Observations on Real World Capital Structures

Capital structure varies by industry. This is attributed to the fact that different industries are characterized by different levels of operating income variability, different types of assets, and different levels of profitability. For example, in the U.S., regulated utility and mature manufacturing firms have relatively high debt ratios. These industries are characterized by stable operating income, tangible assets that could be sold to raise cash under financial distress, and profitable operations. In contrast, young growing technology firms typically have low debt ratios. This industry is characterized by volatile operating income and lots of intangible assets related to research and development. Profits may not keep pace with the need for capital investment.

Please read Lecture Slides 39 - 40 for the determinants of a target capital structure (debt ratio); and Slides 41 - 44 for the summary highlights of CFO survey on the practice of capital structure policy conducted by Graham and Harvey (Journal of Applied Corporate Finance, 2002)!

In addition, William Megginson lists and discusses observed capital structure patterns and influences in his book titled *Corporate Finance Theory* (1997, Addison-Wesley Educational Publishers, Inc.). Here are selected highlights of his findings:

1. Capital structure patterns occur among countries. Differences in corporate governance systems and cultures appear play a role. An important influence is a country's reliance on banks versus capital markets for capital.
2. Capital structure patterns occur among industries.
3. Profitable firms have less leverage.
4. Taxes influence capital structure but are not the only influence.
5. Firms with high financial distress costs use less debt.
6. Financial restructuring that results in increases debt ratio is perceived positively by shareholders while financial restructuring that decreases debt is perceived negatively by shareholders.