Company Theories

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Capital structure, also referred to as finance leverage or financial structure, encompasses various terms and is commonly known as capital structure or financial leverage. It signifies the proportion of debt and equity utilized to fund a business's asset formation. The level of debt employed has a significant impact on managerial behavior and financial decision making. Financial ratios, including the debt/equity ratio (long-term debt/equity or long-term debt/total capital employed), provide a means to gauge the capital structure within a company.

capital structure firm value effect economic

1. Introduction

The intricacies surrounding a company's capital structure make it a highly debated and intricate subject globally, particularly when examining its potential impact on the enterprise's profitability and overall value. As the stock market in Vietnam operates within a distinct economic environment, shaped by unique socio-political institutions and a specific financial-banking system, conducting a study on the influence of capital structure on firm value will provide valuable empirical insights to enrich the capital structure theory.

The evaluation of firm value encompasses key indicators, such as return on equity (ROE), return on total assets (ROA), and Tobin's Q. Efficient businesses effectively utilize capital, leveraging tax shields to their advantage. In contrast, inefficient businesses with low competitiveness and mounting debts that increase bankruptcy risk are compelled to reduce their debt ratio. The inefficient use of capital structure, particularly excessive debt, results in a contrasting effect known as financial leverage. Consequently, firms adopt diverse capital structure strategies in response to their unique situations. Among various factors influencing firm value, capital structure holds a crucial influence. Empirical studies examining the impact of capital structure on firm value have yielded mixed conclusions. Some studies on capital structure demonstrate that firms with higher debt ratios often exhibit improved business performance, aligning with the findings of (Berger and Bonaccorsi Di Patti 2006; Weill 2008; Chowdhury and Chowdhury 2010; Nguyen et al. 2023; Khan et al. 2021; Ayuba et al. 2019; Natsir and Yusbardini 2020; Ramli et al. 2019; Hirdinis 2019; Nenu et al. 2018; Aggarwal and Padhan 2017). This result aligns with Modigliani and Miller's (1963) tax shield theory, suggesting that debt creates a tax advantage that maximizes firm value. However, other studies, particularly in developing countries, such as Jordan, Ghana, South Africa, and India, have found a negative relationship between capital structure and business performance, as observed in the works of (Zeitun and Haq 2015; Dawar 2014; Nguyen et al. 2023; Dang et al. 2019). These studies indicate that higher debt levels increase bankruptcy risk, thus reducing firm value in emerging economies. In the context of Vietnam, empirical research highlights the detrimental impact of a high debt ratio on corporate profitability. Additionally, the studies of

(Đ. B. Thanh 2016) affirm a close association between capital structure and enterprise value. Nonetheless, the variability in empirical findings underscores that this relationship depends on the economic context, the methods of recording financial indicators, and the adopted research methodologies.

2. Agency Cost Theory

The concept of agency costs in the modern firm model was introduced by (Berle and Means 1932), and later developed into the agency cost theory by (Jensen and Meckling 1976). According to this theory, agency costs arise from conflicts of interest between shareholders, managers, and creditors. These conflicts may lead managers to prioritize personal gains over maximizing the business's value. As a result, managers might choose investment projects with lower risk, lower return, and a reduced debt ratio to minimize the likelihood of bankruptcy. To address these conflicts and reduce agency costs, (Harris and Raviv 1991) proposed the use of debt as a mechanism to monitor and incentivize the performance of the board of directors. This is due to the positive relationship between the debt ratio and the company's financial distress. As financial difficulties increase, the company faces a higher risk of bankruptcy, motivating managers to improve their performance to avoid losing their jobs or tarnishing their reputation. By minimizing agency costs between shareholders and managers, the agency cost theory advocates for the strategic implementation of debt as a means to align the interests of managers with those of shareholders and enhance overall business performance.

3. Durand's Classical Theory

Durand (1952) is credited with introducing the theory of the capital structure of the firm. He argued that debt has a "cheaper" cost of capital compared to equity. Consequently, if a company utilizes a significant amount of debt, it can reduce the average cost of capital and enhance the overall value of the enterprise. Additionally, as the debt-to-equity ratio increases, the return on equity is expected to rise since the cost of equity is higher than that of debt. However, Durand also acknowledged that increasing the debt-to-total capital ratio could lead to a higher cost of debt due to the increased risk of bankruptcy. As a result, the impact of capital structure on firm value relies on achieving a balance between the advantages of using debt and equity. Therefore, companies must strive to establish an optimal capital structure that minimizes the average cost of capital and maximizes the overall value of the enterprise. It is important to note that this research refrains from drawing definitive conclusions about the precise optimal capital structure for enterprises, as it is subject to various factors and considerations specific to each business.

4. The Theory of Modigliani and Miller

Modigliani and Miller (1958) put forth the argument that if a firm employs a substantial amount of debt, its shareholders are likely to invest in shares of the company with less debt as a risk-reducing strategy. The key finding of Modigliani and Miller is that a firm's overall value is independent of its debt ratio. However, in a subsequent study conducted in 1963, they introduced new evidence indicating that the cost of capital does

influence capital structure and consequently impacts the firm's value. By utilizing debt, companies incur interest expenses, which are partially deductible when calculating corporate income tax. This tax advantage, referred to as tax shields, enables businesses to lower their corporate income tax costs, resulting in an enhancement of the firm's overall value. The groundbreaking theory of Modigliani and Miller laid the groundwork for the development of subsequent theories on capital structure.

5. Trade-Off Theory

The capital structure trade-off theory was initiated by (Kraus and Litzenberger 1973) and later developed by (Myers and Majluf 1984). According to this theory, there exists an optimal capital structure that enhances the firm's value while considering the costs associated with financial distress. Specifically, a company can continue to borrow until the tax benefits derived from borrowing are balanced with the increased costs resulting from potential financial difficulties. At an average level of debt, the likelihood of facing financial distress is minimal, and the present value of the costs associated with financial distress remains relatively small. Therefore, borrowing provides advantages to the firm. However, as the level of debt increases, the risk of bankruptcy also rises, which can ultimately decrease the firm's overall value. The trade-off theory of capital structure provides insights into the variations in capital structure among different types of businesses and suggests a tendency for companies to aim for an optimal capital structure based on their performance and risk tolerance.

6. Pecking Order Theory

The pecking order theory, proposed by (Myers and Majluf 1984), posits that firms have a preference for internal financing over external financing. According to this theory, businesses prioritize the use of retained earnings for investments, and only resort to external financing when necessary. In the pecking order, firms will first borrow, then issue bonds, and as a last resort, issue shares. The pecking order theory does not invalidate the arguments made by previous theories regarding the importance of tax shields and financial constraints on debt. Instead, it emphasizes that the order in which firms access funding sources is more significant than these factors. A well-performing business typically carries little debt, not due to the fact that it has a low optimal debt ratio, but since it relies on its internal funds and does not require external financing. On the other hand, businesses with poor performance often have high levels of debt since they lack sufficient internal funding for their projects and must seek external financing to sustain their operations. As a result, the observed debt ratio of each firm reflects the cumulative need for external financing that has built up over time in response to their performance and funding requirements.

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