Overview and Learning Objectives

Overview

In Chapter 16, we examined the work of Modigliani and Miller (MM) on the capital structure theory. The conclusion of MM, once corporate taxes are considered, is that the optimal capital structure is around 100% debt financin. However, this is inconsistent with the capital structures seen in real-world firms. Practicing financial managers do not try to finance their firms with close to 100% debt. There appears to be a limit on the amount of debt that is optimal in practice. In this unit we will examine factors that help explain limits on the use of debt.

Learning Objectives

Upon completion of this unit, students are expected to be able to:

- Explain the interactive effects of corporate and personal taxation on tax benefits of debt financing and hence on capital structure.
- Describe bankruptcy (or financial distress) costs in their own words.
- List examples of direct and indirect bankruptcy (or financial distress) costs.
- Explain the static tradeoff theory of capital structure.
- Describe agency problems between bondholders and stockholders (agency costs of debt).
- Describe agency problems between stockholders and managers (agency costs of equity).
- Explain how increasing debt might decrease agency problems between stockholders and managers.
- Explain how investors interpret the information conveyed in debt versus equity financing decisions under information asymmetry.
- Explain the main points of the pecking order theory of capital structure.
- Explain the implications of the pecking order of financing sources on capital structure.
- Describe firm characteristics and key factors that determine capital structure in practice.