

# A Survey of the Relation Between Capital Structure and Corporate Strategy

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## ABSTRACT

This paper responds to the general call for integration between finance and strategy research by examining how financial decisions are related to corporate strategy. In particular, the paper focuses on the link between capital structure and strategy. Corporate strategies complement traditional finance paradigms and extend our insight into a firm's decisions regarding capital structure. Equity and debt must be considered as financial instruments as well as strategic instruments of corporate governance (Williamson 1988). Debt subordinates governance activities to stricter management, while equity allows for greater flexibility and decision-making power.

The literature on finance and strategy analyzes how the strategic actions of key players (managers, shareholders, debtholders, competitors, workers, suppliers, etc) affect firm value and the allocation of value between claimholders. Specifically, financing decisions can concern value creation process (1) influencing efficient investments decisions according to the existence of conflict of interest between managers and firm's financial stakeholders (shareholders and debtholders) and (2) affecting the relationship with non-financial stakeholders, as suppliers, competitors, customers, etc.

To summarize, the potential interaction between managers, financial stakeholders, and non-financial stakeholders influences capital structure, corporate governance activities, and value creation processes. These in turn, may give rise to inefficient managerial decisions or they may shape the industry's competitive dynamics to achieve a competitive advantage. A good integration between strategy and finance dimensions can be tantamount to a competitive weapon.

**Keywords:** *Overinvestment; underinvestment; risk-shifting; capital structure; corporate strategy.*

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## 1. Introduction

This paper responds to the general call for integration between finance and strategy by examining how financial decisions are related to corporate strategy (Kochhar and Hitt 1998). With relatively few exceptions, strategic management and finance appear to be in schizophrenic tension, if not in direct opposition (Ward and Grundy 1996). Bettis (1983) argued that modern financial theory and strategic management are based on very different paradigms, resulting in opposing conclusions. The conflicting state of these two knowledge systems might not matter if managers were able to make the linkages between strategy and finance with ease in practice (Grundy 1992). But the few (empirical) studies available suggest that the general managers do not find these linkages at all easy to make.

The polarity between finance and strategy, two areas of research that traditionally are studied separately, is just apparent, instead, these two areas present many connections, and it is relevant to understand the way in which these areas function individually and interrelate.

In particular, the link between financial decisions and strategy is largely unexplored. An extremely relevant topic, notoriously controversial, to the academic and business communities relates to capital structure decision and their effects on firm's creation of value. A firm's capital structure refers, generally, to the mix of its financial liabilities. In analysing capital structure we focused on the type of funds, debt or equity, used in the firm for financing. Debt and equity are the two major classes of liabilities, with debtholders and shareholders representing the two types of investors in the firm. Each of these is associated with different levels of risk, benefits, and control. While debtholders exert lower control, they earn a fixed rate of return and are protected by contractual obligations with respect to their investment. Shareholders are the residual claimants, bearing most of the risk, and, correspondingly, have greater control over decisions.

In the past, financial theorists suggested that, in perfect and efficient market, financing decisions may be "irrelevant" for firms strategy (Modigliani and Millet 1958); however, in the real world such choices may differentially affect firm value, explicitly because there are several imperfections (Myers and Majluf 1984). Several strategy scholars have argued that financial decisions have strategic importance (Barton and Gordon 1987, Bromiley 1990, Kochhar 1996), especially in affecting corporate governance (Jensen 1986). Oviatt (1984) suggested that a theoretical integration between the two disciplines is indeed possible, and that according to the way managers, firm's financial stakeholders and firm's non financial stakeholders interrelate, transaction cost economics and agency theory provide possible avenues. Barton and Gordon (1987) pointed out that corporate strategies complement traditional finance paradigms and enrich the understanding of a firm's capital-structure decisions. In addition to tax reasons, the value of a firm can be affected by financing decisions in the moment that information asymmetries between the firm's management and its stakeholders are noted, or when "real" decisions differ from financing decisions, because of agency problems, for example, or whether costs of financial distress are generated due to debt. Therefore, it is important to better understand the potential interrelation between capital structure and corporate strategy.

In general, the literature on finance and strategy analyzes how the strategic actions of key players (managers, shareholders, debtholders, competitors, workers, suppliers, etc) affect firm value and the allocation of value between claimholders<sup>1</sup>. It is possible to provide a different role to this corporate players according to how "close" they are to the core of the corporation; if they are corporation's owners, as shareholders and debtholders, or if they are at the boundary of the core, as suppliers, competitors, customers, etc. Specifically, capital structure decisions can concern value creation process (1) influencing efficient investments decisions according to the existence of conflict of interest between managers and firm's financial stakeholders (shareholders and debtholders) and (2) affecting the relationship with non-financial stakeholders, as suppliers, competitors, customers, etc.

From one side, this paper describes the factors affecting agency problems with the financial stakeholders, explaining how debt can cause shareholders (managers) to take on projects that are too risky and to pass up profitable investments, but also identifying various situations in which debtholders and shareholders may disagree on the decision to liquidate the firms. The interactions between managers, shareholders and bondholders can influence the process of identifying, selecting and choosing investment projects and, as a result, the processes of value creation<sup>2</sup>. The presence of these conflicts, together with information

<sup>1</sup> Financial policy decisions of firms is the product of deliberate choices in a strategic environment that features numerous other actors, each armed with their own disparate agenda.

<sup>2</sup> When a firm is defined as a "nexus of contracts" (Jensen and Meckling, 1976) all those who have an interest in the firm's activities are part of the whole of explicit and implicit contracts that a firm is made up of. In this sense, managers are different from all the other stakeholders, since they hold a central position of coordination and execution of all the firm's contracts. Managers have direct control over business activity (even though the stockholders, or suppliers of risk capital, have

asymmetries and incomplete contracting, can give rise to suboptimal investment strategies that do not maximise the firm's value but rather benefit only a specific category of subjects.

On the other side, debt policy can affect the non-financial stakeholders behaviour and the competitiveness in the product market, directly influencing the firm's competitive strategy and, as a consequence, the processes of value creation. A new line of research has analyzed the possible connections between capital structure, stakeholder theory, market structure, and a firm's strategic behavior. First of all, capital structure affects the behavior of non-financial stakeholders, as claimants to the firm's cash flows in addition to shareholders and bondholders. Second, debt level affects market structure and thus leads to either higher or lower industry concentration levels. In addition, capital structure can serve as a way to commit to a certain product-market strategy. According to the underlying assumptions of this notion, leverage will cause firms to behave more or less aggressively, which makes competition "tougher" or "softer." The interaction between how a corporation is financed and how it is viewed by its non-financial stakeholders suggests that capital structure decisions must be incorporated into the overall corporate strategy of the firm. Therefore, the paper describes how firm's financial situation is likely to affect its sales, its ability to attract employees and suppliers, the competitors' behavior in the market, and, in general, the ability of a firm to operate its business profitably.

In all the cases it is important to realize, and be aware, about the role of capital structure in mitigating corporate governance problems and leveraging the firm's competitive advantage.

This paper intends to discuss these interactions and the consequences on the value processes. The rest of the paper is organized as it follows. The second paragraph highlighted how the interaction between managers, shareholders and debtholders affects capital structure and investment decisions, creating the so called problems of underinvestment and overinvestment. The third paragraph focused on the interaction between how a corporation is financed and how it is viewed by its non-financial stakeholders, suggesting that capital structure decisions must be incorporated into the overall corporate strategy of the firms. The last paragraph discusses the main conclusions, providing directions for future research.

## **2. Financial policy and investment: the effect of the relation among managers, shareholders and bondholders**

The interactions among managers, stockholders and debtholders, and its related conflicts of interests, influence capital structure, corporate governance activities and strategy plans, which, in turn, could give rise to inefficient managerial decisions and "suboptimal" investments that generally fall under the categories of problems of underinvestment and overinvestment.

Especially in regards to capital structure planning, the conflicting relationship between managers, shareholders and debtholders could bring managers to act: 1) *in their own interests*, by choosing suboptimal projects that do not provide an adequate yield level but that are low risk, thus ignoring shareholder preference for riskier projects<sup>3</sup>; 2) *in the interest of shareholders*, by making investment decisions that maximise equity value and not firm value and, when operating in inefficient markets, could cause them to make suboptimal choices that

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indirect control); thus it is their specific task to make strategic decisions regarding firm development and to plan resource allocation. This does not always happen, due to the fact that often opportunistic interests bring them to use firm resources inappropriately, by allocating them poorly and by making suboptimal investment decisions that diminish firm value.

<sup>3</sup> As is well known, managers are economic subjects that are more "adverse to risk" than shareholders, in that it is impossible for them to diversify company risk through investment differentiation. In this case, when having to choose between two projects they will tend to prefer low risk investments that are most likely to be successful, due to the fact that most of the managers' personal earnings depend on the firm's fate.

damage debtholders<sup>4</sup>. In this latter case, value is destroyed because of the different objective functions of shareholders and debtholders. Is the contrasting goals to achieve that causes distortions in the corporate strategy formulation. The incentive to maximise equity value is not necessarily coherent with the incentive to maximise firm value. As is well known, firm assets value can be broken down into equity value and debt value; thus, strategies that reduce debt value and leave firm value as it was, increase equity value by transferring wealth from the debtholders to the shareholders.

## 2.1 Overinvestment problems

Problems in overinvestment have to do with the possibility that management can abuse its decision-making power by adopting unprofitable investments (*managerial overinvestment*), that could damage the interests of the shareholders, or overly risky projects (*risk-shifting* or *asset substitution*) in favour of the shareholders but against the interests of the debtholders (Jensen and Meckling 1976, Galai and Masulis 1976, Jensen 1986, Stultz 1990).

### Managerial overinvestment

When considering the hypothesis where ownership and control are separated, the problem of managerial overinvestment consists of a conflict of interest that primarily influences the relationship between the managers, who have control over the firm, and the stockholders, who are the owners of the firm (Jensen 1986). Instead, in a context where property and control substantially coincide (owner-managed firms), the conflict of interest has to do with the relationship between internal shareholders, the group in control or managers and entrepreneurs, and external shareholders who do not participate in firm management (Jensen and Meckling 1976). The problem of managerial overinvestment is based on the hypothesis that managers emphasize the importance of their role, different from that of the shareholders, which gives rise to a conflict of interest *in nuce* that will produce opportunistic behaviour that can lead to a decrease in the firm's total value when the chance arises (Jensen and Meckling, 1976)<sup>5</sup>. Overinvestment problems can take on various forms. Jensen (1986) connects overinvestment to how managers use the financial resources that the firm produces. When profitable investment projects and growth opportunities are lacking, managers prefer to use the free cash-flow (available cash flow that is in excess of the resources that are necessary to handle the firm's investments at a positive net present value) for opportunistic purposes, instead of giving it back to the shareholders through dividends<sup>6</sup>. As Jensen (1986) and Stulz (1990) point out, firm expansion beyond what may be considered an optimal level and the increase of resources directly under managerial control would create higher salaries and would offer greater power and prestige to those who run the firm (the *empire building* phenomenon). The propensity towards empire building tends to stimulate managers to invest all available resources (the free cash-flow) in projects that increase the firm's size but not its value. Essentially, managers tend to invest even in negative present value projects so long as they can increase the firm's size and thus their own private benefits (Degryse and De Jong

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<sup>4</sup> In particular, managers could choose to not support safe projects with positive present net value if that would mean causing an increase in debt value with respect to an insignificant (in terms of absolute value) increase in equity value. In other cases, managers, by acting in the interests of shareholders, could accept risky projects with negative net present value that could significantly damage debt value and transfer earnings from the debtholders to the shareholders.

<sup>5</sup> Beyond their goal of maximising stock value, managers consider the firm a source of economic profit, of self esteem and, more generally, as a means to increase their own human capital, (Jostarndt, 2002); for this reason, managers sometimes end up making inefficient decisions whose only objective lies in increasing their own private profits, with no regard for the eventual consequences that can damage the shareholders.

<sup>6</sup> For example, the resources mentioned could be used towards making the main offices more elegant, buying expensive automobiles, increasing the number of employees that will be under their direct control, using company jets for private purposes, etc.

2001). Managerial overinvestment can also take on other forms. For example, Shleifer and Vishny (1989) assert that managers prefer investing in projects that are even of negative net present value but that increase their own human capital, making firm activity inseparable from their personal skills (*entrenchment*). These authors define managerial entrenchment as a set of self-defence mechanisms that management creates by deciding on firm development strategies so as to emphasize their own competencies and skills, rather than choosing strategies that are in the firm's interest<sup>7</sup>. In this way a dependent type of relationship is created, that attributes importance to the managers' skills independently of whether or not they are capable of maintaining the firm's competitive advantage.

In these types of situations debt, as pointed out by Jensen (1986), can help reduce overinvestment problems by limiting managerial discretion in using agency resources. In fact, making recourse to debt represents an indirect means of control and discipline of managerial behaviour by limiting their tendency to use free cash-flow inefficiently, since it must first of all be used for interest and loan capital reimbursement<sup>8</sup>.

#### Overinvestment in risky projects: incentives for risk-shifting

Overinvestment in risky projects (called also *risk-shifting* or *asset substitution*) produces a conflict of interest between shareholders and debtholders and increases the possibility that managers, after having contracted a debt and while acting in ownership interest, transfer the value from debtholders to shareholders through another rise in leverage, thus increasing the risk of distress and bankruptcy, or else undertake new investment projects that are riskier than the firm's average ones (Jensen e Meckling 1976). Therefore, when firms are indebted, an *ex post* (with respect to debt contracting) risk increase can, *ceteris paribus*, transfer earnings from debtholders to shareholders (Galai e Masulis 1976). In fact, different levels of risk connected to investment decisions made by managers influence the conflict of interest between debtholders and shareholders, since riskier investment and financing policies that increase share value and decrease debt value transfer wealth from debtholders to shareholders.

Jensen and Meckling (1976) show how, due to equity's limited liability, shareholders, and the managers that act in their interests, are encouraged to approve projects that are riskier than the ones initially proposed before the debt was underwritten. This mechanism is based on the fundamental difference between equity and debt, that can be found in the different type of sensitivity they show with respect to the firm's level of risk; in fact, while equity value grows when there is higher risk, debt value decreases when the volatility of the firm's activities increases (Jostarndt 2002).

Shareholders increase their wealth by increasing the volatility of the firm's activities, that then means they approve projects that are too risky and thus end up distorting investment policy. Therefore, shareholders of indebted firms can obtain most of the benefits inherent in a risky project when it is successful, and can avoid totally bearing the costs of unsuccessful projects, transferring them to debtholders thanks to their limited liability (Jensen and Meckling 1976).

## **2.2 Underinvestment problems**

Underinvestment problems have to do with the agency relationship between shareholders and debtholders, following the hypothesis that managers act in shareholder interest

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<sup>7</sup> For example, managers that have a high number of shares can defend themselves from or completely avoid any sort of hostile takeover by maintaining their job even when they are operating inefficiently; the fact they can avoid this mechanism makes room for opportunistic behaviour.

<sup>8</sup> A high level of recourse to debt capital, while assuring a fixed recurring outflow of financial resources that are thus no longer available to managers, stimulates management's commitment to avoid situations of economic distress and bankruptcy, means that company management is more exposed to capital market evaluations (Jensen 1986) and represents a positive sign for the capital market, which results in share appreciation (Ross 1977).

(*underinvestment à la Myers* also called *debt overhang*), or else between new and old shareholders, when managers act in the interests of the old ones (*underinvestment in risky projects* or *risk avoidance*).

#### Underinvestment à la Myers or debt overhang

Myers, in his 1977 study, was the first to point out the possibility that high debt relationships can stimulate managers to reject positive net present value projects, which ends up decreasing firm value. The presence of “risky” debt<sup>9</sup>, that shows a lower market value than the nominal one, has a particularly negative influence on firms’ investment choices.

Myers’ (1977) analysis is based on the concept that firm value is made up of assets in place and growth opportunities (based on the future ability to make profitable investments). Growth opportunities are compared to options, whose present value is a result of not only the expected cash flow, but also the probability that the firm actually takes advantage of them. In other words, the value of growth opportunities depends on investments made at the manager’s (decision makers) discretion, who have the power to exercise these options<sup>10</sup>. The way that the assets in place are financed, and thus the way the firm’s capital is structured, influences the ability to create and take advantage of growth opportunities, since in this manner pressure is put on the quality of the firm’s decision making.

Myers (1977) shows that when there is risky debt managers who act in shareholder interest tend to follow a biased decision making process, that leads them to reject profitable investments that could offer positive net worth to the firm’s value. In other words, shareholders of firms who have risky debt are not willing to finance projects, thus taking on the cost, that would exclusively or mostly benefit the firm’s debtholders; in these cases, the net present value of the project, while positive, would allow the debt’s market value to rise up to the corresponding nominal value, without producing other benefits for the shareholders. In fact, risky debt would act as a sort of “tax” on the profits derived from the new investments, since most of the value created would only serve to allow debtholders to recover their loan (Stein 2001).

In such a situation the investment would be made only when the net present value is positive and higher than the debt’s nominal value (Myers 1977, Bekovitch and Kim 1990). In fact managers, as a general rule, would tend to choose investments whose net present value offers a residual payoff to shareholders, while it is also positive and thus can cover the debt value.

The presence of risky debt creates, *ex post*, potential situations where management can serve shareholders’ interests only by making suboptimal decisions for all the stakeholders (Myers 1977). Therefore, firms that are indebted could not be able to finance positive net present value investment projects, thus losing growth opportunities, and, in the long run, value.

#### Underinvestment in risky projects: incentives for risk avoidance

Brito and John (2002) show how the presence of risky debt does not always create risk shifting, but that in some contexts it can generate situations of risk avoidance (*underinvestment in risky projects*) that are opposite to the former.

<sup>9</sup> As Myers points out (1977), there are no underinvestment problems if the debt’s market value corresponds to its nominal value, i.e. in the presence of a safe debt. Eventual transfers of wealth from debtholders to shareholders could come about only when there is risky debt, for example when the yield value is at 90 with respect to a market value of 50; in these cases, managers could adopt inefficient investment strategies that favour shareholders.

<sup>10</sup> Therefore Myers asserts that firm value depends on activities that can be considered call options (growth opportunities), in the sense that their value is at least partially derived from the firm’s investment decisions.

Incentives for risk shifting traditionally have been analyzed (Jensen and Meckling 1976) with theoretical models based on finite periods (period 0 and 1), without considering the firm as an entity in continuous evolution and thus not taking into account the presence of growth opportunities that can come up in the future, which are a fundamental component of the firm's value.

On the basis of these considerations Brito and John (2002) re-examine incentives for risk shifting in a model where during the final period the firm still shows growth opportunities that have not yet been realized, and show how these have a very strong impact on agency costs determined by risky debt. In fact, these growth opportunities can eliminate the underinvestment problem described by Myers (1977) and reduce the problem of risk shifting, by sometimes converting it into opposite situations of risk avoidance<sup>11</sup>.

Although risk shifting problems seem to be particularly relevant, it can be observed in economic reality that often these types of indebted firms adopt a conservative and prudent investment policy, where they try to focus on the core business by selling extra assets and reducing, instead of increasing, the firm's risk (Brito and John 2002).

While incentives for risk shifting are generated by the shareholders' awareness that they are in any case protected by the principle of limited liability (put options on firm activity), risk avoidance attitudes are produced by the fear that growth opportunities may be lost if the firm were to be put up for sale.

The impact of risky debt on firm decision making depends on whether or not there are future opportunities for investment of value; excessively risky investment policies could damage the firm's possibility to survive at least up until the time when such growth opportunities can be taken advantage of. Entrepreneurs can obviously take advantage of such growth opportunities only if they manage to keep control of the firm, i.e. keep it from going bankrupt; in fact, distress and eventual bankruptcy would make give debtholders firm ownership. The entrepreneurs' commitment is thus towards saving the firm's future ability to obtain those financial resources necessary to be able to take advantage of growth opportunities.

The main conclusion reached by Brito and John (2002) is that the presence of growth opportunities that have not yet been taken advantage of has a notable impact on agency costs of risky debt: firms with low growth prospects that operate in mature sectors and with high leverage are stimulated to overinvest in risky projects (risk shifting), whereas to the contrary, firms with good economic prospects are stimulated to underinvest and to avoid overly risky investments (risk avoidance).

Incentives for risk avoidance, that are generally the result of information asymmetries, allow us to understand why firms with high levels of risky debt and growth opportunities not yet taken advantage of adopt quite conservative investment policies.

### ***2.3 Overinvestment and underinvestment: determining factors and consequences***

From one side, when a firm has risky debt and scarce growth opportunities, managers, acting in shareholder interests, could reject positive net present value investment projects (underinvestment à la Myers), because the value created would be advantageous only for the firm's debtholders and would not avoid distress. They could also decide to promote high risk investment policies (risk shifting) that takes away value from debtholders and maximises equity value. However, if growth opportunities are high, managers can end up choosing conservative investment policies so as to avoid risking to lose their control over the firm (risk

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<sup>11</sup> The concept of risk avoidance, recently brought to light thanks to the contributions of Brito and John (2002), represents an interesting topic for future research, in that it needs more in depth study on both a theoretical and an empirical level.

avoidance). Thus, the main source of these types of distortions lies in the presence of risky debt, i.e. in high levels of debt whose market value is lower than the nominal one and therefore difficult for the firm to handle (crisis situations or financial distress).

On the other side, where firms with low debt levels, high liquidity but low prospects for growth opportunities are concerned, and especially in the case of mature firms, managers could undertake negative net present value investment projects for purely opportunistic reasons (empire building). The origins of managerial overinvestment can be found in the type of decision-making power that management has, that allows it to engage in investments for its own benefit. In this case, as noted by Jensen (1986) and Stulz (1990), an increase in leverage disciplines management's behaviour; in fact, the presence of debt obliges managers to always be able to pay interest rates and meet deadlines and thus increases their commitment towards more efficient company management. Table 1 synthesizes and confronts the main characteristics of such problems.

**Table 1 – Problems of under and overinvestment: characteristics, determining factors and consequences**

	<i>Overinvestment</i>		<i>Underinvestment</i>	
	<i>Empire building</i> or <i>managerial overinvestment</i> (Jensen 1986, Stulz 1990)	<i>Risk shifting</i> or <i>overinvestment in risky projects</i> (Jensen and Meckling 1976)	<i>Underinvestment à la Myers</i> or <i>debt overhang</i>	<i>Risk avoidance</i> or <i>underinvestment in risky projects</i> (Brito and John 2002)
<b>Subjects in agency relations</b>	Managers against shareholders (and also debtholders)	Managers with shareholders against debtholders	Managers with shareholders against debtholders; present shareholders against new shareholders	Managers against shareholders (and also debtholders)
<b>Determining factors</b>	Leverage: low <i>Growth Opportunities</i> : low Cash-flow availability: high	Leverage: high <i>Growth Opportunities</i> : low (high risk but unprofitable growth opportunities) Cash-flow availability: low	Leverage: high <i>Growth Opportunities</i> : low Cash-flow availability: low	Leverage: high <i>Growth Opportunities</i> : high Cash-flow availability: low
<b>Type of firm</b>	Firms that rarely make recourse to debt and that operate in sectors that have scarce growth prospects	Firms that make quite a bit of recourse to debt, especially when in financial difficulty, and that operate in high risk sectors	Firms that make quite a bit of recourse to debt, especially when in financial difficulty, and that operate in sectors with good economic potential	Both young firms with high growth potential (high tech) and mature ones (resulting from LBO)
<b>Influence on value</b>	Choice of projects with negative net present value	Choice of high risk projects, with low probabilities of being successful or even with negative net present value	Refusal towards positive net present value investment projects	Refusal towards risky investment projects but with positive net present value
<b>Role of debt</b>	Reduces such problems due to its ability to discipline management	Exasperates such problems	Exasperates such problems	Exasperates the problem

Source: our elaboration.

The benefits of debt can be found in how they allow problems of managerial overinvestment to be foreseen and prevented when there is a lack of future growth opportunities, while its costs lie in the risk of not being able to undertake positive net present value investment projects because of debt overhang problems or in incentives to make other types of inefficient investment decisions (risk shifting). The existence of a trade-off between the costs and benefits of debt thus becomes evident (Stultz 1990). The benefits of debt would become obvious in how management efficiently exercises its control over firm activity. On the other hand, high debt could increase the risk that positive net present value investment projects are rejected or that excessively risky projects are accepted.

Therefore, problems of incomplete contracts, information asymmetries and conflicts of interest between managers, shareholders and debtholders can give rise to inefficient investment choices both when there is a high and a low level of debt.



As observed by Brito and John (2002), deviations from optimal investment policies, whether or not their determining factors are different, can be classified under two dimensions (table 2): on the basis of the quantity of the resources invested in firm activity and according to the level of risk that the various investment choices can produce.

The first dimension takes into consideration the type of influence the conflict of interest between managers, shareholders and debtholders has on *the level of the investments made by the firm*, or rather on the tendency to engage in investment projects that are of different economic sizes, thus countering managerial underinvestment (Myers 1977) problems with overinvestment ones (Jensen 1986). In Myers' model, the sum total of resources destined to new investments is inferior to what would be desirable and thus negatively influences the firm's ability to take advantage of growth opportunities. In this case, a lower number of projects are undertaken with respect to an "optimal" investment level, which blocks positive processes of creation of economic value. To the contrary, managerial overinvestment always is connected to the firm's investment level, but in this case managers' preference for empire building may bring them to invest more resources than would be considered "optimal", and to engage even in negative net present value projects if they increase the firm's size and allow the managers to enjoy higher private benefits.

The second dimension has to do with the *risk profile of financed projects* rather than influencing the amount of resources that will be used for investments, which mostly causes problems of risk shifting (Jensen and Meckling 1976). In this case the risk/return profile will be the one that will change, by stimulating investment projects that show a risk level that is different from the firm's average one and that is, above all, different from the one that was *ex-ante* appreciated by the firm's investors. In fact, risk shifting problems have to do precisely with the transference of value from debtholders to shareholders through an added increase in leverage that increases the risk of distress and bankruptcy, or through the acceptance of new investment projects that are riskier than the firm's average ones. To the contrary, Brito and John (2002) show that situations of risk avoidance are more common where managers tend to engage in secure investments or in ones that are less risky than the firm's average ones, so as to protect their control over the company and avoid that others can eventually benefit from future growth opportunities.

**Table 2 – Classification of deviant investment behaviours on the basis of investment stock and risk**

<b>Deviations from optimal levels in firm investment policy regarding:</b>		
<b>the firm's level of investments undertaken</b>	⇒	<p><b>Managerial overinvestment</b> (Jensen, 1986; Stulz, 1990)</p> <p><b>Underinvestment</b> (Myers, 1977)</p>
<b>the firm's risk profile</b>	⇒	<p><b>Risk-shifting</b> (Jensen and Meckling, 1976)</p> <p><b>Risk avoidance</b> (Brito and John, 2002)</p>

Source: Brito and John (2002)

It is interesting to observe how each deviation from the optimal investment level has a different motivation. For example, in underinvestment problems the shareholders/managers "underinvest", since most of the benefits would go to the debtholders, and thus prefer to issue dividends before they lose all control of the firm. Where the risk avoidance problem is involved, the shareholders/managers avoid risky projects for the opposite reason: they don't want to lose control of the firm.

Table 3 shows the contexts in which inefficient investment choices are made. In firms that are having financial problems (close to bankruptcy) but that still have high growth opportunities, incentives for risk avoidance are the main determining factor behind sub-optimal investment choices; to the contrary, in firms with low economic prospects incentives

for managerial overinvestment, risk shifting and underinvestment become dominant, depending on whether the firm is in optimal financial shape (with lots of available cash) or is, rather, in financial difficulty (close to bankruptcy).

**Table 3 – Relationship between growth prospects, financial condition and investment choices**

Impact of growth opportunities and financial distress on firm investment policy		Growth opportunities	
		High	Low
Financial conditions	Positive	Optimal investment policy	Managerial overinvestment
	Negative	Risk-avoidance	Risk shifting and underinvestment (Myers)

*Source: Brito and John (2002)*

Therefore, firms' reactions to situations of financial distress strongly depend on economic prospects. In a situation of risky debt where there are few possibilities for growth, incentives for risk shifting and underinvestment become paramount, since the firm could end up not being able to take over the value created by the investments (in that they would benefit only the debtholders). Otherwise it would engage in investments with high yields prospects but that at the same time are much more volatile than the average risk level of the firm's activities. To the contrary, if growth opportunities are good, management will prefer to protect their control over the firm and avoid that others can take advantage of the future benefits of growth opportunities. If financial conditions are positive, i.e. if the firm has a good cash flow that can be used freely once the debt has been covered, the absence of valuable investment prospects could stimulate management to waste cash in organizational inefficiencies instead of returning it the shareholders, or use it for investments that do not recover the cost of the capital.

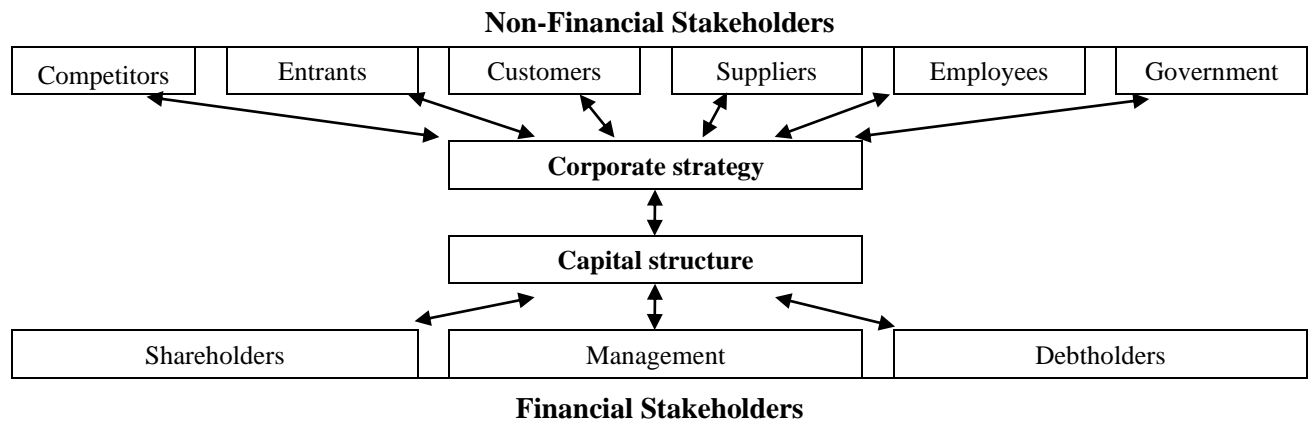
### **3. Financial policy and corporate strategy: the effect of the relation among managers and non-financial stakeholders**

Beside the role of financial stakeholder (shareholders and debtholders) in influencing capital structure decisions and a firm's value, financial policy is also affected by non-financial stakeholders<sup>12</sup>. These have no direct monetary stake in the firm and no direct influence on the firm's financial policy (no decision or voting power). However, a firm's capital structure can affect non-financial stakeholders directly, for instance by affecting the probability of default on their explicit and implicit claims on the firm, as well as indirectly, for instance by influencing the firm's production and pricing decisions. Non-financial stakeholders, as a result, are interested in the firm's financing choices because they can be hurt by a firm's financial difficulties. Consequently, firms may be forced (implicitly) to take the interests of their non-financial stakeholders into account in formulating financial policy.

Figure 1 provides a broad overview of the relations between the firm, its non-financial stakeholders and its financial stakeholders.

<sup>12</sup> Two comprehensive survey of theoretical and empirical works on this topic are the one of Istitieh and Rodriguez-Fernandez (2006) and Franck and Huyghebaert (2004).

**Figure 1 – Overview of the relation between capital structure, financial stakeholders and non financial stakeholders**



Source: modified from Franck and Huyghebaert (2004)

As highlighted by the prestigious and still relevant survey of Harris and Raviv (1991) on capital structure determinants, one of the distinctive categories of determinants that deserve more attention is related to products and product-market characteristics. In their conclusion, the two authors referred to the role of these characteristics as the most promising for future research on capital structure: *“In our view, models which relate capital structure to products and inputs are the most promising. This area is still in its infancy and is short on implications relating capital structure to industrial organization variables such as demand and cost parameters, strategic variables, etc.”*. This observation seems still valid and in vogue (Istaitieh and Rodriguez-Fernandez 2006).

The interrelationship between the financial and real decisions of firms comes from the role of financial instruments in conveying information (on a firm’s profitability) to investors as well as to product-market rivals, consumers, and suppliers (Istaitieh and Rodriguez-Fernandez 2006). Indeed, firms can use their financial policy towards product-market participants (customers, suppliers, employees, competitors) to solve asymmetric information and agency problems. In addition, capital structure can serve as a signaling device to these non-financial stakeholders, and thereby affect their behavior.

The literature that links capital structure and product-market factors relates some elements of modern financial theory to stakeholder theory, industrial organization, and the strategic management of firms. Particularly interesting are the studies on how the design of capital structure is affected by non-financial stakeholders as well as competitive dynamics in the product-market.

#### Capital structure and stakeholder theory

The stakeholder theory of capital structure concerns the important role played by firm’s non-financial stakeholders (customers, workers, suppliers and government) who must be taken into account together with firm’s financial stakeholders (shareholders and bondholders) in determining a firm’s capital structure. This role can be explained by considering customers’ need for a particular product or service (Titman, 1984), as well as firm’s desire to maintain a certain quality and services for its products (Maksimovic and Titman, 1991) and the bargaining power of workers or other suppliers (Sarig, 1998).

In the seminal contribution of Titman (1984) the argument that debt is affected by customers and other nonfinancial stakeholders is explained as it follows. For firms that market durable or unique goods, a firm’s liquidation, as a consequence of a financial crises, may impose costs on its customers, who may not be able to obtain the product, parts, and/or related services, but also on its suppliers, who may have to stop doing business with the firm, and

finally on its employees, if the firm offers them fewer opportunities for advancement. The idea is that a firm's liquidation decision may impose costs on other stakeholders, especially the customers, workers or suppliers who make firm-specific investments. These costs might be transferred to stockholders by customers, demanding lower prices for the firm's product, by suppliers, who may be reluctant or who may even stop doing business with the firm, or by potential employees who avoid seeking jobs in these firms. In particular, customers, who can predict firm's behavior from their knowledge of its financial status, may be reluctant to do business with firms that are threatened with bankruptcy or in financial difficulties and would pay less for the firms' products in the market (Maksimovic and Titman, 1991). Therefore, firms may deliberately use financial instruments to convey information to customers as well as the marketing agents and distributors about its quality, and thus the firm might have an interest in maintaining a low debt level to keep far away the probability of distress.

The stakeholders' views are particularly important for firms whose products need future servicing like automobiles and computers, or whose products quality is important but difficult to observe like prescription drugs. Financial distress, that it follows as a consequence of a high leverage, also will be costly for firms that require their employees and suppliers to invest in product-specific training and physical capital, specialized to the firms' needs. This idea suggests why some firms choose not to borrow when, vice versa, banks are willing to provide debt financing at attractive terms or when tax shield are relevant. On the other hand, financial distress should be less costly for firms that produce non-durable goods like agricultural products, or services that are not particularly specialized like hotel rooms, or whose quality can easily be assessed. These firms should have relatively more debt in their capital structure.

In terms of bargaining power with the employees, it is generally assumed that financial distress can benefit some firms by improving their bargaining positions with their stakeholders. By increasing leverage, the firm can reduce its employees' demands by exploiting their fear that a wage increase will push the firm towards bankruptcy (Dasgupta and Sengupta 1993). Without attractive alternative sources of employment, unionized employees gain less from achieving higher wages if this results substantially increase the probability that the firms will become bankrupt. For the same reasons, government can be pushed to provide subsidies, such as loan guarantees, to a number of distressed firms to keep them far from failing.

By contrary, some studies in this area (Sarig 1998) argue that skilled employees of highly leveraged firms can negotiate better contract terms than can employees of identical, but less leveraged, firms. This is because highly leveraged firms are more susceptible to employees' threats to seek alternative employment than are less leveraged firms. As a result, highly leveraged firms, whose employees are presumably more specialized, use relatively little debt in their capital structure.

#### Capital structure and corporate strategy

The link between corporate strategy and capital structure was developed mainly in the eighties, while the main contributions start in the nineties. Generally, little attention was paid to the role of corporate strategy on financial choices. In particular, studies on the interaction between diversification and capital structure became of interest due to their associated strategic implications regarding corporate governance. Indeed, starting with the study of Jensen and Meckling (1976), financial choices have been evaluated because of the close interaction between capital structure and management choices<sup>13</sup>. In the 1980s, other researchers, motivated by the connection between investment and financial choices,

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<sup>13</sup> Barton and Gordon (1987) pointed out that corporate strategies complement traditional finance paradigms and enrich the understanding of a firm's capital-structure decisions.

highlighted the link between capital structure and diversification (Oviatt 1984, Titman 1984, Jensen 1986, Barton and Gordon 1987, Williamson 1988, Titman and Wessels 1988, Gertner *et al* 1988, Barton and Gordon 1988).

The effect of diversification on capital-structure choices has been explained mostly through the coinsurance effect (Lewellen 1971, Bromiley 1990), the transaction cost theory (Williamson 1988, Balakrishnan and Fox 1993), and by applying the agency cost theory (Jensen 1986, Kochhar 1996). The *coinsurance effect* deals with the reduction of operating risk due to the imperfect correlation between the different cash flows of a firm running diverse businesses (Lewellen, 1971; Kim and McConnell, 1977). It is more relevant for firms that develop unrelated diversification strategies because the lack of correlation between businesses is greater: these firms should be able to assume more debt (Kim and McConnell 1977 and Bergh 1997)<sup>14</sup>. The *transaction cost* approach deals with the governance of contractual relations in transactions between two parties (Williamson 1988). In particular, by matching corporate finance theory and strategy theory, this approach examines a firm's financial decisions in terms of its specific assets, considering debt and equity as alternative governance structures (Markides and Williamson 1996). Firms diversify their activities in response to the presence of an excess of unutilized assets (Penrose 1959), and the kind of diversification strategy depends on the characteristics of these resources (Chatterjee and Wernerfelt 1991)<sup>15</sup>. Therefore, the transaction cost approach, considering debt as a rule-based governance structure and equity as a discretionary governance device; supports the use of debt to finance non-specific assets and the use of equity to finance specific ones (Williamson 1988)<sup>16</sup>. As a consequence, in the presence of highly specific assets (mainly associated to related-diversified firms), that keep a limited liquidation value in case of default, equity is the preferred financial instrument because such assets cannot be easily re-employed. In contrast, in the presence of general purpose assets (mainly associated to unrelated-diversified firms), more valuable as collateral and able to retain their value in the event of liquidation/default, debt is the preferred financing tool (relationship with debtholders, based on the availability of non specific assets, are cheaper)<sup>17</sup>. *Agency cost theory*, rooted on the existence of conflicts of interest between shareholders and managers (Jensen and Meckling, 1976)<sup>18</sup>, provides a further theoretical scheme that supports the influence of diversification strategy on capital structure (Kochhar 1996 and Kochhar and Hitt 1998). Jensen (1986) pointed out the disciplining role of

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<sup>14</sup> Consistent with this argument, several studies (Kim and McConnell 1977, Bergh 1997 and Alonso 2003) have found that the coinsurance effect is one of the most important value-increasing sources associated with unrelated diversification. Firms that follow unrelated diversification can issue more debt and benefit from the fiscal advantages related to debt financing (Bergh 1997). The tax liability of the diversified firm may be less than the cumulated tax liabilities of the different (single) business units.

<sup>15</sup> An excess of highly specific assets is more likely to lead to related diversification because these assets can only be transferred across similar businesses. Conversely, an unrelated diversification strategy should be based on the presence of an excess of non-specific assets.

<sup>16</sup> Debt financing requires a firm to make interest and principal payments according to a schedule stipulated in the contract; in the event of default, debtholders may exercise their pre-emptive claims against the firm's assets (Shleifer and Vishny 1992). At the same time, the shareholders bear a residual-claimant status with regard to earnings and to assets liquidation; their relations with the firms last for the lifetime of the business.

<sup>17</sup> For instance, in the case of financial distress, a firm that operates in three sectors, grocery, mechanical and pharmaceutical, and that has basically general-purpose assets, has the opportunity to liquidate the assets easily and quickly (as it is useable in many activities and industry sectors). As a consequence, the higher capacity to meet the scheduled debt payment, thanks to general-purpose asset liquidity, provides security for the loan provided, reducing the cost of capital and increasing the debt capacity.

<sup>18</sup> Managers, acting as agents, may make non-profitable investments, which are inconsistent with the objective of value creation for shareholders (the principal); while shareholders are strictly interested in the maximization of shareholder value, managers consider the firm as an instrument to increase their wage, self-esteem, private benefits, and, generally, their human capital value. In paying attention to all these benefits, of which just one is based on shareholder value, managers may exhibit opportunistic behaviors.

debt on managerial behavior, in that it reduces managerial discretion regarding free-cash flow. Thus, the Jensen perspective supports the positive role of debt in reducing the ability of a manager to realize detrimental diversification strategies, especially unrelated ones. As a consequence, the result of diversification on the debt/equity choice can be interpreted according to the monitoring effect. Stakeholders, and in particular shareholders, are assumed to have the capability to affect the strategic decisions of managers, in a way to avoid that a diversification strategy, especially unrelated, is realized for opportunistic behaviors. Consequently, shareholders will promote the use of debt as a device to discipline managerial behaviour, limiting diversification decisions (especially unrelated)<sup>19</sup>.

### Capital structure and competitive strategy

An important player affecting corporate financing decisions are the firm's competitors. If investment decisions, incentive to take on a risky project, and liquidation choice are influenced by a firm's leverage, and thus influence the action of its competitors, then leverage choice may be a strategic tool that grants a competitive advantage. Firms may affect both market structure and the competitiveness of an industry by strategically changing their financial behavior, depending on their own capital structure and that of their rivals. A firm's financial structure influences production and pricing decisions as well as firm's pre-commitment to a certain strategic output or price level; it also affects entry and exit decisions through incumbent predatory behavior.

The relationship between market structure and capital structure can be explained by taking into consideration how, during an industry recession, more highly leveraged firms tend to experience lower operating profits and lose more market share than their more conservatively financed competitors—an effect that is exacerbated by product differentiation and industry concentration (Opler and Titman, 1994). Unleveraged rivals can try to take advantage of the situation by using aggressive behavior to weaken the financial position of a competing firm. As a result, financially strong (unleveraged) firms, in an effort to drive out (highly leveraged) competitors vulnerable to financial distress, in particular those firms with specialized products, may take advantage of distress periods to aggressively advertise or price their products<sup>20</sup>. In a highly competitive environment, low-leveraged firms may engage in predatory practices in order to exhaust financially highly leveraged firms and drive them out of the market. The predatory policy of conservatively financed firm is especially effective in industries in which customers and other stakeholders are concerned about the long-term viability of the firms with which they do business. Telser (1966), implicitly assuming capital market imperfections, argued that, as a rule, a firm entering the market has a more vulnerable financial structure than does an incumbent<sup>21</sup>. Therefore, an incumbent with deep pockets can engage in predatory practices, such as a price war or increasing its output, to exhaust the entrant financially and drive it out of the market, at least temporarily<sup>22</sup>. Foresighted firms use low debt levels as a strategic instrument to signal their solvency and toughness to the market, thus deterring any predatory action and risk of aggressive behavior by rivals.

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<sup>19</sup> A diversified firm, especially if organised in unrelated business segments, will increase the use of debt, under the influence of the stakeholders, to constrain potential opportunistic behaviours of the management, that does not allow to face the interest payment at the due deadline (Jensen 1986). Therefore, debt prevents manager from using diversification to destroy value (for private benefit).

<sup>20</sup> The incentives of rivals are greater in concentrated markets, because there are greater gains to be made from such a strategy.

<sup>21</sup> With perfect financial markets this strategy cannot succeed, because the entrant can always secure financing as long as its entry is profitable.

<sup>22</sup> Once again, when an incumbent firm observes the entrant's leveraged financial structure, it increases its output, thus lowering the latter's cash flow and making its default more likely. Therefore, predatory incentives are an increasing function of the entrant's debt level (Poitevin 1989).

Leverage affects the competitive dynamics of an industry in a non-trivial way; in some situations it forces firms to become more aggressive competitors, in others less aggressive. In an industry in which the aggregate demand for a product is extremely uncertain, greater output generally increases risk because it leads to higher profits when product demand turns out to be strong, but lower profits when demand turns out to be weak. Hence, since higher leverage increases a firm's appetite for risk (see risk-shifting problems in the previous paragraph), the greater a firm's leverage, the greater its incentive to produce at a high level of output. Competitors, observing a firm's high leverage ratio, will realize that the firm is going to boost production. Not wishing to drive the price down to the point where no firm profits, the competitors may accommodate the firm's high output by producing at a lower level.

Furthermore, competition and debt can be considered as a trade-off (Nickell, 1996). According to the incentive theory and the agency model, a high level of competition in the product market can replace leverage as a disciplinary mechanism for managers *à la* Jensen (1986), thereby inducing more efficient behavior.

#### 4. Conclusions

Strategy and finance are growing closer together. It is necessary to match strategy and investment plans with financing requirements, complementing external source of finance to strategies for corporate development<sup>23</sup>. A good integration between strategy and finance dimensions can be tantamount to a competitive weapon.

The interaction between financing and real decisions creates a situation in which high or low debt can compromise a firm's ability to take advantage of strategic options. The need to study in greater depth the interaction between real decisions and financing, with respect to interactions with financial and non-financial stakeholders, is a topic of interest to academics and to the business community.

The common theme here is that a firm's financial policy and its ability to support the value creation process are affected by its relationship with (1) financial stakeholders, referring to shareholders and debtholders, and (2) non-financial stakeholders, such as customers, workers, and suppliers.

Debt leverage generates, along with tax benefits, a series of responsibilities and incentives in business management activities that can affect the relationship between managers and stakeholders and, as a consequence, the process of value creation.

The first part of this paper focused on the cost and thus the investment distortions that arise because of the conflicts of interest between management, shareholders, and debtholders. To the extent that lenders anticipate how debt distorts investment incentives, shareholders will bear the costs of the investment distortions caused by their firm's capital structure. A firm with an incentive to make investment decisions that reduce the value of its debt will be subject to higher borrowing costs and may at times be unable to obtain debt financing. As a consequence, firms have an incentive to design their capital structures such as to minimize these investment distortions. This is a well-known topic in management and finance, and in this paper it is discussed with reference to the main literature. We have pointed out the causes, determining factors, and effects that ensue in response to problems arising from the interaction between financial stakeholders.

An high-levered firm can engage actions that are harmful to their shareholders or debtholders but also to their non-financial stakeholders such as customers, employees, and suppliers. Indeed, the conflicts arising between manager, shareholders and debtholders do not appear to be the major source of trouble with debt financing for many firms. An high-levered firm can find difficult to get more external finance and may find it more costly to efficiently carry out its day-by-day business.

<sup>23</sup> Finance allows organizations to quantitatively understand firm's strategic initiative impact on corporate value.

The second part of the paper analyzed the role of non-financial stakeholders in influencing capital structure decisions. The types of products a firm sells, the nature and degree of output-market competition, uncertainty in the product market, and other aspects of the firm's overall strategy have a relevant influence on capital structure, along with taxes, information asymmetries, and agency costs. At the same time, theoretical work has shown an alternative, opposing relationship. Thus, depending on the underlying assumptions, corporate debt can increase or decrease firm aggressiveness. Furthermore, capital structure influences the probability of predation and market exit.

The paper examines the situations where firms should limit their desire to use debt financing, and in contrast, explains why many firms choose to maintain low debt ratio even when lenders are willing to provide debt capital at attractive terms. To summarize, the potential interaction between managers, financial stakeholders, and non-financial stakeholders influences capital structure, corporate governance activities, and value creation processes. These in turn, may give rise to inefficient managerial decisions or they may shape the industry's competitive dynamics to achieve a competitive advantage.

This paper is a prelude to further and more detailed empirical study, able to explore how strategy and finance can be welded more closely together. The research in this area up till now has been largely theoretical, but the subject deserves further empirical examination. A robust research design and data set may offer interesting approaches to understanding how product-market behavior affects capital structure. Future research could simultaneously and empirically study a two-directional effect, considering endogeneity problems, in which debt level affects and is affected by non-financial stakeholders or, in general, by the firm's strategic behavior in the product market. Moreover, most of the reports in the literature up till now have examined how the debt-equity mix drives these decisions, but other aspects of the financing mix may also play a role. Additional studies evaluating the role of capital structure on product-market behavior may benefit from taking into account debt mix, debt maturity structure, debt seniority structure, covenants, etc.

One last consideration should be noted: decision-making regarding capital structure is not simply a matter of deterministic, prescriptive principles, due to the complex number of forces that influence firm relations and managerial activity. It is, rather, an art that, despite all the innovations in financial engineering and changes in the competitive context, are part of today's financial world and cannot be separated from the intellectual skill of "good" financial managers.

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