

Capital Structure: Financial Distress and Information Issues

(Welch, Chapter 19-3)

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Liquidity and Transaction Costs

- ▶ Could be direct costs
- ▶ Could be liquidity-related costs
- ▶ Could be issuing costs
- ▶ Could be recombining (M&M mitigation) costs.
- ▶ Could be dynamic.

Diffuse vs Concentrated

- ▶ Diffuse holdings spread risk but hurt control.
- ▶ Concentrated holdings expose to risk but help control.
- ▶ Classic tradeoff. (Different solutions outside US.)
- ▶ Realistically, most boards and executives are “out of control.”

Investment Banking Jobs

- ▶ As a capital-structure consultant, working for an investment bank, what is your job?
 - ▶ Is it your job to convince the firm to have a good capital structure?
 - ▶ is it your job to convince the firm to change its capital structure?

What if?

- ▶ ...you determine that the firm should have more debt and less equity?
- ▶ Is it your job to convince the managers that they should maximize shareholder wealth?
- ▶ How well will this go?

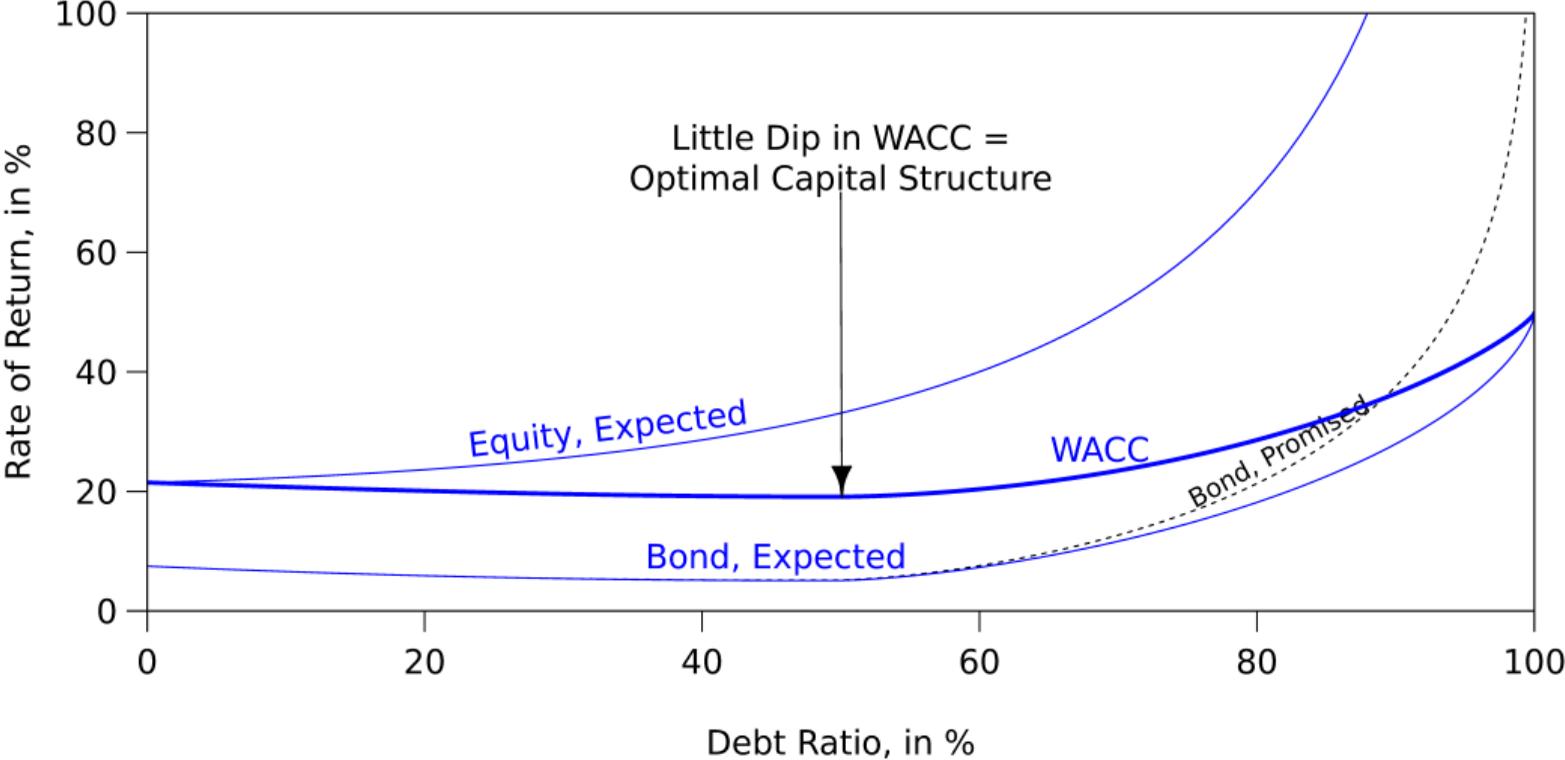
Summary

Effect	Does Favor
Unmitigated Agency Conflicts	Equity
Effect	Should Favor
Financial Distress Costs	Usually Equity
Personal Income Taxes	Equity
Debt Expropriation	Equity
Corporate Income Taxes	Debt
Too much Cash Flow	Debt
(Mitigating Agency Conflicts)	
Behavioral Finance	Situation-Dependent
Transaction Costs	Situation-Dependent

Adjustments?

- ▶ Adjustments can be difficult to make, especially in financial distress.
- ▶ Reputation can help.

Graph: WACC in an ICM



Capital Structure Importance

- ▶ Capital Structure is only of first-order importance for firms with a lot of debt
 - ▶ Think financial firms (often > 90% debt)
 - ▶ Think firms in financial distress (often > 100% debt)
- ▶ Capital structure is of secondary importance in most “normal” companies.
 - ▶ Ordinary firms: 10-30%?
 - ▶ Instead: Focus more on operations, tax-savings, etc.

Graph Footnotes

- ▶ I made up the function. There are no well estimated empirical relations here.
- ▶ Especially with transaction costs, it is likely that the optimum is fairly flat over a wide low range.
- ▶ Firms should not want to be too far off, but optimizing capital structure is rarely a first-order issue,
 - ▶ ...if managers even care about shareholder value!

Graph: Conceptual WACC

