Capital Structure Management 14 April, 2007

1) What is the objective of capital structure management?

The objective of capital-structure management can be viewed as the endeavor to find the financing mix that will minimize the firm's composite cost of capital and maximize the value of the stock.

2) Why is there a built-in conflict between stockholders and bondholders.

Stockholder and bondholders have different objectives, and this can lead to agency problems, whereby stockholders expropriate wealth from bondholders. The conflict can manifest itself in a number of ways. For instance, stockholders have an incentive to take riskier projects than bondholders, and to pay more out in dividends than bondholders would like them to. The conflict between bondholders and stockholders can be illustrated dramatically using the option pricing methodology.

Since equity is a call option on the value of the firm, other things remaining equal, an increase in the variance in the firm value will lead to an increase in the value of equity. It is therefore conceivable that stockholders can take risky projects with negative net present values, which, while making them better off, may make the bondholders and the firm less valuable.

Bondholders and stockholders may also experience conflict in the case of conglomerate mergers, where the variance in earnings and cash flows of the combined firm can be expected to decline because the merging firms have earning streams that are not perfectly correlated. In these mergers, the value of the combined equity in the firm will decrease after the merger because of the decline in variance; consequently, bondholders will gain.

Stockholders can reclaim some or all of this lost wealth by utilizing their higher debt capacity and issuing new debt.

3) What management behavior may be displayed when there is substantial free cash flow? How does “levering up”, the “threat hypothesis” and the “free cash flow theory of capital structure” relate to the cure for this problem.

The interests and incentives of managers and shareholders conflict over such issues as the optimal size of the firm and the payment of cash to shareholders. Managers have incentives to cause their firms to grow beyond the optimal size. Growth increases managers’ power by increasing the resources under their control. It is also associated with increases in managers’ compensation, because changes in compensation are positively related to the growth in sales. Conflicts of interest between shareholders and managers over payout policies are especially severe when the organization generates substantial free cash flow. Free cash flow is cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital. The problem is how to motivate managers to disgorge the cash rather than investing it at below the cost of capital or wasting it on organization inefficiencies.

Payouts to shareholders reduce the resources under managers' control, thereby reducing managers' power, and making it more likely they will incur the monitoring of the capital markets which occurs when the firm must obtain new capital. Financing projects internally avoids this monitoring and the possibility the funds will be unavailable or available only at high explicit prices.

Managers with substantial free cash flow can increase dividends or repurchase stock and thereby pay out current cash that would otherwise be invested in low-return projects or wasted. This leaves managers with control over the use of future free cash flows, but they can promise to pay out future cash flows by announcing a "permanent" increase in the dividend. Such promises are weak because dividends can be reduced in the future. The fact that capital markets punish dividend cuts with large stock price reductions is consistent with the agency costs of free cash flow.

As a possible cure for the problem, leveraging-up debt can reduce the agency costs of free cash flows, and can substitute for dividends. To fully leverage debt, without retention of the proceeds of the issue, enables managers to effectively bond their promise to pay out future cash flows. Thus, debt can be an effective substitute for dividends