Chapter 17: Capital Structure

The *stakeholder theory* of capital structure holds that the way in which a organization and its nonfinancial stakeholders cooperate is an important determinant of the organization's optimal capital structure. These nonfinancial stakeholders may be less willing to do business with a organization that is in financial distress. The interaction between how a corporation is financed and how it is seen by its stakeholders holds that the capital structure decision must be incorporated into the overall corporate strategy of the organization.

The environment in which a organization does business includes:

- customer considerations
- employee considerations
- competitor considerations
- supplier considerations
- community considerations

All these considerations have an impact on corporate strategy.

The nonfinancial stakeholders of a organization have no stake in the financial health of the organization. Financial distress can be costly for an organization because it affects how the view that customers, employees, suppliers, and any other organizations or individuals that have a stake in the organization, have. Financial distress also will be costly for organizations that require their employees and suppliers to invest in product-specific training and physical capital. However, organizations that create nondurable goods or provide services that are not specialized, probably have low financial distress costs.

In *bilateral monopolies*, the terms of trade between the parties are open to negotiation. In such cases, the financial distress of a organization may provide it with a negotiating advantage because suppliers and employees must then consider how their wage and price demands affect the organization's future viability. Financial distress can benefit some organizations by improving their bargaining positions with their stakeholders.

The costs of financial distress outweigh the benefits of the government subsidies. On the other hand, the potential government subsidy is absolutely a consideration that will guide organizations toward using more debt financing.

Organizations can sometimes benefit from debt if high debt ratios allow them to commit to an aggressive output policy that they otherwise would not be able to adopt. For example, a organization may wish to send a message to its competitors that it plans to raise its production. If the competitors pay no attention to this message, the extra production is probably to lessen the price of the output and, thus, cut profits to both the organization and its competitors. Though, the competitor may accommodate the organization by reducing its output instead of engaging a price war. In this case, the organization's profits raise.

Leverage effects the competitive dynamics of an industry. In some situations, leverage makes organizations more aggressive competitors, in other less aggressive.

A highly leveraged organization might be particularly exposed to *predation* from more conservatively financed competitors. A competitor might deliberately lower its prices in an try to drive the highly leveraged organization out of business.

The predatory policy of the conservatively financed organization is particularly effective in industries where customers and other stakeholders are concerned about the long-term viability of the organizations with which they do business.

The empirical evidence supports the idea that high leverage tends to produce losses is market share. There are three reasons:

1. The financially distressed organization faces debt overhang and may invest less, be forced to sell off assets, and reduce its selling efforts in other ways.
2. Because of concerns about its long-term viability and the quality of its products, a highly leveraged organization may find it hard to retain and attract customers.
3. Rivals may view a highly leveraged organization as a less formidable competitor and grab the opportunity to steal its customers and perhaps remove it.

According to the *static capital structure theory* organizations weigh the costs of having too much debt when they are doing poorly against the tax benefits of debt when they are doing well to arrive at their optimal capital structures.

Dynamic capital structure theory is the dynamic process that manages the capital structure choice. Managers make their financing decisions on the basis of what is called the pecking order of financing choices. There are several reasons for this behaviour:

- Managers personally benefit from having their organizations relatively unlevered.
- Managers are unwilling to issue stock when they believe their shares are undervalued.
- Most nonfinancial stakeholders like the fact that the organization issues equity.

When the costs of changing the capital structure are high, an organization's capital structure is determined by its past history:

- Very profitable organizations probably experience raised equity values and thus lower leverage ratios.
- Unprofitable organizations may experience lower equity values and raised debt, and thus have higher leverage ratios.

Organizations deviate from their target or long-term optimal capital structure because of transaction costs and the debt overhang problem and are more likely to take actions that move them toward their optimal ratio when financial distress costs are high.

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