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Endogenous and Exogenous Factors Affecting Capital Structure: A Theoretical Review

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Abstract

Capital structure refers to the way a company finances its operations through a mix of equity and debt. The choice of capital structure has important implications for the risk and return of a firm, as well as its ability to raise funds and invest in future growth. In this theoretical review, we will examine the endogenous and exogenous factors that affect a firm's capital structure decisions. In conclusion, a firm's capital structure decisions are influenced by a complex set of endogenous and exogenous factors. By understanding these factors, firms can make informed decisions about their capital structure, balancing the trade-offs between risk, return, and growth potential.

Keywords: : Indonesia, Capital Structure Theory, Capital Structure Factors, Endogenous Factors, Exogenous Factors, Capital Financing Mix.

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Introduction

Capital is essentially intended to finance the business and generally consists of funds from the owners and funds from lenders. The choice of this combination of funding is made by the managers of the business, who decide whether to borrow from outside, use the profits earned by the business, or ask the owners to increase funding to expand the business, or to increase ROI payments for their shareholders. This combination of sources of business financing is often referred to as the capital structure, which is the mix of financial resources available to run the business and is a key determinant of how the business is operated. Since financial capital is an uncertain but critical resource for all firms, those who provide the resources are the ones who need it (or so-called stockholders) and are seen as being able to control the company to a certain degree. In this regard, debt from debtholders and equity from equityholders are two forms of capital structure instruments that are often used to finance businesses. And although,

debtholders have less control over the company and do not have the right to determine how the company's business is run, they still get returns at a fixed rate and are protected by contractual agreements that determine how much return must be paid to them by the company in addition to the timing of payments. On the other hand, equity owners are the last to claim the return earned by the company, bear greater risk, but have more control over the decisions made by the company (Kochhar, 1997).

The capital structure of a company therefore generally consists of two main financing source components, namely equity financing and debt financing (Van Horne & Wachowicz, 2012). Equity financing is financing provided by the company's own owners and is mainly used to bear the risks faced by the company. Equity owners are therefore seen as co-owning the company through the company's shares and have the right to the profits earned by the business, which are referred to as dividends. However, the company is not obliged to pay these dividends every time it makes a profit as it can keep the profits to fund its business expansion. In addition, equity holders also bear the risks of the business and are the last to receive dividends after the company debtholders who receive payments if the company goes bankrupt. On the other hand, equity financing is financing generated through borrowing by the company from external sources such as banks or by issuing bonds, all of which will generate a fixed return. Debt can be short-term, paid over a period shorter than a year, or long-term. In addition, the equity lender does not have control over the business, but obtains payment for the use of its funds, which is called interest. The borrower, in this case, the company, also has a contractual obligation to pay interest and to repay the principal at maturity, regardless of the company's performance or profitability (Brealey & Myers, 2006; Van Horne & Wachowicz, 2012). Therefore, companies facing investment opportunities will be faced with several types of funding instruments, which in financial terms are a series of financing sources that are the company's choice or called the company's capital structure. Thus, to distinguish between various financing instruments that companies can choose, it is important to first differentiate what is called internal and external financing. Internal financing allows a company to use its saved profits from previous years. In contrast, external financing can basically be divided into equity and debt financing. In other words, companies that opt for external financing tend to issue equity or debt to fund their investments possible. And while debt financing requires periodic interest payments, equity financing is seen as permanent funding because the company is not required to make periodic payments. For example, while interest payments are mandatory, dividends are not. Issuing common stock is the most relevant financing instrument when equity financing is required. Conversely, companies may also choose to acquire debt from various sources (Beck & DeMarzo, 2007, pp. 780-789).

The most traditional way to acquire debt is through bank loans. But although this is the most common way of financing, companies also often seek to obtain debt from the capital market. The existence of capital markets basically allows companies to issue bonds, which require companies to make periodic interest payments and return them in full at the end of their term. Unlike bank loans, bonds can be easily bought and sold in the capital market. Therefore, before starting to discuss the theories of capital structure and the determinants of capital structure in the following two sections, it is necessary to discuss current financing patterns in order to get a comprehensive picture of how institutional, legal and financial differences between countries generally shape the financing decisions of firms.

This needs to be done because based on our empirical research, we found various articles that discuss the causes of the differences in financing patterns that occur today. For example, research conducted by Beck et al (2008) and Fan et al. (2008) who attribute it to institutional differences between countries. This is in contrast to studies conducted by Storey (1994), La Porta et al (1997, 1998, 2000), Rajan & Zingales (1998), and Beck et al (2008) who attribute the differences in financing patterns to the development of the legal order and financial development of the countries concerned. However, despite the variety of studies, in essence we view that these academic studies all come to the same conclusion that in countries characterized by weak legal and financial systems, the use of external financing is rare. Aside from the general conclusion of these previous studies that in countries with underdeveloped institutions, companies generally face different financing opportunities. With reference to the analysis of Beck et al (2008), the following figure presents the different financing patterns that occur in several countries around the world.

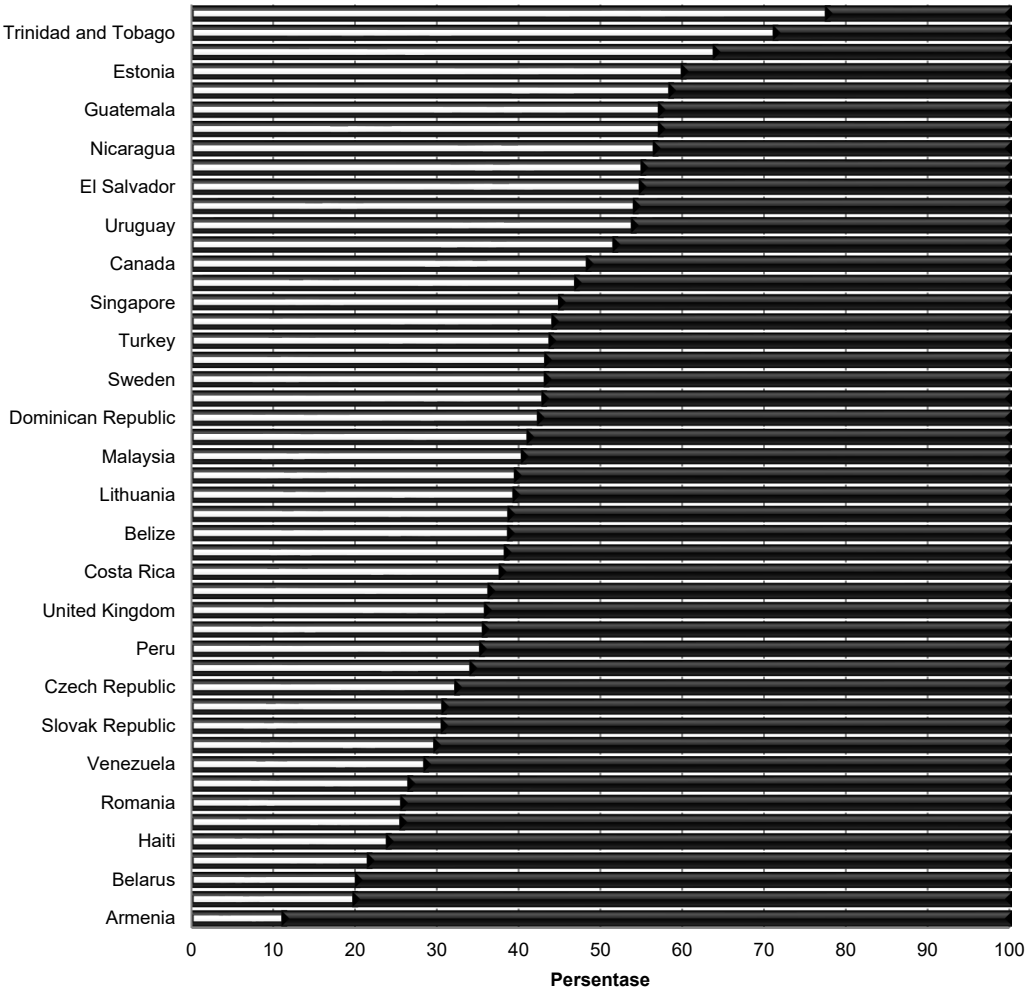

Figure 1. Worldwide Financing Patterns (Source: Beck et al, 2008)

Based on the figure above, it appears that the ratio of external financing (represented by the white box) to internal financing (represented by the black box) varies dramatically across countries. This is particularly evident in most developing countries, including Indonesia, it is internal financing that is mostly used by companies to fulfill their investment needs. Despite this, the figure also provides some puzzling results. This is because on the one hand it is not

surprising that in some developing countries such as Armenia, Moldova & Belarus, firms are not triggered to use large external financing. But on the other hand, the findings are contradictory in that companies in developed countries such as the US, which is generally considered to have one of the highest legal and financial environments in the world, also use less external financing than companies in developing countries such as Colombia, Malaysia or Poland. As a provisional conclusion, we can state that a set of characteristics have indeed influenced the financing patterns of firms in different countries. And while institutional development and the legal and financial environment do play an important role in corporate financing decisions, firm characteristics also have a large impact on financing patterns across countries.

Literature Review

The classic view of optimal capital structure derived from the irrelevance theory proposed by Mondigliani & Miller in 1958 states that the transfer of "expensive" equity into "cheap" debt will increase the value of the company up to a certain point. In other words, leverage will cause the Weighted Average Cost of Capital (WACC) to decrease as borrowing increases. The optimal capital structure can then be achieved when WACC is minimized, and firm value is maximized. After this point, losses will arise due to too much diversion from equity to debt, leading to an increase in WACC and a decrease in firm value. On the one hand, when the firm's leverage is too low, the firm will miss the opportunity to acquire (cheap) debt. But on the other hand, if the firm's leverage is too high, then the financial risk together with the WACC will increase which ultimately decreases the value of the firm. In other words, when financial risk increases due to high leverage, shareholders as well as debtholders will demand a higher rate of return, which in turn leads to an increase in the cost of equity and the cost of debt respectively. Thus, although leverage increases firm value to some extent, debt should be used with caution (Myers & Majluf, 1984; Kester, 1986; Berk & DeMarzo, 2007).

However, one of the main issues with the classical or traditional view of capital structure is that it is basically a descriptive theory based on the conditions in a perfectly competitive market. The classical capital structure theory will therefore generally be difficult to apply in real conditions because perfectly competitive markets are highly unlikely to occur. Therefore, we will explore capital structure theories that are classified as traditional or classical approaches based on perfectly competitive market, namely irrelevance theory. The review is then continued with the newer capital structure theories based on the irrelevance theory to imperfectly competitive markets through trade-off theory, agency theory and information asymmetry. The emergence of many of the above theories was essentially triggered by the famous work of Modigliani & Miller (1958) which sparked a debate on the capital structure decision of firms. Based on the assumption of perfect capital market, they theoretically showed that the financing mix of a firm seems irrelevant and therefore can be ignored. From this discussion of classical capital structure theory comes the essence of irrelevance theory and its implication to corporate capital structure decision. Since then, various academic works have emerged to test the validity of irrelevance theory which essentially includes cases of market imperfections that are a driving force for increasing firm value. For example, the trade-off theory includes two cases of market imperfections namely taxes and bankruptcy costs in its theoretical model to determine the

optimal corporate capital structure decision. The fundamental idea of this theory is basically that firms need to weigh the tax advantage gained from the use of debt with the cost of bankruptcy. Agency Theory then also considers the conflict of interest between various stakeholders as an important element in determining the optimal capital structure of the company. Specifically, this theory includes agency costs in their model and then indicates which financing instruments to use to reduce agency conflicts. However, as implicitly implied in the description of the theory, a uniform and consistent explanatory explanation to the capital structure of the firm cannot be achieved if we use agency theory. Furthermore, if we focus on a form of market imperfection that is also seen to influence the company's capital structure decision, namely the information asymmetry that occurs between managers and stakeholders that often occurs in reality, then this gives birth to the pecking-order theory which postulates that companies should prioritize the use of internal financing, then debt and the last is equity in order to mitigate the costs associated with heterogeneous information between stakeholders.

Factors Affecting Capital Structure

This section will specifically provide an overview of the factors that have an influence on firms' capital structure decisions. Based on the previous empirical literature, we will discuss the most relevant factors that are proven to have a significant impact on the leverage decision of the firm as stated by Titman & Wessels (1988), Rajan & Zingales (1995), Chen (2004), Barclay (2004). Zingales (1995), Barclay et al (2006), Delcoure (2007), Antoniou et al (2008), De Jong et al (2008), Kim & Berger (2008), and Frank & Goyal (2009). This section is related to the previous subchapters that have theoretically outlined the main capital structure theories known today, the difference is that this section provides a theoretical basis for an in-depth empirical study of the various factors that determine the capital structure of companies that are will be carried out later and to develop hypotheses and conceptual frameworks in our next article.

Endogenous Factors

This section begins our review of the key debt factors and their influence on a firm's capital structure decision. These key debt factors are the ones that have been most frequently analyzed by academics and have shown a significant impact on corporate leverage decisions. We recognize that this section and the subsequent sections devoted to exogenous factors only discuss a limited number of debt determinants. In addition, we recognize that these factors will be discussed in relation to the predictive ability of trade-off theory and pecking-order theory. This is because we will more deeply explore and theoretically examine the empirical results of the study to answer the research question of which capital structure theory can better explain the empirical findings of this study in the analysis section later rather than now.

Company Growth

The first endogenous factor that has an influence on the capital structure of the company is the growth of the company. The growth opportunity of a firm is generally measured through Tobin's Q. This essentially happens because there is an inverse relationship between leverage and growth opportunity of a firm. In other words, the greater the growth opportunity owned by

the company, the less they use leverage. This negative relationship has also been confirmed by Barclay et al (2006). On the other hand, this empirical finding seems to be in line with the prediction put forward in the trade-off theory, which states that large growth opportunities can increase the cost of financial distress which ultimately leads to lower leverage. On the other hand, the negative relationship between growth and leverage still contradicts the view of the pecking-order theory. This is because the pecking-order theory states that growth opportunities should be financed by leverage instead of equity, which will eventually lead to increased leverage. A more in-depth description of the validity of each capital structure theory based on the respective debt factors will then be provided in the next section of analysis in this dissertation.

Company Size

Generally, the size of a company is determined through the calculation of the amount of assets or the age of the company. In most empirical studies, size and leverage show a positive relationship. And therefore, the larger or longer a firm is, the more leverage it will use. This empirical finding is in line with the trade-off theory, as these types of firms are exposed to lower default risk than newly established or smaller firms. Furthermore, larger and older firms are seen as having a record of success itself and hence gains the attention of financial analysts and credit ratings. And hence, the company can afford to use more debt financing. The study conducted by Beck et al (2008, pp.476-484) then shows that firm size has a significant role in the firm's capital structure decision. This was stated by Beck et al (2008) after using a database of survey results on firm characteristics in 48 countries, where the authors proved that smaller firms use less external financing, apart from the fact that smaller firms engage in smaller debt financing.

Asset Structure (Tangibility of Assets)

The ratio of fixed assets to total assets is an excellent measure to determine the asset structure of a company. Most studies have detected a positive relationship between asset structure and the level of leverage owned by the company. Therefore, the greater the asset structure of the firm, the greater the incentive the firm has to increase the leverage of the firm. This is also in line with the core of the trade-off theory because asset structure is often used as collateral for debt financing and will reduce the cost of financial distress and ultimately increase the company's debt capacity. This is also consistent with the pecking-order theory, where according to this theory, collateral is used to eliminate the relevance of information asymmetry.

Liquidity

The impact of asset liquidity on corporate capital structure decisions has been a source of debate for a long time. Although some scholars claim to have found a positive relationship between current assets and leverage (Shleifer & Vishny, 1992; Sibikov, 2009), there are also some scholars who see a linear or so-called curvilinear relationship between current assets and leverage such as the research results of Myers & Rajan (1998) and Morellec (2001). Furthermore, the reason for this positive effect arises from the view that less current assets are

often associated with higher liquidation costs, which in turn leads to higher distress costs. Hence, in order to mitigate these higher distress costs, firms are seen to need to lower their debt levels. In other words, firms with current assets are said to have higher financial flexibility, which will make them viewed positively by the market and hence make debt financing less expensive. However, empirical findings also find a negative effect that less current assets will cost more for the firm to divert value from bondholders. Therefore, less current assets will lower the cost of debt financing, which in turn will increase leverage. In this regard, Morellec (2001) argues that the impact of asset liquidity on a firm's capital structure decision will depend on whether constraints on asset disposition are dominant. Myers & Majluf (1984) suggests that less current assets will discourage managers from attempting to divert value from investors.

Profitability

Generally, the higher the profitability of a company, the less leverage it will use. Thus, a negative relationship between profitability and leverage is likely to occur. This is evidenced in empirical research conducted by Harris & Raviv (1991), Bennett & Donnelly (1993), Rajan & Zingales (1995), and Fama & French (2002) which confirm the inverse relationship between profitability and leverage. This finding is in line with the essence of the pecking-order theory, as firms with profitability are often associated with large internal funds and can therefore limit themselves from external financing. However, this is different if we take the view of the trade-off theory, where a positive relationship between profitability and leverage is predicted. Therefore, since the higher the profitability of a firm will make it face lower bankruptcy costs, the firm should exploit the tax saving benefits by increasing its debt level.

Average Ratio of Industry Debt

Furthermore, empirical studies have also proven that firms that compete in the industry will on average be highly leveraged as well as highly leveraged tends to have a larger amount of debt financing. This is empirically proven in research conducted by Dittmar (2004), Elliot et al (2008), and Frank & Goyal (2009).

Exogenous Factors

This section will discuss some exogenous factors that can have an influence on the capital structure of a firm. These exogenous factors, according to our observation, are often overlooked in empirical studies but have a significant role in determining a firm's capital structure decision.

Deregulation

The first endogenous factor affecting corporate capital structure is related to deregulation. This is shown in a recent study conducted by (Opler et al., 1999) which explicitly attributes the evolution of capital structure in response to industry deregulation. Due to the undeniable fact that deregulation is often associated with transformations in the operating environment of firms, the author assumes that such economic shocks may have an influence on the capital structure of firms. Furthermore, he also states that debt factors, such as profitability, firm size, and asset

structure will only hinder the financing structure of the firm insignificantly when economic deregulation occurs (Opler et al., 1999). More specifically, his study shows that firms exposed to industry deregulation will experience a decline in profitability and significant assets structure, while on the other hand experiencing increased options for growth. Due to these developments, companies generally seek to reduce or even eliminate their debt levels. Furthermore, his study also shows that leverage is less inversely correlated with profitability and market-to-book and more positively related to firm size after deregulation (Opler et al., 1999).

Bank Concentration and Institutions

One of the most comprehensive empirical studies in this regard has been conducted by La Porta (2002) who studied the effect of bank market concentration and institutions on firms' capital structure decisions, where they analyzed 12,049 firms in 39 countries from 1995 to 2001. The bottom line of their research shows that firms exposed to greater concentration of banking institutions and stronger protection of creditors' rights will tend to have a higher level of debt. In contrast, firms that face strong property rights protection tend to have lower debt levels (La Porta, 2002). Furthermore, they show that greater bank concentration is a substitute for creditor protection and asset structure to mitigate agency costs between shareholders and bondholders. And in the case of weak protection rights, firms tend to follow the views expressed in the pecking-order theory due to higher agency costs from external financing (La Porta, 2002). They, therefore, indicate that bank concentration and credit right protection in particular facilitate access to debt financing.

Access to Capital Market

Most empirical studies on this subject focus more on publicly traded firms that have access to capital markets, and only a small number of academic works study the capital structure of private firms. One of the empirical studies that focuses more on private firms in this regard has been conducted by Baker & Wurgler (2002) who attempted to analyze how access to capital can affect the capital structure of firms. By studying firms in the UK from 1997 to 2000, the author empirically proves that access to the capital market has several implications for firms' capital structure decisions. First, it is related to the effect of the degree of access to capital markets, where the results imply that private companies use more leverage than public companies. The second is related to the effect of sensitivity that occurs when private companies avoid access to capital markets, where this leads to greater sensitivity to their capital structure and causes fluctuations in company performance. This will have a heavier impact on private companies than public companies due to the higher cost of equity issued by private companies.

Concluding

Previous section has reviewed the main factors that can have an impact on a firm's capital financing mix. Certain exogenous debt determinants such as the effect of growth opportunities, firm size, asset structure, liquidity, profitability and the average ratio of industry-wide debt can have certain consequences for a firm's capital structure. It should be noted that the purpose of

this section is not to provide an in-depth analysis of the determinants of debt which is the focus of this study which we will do later in the analysis section after obtaining empirical results on factors affecting capital structure in various industrial companies in Makassar. Furthermore, this section has shown that endogenous factors also have an impact on financing decisions. This is particularly the case for firms that are exposed to industry deregulation but experience significant declines in profitability and asset structure, while at the same time are faced with increased alternative options to grow their business, and ultimately lead firms to reduce their debt levels. This happens even though other endogenous factors such as greater bank concentration and stronger creditor rights may make firms more likely to pursue higher debt levels. Finally, this section has also shown that private firms tend to have greater leverage levels than public firms. This is an interesting point to analyze in more depth as empirical studies have shown that firm value is significantly affected by the firm's leverage decision (Baker & Wurgler, 2002; Elliot et al, 2008; Frank & Goyal, 2009). In addition, the market-to-book ratio which is generally used to analyze the effect of valuation on leverage is expected to be negatively related to the level of debt, which in turn leads companies to issue equity when they perceive that the real valuation is now overvalued, and vice versa.

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