

# Evaluation Of Capital Structure Theories

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## Introduction

The Capital Structure Theory examines the sources of financing opportunities that are available for companies. According to Ardalan (2017), there is an increased need for effective financial management, which leads to the theorization of capital structures based on debt and equity financing while examining the company's market value. Since the case of Modigliani and Miller, researchers and academics have found interest in understanding the role of capital structures in influencing a firm's market value. Denis (2012) asserts that traditional theories of capital structure contain weaknesses that can be dealt with using effective methodologies. However, the contemporary views indicate the complexity of understanding the role of capital structures. The theories include the tradeoff theory, the pecking order theory, and the free cash flow theory. Primarily, the Theories examine the influence of capital structure on the performance of a company. Hence, the report evaluates the influence of capital structure policies in the decision-making process for HSBC Holding and Barclays PLC.

## Evaluation of Capital Structure Theories

According to Barclay and Smith (2005), the theories of Capital Structure are useful when examining the company target through an assessment of the cost of taxes, bankruptcy, and information. There are different types of arguments that try to explore the link between market value, debt, and equity financings. Myers (2001) asserts that there is no universal theoretical framework for firms. However, the theories of debt-equity funding provide conditional guidelines that are essential for management. In essence, the debate on the usefulness of financial capital structures remains. Taxes and debts are known to influence the market value of a company, although there is a need to understand their influence on the type of capital structure.

## Trade-off Theory of Capital Structure

The Trade-off Theory of Capital financing prescribes the notion that companies choose the amount of debt and equity finances for efficient performance and profitability. The theory stipulates the leverage accorded by the liability of a firm. According to Myer (2001), the advantage of debt financing is reduced taxes; however, there is a downside involving the risk of bankruptcy. Thus, there is a need for balancing debt financing in the capital structure to ensure leverage is maintained at an optimal position. According to Hackbarth *et al.* (2007), the Trade-off Theory opens questions on the type of debt structure and, thus, the optimal mix between non-market and market debt options. Moreover, the theory fails to consider the issue of informational asymmetry that is required for balancing

between debt and equity. On the other hand, Graham and Harvey (2001) indicate that firms underutilize the advantages of debt financing while some operate with less debt. The resultant aspect is that the trade-off theory is weak as a method for capital structuring. Despite the challenges, the application of the trade-off theory continues, with companies focusing on dealing with data asymmetry for better balancing of debt-equity ratios.

## Pecking Order Theory

The Pecking Order Theory of Capital structure points to three sources of financing: internal, debt, and equity (Myer 2001). Based on the theory, the management of internal information on the performance of the company; thereby, their decision of the intended source of financing is a result of insight. In essence, for business financing, internal funds are the priority, followed by debt and equity. According to Sarkar (2011), the pecking order theory has a similar interest in debt to the trade-off model. In essence, the theory points to the manager's role in protecting the market value of the company by avoiding issuing equity.

Despite the practicality of the Pecking Order Theory, there is a failure to explain why some firms choose equity financing as a source for expansion (Yang *et al.* 2014). In essence, equity financing does not necessarily hurt the company's market value. However, the weakness is not universal, and various companies have used the theoretical framework. According to Chen (2004), the Pecking Order Theory explains why some companies are reluctant to issue equity to the public as it affects the market value of shares. Virtually, the use of the theory ensures that shareholder interests are first considered.

## Market Timing

According to Denis (2012), market timing implies to a situation in which equity does not affect the share value; thereby, managers can overvalue stock and create wealth for stakeholders. In essence, timing is done to ensure managers issue equity bonds at the right moment. However, the theory fails to provide an efficient prediction of marginal equity issuance.

According to Myer (2001), there are two types of conflicts that arise from capital structure theories: between shareholders and managers and between debt and equity financiers. In essence, capital-financing theories link with empirical data; however, they are ineffective in assessing decisions. Despite the challenges, Denis (2012) asserts that the puzzle of Capital Structure has led to the development of new dynamic techniques that address the problems. In essence, the future would involve new theories that are a combination of traditional views and solutions to the challenges.

# Analysis of HSBC and Barclays

HSBC Holdings and Barclays PLC trade in the London Stock Exchange are under the banking and finance sectors. Thus, the two present significant examples when examining capital structures and their influence on market value.

## Courtesy [Financial Times]

According to the rates as pointed out by the Financial Times (2018), HSBC has, over the years, used less on no debt to finance its expansion. In essence, HSBC Holdings Capital financing disagrees with the trade-off theory of capital structures. On the other hand, Barclays PLC's Capital Structure works to ensure leverage, which is, in essence, in line with the trade-off theory. The differences between the companies point to the complexity of examining Capital Structures. Barclays (2018) points out that the company employs a unique debt leverage mechanism that ensures compliance with regulations and a balance with its equity to ensure profitability.

Moreover, Barclays (2018) agrees that their debt financing is dependent on the particular time and the requirements of the firm. In essence, this aligns with the market timing theory, which Denis (2012) attributes as significant when managers are working with the interests of shareholders. The contrast with HSBC Holding is an indication of the complexity of understanding the influence of capital structure on profitability and market value. In essence, the companies maintain a favorable market value based on their sizes in spite of the differences in capital structures. Thereby, the theoretical perspective on financing points towards various company preferences; however, the choices are dictated by company strategy and goals.

According to data from the two banks, Sovbetov (2013) asserts that the level of dependency on debt leverage in the UK is high, with many financial companies opting for a ratio of nearly 5%. The overlaying assumption of the theories is that the higher the rate, the better places a company is in the market. In essence, the higher the debt of a company is, the higher the increase in market value. However, in the case of Barclays is operating under 5% ration of debt to equity (Barclays, 2018). On the other hand, HSBC is working with near-zero ratios on its debt/equity percentage (Financial Times, 2018). In essence, it points towards conflict with the theories of capital structures.

## Conclusion

The Capital Structure Puzzle remains a complicated aspect without a unique structure for attaining an optimal state. The theories of Capital Structure provide insightful information into the decision-making in companies when it comes to financing; however, there is no consistent approach. Whether choosing equity or debt is dependent on company goals and preferences; thus, each theory is coupled with a particular type of weakness. Despite the shortcomings, the approaches contribute to the

understanding of how companies select their sources of funds. Moreover, in the case of the two listed companies, the theoretical analogy applies; thereby, there is evidence of the practicality of the theories. Essentially, it is applicable in real life; however, the approaches fail to frame reality with companies using different methods of financing. Conclusively, the ideology behind capital structures is limited; thereby, it is hard for managers to use. However, future developments may address the problems by creating a framework for capital structures that may prove practical.

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