Corporate Finance, Module 17, “Optimal Corporate Borrowing”

Required reading:

(The attached PDF file has better formatting.)

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{The Brealey and Myers textbook is excellent. We say to read certain sections and to skip others. This does not mean that certain sections are better; it means that the homework assignments and exam problems are based on the sections that you must read for this course. Some of the skipped sections are fascinating, but they are not tested.}

Read the boxed introduction on page 489. As Brealey and Myers say: “We’re shooting for a theory combining MM’s insights plus the effects of taxes, cost of bankruptcy and financial distress…”

Read section 18.1, “Corporate Taxes,” on pages 489-493. Brealey and Myers do an excellent job of removing the complications of corporate taxes and presenting the theory.

Skip section 18.2, “Corporate and Personal Taxes,” on pages 493-497. In truth, a complete analysis of all taxes, both corporate taxes and personal taxes, with emphasis on the difference between taxes on capital gains and stock dividends, is necessary to analyze capital structure. But the tax analysis detracts from the concepts. If you ever analyze capital structure, you must spend several days examining the tax liabilities caused by debt and stock dividends, but the final exam for this course concentrates on corporate taxes, not personal taxes.

Read section 18.3, “Costs of Financial Distress,” on pages 497-500, skipping the sections “Evidence on Bankruptcy Costs” on pages 500-501 and “Direct vs Indirect Costs of Bankruptcy” on pages 501-502. Skip also the section “Who Can Afford to Go Broke?” on page 502. Read the sections “Financial Distress Without Bankruptcy” on page 503, “Risk Shifting: The First Game” on page 504, and “Refusing to Contribute Equity Capital: The Second Game,” on pages 504-505. Skip the section “And Three More Games, Briefly,” on pages 505-506, and skip the section “What the Games Cost” on pages 506-507.

Read the section “Costs of Distress Vary with Type of Asset” on pages 507-508 and the section “The Trade-off Theory of Capital Structure” on pages 508-510. These are important sections; the trade-off theory is the mainstream view. It is not perfect (that is, it can not explain everything), but it does as well as anything else.

Read section 18.4, “The Pecking Order of Financing Choices” on pages 511-514, but skip the final sub-section, “Free Cash Flow and the Dark Side of Financial Slack” on pages 514-515. The pecking order is Myers’s theory, given as a presidential address to the financial analysts community many years ago.

Read the summary on pages 515-516.