Capital Structure

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Abstract

The optimal proportion of debt to equity in capital structure has been theorized for many decades. Some experts suggest that the proportions of capital structure are irrelevant and have no weight on profitability. Others suggest that there is a trade-off to leveraging capital. Tax shields should correlate with interest rates, thus optimal capital structure will be dependent on corporate needs. While it incurs costs, debt has valuable advantages for consideration. The low fixed costs and tax deductions of debt are attractive to corporations. Financing though equity may serve similar purposes, however, accompanies high costs and increased investor demand. Additionally, legal rights of stockholders require companies to share profits and managerial oversight. Despite attractions to debt financing, there are associated risks. Financial distress is expensive. Poor planning and execution can lead to default or bankruptcy. Ultimately, there is no single capital structure that is optimal for every corporation. Financial managers should be prepared to modify and update their firm’s balance of debt and equity.

Capital Structure

Corporations are like snowflakes, no two are exactly alike. While companies may produce the same products or offer like services, none operate on the exact same corporate or capital structure. In fact, when analyzing the financial organization of highly profitable firms, there is not one secret formula to financial success. So, if each company is different, why analyze the proportion of debt to equity? Experts have concluded that corporate profitability is closely correlated to its capital structure and thus increasing value may not be accomplished without its fundamental financial analysis (Surowiecki, 2009). Examining various theories, benefits, and detriments to capital structure may enable financial managers to offer optimal solutions to their corporations.

**Capital Structure Theories**

Many have theorized of the corporate debt policies and the most ideal capital structure; none of which provide an optimal model. Traditional theories suggest that, given a low cost of capital and a high market value of the corporation, optimal debt to equity proportions truly exist. Further, more debt equates to a higher return on equity and offers higher profitability (Brealey, Myers, & Alllen, 2014). However, there are costs and risks to borrowing that should be considered; if there were not, companies would borrow for most of their assets, if not all. Ultimately, financial managers need to find the most appropriate arrangement of securities that 1. attract investors and 2. maximize the after-tax income (Surowiecki, 2009).

Two professors in the 1950’s, Madigliani and Miller (MM), theorized that debt and equity composition is irrelevant to the value of a firm because, despite the capital structure, value remains the same. They offer two propositions to support such a theory. The first suggests that the sum of two parts will always be the same no matter how the parts are divided. When splitting a candy bar with a friend, it is irrelevant how the proportions are divided: the entire candy bar will be eaten. Decisions of long and short-term debt also have no discrimination toward value. The second proposition suggests that investors will demand a higher return on the risk of debt. As debt increases, so will the expectation for a return. Thus, companies can use any combination of debt and equity and value will be unchanged. Of course, Madigliani and Miller do not consider costs of taxes, bankruptcy, or financial distress in their theory. These costs are a very real consequence of today’s economy and deserve thorough attention (Brealey, Myers, & Alllen, 2014).

Other theories such as the Trade-Off offer more specific insight into capital structure decisions. Experts suggest that when deciding on an appropriate debt policy, there is always a considerable tradeoff between interest rates (costs) and tax shields (assets). Thus, the Trade-Off Theory implies that such compromises will vary amongst corporations (or even project to project). Profitable companies with lower risks and high taxable income should incorporate more debt. These companies typically have lower interest rates and could easily benefit from tax shields. Yet, firms that have higher risks and much lower profitability should depend on a higher proportion of equity. The Trade-Off theory also considers the high costs of financial distress such as bankruptcy and those decisions made prior to bankruptcy. It formulizes that a firm should add debt until the benefits of its tax shield match the costs of such financial distress as demonstrated below:

*Value of all-equity financed + PV(tax shield) – PV(costs of financial distress)*

Far more theories exist than can be described here as optimal capital structures have been an ongoing controversy. No single theory encapsulates the needs or objectives of every corporation; such decisions are left to financial managers (Brealey, Myers, & Alllen, 2014).

**Benefits and Detriments to Leveraging**

Today’s financial experts have reiterated how debt is bad and interest payments are harmful to personal credit standings. In the event the loan cannot be repaid, such philosophies are true. However, in the corporate environment, financial managers must analyze the benefits of a suitable debt policy. First, the growth that can be generated by debt financing allows a company to expand, generate additional profits, or provide more secure business operations without sharing profits with shareholders. Debt’s quick liquidity is another benefit to companies with such a demand and can support emergency situations such as disasters, recalls, or product modifications. And while there are costs associated with debt financing, these costs are fixed, known in advance, and can be spread out long-term (Hartman, 2013). Ultimately, the greatest benefit to debt (and maybe the single-most reason to leverage) is that interest payments paid on the debt are tax deductible. Thus, the optimal capital structure would be one in which interest expense equated to the corporation’s tax shields.

Corporate financing can, of course, be accomplished through equity financing and could offer risk mitigation. However, there are disadvantages to doing so. First, the profit generated by financing through equity must be shared with stockholders or other investors. These investors will expect to be updated and informed about operational, administrative, and managerial decisions that affect their investment. Additionally, high costs accompany the issuing of stock, stock splits, or other associated methods with equity financing. Finally, stockholders have high expectations for the return on investment when they have contributed monetarily (Nolo, 2007). James Surowiecki (2009) reports that tax shields can make corporate debt forty-two percent less expensive than financing through equity. Often the safer bet of financing through equity does not outweigh the risks of debt (Surowiecki, 2009).

While the tax code is written to support leveraging capital, there can be too much of a good thing. The most recent U.S. economic crisis was an example of debt exceeding benefits. The most considerable disadvantage of debt financing is that of default. High costs are not only associated with bankruptcy but also that of the decisions made prior to the bankruptcy decision. Without accountability from stockholders (as corporations would have through equity financing), decisions made with debt may easier lead to default decisions (Surowiecki, 2009). High interest payments are another significant disadvantage to debt. Corporations lacking stable credit history (or credit history at all) often find debt is more costly. Cyclical operations and poor borrowing practices for these corporations will lead to poor financial health (Graham, 2000). And despite the financial health of a company, lenders will see higher-debt financed companies as a higher risk.

**Conclusion**

So what is the most optimal capital structure? Join the hundreds of experts analyzing the secret formula. Ultimately, the answer will be found within the corporation through its financial discipline, operational practices, and ability to effectively generate profits. High risk projects should be financed though equity. The accountability of investors will enable the company to stay on track without the risk of bank default. Unleveraged firms should consider adding debt to its capital structure as it would provide a tax shield and save money. The capital structure is a balancing act of risks, profits, and returns. Financial managers must often analyze the best mix of debt and equity for their company as it can quickly become unbalanced. One answer is not right for every company or for each company forever. Capital structure is an ongoing study that requires financial discipline.

References

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