

Key Concepts

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BANKRUPTCY RISK AND BANKRUPTCY COST

- Economic VS legal Bankruptcy
- Risk of Bankruptcy and cost of Bankruptcy
- Risk Neutrality
- Bankruptcy costs lower the advantages of debt

BANKRUPTCY COSTS

- Direct Costs:

- Legal and administrative costs
- Expert witnesses (usually finance professors)
- White, Altman and Weiss estimate these costs 2 to 3 percent

- Indirect Costs: (impaired ability to conduct business)

- Customers
- Suppliers
- Employees
- Clearly exist but difficult to measure

AGENCY COSTS:

- Incentive to take large risk

- Take larger risk because they feel as though they are playing with someone else's money
- They will invest in riskier projects because they have nothing to lose
- Using equity as a call option

- Incentive Toward Underinvestment

- May not invest in positive NPV projects because the proceeds would go to the debt holders when they repossess assets.

- Milking the Property

- Payout extra dividends during financial distress
- These strategies do not affect firms that are on firm financial footing
- They affect only those firms that are close to financial distress

The distortions only affect companies with high probability of distress, well diversified firms and ones protected by the government has awesome debt.

HOW TO REDUCE COSTS OF DEBT:

- **Protective Covenants:** specifies an action that the company agrees to take of a condition the company must abide by.
 - Keep working capital to a minimum level
 - Furnish periodical financial statements to lenders
 - Maintain certain assets as security for lenders

- **Negative Covenants:** Limits of prohibits actions that the company may take.
 - Limits on amount of dividends to be paid
 - Firm can no pledge certain assets to other lenders
 - Firm needs approval to lease of sell major assets
 - Firm may not issue new loans

Managers can avoid the restrictions of covenants by:

- **Issuing no debt:** bad because of tax advantages
- **Issue debt with no restrictive and protective covenants:** market price of debt will be much lower and the cost of debt will be higher
- **Write protective and restrictive covenants in to the loan contract:** if the covenants are clearly written, the creditors may receive protection without large costs being imposed on the shareholders

Costs are so high because there are multiple lenders. If there was only one (or very few) negotiations would be easier.

STATIC THEORY there is an optimal debt capacity for every firm.

MARKET CLAIMS the claim of stockholders and bondholders

NON-MARKET CLAIMS government claim and possible litigants

SIGNALING:

- Firms with low anticipated profits will take lower debt
- A more successful firm will probably take on more debt
- Higher firm value for a higher level of debt
- Exchange offers theory:
 - Debt for equity leads to negative market reaction
 - Equity for debt leads to positive market reaction

PECKING ORDER THEORY

Is caused by asymmetric information, the manager knows more about the company than investors do. This is a violation of EMH because if investors did know, timing in the market would be impossible.

The order

- Internal funds
- Debt (if stock is under valued)
- Equity (if stock is over valued)
- (Super nice and all but the manager needs to consider more than just timing, there is also taxes, financial distress and agency costs)
- **Implications:**
 - There is no target amount of leverage
 - Profitable firms use less debt
 - Companies like financial slack

FREE CASH FLOW:

- Bad acquisition
- Investment in negative NPV projects
- **Free cash flow hypothesis:** implies that debt reduces the opportunity for managers to waste resources.
- Solution: pay dividend

CAPITAL STRUCTURE REAL WORLD:

- Most Canadian firms have low debt to equity ratio
- A number of firms use no debt
- Corporations employ target debt to equity ratios
 - No mathematical formula for establishing B/S
 - Important factors are: taxes, types of assets and uncertainty over operating income
- Capital Structure varies across industries
 - High growth VS low growth