



# Corporate capital structure and the characteristics of suppliers and customers<sup>☆</sup>

Jayant R. Kale<sup>a</sup>, Husayn Shahrur<sup>b,\*</sup>

<sup>a</sup>*J. Mack Robinson College of Business, Georgia State University, Atlanta, GA 30303, USA*

<sup>b</sup>*Department of Finance, Bentley College, Waltham, MA 02452, USA*

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## Abstract

We investigate the link between a firm's leverage and the characteristics of its suppliers and customers. Specifically, we examine whether firms use decreased leverage as a commitment mechanism to induce suppliers/customers to undertake relationship-specific investments. We find that the firm's leverage is negatively related to the R&D intensities of its suppliers and customers. We also find lower debt levels for firms operating in industries in which strategic alliances and joint ventures with firms in supplier and customer industries are more prevalent. Consistent with a bargaining role for debt, we find a positive relation between firm debt level and the degree of concentration in supplier/customer industries.

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\*Corresponding author.

*E-mail address:* [hshahrur@bentley.edu](mailto:hshahrur@bentley.edu) (H. Shahrur).

## 1. Introduction

Since Modigliani and Miller's (1958) capital structure irrelevance result, researchers have searched for capital structure explanations primarily within the context of firm boundaries that are determined by explicit contracts among stakeholders including shareholders, debtholders, managers, and the government. The research in this stream of literature provides important insights into the effects of taxes, bankruptcy costs, information asymmetries, agency issues, and other frictions on corporate leverage decisions. Building on this work, another body of research (see, e.g., Titman, 1984; Maksimovic and Titman, 1991) analyzes a firm's capital structure decision in a setting in which the firm's boundaries include implicit as well as explicit contracts. We contribute to this latter stream by investigating how the inclusion of suppliers and customers as stakeholders affects a firm's leverage choice.

We focus on two aspects of the relation between a firm's debt level and its dealings in the input and output markets. First, we hypothesize that a firm can use a lower level of debt in its capital structure to induce its suppliers and customers to undertake relationship-specific (R–S) investments. Our hypothesis is based on the work by Titman (1984) and Maksimovic and Titman (1991). Titman (1984) suggests that a firm with a unique product may require its customers to undertake investments that lose value if the firm goes into liquidation. In this setting, lower leverage commits the firm to a liquidation policy that takes into account the effects on its customers. Further, customers may not be willing to deal with a highly levered firm, which is less likely to worry about its reputation (Maksimovic and Titman, 1991). We apply this intuition to R–S investments by suppliers and customers and hypothesize that firms that expect their suppliers/customers to undertake R–S investments will carry lower levels of debt.

Our second hypothesis considers the relation between a firm's choice of debt level and its bargaining position relative to its suppliers/customers. The intuition for our hypothesis follows from the extant literature on the role of debt in management–labor union bargaining (see, e.g., Bronars and Deere, 1991), which suggests that raising the debt level increases the management's bargaining power vis-à-vis a labor union by reducing the amount of firm surplus available for sharing with labor. Specifically, we hypothesize that a firm may choose a higher debt level when it faces suppliers/customers who have relatively higher bargaining power. The empirical implication of this hypothesis is a positive relation between a firm's debt level and measures of supplier/customer negotiation power.

In order to test our hypotheses, we construct two separate data sets. The first data set identifies suppliers and customers at the industry level and the second consists of key customer and supplier firms. The industry-level data offer three distinct benefits relative to the firm-level data. First, the sample of firms in the industry-level data set is much larger. Second, endogeneity issues that are endemic to corporate finance research are likely to be significantly less severe in tests that relate a firm's capital structure to variables measured for supplier and customer *industries* than to variables measured for supplier and customer *firms*. Third, industry-level data allow us to relate firm financing decisions to important variables such as the levels of buyer and supplier power that need to be measured at the industry level. The main advantage of the firm-level data set, on the other hand, is that it identifies supplier and customer firms more precisely and thus the inferences based on the findings from this data are cleaner. Further, it allows us to examine the effect of a firm's leverage on the R–S investments of its key suppliers and customers.

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