



***“Capital structure effect on the value of a firm.
(UK case)”***

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Introduction.

Capital structure is related to the proportion that a firm is financed by outside financing resources compared to internal financing. In order to finance their activities or to invest on new projects firms need to raise their funds. There are two ways of financing which are debt and equity. Debt consists on financing by outside resources like loans ,overdrafts, etc. Equity is an internal way of financing and it consists on selling shares to existed shareholders, selling their firm's assets, using retained earnings etc. The research will investigate the determinants of capital structure in UK companies and the relationship between capital structure and the firm's value . The study will mostly include the retail industry. In this chapter there will be explanation of the topic, a background of the study , aims and objectives of the research, a brief review of literature about the capital structure theories, researching methodology and ethical consideration and an outline of what is expected as a result of the research.

Background of the research.

Managers of different companies have to make big and challenging decisions in different point of times. There are three major decisions of a company. Investment decision which consists on choosing the most profitable project, financing decision which is directly related to the capital structure and dividend decision which is related to the capital structure as well. All of these decisions aim to achieve the same objective, increasing the firm's value or in other words the shareholder's wealth. This research will discuss when the capital structure affect the stock performance negatively, positively or does not have any impact on the shareholder's wealth. This study will select 50 companies in UK to be examined. There will be a critical analyse based on their financial statements to see how their capital structure has affect their value during the last five years. Companies will be from different sectors and industries but retail industry will contribute mostly in this case study. United Kingdom is a developed country with healthy financial markets, therefore it is easy for companies to access these markets and to raise their funds. Different managers have different criteria when deciding which way of financing to choose. In one hand choosing debt has some benefits such as: debt is less costly than equity in company's perspective,. Furthermore ,holders of the debt do not have control in the company which happens in case of equity. Other managers may see equity as a better choice since it is not a compulsory obligation. Firstly, they may choose to pay dividends or not and secondly, shareholders are the last to be paid, thirdly , in cases of bankruptcy they do not have to pay back the money invested by shareholder but they just share the earnings from selling firm's assets. On the other hand when issuing new shares to increase their funds ,firms should take into consideration that they are losing a little bit of their ownership. The more shares issued, the less the firm is owned by the existed shareholders. Also, one of the differences between equity and debt is the fact that when choosing debt as a finance resource, company has to pay interest which is an expense for the company, consequently it is tax deductible. Meanwhile, in case of equity the company pay only dividends which are not tax deductible but on contrary, shareholders may be taxed to times. One is a tax on their earnings by dividends and the other is tax on capital gain which is the difference in the share price. There can be other factors to take into consideration when deciding between two alternatives but managers always try to compare advantages and

disadvantages of these alternatives respectively and then choosing the optimal capital structure.

Literature review:

According to Clayman et al (2012) companies aim to find an optimal mix of debt and equity which minimize the weighted average cost of capital in order to maximize the value of the firm. There are different theories that see capital structure as an irrelevant factor related to a firm value while other theories demonstrate that there is a strong relationship between capital structure and shareholder's wealth. **NI approach** suggests that the more the company is financed by debt, the more the cost of capital will be decreased, consequently the higher the value of the firm will be. As stated by Arnold (2013), financing by debt is less costly due to the fact that since it is less risky investment in investor's perspective the return is less while investing in shares is more risky, therefore shareholders require higher return which is a cost in firm's perspective. **NOI approach** suggests that the mix of debt and equity has no impact on stock performance. On the other hand according to **Modigliani and Miller (1963)** financing by debt is beneficial since the interest paid by companies is tax deductible. **Traditional approach** states that there can be an optimal mix of financing by debt and financing by equity. All of these theories have made some assumptions which can be seen as a limitation for each theory to be accepted. For example, one empirical research in the UK suggests that despite the concentration of the industry and despite the tax rate, the higher the gearing ratio, the lower the value of the firm. Meanwhile, another empirical research in the UK witness that tax is an irrelevant factor when deciding which way of financing is better.

Aims and objectives:

As discussed above different theories suggest different factors when choosing the optimal capital structure while other approaches see the combination of debt and equity as an irrelevant factor when trying to maximize the value of the firm. To examine this relationship, the study will consider specific firms, analysing their liquidity ratios, leverage ratios, firm values, stock performance for companies whose shares are traded on London stock exchange etc. This study aims to examine if there is any difference in the capital structure between companies which are within the same industry and between companies which are listed on London stock exchange and companies which are not listed on this market. Based on literature review, empirical researches, research papers, annual reports of different companies and analysis of these annual reports the aim of the study is:

- Analysing the capital structure of different companies in different sectors.
- Finding if there is or not a relationship between capital structure and the value of a firm.
- Analysing if there is a difference in the capital structure based on the size of a company.
- Conducting an empirical research to examine which factors should be taken into account when deciding the combination of debt and equity.

Research Question:

There are many literature suggestions related to the importance of the capital structure in shareholder's wealth but some empirical researches and case studies as mentioned above suggest the opposite. This research will examine what happens in the practice and perhaps answering some of the questions below:

- Is there any relationship between capital structure and a firm value?
- If yes, which is the optimal combination between financing by debt and financing by equity and which are the factors to take into consideration when making financing decisions?
- Is there any difference in capital structure between companies based on size and industry?

The Methodology:

Methodology used in this research paper will be mostly based on secondary data. There are two stages of this study. The first stage is the literature review. This stage is related to identifying the suggestions by different theories and authors about the capital structure and its importance to the value of a firm. It will include books, reports, magazines, journals, research papers etc. After that there will be examined about 50 companies in the UK. By analysing their financial reports from 2013-2018 there will be calculated all the ratios that are related to the capital structure and the value of the firm to see if there is any real relationship between them. The calculations will be illustrated by graphs using MS-EXCEL. After analysing all the ratios there will be a comparison between the years, between different companies based on size and between different companies based on the industry that these companies belong to. All of these analysis will be done in order to see how a right financing decision contributes to the shareholder's wealth and to see if there should be any factor to take into account when choosing the mix of debt and equity.

Ethical Considerations:

'Ethic' is referred as the most proper behaviour when conducting a research. It consists on the responsibilities and rights of the diverse people involved in the research. The researcher is responsible to respect all the ethical codes when gathering data. For example, the researcher should not mention names or private information of people involved in the study.

Furthermore all the people involved in interviews should know the aim and the purpose of the study while the researcher should guarantee a free-pressure atmosphere when asking people to give them any answer or any opinion and guaranty that these individuals will be safe and guarded. In this study it can be said that ethical consideration is important but, since this paper will not use primary data, therefore there will not be such a huge focus on ethics. The data will be collected by financial annual reports published by companies on their websites which are accessible to everyone. Furthermore, there will not be included any personal experience or personal opinion about the companies selected for this study.

Limitations of the study:

This research paper will examine only 50 companies which is relatively a small number in a developed country where there are more than 2000 companies listed on London Stock Exchange. On the other hand, 5 years data is not enough to see the performance of one long established company. Meanwhile, there are many factors to take into consideration when examining the capital structure in different companies and some of these factors are difficult to evaluate. For example, behavioural finance is one difficult factor to explain because different managers behave differently. Some of them are risk taking while others are more conservative. There is a difficult examination while talking about manager's behaviour because in this way the results of the analysis will be subjective. Furthermore, there can be some political factors which affect the equity market, consequently the ability of the company to be financed by equity. One of these factors is Brexit which is supposed to have many impacts on financial markets and on the economy but its effects will not be covered in this study.

Timeframe:

