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Does Capital Structure have an Impact on Operating Performance and Policies of the Firm?

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During the past forty years, Capital Structure[1] has been the subject of extensive literature in the theory of business finance. Several theoretical issues and valuation model regarding the impact of financial decision, particularly, debt policies have been appeared in finance literature.

The issue is whether or not the value of the firm can be changed by changing its capital structure. This may seem to be a relatively straightforward question, but empirical testing has proved difficult and complex.

The Modigliani and Miller's paper (1958), has been hailed as a landmark in the modern theory of finance. Taking the standard valuation model, M&M asserted the capital structure irrelevance

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1- The Mix of different firm's Security, Debt and Equity, is Known as its Capital Structure.

theorem by proving that, under strict conditions (e.g. no taxes, no bankruptcy cost, frictionless financial markets, earning stability), the value of the firm is independent of its capital structure and the cost of capital would not change by changing the capital structure, so long as the earnings do not change as a result of altering the capital structure, M&M assumed that the variability of operating earnings dictates the firm's risk class, and further assumed that this would not change by altering the capital structure.

One strand of the theoretical and empirical work has, therefore, concentrated on establishing the appropriate discount rate (r_A) for a firm by reference to its risk class. Alternative models have been developed to show the link between risk and cost of capital e.g. Capital Asset Pricing Model, Arbitrage Pricing Theory, Option Pricing Theory.

Another strand challenged M&M's strict assumptions and attempted to identify an optimal capital structure by reference to such variables as taxes (corporate and personal), information and signalling, financial distress and bankruptcy costs, financial transaction cost, non linearity of cost of capital, lenders attitudes and norms, agency problems, adverse incentives, earning volatility, industry characteristics, assets structure, cost structure and operating leverage.

Yet little, if any research, has examined the possible influences exerted by the capital structure on the operating earnings of the firm, though some of the factors identified in the literature implicitly recognise the existence of a relationship between earnings & capital structure. For example, volatility of earnings, cost of financial distress and cost structure are three operating factors which are suggested as explanatory variables for a given capital stucture.

Even then, the interesting question of the direction of causality in such a relationship does not seem to have attracted much attention, except perhaps for the financial stress vs gearing trade-off hypothesis. Yet, it is unclear, empirically speaking, whether firms treat capital structure as the managerial instrument by which to adjust for the effects of these underlying factors, or that firms adopt particular capital srructures and adjust their internal structures & policies to fit with the chosen structure. Empirical evidence, on the relationship between non-debt tax shields and gearing levels (De Angelo and Masulis, 1980, Bradley et al., 1984, Titman & Wessel, 1988), provide contradictory conclusions. Whereas, Bowen et al., 1982, Marsh, 1982, suggest that firms have target gearing levels dictated by industry norms.

Moreover, tests of equity market value changes following capital re-structuring (Wippern, 1966 and Brigham & Gordon, 1968, Masulis, 1980)suggest that M&M may be a good approximation of stable capital structure conditions (or modestly changing structures) but is inadequate in fully describing the effect of major changes. This represents an implicit recognition of a market inefficiency in information processing regarding assessing expected earnings and that financial markets accept the "management's, inside information" if signalled by this method. Capital structure then becomes a managerial instrument for managing market expectations and perceptions of the firm.

Therefore, a potentially useful approach to the study of capital structure, either searches for factors which lead to a particular capital structure decision, or isolates and examines the consequences of the given capital structure by examinng the extent and direction of any association between operating factors and decisions which influence the firm's earnings and its capital structure will represent a major contribution to the theoretical knowledge and financial decision making and lead to a better understanding of the valuation of firms and the value creation potential of leverage.

Our current research examines the capital structure decision from both points of view in relation to an increasingly important economic activity (Management Buy Outs). It attempts to identify the factors that influence the structure of the funding package and the consequences of this structure on the operation performance and policies of firms which have been bought out by the managers.

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