Financial Management

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Part A: ***Discuss Critically evaluate the importance of capital structure and the cost of capital in the efficient financial management of large companies..***

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Part A: ***Critical evaluation of the importance of capital structure and the cost of capital in the efficient financial management of large companies***

A.1. Capital structure is defined as

> *'The way a corporation finances its assets through some combination of equity, debt or hybrid securities. A firm's capital structure is then the composition or structure of its liabilities' (Wiki, 2009)*

It comprises of some or all of the following:

Equity: Preferential shares, common shares

Debt: Short term debt, corporate bonds, warrants, convertibles, capital leases as a substitute for financing debt.

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While the theory of modern capital structure dates to Modigliani-Miller's (1958) work, it assumes perfect market conditions. In reality, however financing decisions do impact a firm's value and investing decisions. This is driven by market imperfections like taxes, bankruptcy costs, agency costs and information asymmetry (Harris & Raviv, 1991). These imperfections have led to the search and definition of what could be the optimal capital structure and is an issue addressed by several theories.

Trade-off Theory: This leads to the understanding that capital structure is driven by a trade-off between potential increase in a firm's value through interest tax shields and the decrease due to the costs of financial distress. It helps understand why most companies e.g. in the airline industry have historically operated with high leverage. They have airplanes which are safe, tangible assets and (before the past few years and the fluctuations in costs of aviation fuel) steady taxable income. Alternately, most technology and service companies (even those with large steady incomes) operate with little debt since they have largely intangible assets. However it fails to explain why really profitable companies e.g. Microsoft, Pfizer etc. despite large tax shields have low or no debt.

Pecking Order Theory:

Since asymmetrical information means that management knows their own company better than the markets, they prefer using internal funds i.e. reinvested earnings to external financing i.e. new debt, followed by hybrid securities and then new equity issues in that order. Thus, despite potentially high target debt ratios, within an industry, the most successful firms are most likely to have lower debt levels than the lesser successful firms (Marsh, 1982).

This also explains why companies with high risk offer warrants and convertibles instead of simply issuing equity when they are unable to get secured long term debt. These instruments allow holders to impose restrictive conditions on future issues of debt and diminish the conflicts of interest between shareholders and bondholders.

Impact of Growth Opportunities: Research shows that companies with higher and positive NPV growth prospects tend to have comparatively lower debt compared to lower growth companies and industries (Moon and Tandon, 2007). This is because for high steady income corporations, high leverage is beneficial. As per the free cash flow hypothesis, managers receive utility from increasing firm size and thus the over-investment problem is more severe for firms with fewer growth opportunities. In fact the scheduled interest and principal payments of debt play a disciplinary role and act as a control mechanism affecting finance decisions and forces managers to make improvements in operating efficiency, leading to more efficient financial management.

Impact of type of equity ownership: Not only does the amount of leverage impact the overall financial health of a corporation, so does the details of who holds the large equity stakes in the corporation i.e. the profile of the key shareholders.

1. *State Ownership*: Large corporations with a large degree of direct or indirect state ownership are likely to be less efficiently managed than those owned through private ownership, and are likely to have a lower growth rate per capita of income (Panayotis Kapopoulos, Lazaretou, 2009). This is one reason why the current bail-outs of large corporations like AIG and General Motors with tax-payer money, though deemed necessary, are in fact a matter of concern for the future.
2. *Managerial Equity*: Giving stock options to managers is held to be common wisdom now, since it gives them a vested interest in ensuring the efficient running of the company. However, too much of a good thing is not too good. In fact, the ability of managerial equity ownership to reduce agency costs decreases as levels of ownership increase. (Kate Jelinek, Pamela S. Stuerke, 2009). Also, in some industries, high levels of ownership lead to increased expense ratios, suggesting increased perquisite consumption. This suggests that, above a certain level in some industries, managerial equity ownership only marginally encourages efficient asset utilization but does not significantly deter excessive spending.

Impact of Country of Operations: Where a specific company is listed and which countries it has its operations in has implications on optimal levels of leverage to ensure efficient financial management of the

company. This is due to several reasons e.g. local corporate taxation levels, robustness of legal systems, economic climate etc.

1. *Corporate Taxation Levels*: Higher corporate taxes imply a greater need for large tax shields, encouraging higher leverage. At the same time, low corporate taxes in specific countries, may also encourage more companies to list and base themselves there. This in fact, is a ploy often used by developing countries, to attract foreign companies and lead to rapid growth in the local economy.
2. *Legal and Financial Framework*: Developed countries, are likely to have more stable, robust legal and financial systems and be better at protecting the rights of financial claimants. Hence in such countries, firms are likely to have lesser total debt and more long-term debt as a proportion of total debt. (Fan, Joseph P. H., Twite et al, 2008). As a result, the relationship between profitability and leverage tends to be stronger in countries with weaker shareholder protection.

Impact of Geographical Spread of Companies: As multi national companies (MNCs) operate in many imperfectly correlated economies, they would be expected to have lower earnings volatility, leading to a lower probability of bankruptcy. This given the trade off between interest tax shields and expected costs of bankruptcy would theoretically be expected to lead to higher leverage. However, international

diversification leads to an exposure to fluctuating exchange rates, varying tax systems, international political risk and systematic differences in the agency costs as compared to domestic (single country) corporations. These factors have led to MNCs having lower levels of total debt than domestic corporations, as shown through empirical data (Todd A. Burgman, 1996)

A.2. There exist two concepts of 'cost of capital' (Brealey-Myers, 2003*)*

Opportunity cost of capital (r): This is the expected rate of return offered in capital markets by equivalent-risk assets. It depends on and varies with the risk of a project's cash flows, and is the correct discount rate for all-equity-financed projects

Adjusted cost of capital (r*): This is an adjusted opportunity cost or hurdle rate that reflects the financing side effects of an investment project.

Usually a weighted average cost of capital (WACC) is used to evaluate equity-financed decisions; it encapsulates the impact of the cost of debt resulting in WACC being lower than the opportunity cost of capital. WACC is important in that it is used as a *'hurdle rate'* to value and evaluate financial profitability of proposed capital investments.

However, since WACC assumes similar risk profiles, it cannot be used be used by large diversified corporations across all industries. A different WACC for each unrelated industry is needed. Also, in case of securities like convertibles and junk bonds, the odds of default being high, it is difficult to estimate the expected rate of return and hence WACC. However, since on most debt, defaults are rare, an approximation of WACC could be used for valuation.

The importance of WACC lies in the fact that it can be used as a benchmark for almost all investment decisions. Where needed, due to differences in business risk or financing debt-equity ratios it can be adjusted e.g. by debt rebalancing. However in cases where WACC cannot be used adjusted present value (APV) is needed.

Thus we see that both capital structure and cost of capital are interconnected concepts which have an extensive impact on the financial management of large corporations and hence need to be managed. In fact, the choices made by corporations are actually heavily influenced by prevalent market conditions and thus vary by numerous factors e.g. growth opportunities, pattern of equity holding, diversification across geographies, nature of assets, bankruptcy risks, taxation schemes etc.

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