Corporate Finance, Module 17, “Optimal Corporate Borrowing”

Required reading, Eighth Edition:

(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 introduction on page 469. 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 469-473. 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 473-476. 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 476-480, skipping the sections “Evidence on Bankruptcy Costs” on page 480 and “Direct vs Indirect Costs of Bankruptcy” on pages 480-481. Read the sections “Financial Distress Without Bankruptcy” on pages 481-482, “Debt and Incentives” on page 482, “Risk Shifting: The First Game” on page 483, and “Refusing to Contribute Equity Capital: The Second Game,” on pages 483-484. Skip the section “And Three More Games, Briefly,” on pages 484-485, and skip the section “What the Games Cost” on pages 485-486.

Read the section “Costs of Distress Vary with Type of Asset” on pages 485-486 and the section “The Trade-off Theory of Capital Structure” on pages 488-490. 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 490-494, but skip the final sub-section, “The Bright Side and the Dark Side of Financial Slack” on pages 494-495. 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 495-496.