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Capital structure determinants of Portuguese footwear sector SMEs: Empirical evidence using a panel data



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Abstract The main objective of this paper is to study the capital structure determinants of SMEs in the footwear industry and their indebtedness. Using panel data methodology and considering a sample of 70 firms we study the capital structure determinants between 2010 and 2013. The paper examines the indebtedness level in light of the two main theories – the *Trade-off* theory and the *Pecking Order* theory and we chose the footwear sector because of its importance in the Portuguese economy. In addition to total indebtedness we extend the literature by analyzing the differences between short-term and long-term indebtedness and the impact of the presence in foreign markets on debt structure. The results suggest that profitability, growth, total liquidity, risk and presence in foreign markets are key factors affecting the capital structure of footwear firms and that *Pecking Order* theory seems more suited to those firms.

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1. Introduction

Small and medium enterprises (SMEs) are commonly referred to as the backbone of any economy and one of the main problems reported by Portuguese SMEs is how to finance their activity, being largely dependent on banks. Nevertheless, following Basel III regulations, banks need to better scrutinize their lending activity in order to compute minimum

capital requirements which, allied to the economic slow-down and the need to deleverage, lead banks to reduce their lending activity, in particular toward SMEs. Thus, SMEs' capital structure is strongly affected by that factor. SMEs play a critical role in the global economy, as suppliers of employment and key agents for local and regional communities' well-being and the role of these firms ultimately depends on the flexibility they have to undertake entrepreneurial strategies and promote innovation.

The objective of this paper is to study the capital structure determinants of the Portuguese footwear sector SMEs and the way those determinants could influence their

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indebtedness levels. The footwear sector has hardly been researched in terms of capital structure, so we extend the literature by analyzing the determinants of short and long-term indebtedness from a selected sample of footwear firms, covering the period from 2010 to 2013. Also, our paper extends the literature since it is focused on SMEs belonging to the Portuguese footwear sector and examines the link between internationalization and debt structure.

The next section presents an introduction to this issue and a literature review, discussing the importance of SMEs in the overall economy and the reasons to study the footwear sector. Section three presents the hypothesis to be tested. The following sections present the data and methodology used and the results, with the final section presenting a discussion about the results and some concluding remarks.

2. Relevant literature and reasons to study the footwear sector

2.1. Capital structure theory

Capital structure theory had its debut with [Modigliani and Miller \(1958\)](#) which developed a theoretical model concluding that a firm's capital structure is irrelevant to its value, asserting that a firm consists of a set of assets representing a certain capacity to generate returns, at a certain risk that determines the cost of capital.

In a later approach, [Modigliani and Miller \(1963\)](#) acknowledged that their previous model was based on a set of unrealistic assumptions, considering now the effect of taxes and the risk of leverage on capital structure. The introduction of the tax effect, which originated the development of the *Trade-off* theory of capital structure, had implications on the determination of the firm market value. That is, indebtedness brings a tax benefit that allows the firm to increase its value because interest paid is deductible. The approach made by [Modigliani and Miller \(1963\)](#) about the importance of indebtedness on the firm capital structure allowed an approximation to a traditional view. If for the authors the effect was essentially the result of the maximization of tax profits generated by the usage of debt capital, for the traditionalists it was the result of financial leverage. So, [Modigliani and Miller \(1963\)](#) explained that the maximization of the firm value occurs when assets are totally financed by debt, *ceteris paribus*.

[DeAngelo and Masulis \(1980\)](#) included the effect of other tax benefits besides debt in the firm's capital structure analysis and held that the tax advantage given by debt is limited, considering the model from [Miller \(1977\)](#) as unrealistic and excessively sensitive to changes in tax laws. Also, according to [Myers \(1984\)](#), as the firm increases its indebtedness it also increases its tax benefits and financial difficulties, so that the firm has to find a point of indebtedness that maximizes its value. According to the model from [Myers \(1984\)](#), the indebtedness level is limited by the costs of an eventual financial difficulty, that is, the market value of the firm is an increasing function of the tax benefits generated by indebtedness until a point where doubts begin to be raised concerning the firm's financial health and bankruptcy costs begin to be high.

[Jensen and Meckling \(1976\)](#) provided a relevant contribution to the capital structure theme with the agency costs theory, discussing the tax effects and the risk of leverage. These authors depart from the agency relationship, that is, when someone is brought in to manage then other costs could arise. Those costs result from a conflict between shareholders and managers, mainly because managers could act according to their personal interests, possibly manipulating and hiding relevant financial and strategic information from shareholders, instead of trying to maximize firm value.

[Jensen \(1986\)](#) observed that these situations occur when there are excessive free cash flows, that is, there is available cash after financing all the projects, thereby increasing manager's tendency to spend the available resources in sumptuary goods or projects that will not reward the invested capital. [Ross, Westerfield, Jaffe, and Jordan \(2011\)](#) found that the behavior of shareholders and the risks incurred by the debt owners can prevent greater financial leverage. When a firm uses capital from third parties conflicts arise between shareholders and creditors, those conflicts are aggravated when the firm goes through greater financial difficulties. [Myers and Majluf \(1984\)](#) found that managers possess information that it is not known by the market, due to the fact that *insiders* have information about the firm's investment opportunities that is unknown to external investors.

The controversies around the *Trade-off* Theory lead to the development of the *Pecking Order* theory which had its roots in papers from [Myers and Majluf \(1984\)](#) and [Myers \(1977, 1984\)](#). This theory of capital structure was the result of the presence of asymmetrical information between "inside" managers and "outside" investors, asserting that the firm should use leverage to finance established assets and stocks to finance new growth opportunities.

[Myers and Majluf \(1984\)](#) state that the *Pecking Order* theory consists of a hierarchical sequence of financing decisions, that is, firms first use internally generated (self-financing) funds to finance their investments, only resorting to external financing when those funds are not enough, first preferring loans and then stock issuance. According to [Myers \(1984\)](#), firms prefer internal financial resources, adjusting their dividend policies to their investment opportunities, with the objective to avoid sudden changes in dividend payments.

According to [Myers \(1984\)](#), firms with a higher capacity to generate results have lower levels of debt capital, not because of a policy of low indebtedness but because they do not need to resort to external resources. On the contrary, unprofitable firms tend to issue debt because the ability to generate funds internally is not sufficient to meet their investments ([Rajan & Zingales, 1995](#)).

2.2. Why study the footwear sector?

In spite of the harsh economic situation, with the intensification of the euro zone sovereign debt crisis, in 2013 SMEs maintained their position as the backbone of the European economy.¹ Representing over 99% of all firms,

¹ According to the Commission Recommendation 2003/361/EC of 6th May the definition of micro, small and medium-sized enterprises

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