007). The M and M theory has termed the dividend policy as being irrelevant this is because it takes this as just policy affecting earning retention. The theory supports its stand by stating that the different methods of equity financing gives equivalence of shareholders wealthy. For



example it is clear that if dividends are retained to finance expansion of a firm then the market price of shares rise this indicates raise in share holders wealthy. On the other hand when a company decides to sale new share to finance its additional projects, shareholders will receive high divides but they will not benefit from capital gains.

Company has the option of paying divides in cash form or even issue stock dividends. Issuing dividends increases the number of shares this does not alter the position of the company financially. The only difference is that the value of each share is altered. The company can opt to use the money required for paying dividends to repurchase stock, this stocks can be sold later. (Brealey, et al, 2006).

Market capitalization is the total value of the shares in a firm. It is considered when initiating the divided policy. To get the value of share the number total number of company shares is multiplied with the prevailing market value. This means that of dividends are paid the market share price increases built when dividends are retained the market prices falls in equal extend as the retained amount but the number of shares increase.

Contrary to M and M theorem, there are shareholders who depend on dividends as there income. This share holder never likes the idea of selling their shares because they fear that they will not make capital gains in future. In this case arbitrage techniques must be applied to ensure the shareholder generates the required income regardless of dividends policy. (University of Leicester, 2007).

The above consideration makes divided policy crucial. This is why dividend growth lags around two years behind earning growth to gives certainty on

ability to sustain the level in future. This is due to the fear of reducing dividends in subsequent year hence sending unfavorable information to the market. (Lumby and Jones, 2003). External financing through taking a loan, changes gearing ratio of a firm, it is therefore brings the interdependency between capital structure hypothesis and dividend irrelevance hypothesis. This correlation between the two elements forms the basis of the Modigliani-Miller theorem.

### **Tax exhaustion**

Gearing ratio is determined by tax exhaustion. There are times when a firm increases its debt financing to extend of having negative taxable income. This means that the company is unable to reap all the benefits of tax relief. Therefore the borrowing capacity must be constraint because the marginal cost i. e. the borrowing risk to be incurred lacks cushion of marginal benefit of tax relief. The tax factor is not exclusive the firm management considers the general industry gearing level as well. In addition, the company considers interest cover ratio of the available loan. This indicates the company ability to fulfill its debt obligations. The greater the interest cover ratio the lower the risk consequently the lower the marginal cost associated with the loan. The BP Company has not yet reached its tax exhaustion but the company gearing ratio has not been high. The company is comfortable with the tax shield associated with depreciation.

### **Profitability**

Modigliani and miller (1963, pp443-445) are of the idea that due to tax subsidies on interest paid against a loan management may prefer debt

financing. Therefore companies making very high profits may prefer high gearing ratios to gain from the tax shields associated with debt financing. This is contrary to DeAngelo and Masulis (1980 pp 3-29), which argues that these tax shields are irrelevant to the highly profitable companies because they already get depreciation tax shields. Myers (1984) is of the idea that companies prefer internal capital sources to external capital sources due to information asymmetry. Therefore gearing of highly profitable companies like Microsoft Company prefer internal debt financing. Therefore the level of gearing is inversely related to profitability.

### Conclusion

The trade off theory proposes that companies should aim at saving as much as possible from tax shield. On the other hand it tries to minimize the costs associated with obtaining external financing.

The M and M theory (1963) argues that, changing the capital structure does not in any way make the shareholder better off.

The management considers diverse reasons before deciding the capital structure of company but not only trying to benefit from tax shields offered by government.

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