

# [Importance of capital structure choice](https://assignbuster.com/importance-of-capital-structure-choice/)

Many academics have researched the relevance of capital structure choice and used many drivers to explain the choices of capital structure, being the drivers of cost of debt and capital core focus of many researchers. According to the papers of Myers and DeAngelo and Roll, companies monitor their capital structure and pay attention to their level of leverage and to drivers that influence their cost of financing. In this assignment, arguments on the degree of relevance of capital structure are presented first, then the key drivers of capital structure choice used by different researchers and lastly, the relevance of and business and industry profitability and risk.

1. The relevance of capital structure

Myers (2001) bases on Modigliani and Miller propositions and implies that companies may use the weighted average cost of capital to target a specific ratio that maximizes the value of the firm. Furthermore, based on Donaldson’s pecking order theory, he proposes a modified pecking order theory and affirms that most aggregate gross investment by U. S. nonfinancial corporations has been financed by internal cash flow rather than external financing, and most of that external financing is debt.

On the other hand, findings of Deangelo and Roll (2016) refute that companies target a ratio of capital structure and maintain target-rebalancing models to maintain such ratio that maximizes the value of the firm, they prove that many companies do not have stable capital structures over time but instead companies have wide target zones over which leverage is a matter of indifference with weak rebalancing incentives when external factors move leverage outside the boundaries of the target zone. However, they add that managers care about maintaining an investment grade credit rating that fits the desired target zone of leverage.

Milken (2009) argues that capital structure matters at any time for any corporation of any size because it significantly affects both value and risk of corporations. Moreover, he explains that economic cycles and patterns repeat and companies usually use capital markets to push out debt maturities and pay off loans, hence capital structure choice might be very influenced by the opportunities and threats presented to companies by the economic cycles they experience, which alter the options of funding available for companies.

Baker & Wurgler (2002) refute Modigliani and Miller capital structure irrelevance; they affirm that a variety of evidence suggests that equity market timing is an important aspect of real financial policy. Moreover, they found that market valuations have substantial effects on capital structure.

2. Key drivers of choice of capital structure

According to Myers (2001), the main drivers of the choice of capital structure are taxes, differences in information and agency costs, because those factors have an impact on the cost of debt, the cost of capital and the weighted average cost of capital of the firm.

Conversely, DeAngelo and Roll (2016) conclude that investment policy is a first-order influence on leverage decisions and two other very important factors are payout policy and financial flexibility. In addition, their findings show that important changes in leverage are related to significant increases in company’s asset growth and capital expenditure, which are due to company expansions when there are investment opportunities available and economic booms, as the one that followed World War II.

Consistently with DeAngelo and Roll, after performing an analysis based on acquisitions by Fortune 500 companies during 1981-1983, Amihud, Lev and Travlos (1990) found that companies with higher managerial ownership fraction are more likely to finance acquisitions by cash or debt rather than stock offer, hence they conclude that capital structure policies may sometimes be motivated by corporate control considerations. Furthermore, after surveying 392 CFOs of Fortune 500 firms, Graham & Harvey (2001) found that based on how they choose the level of leverage of the firm, financial flexibility was the factor that most CFOs considered as ‘ very important’, credit rating was the second factor, earnings and cash flow volatility was the third factor, the level of interest rates was in fifth place, interest tax savings sixth, transaction costs and fees seventh and bankruptcy/distress cost was only chosen as a ‘ very important’ factor by 20% of CFOs surveyed. In addition, they found that most companies had a flexible debt to equity target ratio or range, some did not have a target ratio or range and only 10% had a very strict target.

Therefore, their findings are consequent with DeAngelo and Roll affirmations that firms closely keep track of the credit rating, that financial flexibility is one of the most important factors for taking financial decisions and that most companies do not target a strict ratio and keep that capital structure constant over time.

Contrary to Myers pecking order theory that argues that issuing new equity signals that management thinks that the stock overpriced and a share repurchase signals an undervalued stock, Milken (2009) affirms “ history has shown that these theories are wrong with regard to deleveraging by companies, over the past 40 years when companies use the proceeds from issuance of stocks or other equity-linked securities to deleverage by paying off debt, the perception of credit risk actually declines and the stock price rises.”

According to Milken (2009), optimal capital structure evolves continuously, he identified six factors that indicate the rising business risk: the company and its management, industry dynamics, the state of capital markets, the economy, government regulation and social trends. Moreover, he adds that when financial institutions weaken by recessions, corporations are able to raise money cheaply in public and private markets and take advantage of low absolute levels of interest rates as in 2009. Consistently with Deangelo & Roll findings, Milken affirms that when corporations improve their balance sheets and have a strong capital structure, they turn to financial markets to obtain funding for expansion by mergers and acquisitions of companies.

Titman & Wessels (2016) identified eight key drivers of capital structure choice: type of assets owned by the company (according to Myers and Majluf it is advantageous for companies to sell secured debt due to information asymmetry), non-debt tax shields (Deangelo and Masulis argue that tax deductions for depreciation and investment tax credits are substitutes for tax benefits of debt financing), growth (might determine the choice of short or long term financing), uniqueness, industry classification, size (affects level of leverage, cost of issuing equity and choice of term of financing), earnings volatility and profitability.

Apart from factors already mentioned before, Harris & Raviv (1991) analyze three additional factors that affect capital structure choice: level of investment in research and development, advertising expenditures and free cash flows, they conclude that leverage increases with fixed assets, non-debt tax shields, growth opportunities, and firm size. On the other hand, leverage decreases with volatility, advertising expenditures, research and development expenditures, bankruptcy probability, profitability and uniqueness of the product. Their findings validate Myers affirmations that agency costs of debt are important for taking decisions regarding the level of leverage.

After using data from 29 OECD countries from 1981-2009 to perform a quantitative analysis of the effects of taxes on capital structure, Faccio & Xu (2015) concluded that corporate and personal taxes are significant determinants of capital structure choice, they found that firms tend to increase leverage when corporate taxes or personal taxes on dividend income increase and tend to reduce leverage when personal taxes on interest income increase. Hence, their findings are consequent with Myers affirmations that corporate taxes have effects on level of leverage of firms due to tax shields benefits.

While most research on capital structure choice is based on data from large U. S. firms, Chen (2004) performed research based on data from 88 Chinese public-listed companies for the period 1995-2000, he found that there is a negative relationship between profitability and debt and between the size of the firm and long-term debt, on the other hand, he found a positive relationship between growth opportunity and debt and between tangibility and debt. This proves that DeAngelo and Roll affirmations that investment opportunities for growth impact the level of leverage of firms.

Basing on a behavioural economics approach, Antonczyk & Salzmann (2014) used data of the dimensions of individualism and collectivism from 42 countries, individualism and collectivism are linked to overconfidence and optimism, the study aimed to determine if managerial irrationality is an important factor in corporate financing decisions. They found that countries with higher scores in individualism are related to higher overconfidence and have on average higher debt ratios.

After performing a research using market to book ratio to measure managers’ perception of timing opportunities, Barker & Wurgler (2002) found that low leveraged firms tend to be those that raised funds when their valuations were high, conversely high leverage firms were the ones that raised funds when their valuations were low, their hypothesis is that capital structure is the result of past financing decisions trying to time the equity market. Their findings relate to Myers pecking order theory that explain that internal financing is preferred, then debt financing and lastly equity financing and the lemons problem, because it proves that firms are only willing to sell equity when they consider that their stocks are overvalued or shift risk from debtholders to equity holders.

After undertaking interviews with companies’ secretaries and senior financial personnel of 48 listed Australian companies, Allen (1991) found that consistently with Myers, 75% of Australian firms did have a target ratio and tax issues had a major influence on financing decisions in 85% of the firms. Moreover, 52. 1% of the firms financed internally while 43. 8% financed internally and externally, 24. 4% of the firms financed medium/short term (up to 3 years). Furthermore, when considering the drivers of making an equity issue, 46. 7% financed to reduce leverage if market conditions right, 20% to make an acquisition and 8. 9% to fund a major expansion. On the other hand, consistently with Deangelo and Roll, the drivers of debt financing were: 32. 6% to fund a major expansion, 20. 9% to make an acquisition and 30. 2% if market conditions right.

3. Business and industries profitability and risk

Myers (2001) affirms that “ if debt has tax advantages for companies, firms with high profitability have more taxable income to shield and they can commit to more debt without risking financial distress.” Nevertheless, Myers found that debt ratios are low or negative for businesses with high risk, high profitability and considerable proportion of intangible assets. Consistently with this argument, Milken (2009) presents the case of industries as airlines, aerospace and technology, which overleveraged during the 1960s, but as the perceived risk of investing in those industries grew in the 1970s, their debt securities fell and they had to deleverage to avoid default. Moreover, Milken (2009) concludes that “ enterprises with more volatility in their revenue streams struggle the most with wrong capital structures because they tend to leverage too much during cycles of credit expansion and they are unable to build enough liquidity to survive contractions.”

For the case of China, Chen (2004) found a negative relationship between profitability and debt of Dow-China 88 index; he affirms that the pecking order theory of Chinese listed firms might be retained profits, then equity finance and lastly debt. The reasons why equity is preferred over debt: an undeveloped bond market, substantial capital gains in secondary markets, lack of enforcement of company laws, limited tax effects predicted by trade-off model due to the state controlling stakeholders of firms, being the owner of banks and the beneficiary of tax. Hence politics and legal enforceability has an impact on financing decisions of companies in different countries.

Titman & Wessels (2016) argue that according to many authors firms optimal debt level is a decreasing function of the volatility of earnings and basing on Myers pecking order theory, firms with high profitability have more retained earnings, and hence they might have lower debt ratios. Also, Faccio & Xu (2015) affirm that profitable firms and firms with positive tax outlays are more affected by corporate taxes, on the other hand, firms which have individuals as the marginal investor are more affected by personal taxes.

Conclusion

Capital structure choice is influenced by many external and internal factors that affect the cost of financing of firms. Decisions regarding capital structure are very important because they have consequences on the ability of the company to grow, fund operations and new projects at a lower cost, increase returns for shareholders and stay in business, as wrong capital structures may lead to bankruptcy.

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