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The influence of cash flow on the speed of adjustment to the optimal capital structure

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ABSTRACT

The aim of this paper is to examine the influence of cash flow on French SMEs' speed of adjustment (SOA) to their capital structure targets. Adjusting a firm's financial structure results in transaction costs, including information costs, bargaining costs, and monitoring costs. Transaction costs have a strong influence on the SOA of a company's financial structure to its target leverage (TL). Furthermore, transaction costs are considered higher for SMEs than for listed companies. In this context, studying cash flows is particularly relevant because cash flow is a resource that involves low transaction costs. We apply a two-step model to French panel data collected during the period 2005–2014. In the first step, the TL is estimated. We considered two leverages: a short-term leverage and a long-term leverage. In the second step, the target is used to estimate adjustment speeds by distinguishing between over-levered companies and under-levered companies. There are two main contributions of this study. This study's first contribution was that we found a significant difference in the SOA between over-levered and under-levered firms for short-term leverage but not for long-term leverage. This study's second contribution was to highlight SMEs' behaviour while adjusting their financial structure. For over-levered firms, the statistical results showed that the speed of firms with a positive cash flow is higher than the speed of firms with a negative cash flow. Contrary to findings related to listed companies, for under-levered firms, our results do not show that a negative cash flow implies a faster adjustment to TL.

1. Introduction

Ever since Modigliani and Miller's 1958 contribution, many works have been devoted to the study of capital structure. The trade-off theory holds that each firm has an optimum capital structure. This optimum is the result of a trade-off between the benefits (i.e., the tax benefits of interest payments) and costs (i.e., the costs of financial distress) of debt. Classic research on financial structure has focused on listed companies. The literature has raised the question of whether SMEs' financial management can be analysed using tools built for listed companies (Michaelas et al., 1999). Ang (1992) stresses that agency, information, failure costs, taxes, and transaction costs matter not only for listed companies but also for SMEs. For these reasons, Psillaki and Daskalakis (2009) have found that the theory initially built to study the capital structure of listed companies can be used to study SMEs' capital structure. And in the conclusion of a study dedicated to UK SMEs, Michaelas et al. (1999) have shown that most of the determinants of capital structure used in financial theory seem to be relevant for small businesses in the U.K. It is thus legitimate to consider the existence of a target debt structure for SMEs. Michaelas et al. (1999), Ozkan (2001), Cassar and Holmes (2003), Psillaki and Daskalakis (2009), Heyman et al. (2008), Aybar-Arias et al. (2012), Palacin-Sánchez et al. (2013), and Mateev et al. (2013) are among those who have studied

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SMEs' financial structure. The most commonly used determinants include size, age, sector, profitability, tax shields, growth and asset structure. When a firm's financial structure moves away from the TL, the company experiences deviation costs and therefore has an incentive to move closer to its target. For an over-levered firm, deviation costs are an increase of the cost of failure, whereas for an under-levered firm, deviations costs are a shortfall caused by the loss of tax savings.

Nevertheless, firms also experience adjustment costs when they adjust their financial structures. If there were no adjustment costs, the leverage observed should equal the optimal leverage. These costs are transaction costs and include information costs, bargaining costs, and monitoring costs. A firm incurs these costs when finalizing a contract that affects its financial resources. The leverage moves closer to the target only when the transaction costs are lower than the deviation costs. These costs are the reason that a firm's adjustment to its optimal financial structure might only be partial; they are the reason that the notion of SOA arose. Speed of adjustment is defined as the ratio between the variation of the observed leverage and the deviation from the target.

The literature describes several variables that moderate the SOA. All of these studies revolve around the same key point: the importance of adjustment costs. High adjustment costs have a negative impact on the SOA. The literature reviews the elements that are likely to affect these costs.

The first factor is the distance to TL. [Mukherjee and Wang \(2013\)](#) and [Welch \(2004\)](#) show a positive relationship between this distance and the speed of adjustment. Two things can explain these results. First, the costs of not adjusting—especially bankruptcy costs in the case of an over-levered firm—increase with this distance and thus, managers are more likely to adjust. Second, the presence of fixed costs decreases the adjustment speed if the distance is small.

The impact of market valuation and equity mispricing on adjustment speed has also been studied ([Warr et al., 2012](#)). An over-valuation of equity reduces the issuing cost and the adjustment cost when the firm is over-levered. Consequently when equity is undervalued, issuing equity is more costly and adjustment costs are higher. The authors found that for over-levered firms, the speed of adjustment is higher when equity is over-valued. They provide evidence based on a sample of US listed companies.

[Lockhart \(2014\)](#) shows that the existence of a credit line provides the firm with a low marginal cost that leads to a more rapid adjustment.

[Drobetz et al. \(2015\)](#) study both the differences in adjustment speed across financial systems and the impact of recession and sector. They note that these differences are attributable to different adjustment costs.

Company size is also likely to impact adjustment costs. [Mukherjee and Wang \(2013\)](#) find that large firms adjust more quickly than small firms.

The moderating effect of cash flows on the speed of adjustment has also been studied by [Byoun \(2008\)](#) and [Faulkender et al. \(2012\)](#). These studies of listed companies conclude that cash flows have a strong influence on the SOA. Both use the same argument in their work: positive CF enables financial structure adjustment at low transaction costs.

Almost all of these studies are dedicated to listed companies. [Aybar-Arias et al. \(2012\)](#) are an interesting exception. In this work, we study the SOA to TL in the context of French SMEs. We examine cash flow's impact on this speed by distinguishing between long-term and short-term debt leverage. Questioning the SOA in the context of SMEs appears well founded because financial structure management is particularly important for small companies. First, SMEs experience a higher risk of failure than listed companies. Therefore, the issue of debt is a major issue. Second, SMEs have fewer financing options than listed companies because SMEs cannot access capital markets. Third, SMEs experience higher transaction costs than listed companies when raising funds and do not have the same fundraising skills as big companies ([Holmes and Kent, 1991](#)). It is also more difficult for SMEs to manage the complexity of administrative procedures. In a 2015 inquiry by the European Commission dedicated to the financing of European enterprises, 7% of respondents cited paperwork as the main factor limiting their debt ([European Commission, 2015](#)).

Informational asymmetry in the relationship between SMEs and their financial environment—mainly banks—also plays an important role. First, SMEs disclose less financial information than do listed companies. Second, this information is subject to less-stringent audit standards, leading to an increase in informational asymmetry. This asymmetry generates higher transaction costs. For example, when obtaining a bank loan, asymmetry can lead the lender to require additional guarantees. In the European Commission study cited above, it appears that most SMEs are experiencing an increase in the non-interest costs of financing. The lender must also support monitoring costs after the loan has been granted to ensure, for example, that there is no opportunistic use of the loan. This issue is more acute in the French context. France's legal structure is considered to offer poor protection to investors and creditors. On a creditor-rights scale, a score of 0 (weak creditor rights) has been assigned to France by [Oztekin and Flannery \(2012\)](#). Additionally, [Psillaki and Daskalakis \(2009\)](#) note that transaction costs tend to be particularly acute in France.

Studies of the SOA have adopted two empirical approaches. Some rely on a two-step procedure: in the first step, the TL is obtained and in the second step, the SOA is estimated ([Byoun 2008](#); [Faulkender et al., 2012](#)). We choose to follow this option. Other works develop an integrated model in which determinants of TL and SOA are estimated together in a single model ([Aybar-Arias et al., 2012](#)).

This paper's aim is to study the impact of cash flows on SMEs' SOA. This question has been addressed in prior studies; however, those studies examine listed companies ([Byoun 2008](#); [Faulkender et al., 2012](#)). This question is even more important to SMEs: cash flows involve low transaction costs and are SMEs' primary source of funding. We choose two measures of debt ratio: short-term debt leverage and long-term debt leverage. The targets and adjustment speeds associated with these leverages may differ. Long-term debts are usually contracted to fund fixed assets. Their negotiation is often long and includes the acceptance of guarantees. Short-term debts are generally used to fund the operating cycle. Their management is easier and the transaction costs involved are a priori lower. For all of these reasons, it appears relevant to distinguish between the two types of debt.

We obtained several interesting results. First, we compared the SOA of over-levered and under-levered firms. Studies of listed companies note that over-levered firms show a greater SOA to their debt leverage target. The SMEs in our French sample behave

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