Corporate Finance Theory: Leverage Measures And Trade-off Theory

Corporate Finance Theory

Leverage measures

Leverage measures, allow for financial managements to identify if they are meeting their financial obligations. This therefore needs to be measured with either market valued balance sheets or book balance sheets.

The correct measure in the right measuring principle is the ratio which is derived from the market value balance sheets. Thus using the emphasized ratios which many financial economists use. This is beneficial as this balance sheet uses the current prices of the current assets thus, using current prices of the market. Using market value balance sheets also allow businesses to actually understand how much actual debt and equity they are looking at, while seeing market values of their assets also. While book balance sheets are different to market value by using historical values for the debt and equity. Also within balance sheets any changes made in the capital structures are all made at current market values which is a link to market-value balance sheets.

The trade-off theory applies the market leverage over book leverage, which shows growths and declines in debt levels which take current market values into account. For example, a decision to reduce financial distress by the retirement of debt requires the existing debt to be actualized at market value, this then results in a fall in interest tax shields which is derived at the market value of the retired debt. Also trying to increase interest tax shields with growing debt makes the new debt formulised to be acquired at the current market prices. The trade-off theory also explains that businesses tend to finance their businesses with debt and equity which then allows the business to start and grow.

The pecking order theory is also based on the market values of the company’s debt and equity. The pecking order theory consists of three sources of financing internal funds, debt and new equity. This theory also hypothesises that the general cost of financing leads to an increase with asymmetric information. The pecking order theory also is based around current market values. When a company internally finances from reinvested earnings its equity is based around the current market values, also if internal financing is increasing its distribution with their earnings which are generally heading to shareholders. While as the capacity of the debt is also measured by current market values of debt, as markets view the existing debt as the payoff of the debt.

Trade-off Theory

The trade-off theory generally explains its theory through market leverage. Showing that the changes in the market value of capital can change the capital structure with the amount of weight in debt. Therefore, a business decides to reduce the amount of debt which therefore allows for existing debt to be attained at the market value. Seeing the decrease in debt or

decrease in interest tax shields also coincides with the current market value of debt. As shown below in Figure 18.2 we can see the trade-off theory into work showing the leverage measures of debt and equity while also showing affects from the interest rate tax shield. The figure also shows the optimal place the business should aim for which is the highest point of the curve.

For example, suppose that the firm is willing to increase the debt this will therefore allow for the interest to be based around the current market value. The threat of financial distress is what the trade-off theory relies on with the market conditions that apply.

A company is in a decline position when the debt ratio is continuously increasing, if the firm then tries to issue new equity the equity shareholders will foresee a high business risk associated with their investment with that firm. This meaning this firm is trying to add equity for debt they have lost, this can lead to liquidity issues for this firm. Therefore, investors will be scared to purchase more shares as the risk is high with this specific firm. Showing a problem for the firm as their anticipated equity growth may not occur as investors may not be willing to take the risk on the firm no longer

If this goes through we can see many equity shares being purchased which will then see higher amounts of dividend payout to investors which will therefore increase the firms cost of equity. This will lead to the firm’s overall cost of capital being skyrocketed, which will lead to bankruptcy of this business. Therefore, the firm would see far more problems if they were to issue more stocks of the firm as this will lead to financial distress. Which will be a problem as this will more than likely lead the firm to liquidation and investors receiving nothing back on their investment. Rather than issuing more stocks the firm should allow for private placement of shares of their frim to avoid some problems.