ISSN: 2688-9323

The Impact of Capital Structure on Corporate Performance

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Abstract

Capital structure reflects the proportion of investment capital and borrowed capital, which directly affects the total capital cost and affects the corporate performance. Capital structure is one of the important indicators to analyze and evaluate the financial situation and credit level of a company. With the development of our society, the capital market is constantly improving. Therefore, corporate performance needs to be concerned. Capital structure as an important factor affecting the performance of the company, so there is an important research argument between capital structure and corporate performance in the academic field.

Keywords

Capital Structure; Corporate Performance; Listed Company.

1. Background

The market competition is increasingly fierce due to economic globalization in recent years. For the purpose of surviving and developing in the fierce market competition, corporations are constantly looking for ways to enhance corporate performance. Capital is the basis on the development of the companies[1]. Capital structure reflects a financing methods and financing structure of the companies, which plays an important role in the management of a corporation. Thus, companies need to consider the approaches which can reduce the cost of financing and obtain the necessary funds for operating activities at a low price. According to the relationship between capital structure and corporate performance, the reasonable capital structure is determined so as to enhance corporate performance. Therefore, it is necessary to process a study on the impact of capital structure on corporate performance.

There are two important aspects of capital structure. To the broad sense, capital structure is the formation of capital, which contains the combination of equity structure and debt structure. Such as issued bonds, bank loans, payable accounts, issued stocks, etc. To the narrow sense, capital structure refers to the proportion of long term debt and long term equity. Since the famous MM theory was proposed by Miller and Modigliani in 1985, the relationship between capital structure and corporate performance has been studied and explored continuously by academic circles. MM theory claims that there is no relationship between capital structure and corporate performance. However, there is no instructive sense to reality, because of the harsh assumptions. After that, scholars constantly relax the hypothesis, introducing tax, bankruptcy costs, agency costs and other factors. Even more, scholars put forward the balance theory, agency theory, pecking order theory and signal theory. Nowadays, the study of capital structure and corporate performance is also divergent and some conclusions even contradict each other. The results are also different between western capital market and the eastern empirical research. Therefore, the research on the influence of capital structure on corporate performance is more meaningful. At present, adjusting the capital structure and improving the performance of the company are the most important issues that need to be discussed and solved.

2. Motivation of This Study

Capital structure is an important part of financial management, which might also significance for corporate structure, corporate value and corporate performance. It is clear that the appropriate capital structure is beneficial for companies to standardize behavior, which can also improve the value and performance of companies. In addition, the change on capital structure is a signal for the corporation, which can reflect the expectations of investors to the enterprise future earnings. The research of capital structure and corporate performance can not only illustrate the intrinsic relationship between the proportion of capital structure and the value of company, but also provides theoretical underpinnings to guide the investment decision and financing decision. The previous theoretical underpinnings include Modigliani and Miller theory, Trade-off theory, agency theory, pecking order theory and signaling theory. Based on these theories, this study can continue to consider empirical implications which are important to explain whether or not capital structure is related to corporate performance.

3. Theoretical Underpinnings

3.1. Modigliani and Miller Theory (MM Theory)

MM theory is divided into three different stages. The first stage is the early MM theory which is not includes tax. The second stage is the modified MM theory which is includes tax. The third stage is called as Miller model:

(1). the early MM theory (without tax). Modigliani and Miller initially proposed the MM theory in 1958, which established the footstone of capital structure. The early MM without tax theory concluded that the market value of an enterprise is related to the expected level of return rather than the capital structure. However, the conclusion is based on some key assumptions which are not really existed. First, tax are not considered in the early MM theory, neither corporate tax nor personal tax. Second, the early MM theory assumes that the capital market is perfect, thus there is no transaction cost and bankruptcy cost in the market. Third, capital can freely flow without constraint, however, in the real world, there are a large number of factors might impede capital flows. Fourth, information is available to both insiders and outsiders who might not easy to access[2]. Therefore, Modigliani and Miller theory revised the early MM theory.

(2). the revised MM theory (with corporation tax).

In 1963, Modigliani and Miller introduce tax on the basis of the early MM hypothesis. The revised MM theory reveals that the interest expense can deduct tax, so the company can achieve the purpose of tax saving. As a result, the value of the company will be increased and the performance of the company will be improved [3].In conclusion, the revised MM theory can be simply summarized as under the condition that corporate tax are taken into consideration, the more debt financing, the higher the company performance. Therefore, when the debt ratio reaches 100%, the value of enterprise is biggest.

(3). Miller’s theory (with corporation and personal taxes).

Miller revised the MM theory again in 1977. Corporate income tax is introduced in Miller’s theory, meanwhile, the personal tax also been taken into consider. The model uses the personal income tax to correct the modified MM theory, because the modified MM theory overestimates the benefits of debt. The loss of personal tax and the reduction of corporate tax through borrowing debt are roughly equal. Thus, the Miller model went back to the original MM theory[4].

3.2. Trade-off Theory

On the basis of MM theory, Trade-off theory emphasizes the optimal capital structure of maximizing the value of company. In addition, firms with volatile cash flows and high sensitivity to economic shocks can lead to financial distress or even bankruptcy if they use too much debt. The costs caused by enterprises in financial distress are divided into direct and indirect costs. First, direct cost refers to the legal expenses and administrative expenses incurred by the bankruptcy, liquidation and reorganization of an enterprise. Second, indirect cost refers to the loss of enterprise value caused by financial distress, which leads to the deterioration of enterprise credit status and the decline of continuous operation ability. Such as, it might lead to loss of company's customers, suppliers and employees.

In 1970s, Myers and others introduced the cost of bankruptcy on the basis of considering the tax revenue. There are three forms of the relationship between debt borrowing and corporate performance. Firstly, if the tax saving of debt is greater than the cost of financial distress, the tax detectable of debt plays a leading role. Secondly, if the tax benefit and the financial distress are the same amount, the enterprise value is the highest. Meanwhile, debt to equity ratio is the optimal capital structure. Thirdly, if the tax saving from debt is less than the cost of financial distress, the adverse effects of financial distress will excess the benefit of tax saving of debt, so the value of enterprise may even accelerate the decline. According to the Trade-off theory, if the bond capital is greater, the performance of the company will be greater. However, under the condition that the debt is extremely high, which might cause an increase in agency costs and bankruptcy costs. As a result, excessive debt borrowing might lead to a decline in corporate performance. Furthermore, there are two important factors which may influence financial distress. The first important factor need to be noticed is that the profitability of financial distress. The second factor is the cost of an enterprise's financial difficulties.

3.3. Agency Theory

If a principal needs the help of an agent to operate the activities of the company, there might produce agency problem. Agency theory is used to study the cause of the problem and to learn the ways to control the problem. In the agency theory, the shareholders could be described as principals in a company. Even more, the managers could be described as agents who are authorized to represent the interests of shareholders. However, in reality, there is the power of shareholders is extremely restricted. In general, shareholders have no right to inspect the books of account and observe the inventory of warehouse [5].

Agency theory might lead to some agency problems. There are two main important agency problems need to be listed as follow. First, there is an assumption of agency theory that agent and principal only represent their own self-interest. The interests between agent and principal may conflict to some extent. The shareholders have no ability to run the business, which might cause agency problem in the company. Therefore, shareholders might have tendency to depend on the ability of directors. In addition, shareholders are the representative of the principals. Meanwhile, directors are the representative of the agents. Second, if the manager deliberately violates trust because of personal interests, the separation of ownership and management might cause intentional action, omission, neglect or incompetence[6].

In order to solve the agency problem, some agency solutions need to be taken into account. There are two essential solutions need to be considered. Firstly, one essential solutions need to be considered is that shareholders exercise the power to dismiss the management from organization. However, shareholders need to take some actions to solve the problem. In a large number of companies, the shareholders might not have enough power to solve the self-interest. Eventually, the shareholders need to vote for the result whether or not the manager should be dismissed or removed. Secondly, shareholders need to take some actions to exercise control. However, the actions might be expensive, time consuming and difficult to manage. In addition, the reasons why control activities are expensive are due to the wasteful of time and hard to handle due to the two dilemmas. First, it is difficult to verify the actions of directors. The manager can get more information than the shareholders about the activities. Second, it seems difficult to introduce actions to control the activities of the manager, which might prevent the effective and efficiency of the operation.

3.4. Pecking Order Theory

In 1984, the pecking order theory was put forward by Myers and Majluf. The biggest innovation of the pecking order theory is that it focuses on the transaction costs of financing. Thus, pecking order theory believes that organizations should first choose the financing methods which have lowest cost. Therefore, the first choice of corporate finance is retained earnings, followed by low risk bonds, and then takes high risk bonds into consideration. Finally, the company will consider issuing shares.

The internal financing primary uses the cash flow in the company, which can be calculated as the net profit plus depreciation and then minus dividend. It is unnecessary for an enterprise to sign a contract and pay a large amount fees with investors by the use of internal resources, so internal financing is the preferred methods of financing. Under the condition that the retained earnings are not enough to the requirements of the project capital, and then external financing is needed. Debt financing is always primary be chosen between external debt financing and external equity financing, because investors believe that corporate stocks are more likely to be overvalued than bonds [7]. Therefore, in the process of raising capital, enterprises should follow the basic order of first internal financing and then external financing. If external financing is needed, priority should be given to debt financing (first ordinary bonds, post convertible bonds), and equity financing will be considered in the light of the differences in risk procedures. Especially, in the case of overvalued stock, management will try to finance new projects by issuing additional shares, allowing new shareholders to share the risk of investment.

Pecking order theory draws numerous conclusions which need to be summarized and listed as follow. Firstly, companies prefer internal financing to raise capital. Secondly, in general, changes in the net cash flow of companies might reflect changes in external financing. Thirdly, if external financing is necessary for the company, the company will first issue the safest securities, that is, the companies will primary issue debt. Fourthly, the debt ratio of the companies can be seemed as a mirror which means the cumulative demand for the external financing of the company.

3.5. Signaling Theory

Signaling theory can be defined as the capital structure of an enterprise can transmit information about the future development of an enterprise, which was proposed by Ross in 1977. Linter and Pettit promoted the development of signaling theory, showing that the more of the executives and entrepreneurs hold, the higher the value of information that companies deliver to the outside. The high debt ratio shows that the company is confident in the development of the next few years, which also represent an increase in the value of business to attract investors. In addition, in 1977, Ross proposed four conditions that must be met for effective information delivery. The first condition is that the management of the company is always active in making real signals. The second condition is that the enterprise will perform good performance of signal, which is difficult to be imitated by the enterprise with poor performance, because of high costs. The third condition is that the signal must be connected to observable events. The fourth condition is that in the case of passing the same quality information, there is no lower cost than the theory of information transmission[8].

There are still a large number of defects, although signaling theory has been widely accepted as the mainstream theory of dividend distribution policy. First, market response to increase and decrease of dividend can not only demonstrated by signaling theory, but also can be demonstrated by other theories, such as agency cost theory. Second, signaling theory cannot illustrate and forecast the differences of dividend in different industries and countries in an effective and efficient way. Third, signaling theory might not explain the reason why companies do not convey information in other cost effective ways. Fourth, under the condition that the market becomes more and more effective, dividend payments cannot simply be used as a unique means of signaling. Fifth, in the fast growing industries, dividend payout ratio is generally low. However, the enterprises with low payout ratio often have good corporate performance.

4. Suggestion for Improving Corporate Performance

Capital structure is the core of corporate management, which plays an important role in the development of the company. Based on the studies on the capital structure and performance of listed companies, the following opinions are put forward:

First, the capital structure of the listed companies should be further adjusted and optimized. According to the Trade-off theory and agency theory, listed companies should balance the costs and risks which arising from equity financing and debt financing. For the purpose of improving the performance of listed companies, a reasonable capital structure needs to be established. The listed companies can reduce their financing costs by issuing shares in the capital market, increasing short-term liabilities and reducing long-term liabilities, thus corporate performance can be improved.

Second, the mechanism of corporate governance and the system of company management of listed companies need to be improved. Resolving the conflicts between shareholders and directors is an important part of corporate governance. There are two main ways to solve the problem, which can be named as incentive policy and control policy. First, incentive policy is the company gives directors a certain amount of incentives and benefits, such as bonuses and shares of the company. Second, control policy refers to the control and supervision of managers, such as the appointment of independent directors. The purpose of incentive and control policy is to implement employee stock ownership plans, increase the proportion of executive stock ownership and stimulate the enthusiasm of employees within the enterprise. Therefore, corporate performance can be improved.

Third, the listed companies need to broaden financing channels. On account of most of the listed companies will face financing difficulties. Therefore, the listed companies need to broaden the financing channels for enterprises continuously, such as corporate bonds, financing leases, retained earnings and so on.

Fourth, the shareholding ratio of largest shareholder in the listed companies needs to be increased. The way of increasing the shareholding ratio of the largest shareholder is conducive to the consistency of corporate policy, which might also reducing agency costs and increasing corporate performance.

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