



UNIVERSITY OF GOTHENBURG
SCHOOL OF BUSINESS, ECONOMICS AND LAW

The Low Leverage Decisions of Knowledge- based Firms

*An empirical study of the impact of employees' risk preferences
on the firm's capital structure decisions*

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Abstract

The low leverage decisions of knowledge based firms

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A distinctive trait of knowledge-based companies is their dependency on the competence and contribution of their employees. They are commonly structured as partnership firms and tend to have a low amount of tangible assets and virtually no debt. Although theories within capital structure state that debt can indeed be beneficial, knowledge-based companies persistently choose to completely avoid the use of long-term debt and hence do not adequately fit the description of any of the dominant theories within the field.

The aim of this thesis is to analyse and explain the process behind the capital structure decisions of knowledge-based firms. The main purpose is to see how well these companies align to the major theories within the field and seek further explanations in alternative theories where the former do not suffice. Moreover, due to the nature of the firm's assets an interesting aspect to investigate further is whether the risk preferences of the firm's employees affect the firms financing decisions. The emphasis is put on partners' ability to impact decisions as they have decision-making authority and incentives to maximise profitability, gaining rewards in the form of substantial yearly dividend payments.

The study was performed with the use of a qualitative method, which enables a profound understanding of what affects decisions. Primary data was collected through interviews with representatives of four knowledge-based firms operating in the fields of law, consulting and advertising, which were deemed to provide a broad and fair view of the industry. We sought to interview employees that had great insight in the companies' finances; therefore the interviews were conducted with either the Chief Financial Officer or Chief Executive Officer of the respective firms in order to gain as high reliability as possible.

The study showed that the main reason for avoidance of debt was most often referred to the interviewed companies' low investment needs. Moreover, theories in the area were found not to be actively considered, even though evidence in favour of them can be found. Much of the findings aligned with the implications of the pecking order theory, but even so the extreme policies of knowledge-based need more explaining. In line with the stakeholder co-investment theory the thesis investigates whether the risk preferences of the firms' employees, in being the most important stakeholder, in any way affect decision-making. It was found that even though not explicitly expressed, many times decisions are made that favour the employees over the overall financial benefit of the firm. Rather than increasing the market value of the company by taking on debt, dividend-payouts create value-enhancing activities on a personal level.

Keywords: Knowledge-based, human capital, capital structure, low leverage, partnership, dividends, stakeholder co-investment

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1. Introduction

1.1 Background

An increasing number of companies of today are knowledge based and therefore highly dependent on the competence and performance of their employees (Ployheart and Moliterno, 2011). The general definition states that a knowledge-based company is human capital-intensive and provide non-standardized, creative and individually adopted services for clients that require complex problem solving (Sveiby and Risling, 1987). Further common denominators are that they do not possess a significant amount of tangible assets, and tend to avoid the use of long-term debt despite the fact that prevailing theories such as the Modigliani and Miller propositions and trade off theory state that they might benefit from acting otherwise.

Capital structure refers to how companies choose to combine and balance their use of equity and debt capital. Taking on debt could be beneficial from a valuation perspective as it allows for shielding some profit from corporate taxation, but it also increases risk in terms of probability of distress, which implies that there is great complexity in these decisions (Hillier et. al, 2013). Due to the risky nature of debt capital the tangible assets of the firm are of big importance for lenders. If the firm goes bankrupt – the likelihood for which increases with a higher amount of debt – debt holders will have collateral in assets that could be of value in a second-hand market. Consequently, in line with Titman (1984), it is considered to be more risky to lend to unique, specialized firms because of the lack of tangible assets to materialise in the event of financial distress.

Valuation in these types of companies is problematic in the sense that investments in human capital do not directly show positively on the balance sheet, but intrinsically is of great importance for the continued success of the firm. Thus, the instinctively logical inference when discussing financing in knowledge-based firms is that they should be cautious in their use of long-term debt due to the nature of their assets. However, the problem is more complex than that. Knowledge-based firms that have a substantial market share, historically stable cash flows and excellent profitability persistently choose not to take on debt, although increased leverage potentially could be advantageous for firm value. This apparent contradiction invites to interesting reflections on possible reasons for this resolute avoidance of debt capital. The capital structure of a company is thus not merely the result of short term financing decisions stemming from single investment opportunities, but deliberate and carefully considered decisions that can have substantial effects on firm value and can serve as a statement to the market of the financial wellbeing and intentions of the firm (Miglo, 2007; Lindblom, Sandahl and Sjögren, 2010).

There is vast material covering the research field of capital structure. However, the dominating theories do not reach consensus in their explanations of the problem and do in some respects even contradict each other (Shyam-Sundars and Myers, 1999). The trade-off theory says that firms can reach an optimal capital structure and therefore should issue debt as long as the tax benefits of leverage are not offset by costs of distress. On the other hand the pecking order model advocates using retained earnings primarily, before issuing new debt, resulting in lower leverage than predicted by the trade-off theory, and hence not supporting the existence of an optimal capital structure (Fama and French, 2002). The literature therefore often focuses on comparing and contrasting theories trying to find evidence for which best explains real life situations. This research, however, has not yet succeeded in agreeing on how capital structure in practice is explained, as the theories in some respects are mutually exclusive and therefore cannot independently provide sufficient explanations of real life diversity (Beattie, Goodacre, Thompson, 2006; Lindblom, Sandahl and Sjögren, 2010). Furthermore another common approach is to aim focus at a specific industry or market in order to find explanatory evidence as to which theory best explains the leverage decisions of the firms (Rajan and Zingales, 1995; Mackay and Phillips, 2005). Again, this research fails at providing sufficient explanations, as evidence shows that managers often claim to follow opposing theories, for example maintaining a target capital structure while at the same time following a specific pecking order (Beattie, Goodacre, Thompson, 2006).

1.2 Problem discussion

Frank and Goyal (2003) examine various factors' ability to predict leverage, resulting in new insights into what characteristics can be considered reliable in determining leverage. Following up with a new paper, they draw upon these results to identify the most important factors to use when categorizing firms according to their capital structure (Frank and Goyal, 2009). They find that median industry leverage, tangibility of assets, profitability and market-to-book ratio are most significant, results that are consistent with earlier research. In line with these findings, profitable firms with a substantial amount of intangible assets generally tend to have lower levels of debt (Myers, 2001). Firms holding assets with these characteristics face greater risk of bankruptcy as debt holders are less likely to have their claims satisfied in case of financial distress, and hence they will take on less debt (Minton and Wruck, 2001). Earlier literature tends to find this explanation satisfactory and further research on the area of low leverage firms has subsequently been quite sparse.

Minton and Wruck (2001) state that financially stable firms that experience high cash flows actually tend to have lower leverage than what is predicted by major theories. This phenomenon

is especially evident when looking at knowledge-based firms who completely avoid the use of long-term debt despite being stable and profitable. Hence they would not be in any immediate risk of financial distress, but could rather benefit from including some debt in their capital structure. This contradiction implies that there must be more to the capital structure decisions of knowledge-based companies than can be explained by major theories.

Much of the previous research on capital structure focuses on identifying factors of companies that can be used as benchmarks when explaining leverage decisions of similar firms (Titman and Wessels, 1988; Frank and Goyal, 2003). However, this is often done using quantitative methods such as regression analyses and tends to result in generalizations giving explanatory evidence that poorly captures the diversity and uniqueness among firms. Often these factors are limited to providing adequate explanations that are applicable on the median firm, but can hardly be used as evidence on an individual level. Nevertheless they can, if deemed sufficiently reliable, provide a good starting point for further analysis.

Beattie, Goodacre and Thompson (2006) emphasize the interesting aspects of investigating the process rather than the outcome of capital structure decisions. Such information is best accessed using qualitative measures, and this way the gap between the theory and practice of capital structure decisions can be overbridged (Bancel, Mittoo, 2004). The importance of this approach is even more reinforced when considering the fact that managers tend to rely on informal factors when deciding upon a capital structure (Graham and Harvey, 2001), an aspect that is best captured by qualitative studies. Therefore questions can be raised as to whether the decision to hold low levels of debt is merely derived from these specific firm characteristics, or if there are other important contributing factors to be taken into account. Financially conservative firms do possess similar characteristics, among others asset tangibility as mentioned above, resulting in sensitivity to financial distress. However, grouping them together and assigning the leverage decision solely to bankruptcy probability, which is said to be the main driver of capital structure decisions in low leverage firms (Titman, 1984; Minton and Wruck, 2001) does not capture the diversity within the field (Beattie, Goodacre, Thompson, 2006).

Offering a more dynamic view of the matter of low leverage, Frank and Goyal (2003) discusses the stakeholder co-investment theory where the central idea is that the firm has several different stakeholders who contribute to the success of the firm. Therefore their interests must be considered when making leverage decisions, or else they may stop contributing. This is in line with Bancel and Mittoo (2004), who claim that European firms are driven by the objective to maximize all stakeholder wealth, as opposed to the US model where the objective is to maximise

shareholder value, and Lindblom Sandahl and Sjögren (2010) who stress the importance of considering stakeholder reactions in future research on financial behaviour.

Furthermore, the literature has long struggled to identify a single cost of financial distress large enough to offset the tax benefits of debt and validating the content of the trade-off theory (Berk, Stanton and Zechner, 2010). The stakeholder co-investment theory offers new insights to this matter. If the definition of a knowledge-based company is that their principal asset is the human capital, the intuitive implication is that their main stakeholders are the employees. Hence the potential loss of the employees' contributions would then be the most influential indirect cost of financial distress in a knowledge-based firm (Frank and Goyal, 2003). As said before, taking on debt increases risk as it increases the probability of financial distress. Subsequently, the employees face higher risk of losing value of their firm-specific investments if leverage increases, and may be reluctant to work hard if they feel this is the case. If they are risk averse they may therefore be adverse to higher levels of debt in the company. Thus it is of great importance not to make decisions that might cause a stir among the employees, which will be reflected in the leverage decision. This is further amplified by the fact that knowledge-based firms are traditionally privately held partnership firms where ownership lies with a number of employees, who are also active in the company and have decision-making authority. When ownership and management is not separated decisions will be influenced by the personal preferences and risk perceptions of the partners. As the partners have ability to influence decisions, the low leverage of these firms may thus be a result of their risk aversion. Hence an important and interesting question is whether and to what extent the risk preferences of the employees, or more specifically the partners, affect the firm's capital structure decisions. This leads us to the purpose of our thesis and the following research questions.

1.3 Purpose and research questions

The purpose of our study is to analyse and explain the underlying factors of capital structure decisions in knowledge-based firms. Due to the reliance on human capital and the importance of the partnership structure for managing purposes, we wish to investigate whether the firms' financing decisions are directly or indirectly influenced by the partners' and to a lesser extent other employees' perception of risk.

Research questions

- ❖ Why do profitable and financially stable knowledge-based companies choose to take on virtually no debt even though theories state that they would benefit from leverage?
- ❖ To what extent are risk preferences of partners and remaining employees considered when making financing decisions?

2. Research method

In the following section we will present and motivate the choice of research design and method for gathering of data for our study. We will also address the validity and reliability of our material as well as the primary and secondary data sources.

2.1 Scientific approach

2.1.1 Explanative study

The thesis takes the form of an explanative study. An explanative study is one in which you seek a profound understanding of a field of study, and where you wish to describe and explain underlying factors of known facts (Björklund and Paulsson, 2012). Some empirical evidence on capital structures of financially conservative firms does exist, but we feel that a deeper knowledge and explanation of underlying factors of decisions in knowledge-based firms is appropriate. For this purpose an explanative study is suitable.

2.1.2 Inductive approach

An inductive approach to the relation between research and theory will be used for this thesis. Induction is a scientific approach in which you seek to discover patterns in a certain field of study that can help summarize empirical findings, which in turn could help make general assumptions and build theories within a scientific field (Bryman and Bell, 2007). In brief, theories are constructed and based upon empirical findings. This approach was suitable for our study because few qualitative studies have been conducted on the topic of financing decisions within knowledge based firms, and hence there was little empirical material actually supporting the simplifications and general assumptions that are often made about low leverage firms. Literature shows that financially conservative firms tend not to follow any of the prevailing theories of capital structure outright (Minton and Wruck, 2001), and therefore we find it appropriate to use material that will emerge during the course of the study in order to theorise our findings (Bryman and Bell, 2007). Furthermore we feel that the use of various theories as starting point for conducting our study might limit our understanding and ability to objectively interpret and draw conclusions from the collected material. This because, as previously stated, prior research indicate that knowledge based companies tend not to follow theories very well. Instead we seek to as far as possible keep an open mind towards our empirical material in order to gain a deeper understanding of what affects decisions, and subsequently analyse our findings relative to pertinent theories as to see how well the material aligns to these.

2.1.3 Qualitative study

A qualitative study is characterized by the fact that the collection of empirical data does not involve the gathering or processing of quantitative data such as numbers, but instead focuses on the importance of words (Bryman and Bell, 2007). The qualitative method takes on an inductive approach where research generates answers that in turn help formulate conclusions (Bryman and Bell, 2007). This approach was suitable for our study as we seek to obtain deeper knowledge in an area that to a great extent already has been researched through quantitative measures (Beattie, Goodacre and Thompson, 2006). The study, among other things, seeks to find behavioural aspects that cannot be examined through quantitative measures such as the regression techniques commonly used. Survey based studies can provide information on managerial beliefs and attitudes that greatly affect decisions on financial policies (Lindblom, Sandahl and Sjögren, 2010), information that is quite difficult to obtain through the use of quantitative methods. Furthermore, much of the earlier empirical literature has to a great extent been dominated by statistical regression studies, whose main shortcomings are that they fail in fully reflecting the diversity among firms decisions that can be found in reality (Beattie, Goodacre and Thompson, 2006). Regression studies have a tendency to generalise results, as they are incapable of capturing the variability that is found in real life. Moreover, quantitative studies are limited to focus on outcomes and results and therefore neglect the importance of the decision making process in financing decisions. Recent empirical research hence emphasize the need for complementing the archival regression method with a more dynamic approach that takes into account the behavioural aspects of the decision making process (Beattie, Goodacre and Thompson, 2006). On the same note, Lindblom, Sandahl and Sjögren (2010) stresses the advantage of qualitative, survey-based studies in their ability to directly approach decision makers on their beliefs and perceptions, hence providing a very useful complement to event studies.

Knowledge based companies and their zero debt financial strategies in many respects contradict existing theories and theses. In quantitative studies financially conservative policies are often attributed to firm characteristics such as asset tangibility and market to book value (Frank and Goyal, 2009), but as observed by Minton and Wruck (2001) low leverage firms still adopt policies that cannot fully be explained by major theories. Our area of investigation is therefore oriented toward the process behind the financial decision making of firms more than to facts of the current situation, which already have been explored in many previous studies. As we just argued, quantitative models often aim at finding evidence for or against existing theories in order to explain observed capital structures (Beattie, Goodacre and Thompson, 2006). Consequently little effort is put into examining the underlying factors of decision-making, especially of deviant companies such as knowledge-based firms, and hence this is what we wished to investigate.

Furthermore, even among congenerous firms there is great individuality, therefore conclusions about incentives behind decisions might be hard to externally motivate without speaking to a representative of the company, thus further motivating the choice of the quantitative method.

2.2 Research design

2.2.1 Data collection

Primary data for our study was collected with the use of interviews. The interviews were conducted with representatives of four different knowledge-based companies. In the following we will present and motivate our chosen interview technique and its benefits for our purpose, as well as our choice of companies and interviewees. Furthermore, literature studies have been conducted in order to gain knowledge of the area in general and compose the theoretical framework on which the analysis is based. The gathering and review of academic journal articles and secondary data will be described in detail in the end of this section.

2.2.1 Case study

A case study aims its interest to the complexity and unique characteristics of a single chosen study object, and is appropriate when the case itself is of importance and exhibits a complexity that benefits from in-depth clarifications (Bryman and Bell, 2007). When aiming at explaining how and why certain phenomena happen, explanatory case studies are considered to be suitable (Yin, 2003). This is well in line with this thesis as the purpose is to analyse and explain the phenomenon of low leverage in knowledge-based firms. As previously stated, capital structure decisions in these firms tend to contradict predictions of major theories and earlier research, and the statistical methods commonly used fail in explaining underlying factors affecting decisions and reflecting the variability found in real life. Therefore the case study as research method is chosen as it facilitates gathering of information about organisational processes and real-life events (Yin, 2003), information that cannot be obtained through regressions and that is crucial for fulfilling the purpose of this thesis. Moreover, the case study is to be preferred when the phenomenon is closely intertwined with its context and thus the method allows for covering the context as well (Yin, 2003). Our knowledge-based firms are highly dependent on and affected by the context in which they operate and therefore surrounding factors must be taken into consideration when explaining their leverage decisions. This is best done by a case study.

2.2.2 Choice of companies

The initial aim was to conduct interviews with four firms within the knowledge-based sector, each operating in different areas. As knowledge based companies are commonly said to be

represented by four different fields, that is, law firms, advertising agencies, auditing firms and consulting firms, interviews with one firm operating in each of these four fields respectively would be appropriate for the scope of the study and provide us with valuable information. Our objective was to interview companies that could be considered to be representative within each field and somewhat comparable, however, the study ultimately had to be restricted to companies from whom we could get affirmative responses and that were willing to be interviewed within the time frame that was set out.

The main criteria for the choice of companies was that they were well established and had been in business for several years, as to ensure that their businesses were sufficiently stable and thus eliminating the impact of volatility. Furthermore we chose not to investigate companies whose main activity is to engage in research and development, and also actively disregarded newly founded knowledge-based companies. These firms have yet to receive stable cash flows and will experience little benefit from the tax-shield of interest if taking on debt. Moreover, the area of fast growing complex technology firms, and the issue of financing of newly founded IT-companies in particular, is already covered by quite much empirical research. Therefore we aimed our efforts at identifying major players in the market of knowledge-based companies that would be sufficiently profitable and stable to benefit from shielding cash flows from corporate taxation.

Further criteria for the selection of companies were that they had no or very little long-term debt on their balance sheet and that they were not publicly listed. When familiarizing ourselves with the industry we found that the majority of knowledge based firms are privately held, and therefore we chose to exclude those listed as they were not representative for the industry and including them would profoundly skew our analysis. Listed firms will have differing objectives than their privately held equivalents due to ownership being traded in the open market. Moreover the firms had to have a partnership structure, meaning that ownership lies with active employees. The partnership structure entails integration of ownership and control, which results in interesting implications for financial decisions that involve different degrees of risk. Suitable companies were identified using the database Retriever Business, from where annual reports were accessed and studied to find companies matching the above-mentioned criteria. We initiated contact with 18 suitable companies via e-mail during the course of several weeks, four of which responded and were willing to be interviewed in person within a passable time frame. Ultimately, all of these four firms were interviewed, two of which were in active in the legal market, one in consulting and one in advertising. Although the selection did not entirely match our initial objective, due to the time constraint we felt that it would suffice.

2.2.3 Interviewees

In order to obtain maximum possible insights into the financing decisions of each firm we aimed at interviewing senior employees with authority or good insights into the firms' finances. During the initial contact with the company, we expressed our wish for speaking with persons in leading positions, resulting in interviewees holding the position of chief financial officer for three of the interviews and chief executive officer for one of the interviews. Interviewing CFO's was deemed to be most beneficial since they have the ultimate responsibility over the firms financing decisions and hence would provide us with the best information for our purpose. It should be noted that their individual risk preferences are not of primary interest, but rather their view on how all employees, or more specifically the partners, affect financing decisions. Two of the interviewees, in company two and four, were partners in their respective firm, which was not one of the initial criteria for the choice of participants but could be of help for the study since one aspect that might be of importance for our was the effect of ownership and governance not being separated. There may be questions as to whether this might affect their answers compared to the other two respondents, but due to the limited scope of this study we have chosen not to further elaborate on this particular subject.

2.2.4 Anonymity

In connection with the interviews we raised the question of anonymity and opportunity for participants to review the material before publication, an initiative that was well received among the interviewees. For one participant overlooking the material was a criterion for giving consent to the interview and by maintaining anonymity we could reduce the risk of interviewees not approving of the material, something that could otherwise result in a precarious situation for us close to our deadline. Bryman and Bell (2007) state that it is often vital to maintain anonymity in order to get consent of participants for analysis of the data by others. Our participants are in high positions and therefore it is not surprising that they wish to be cautious of what statements they approve for publication. As it was not the individual company that was of interest for our study but their ability as a sample to represent the population of knowledge based companies we wished to investigate, we felt that the omission of names and irrelevant firm-specific facts would not affect the study in any negative manner. We addressed the issue of anonymity by the use of company pseudonyms (Bryman and Bell, 2007).

2.2.5 Interviews

The gathering of data for our case study was mainly conducted through personal interviews, in order to capture the diversity and behavioural aspects of the decision making process. The empirical material obtained by interviews is to be regarded as primary data as it is produced for the purpose of the specific study (Björklund and Paulsson, 2012). The qualitative interview is

flexible and focuses on the viewpoint of the interviewee, recognizing the possibility of significant topics arising during the course of the interview thus changing the direction of the discussion (Bryman and Bell, 2007). To ensure that we would obtain as much valuable information as possible we decided to make use of a semi-structured interview technique. Semi-structured interviews are characterized by having predetermined topics but allowing for open discussions where follow-up questions that arise during the course of the interview are asked when appropriate, depending on the direction the interview takes (Björklund and Paulsson, 2012). This way we could control the interview with respect to our fields of interest but at the same time provide the interviewees enough space to speak freely depending on which topics might be of particular interest to them and their companies, and thus allowing for the possibility of new significant issues emerging. This was deemed to be beneficial for our study as the targeted companies are fundamentally different in nature and a structured interview would not have been sufficient for capturing the diverse nature of the companies in question.

The interviews were performed in person at the respective offices in Gothenburg and Stockholm, and were in three of the four cases recorded and immediately after transcribed. This is beneficial as it helps limit information losses due to problems remembering the topics discussed, and allows for better interpretation of answers in retrospect (Bryman and Bell, 2007). As advised when conducting semi-structured interviews, we composed an interview guide containing fairly general questions on our topics of interest that was sent to the interviewees some days before the scheduled meetings, together with a brief explanation of our aim and purpose (Bryman and Bell, 2007). This interview guide can be found in appendix 1.

2.2.6 Literature studies

We commenced our literature search by reviewing past work in the area, in order to gain basic knowledge of the capital structure research field in general. Initially the main focus was aimed at quite recent academic journals where we sought interesting openings that might be of relevance for the purpose of our thesis, after which we shifted focus to more theoretically oriented journal articles that could form the basis for our theoretical framework. During this section of the literature search a pattern could be discerned, showing which authors were commonly cited and thus pointing us in the appropriate direction allowing for collection of very useful acknowledged academic material. Also, much focus has been aimed at the search and reading of qualitative research in the area in an attempt to justify and facilitate our choice of research design. In addition business research method literature was consulted throughout the course of the writing to provide support and guidelines for the study design.

A great advantage of literature studies is that it allows for fast and easy access to information and facilitates mapping the research field when composing the theoretical framework (Björklund and Paulsson, 2012). Published journal articles are to be regarded as primary data, as it is academic work that has been peer reviewed and is hence well recognized in the academic world. However, as with all written material, they are written for a purpose specified by the author, a purpose that may not necessarily fully align with that of the reader. Therefore one must always be cautious when interpreting the work of others.

2.2.7 Secondary data as a complement to our used data

Secondary data is material collected by other researchers or assembled by organizations for their own purpose, and its use as a complement to primary data may be beneficial as it introduces an element of comparison (Bryman and Bell, 2007). Although the gathering of data for this thesis was mainly conducted with the use of interviews and academic journal articles, interviewing requires preparatory work. Therefore, to familiarise ourselves with the chosen companies their recent annual reports and websites were studied so that we could customise follow-up questions and hence extract as much valuable information as possible from the interviews. These sources have been excluded from the reference list due to the respondents' wish for anonymity.

Moreover, textbooks on capital structure have been consulted when necessary as to provide comprehensible overviews and clarify theories, and several past theses have been read to help design this study. Secondary data sources many times enables the reader to examine data that, if taken from reliable sources, may be of far better quality than any data collected by oneself. However it is important to bear in mind that it is difficult to control quality and measure the reliability of the material (Bryman and Bell, 2007). Therefore it must be considered how up-to-date the material is, how independent its source or sources are, and if it might in any way have been distorted. Who is responsible for the material and for what purpose is it developed is crucial for the degree of objectivity (Björklund and Paulsson, 2012).

2.3 Reliability and Validity

Reliability and validity are the most important measurements of the credibility of the study and should always be considered in academic material. The researcher must always evaluate the choice of research design critically and strive towards as high degree of reliability and validity as possible with respect to the resources and time at hand (Björklund and Paulsson, 2012).

Reliability is concerned with the accuracy and consistency of measurements, that is, the probability of obtaining the same results if the study was to be repeated (Bryman and Bell, 2007). High reliability thus means that the acquired results can be considered correct and that the same results would be obtained from a similar study, and are hence not influenced by chance. This

matter is particularly important in quantitative studies and is harder to address with a qualitative approach, as data is much less standardized and credibility cannot be estimated with numbers (Bryman and Bell, 2007). We have tried to uphold the reliability by as far as possible trying to design each interview in a similar manner as the others. Nevertheless, as our selection of firms due to time constraints is quite small high reliability may be harder to achieve. This problem is somewhat addressed by the choice of senior, proficient employees for our interviews, which increases reliability in the obtained answers. Also, the decision to maintain anonymity allows respondents to speak more freely, which also facilitates the access to valuable information. Nevertheless, as our primary data mainly consists of interview material a high degree of reliability is hard to measure. We cannot control the interviewees' interpretations of the questions and whether they provide us with honest and correct answers. Moreover, reliability is affected by our preconception and interpretation of the answers and therefore it is of utmost importance to as far as possible strive to maintain objectivity when processing the material.

Validity addresses the question of whether the study in fact measures what it is intended to measure, and provides us with the information that it is meant to in order to fulfil the purpose of the thesis. The degree of validity is dependent on that the data collected is relevant and correct, and can be increased by the use of multiple perspectives on the problem (Björklund and Paulsson, 2012). In order to maintain validity in our study we have during our interviews tried to as far as possible keep to the subject and guide the discussion in a direction consistent with our purpose, with the use of relevant follow-up questions. Moreover the empirical material obtained from the interviews was sent to the respondents for approval ensuring that we had correctly interpreted their answers. Furthermore we have through the use of secondary data sources such as annual reports sought information that could help validate the material obtained in the interviews. In qualitative research validity can be increased by the suitability of the chosen method (Björklund and Paulsson, 2012). The use of interviews as primary method of gathering data benefits the purpose of this study and hence increases validity.

3. Literature Review

3.1 Introduction

There are a number of more or less acknowledged theories concerning the research field of capital structure. As previously discussed, the predominant models provide different explanations of capital structure decisions and in some respects tend to contradict each other, as some of the content in these can be considered mutually exclusive (Beattie, Goodacre and Thompson, 2006). This chapter will initially provide a brief overview of the major theories, after which a more comprehensive and thorough description of the theories we consider to be of importance for our study will be given.

In 1958 Modigliani and Miller introduced the concept of capital structure irrelevance, saying that firm value is completely unaffected by its capital structure. They follow up with a model considering market imperfections, resulting in the ground-breaking insight that companies can use debt not only as a source of financing but as a means to boost firm value by shielding taxes from the government (Modigliani and Miller, 1963). The notion of an optimal capital structure has ever since been a popular concept in the field of corporate finance, and much research has been dedicated to deriving an optimal debt-to-equity ratio and to find patterns explaining actions of firms (Bradley, Jarrell and Kim, 1984). This theory has formed the basis for dominant theories of today; the most acknowledged being the trade-off and the pecking order theories.

In response to Modigliani and Miller's proposals implying that the firm, in order to achieve maximum possible value, would increase its leverage as long as there is tax to be shielded, came the trade-off theory of debt (Kraus and Litzenberger, 1973). Introducing the risk factor of leverage the trade-off theory takes into consideration the increased risk of bankruptcy that comes with higher levels of debt. This resulted in a model where tax benefits of debt decreases as leverage increases, due to the offsetting effect of costs of financial distress. The trade-off theory is often supplemented with the agency theory in which the tax benefit of debt is further offset by agency costs, that arise when managers and shareholders due to asymmetric information have differing objectives (Jensen and Meckling, 1976). Further, the main competing theory, which is said to be most popular in practice (Beattie, Goodacre and Thompson, 2006), is the pecking order theory. Claiming that companies due to transaction costs choose their preferred funding according to a specific pecking order, firms are said to at first favour the use of retained earnings, then external funding in the form of debt, and as a last resort only issuing new equity (Myers, 1984). This theory, unlike the trade-off theory, does not imply an optimal capital structure, as equity is both most and least preferred.

3.2 Modigliani and Miller propositions

Before Modigliani and Miller presented their article on capital structure irrelevance in 1958 there was little material in the literature dedicated to the effects on corporation valuation resulting from the differences between debt and equity financing. They argued that in a world with perfect markets and sure returns, the difference is merely reduced to one of terminology. Nevertheless they stressed the lack of a qualified model describing the effects of a firm's capital structure on the valuation of the firm (Modigliani and Miller, 1958), and aimed to develop such a theory.

3.2.1 The irrelevance proposition

Basing their suggestions on a world with perfect capital markets, Modigliani and Miller (1958) found that the firm's market value is unaffected by its capital structure. In equilibrium the market value of the firm's assets always equals its discounted profit, which results in the firm being indifferent to the choice between debt and equity financing. This statement is called the Modigliani and Miller proposition 1, or commonly, the capital structure irrelevance proposition. Furthermore they argued that the use of debt changes the market for shares as they become subject to increased financial risk. As increasing leverage amplifies the risk of equity, it follows that return on equity must increase accordingly. Investors will therefore require higher yields on their investments in order to compensate for the increased risk they are subjected to. This is known as the Modigliani and Miller proposition 2. Moreover the weighted average cost of capital will be unaffected by the firm's leverage decision as the rise in the price of equity resulting from increased leverage is offset by the simultaneous increase in the amount of cheaper debt. Consequently, even though debt appears cheaper than equity a firm cannot reduce its cost of capital, and hence increase firm value, by adding debt to its capital structure.

3.2.2 Considering market imperfections

The initial propositions are based on a world with perfect capital markets and hence not applicable on real life firms. Modigliani and Miller acknowledges this error and subsequently present corrections of the models considering market imperfections such as taxes (Modigliani and Miller, 1963). Initially they argue that taxes could be neglected, as "the market value of firms must be proportional in equilibrium to their expected returns net of taxes" (Modigliani and Miller, 1958). This statement, however, they later deemed to be wrong, arguing that due to the tax deductibility of interest levered firms will experience after tax returns that are no longer proportional. For a firm with permanent debt this means that market value increases with the present value of the interest tax shield. Furthermore, increasing leverage would also lower the weighted average cost of capital, making investments more appealing.

3.2.3 Implications for further research

Modigliani and Miller's research has had major implications for the research field of capital structure as it resulted in the ground-breaking insight that the use of debt financing can result in significant benefits for firm value and cost of capital. Capital structure decisions can hence be used as a strategic tool. Returning again to the popular notion of an optimal capital structure, this would immediately imply an optimal debt level of 100% (Titman, 1984). However, in their corrective paper Modigliani and Miller dissuade readers from strictly adopting this view, as they recognize the possibility for other sources of funding being beneficial. Nevertheless the theoretical interpretation of the theorem would deem the maximisation of debt levels as optimal.

3.3 Trade-off theory

3.3.1 Static trade-off theory

Building on the models of Modigliani and Miller (1958, 1963) that advocate maximisation of debt, Kraus and Litzenberger (1973) presented what is commonly known as the static trade-off model. They broaden the concept of market imperfections claiming that in addition to corporate taxation, costs of potential bankruptcy are central to a theory of the positive effects of capital structure on firm value. The use of debt financing entails a legal obligation to pay a fixed amount as interest, resulting in positive effects on firm value but also increased risk of bankruptcy. As long as the firm does not risk bankruptcy, control lies with equity holders who wish to maximise their own wealth. In the event of bankruptcy however control instead passes on to the firm's debt holders, who seek to maximise their respective wealth (Titman, 1984). Defaulting on interest payments leads to insolvency and entitles debt holders to a legal claim on assets, and the associated penalties the firm incurs may thus drive the firm into bankruptcy. Hence the risk of bankruptcy increases with increased leverage, as more debt means more interest payments that must be honoured. In a world with market imperfections the tax benefits of debt that were previously considered quite substantial would thus to some extent be offset by bankruptcy costs.

The importance of bankruptcy costs for corporate valuation had been discussed before (Hirschleifer, 1966) but Kraus and Litzenberger (1973) further builds on this concept and present a single-period model considering both taxes and bankruptcy costs in a complete capital market, resulting in the possibility to derive an optimal capital structure for the firm, where maximum possible value is yielded. The market value of debt is said to decline as the amount of debt increases due to the greater risk of insolvency, which results in that debt holders recognise they face greater risk of not realising their claims, and hence pay less for the debt initially. The value of the levered firm in any state thus equals value of the unlevered firm plus the difference between the tax benefits of debt and any bankruptcy costs,

3.3.2 Indirect bankruptcy costs

Miller (1977) argues that the deadweight bankruptcy costs such as legal fees referred to by Kraus and Litzenberger (1973) are actually negligible when compared to the proportionally much more significant tax savings opportunity. Hence the static trade-off theory alone would not be sufficient to foil the initial theory of Modigliani and Miller (1963). A widening of the bankruptcy cost discussion to include possible indirect costs such as loss of customers or impaired ability to maintain operations would then allow for a more dynamic view of the matter. For the purpose of corporate valuation expected costs of bankruptcy, not ex post costs, are what matters. Although studies show that actual costs of bankruptcy may be quite substantial, expected direct costs prior to any situation of financial distress are often negligible, in the area of 1% of firm value (Miller, 1977). With this in mind, direct costs of bankruptcy alone would have little offsetting effect on tax benefits of debt. As introduced by Miller (1977), indirect costs of bankruptcy would include negative effects on firm profitability resulting from the firm being in financial distress, such as the potential loss of customers and suppliers, employees, or the change of managements focus from more profitable activities to handling pressing matters of distress.

The matter is even more elaborated by Titman (1984). Earlier literature disregards the discussion of indirect costs regarding them similarly negligible as direct bankruptcy costs, but Titman emphasizes the substantial significance of impacts indirectly related to the bankruptcy situation. He recognizes that in the event of bankruptcy, costs are borne by not only stockholders and bondholders but instead collectively by all of the firms potential stakeholders. If stakeholders fear the firm will go bankrupt, they will stop contributing to the wellbeing of the firm, incurring costs that the firm will indirectly bear (Titman, 1984). Therefore, in line with what was inferred by the static trade-off theory the tax benefit of debt is offset by expected indirect costs of bankruptcy. Similarly, as probability of bankruptcy increases stakeholders will be less prone to contribute, paying less for the firms debt initially so that the cost is actually borne by equity holders, resulting in a reduced tax benefit of interest payments.

3.3.3 Implications for further research

The trade-off theory endorses the existence of an optimal capital structure, in which the optimum level of debt lies where tax benefits are exactly offset by expected costs of bankruptcy (Shyam-Sunder and Myers, 1999). Much subsequent empirical research has therefore focused on determining optimal debt levels for firms. The difficulty herein lies in correctly appraising distress costs that can vary immensely across firms depending on many factors, for instance asset tangibility. Consequently the trade-off theory also provides predictions of how firms should choose their capital structure, in saying which type of firms should be highly leveraged and which

should not. Furthermore earlier literature mainly focuses on the interests of stock- and bondholders in the event of bankruptcy. With the recognition that the firm has several other stakeholders, each of whom are contributing with firm-specific investments that face risk of losing value in the event of liquidation (Titman, 1984), more implications on capital structure decisions appear. Firms that in the event of bankruptcy would impose great costs on their stakeholders should subsequently choose to incorporate less debt in their capital structure.

3.4 Agency theory

The classic trade-off theory with its optimal debt level, trading off the benefits and disadvantages of debt, is often complemented with a theory of agency costs. The use of debt gives rise to conflicts between shareholders and debt holders that can further limit the benefits of leverage, and ultimately have negative effect on market value of the firm (Jensen and Meckling, 1976). Traditional agency theory discusses the agent-principal dilemma, where ownership and control is separated so that the decision-making is carried out by a separate entity, the agent, who work on behalf of, but perhaps not always in the best interest of, the principal. In a capital structure context, this implies that management due to differences in access to information may be more or less inclined to act in the best interest of the firm's shareholders. Different levels of debt put constraints on management, and the firm can thus use capital structure decisions to control management incentives. This was discussed by Titman (1984) who derives a model of optimal capital structure considering a principal-agent situation where the principal, represented by the firm's customers, incurs costs in the event of bankruptcy. These cost however are indirectly borne by the agent or the firm, as wary customers will predict these costs and be willing to pay less for products initially. Hence the tax benefits of debt are partially limited. In the following we will discuss how constraints on managers can affect the market value of the firm.

3.4.1 Agency costs

The importance of agency costs for the firm's capital structure was first discussed by Jensen and Meckling (1976). They aim to define types of agency costs that arise as a result of the choice between levels of debt and equity in the firm's capital structure. The agency relationship is defined as one where management is engaged by the shareholders and given authority to partly handle decision-making. However, as both parties are to be regarded as utility maximisers their interests will not always align (Jensen and Meckling, 1976; Fama and Jensen, 1983). They stress the fact that it is virtually impossible for the principal to ensure that the agent will at all times make decisions that are entirely in the best interest of the principal, and therefore they present course of actions that can be taken in order to limit deviations from their interests. Hence agency costs are all costs associated with monitoring and insuring that managers work in the best interest of the shareholders, as well as the residual loss shareholders experience when this fails. These

costs have a negative effect on firm value and reduce the tax saving effect of debt in a similar manner as with the bankruptcy costs discussed earlier. To illustrate this, Jensen and Meckling (1976) use an example of a firm that is fully owned and managed by a single owner. Management and ownership is completely integrated and all decisions are made to maximise utility. If part of the ownership is transferred to outside shareholders, however, there will be a divergence between the interests of the different owners. The manager subsequently no longer bears the costs of his actions alone, and therefore might act in ways that maximises his own utility rather than that of all shareholders. In order to ensure that managers do not act this way other shareholders can take monitoring measures, thus the firm experiences monitoring costs.

3.4.2 Free cash flow theory

Furthermore, the discussion can be elaborated in order to explain how debt can be used as a means to control managers. The free cash flow theory states that the more cash available at the hands of managers, the more power they have to act in their own interest. Excess cash can be reduced by dividend payouts to shareholders or by increasing debt levels and thereby incurring obligations to pay interest (Jensen, 1986). Reducing free cash flow is hence beneficial as it reduces managerial waste in the form of overinvestment in potentially low-return projects. This is especially evident in the event of financial distress, as firms near bankruptcy can be inclined to gamble with shareholders money, feeling that they have nothing to lose, thus investing in overly risky projects that would otherwise have been rejected (Hillier et al, 2013). Also, as leverage increases probability of bankruptcy (Kraus and Litzenger, 1973) higher levels of debt enhances pressure on managerial efficiency and importance for them to run business more fiercely increases, which is beneficial for the future success of the firm (Jensen, 1986).

3.4.3 Implications for further research

Jensen and Meckling (1976) argue that agency costs further validates the proposition of the trade-off theory in saying that capital structure is not irrelevant in corporation valuation. Agency costs are hence an additional limitation to the benefits of debt as it reduces the market value of the firm. Even if the firm faces no imminent risk of distress, these information asymmetries will be anticipated by cautious stakeholders and thus affect the price of debt, incurring costs that will be borne by the firms shareholders and which will be reflected in the market value of the firm (Hillier et al, 2013). Therefore agency costs are often incorporated into the trade-off theory. An immediate implication for the leverage decision is hence that firms more susceptible to similar issues will choose lower levels of debt.

3.5 Pecking-order theory

While much of the early empirical research tends to focus on the notion of an optimal capital structure, evidence from reality actually shows little support for optimal debt ratios in explaining real life financing decisions (Myers, 1984). Offering an in some respects opposing view to that of the classic trade-off theory is the pecking order theory. Abandoning the earlier dominant opinion of capital structure theories that debt can be used as a means to affect corporation valuation, Myers and Majluf (1984) present a model of financing behaviour where capital structure is a result of information asymmetries between the firm and the market that affect the choice between different types of funds. The resulting debt to equity ratio thus reflects the firms' need for external financing rather than the strive towards an optimal capital structure (Myers, 1984; Shyam-Sunder and Myers, 1999).

According to Myers and Majluf (1984) there are three main types of investment funds. Internally generated equity capital in the form of retained earnings and external capital such as new equity issues or long-term debt financing, all of which come with different degrees of risk for the firm. Myers and Majluf (1984) find that managers choose how to finance investments outlays based on the cost of the specific type of capital, and thus seem to prefer internally generated funds to external capital due to the significantly lower cost and hence also lower risk. This directly contradicts the findings of the commonly cited trade-off theory, as equity exists in the form of both internal and external capital and is hence both most and least preferred (Myers, 1984).

In contrast to the core idea of the agency cost theory, the pecking order theory admits no opposing objectives between managers and shareholders, but instead assumes that managers act in the best interest of its present shareholders rather than new investors (Myers and Majluf, 1984; Lindblom, Sandahl and Sjögren 2010). Furthermore managers are generally believed to be in possession of superior information compared to that available to the market. As capital structure alterations can be used as a means to convey information to investors (Myers, 1984), prospective investors therefore believe that the decision not to issue new equity signals financial wellbeing, and that the firm is currently sufficiently profitable to cover all necessary investments. If the firm instead was to issue new shares, this apparent need for external financing would imply bad or at least less good news, resulting in negative signals to the market and a subsequent drop in share prices (Myers and Majluf, 1984). Therefore, due to information asymmetries firms may be reluctant to issue new equity, as external equity is substantially more risky than internally generated funds (Myers, 1984). On the same note, this implies that a firm would rather choose to turn to debt financing before external equity, and hence issuing new shares in order to finance investments is used only as a last resort (Myers and Majluf, 1984). This is the core idea of the

pecking order theory of financing, saying that the firm, when choosing how to finance investments, first makes use of retained earnings, then debt, and only on rare occasions issues new shares (Myers, 1984).

Differences between pecking order and trade-off theories

The pecking order theory consequently directly contradicts the trade-off theory in many important respects, one of them being that it does not advocate the existence of an optimal capital structure (Shyam-Sunder and Myers, 1999). It also disregards the use of debt financing for corporation valuation purposes in favour of the risk and cost perspective of financing sources. Intuitively this raises questions regarding the accuracy of either of the theories. However, many tests of these theories have been carried out (Beattie, Goodacre and Thompson, 2006; Lindblom, Sandahl and Sjögren, 2010) showing that the pecking order theory is the one that gains most support among real life firms, implying that risks and signals to the market are more important to managers in practice than is theoretical value enhancing benefits of financing decisions.

Theoretically the optimal course of action for any firm is to evaluate investment opportunities as if the firm always had plenty of cash at hand, and hence invest in all positive net present value projects (Myers and Majluf, 1984). This however does not allow accounting for the risk factor of the different types of funds discussed above. As internally generated funds are least risky, firms with large excess cash balances will accept more profitable projects than firms that would need to turn to external financing in order to invest. Therefore firms facing profitable investment opportunities but having low cash balances might forego investments they otherwise would have accepted due to reluctance to seek external financing (Myers and Majluf, 1984). Here another contradiction to the trade-off theory appears. Large, profitable firms acting in stable environments would according to the trade-off theory benefit from increasing debt levels and shielding profit from taxation, and thereby increasing firm value. According to the pecking order theory however, profitable firms would experience no need for external financing but rather finance investments with the use of retained earnings, thus keeping a low debt to equity ratio.

3.6 Stakeholder co-investment theory

Frank and Goyal (2003) provides a more dynamic approach to the importance of risk of financial distress, in a theory that has many similarities with the classic trade-off theory of debt. Traditionally, theory states that the firm primarily should act in the interest of its shareholders (Hillier et al, 2013). Nevertheless, the firm has several other stakeholders all of which have a stake in, and contribute to, the continued wellbeing of the firm. These stakeholders range from managers and employees to customers and suppliers. Conversely, the firm is dependent on these stakeholders to keep contributing their so called co-investments and

therefore need to at all times aim at keeping them satisfied and willing to keep investing. The success of the firm is hence a direct consequence of the level of contribution of its stakeholders, a fact that becomes especially evident in firms that require a great degree of firm-specific investments. Firm-specific investments are investments by stakeholders in for instance human capital that is unique for the firm in question. Therefore, in the event of bankruptcy, these firm-specific investments can lose value, and thus stakeholders may be reluctant to invest in a firm that faces higher risk of financial distress (Frank and Goyal, 2003). Consequently, a firm that is highly dependent on its stakeholders unique contributions will employ lower levels of debt, while firms such as manufacturing companies that rely more heavily on tangible assets will incorporate more debt and thus to a greater extent enjoy the benefits of the interest tax shield. This line of thought can be traced back to Titman (1984) who claimed that firms producing goods that are unique should make use of less debt, as they would face higher costs in the event of financial distress. The same predictions are given by the stakeholder co-investment theory, which stresses the importance of asset tangibility for capital structure choices, as firms in unique industries have more specialized employees, which would result in greater distress costs (Frank and Goyal, 2009).

Lindblom, Sandahl and Sjögren (2011) draw the logical conclusion that the risk preferences of managers are of great importance as they pre-eminently influence the capital structure decisions of the firm. They also refer to the fact that stakeholders accept a certain amount of risk when entering in contracts with the firm. Therefore, contracts between the firm and its stakeholders will have implications for the chosen capital structure (Zingales, 2000) and leverage can seriously impede stakeholder interaction (Frank and Goyal, 2009). The stakeholder co-investment theory further builds on this finding as it, in contrast to the classic trade-off theories, implies an importance of the risk preferences of all stakeholders in deciding debt to equity ratios. Further support for the stakeholder approach is given in Bancel and Mittoo (2004) who in their survey study find that while American firms in accordance with classic theories are prone to maximising shareholder value, European firms on the other hand tend to focus on maximising stakeholder value. This further validates the importance of allowing a wider interpretation of who may affect the firm to employ lower levels of debt than what is predicted by the trade-off theory.

3.7 Recent studies on capital structure in low leverage firms

Recent empirical evidence show that many firms of today tend to be under-leveraged, holding less debt than what is predicted by dominant theories such as the trade-off theory and the pecking order theory (Graham, 2000; Dang, 2013). There is scarce material covering financial decisions of knowledge-based firms and we have not yet managed to find studies that specifically concern their capital structure and low leverage. However, studies have been made that examine

the phenomenon of financial conservatism and zero-debt policies in general, and the results of these studies can be regarded as adequately consistent with the actions of knowledge-based firms. For instance, Minton and Wruck (2001) aim at explaining why many firms persistently maintain low leverage policies and neglect to utilize the potential benefits of debt financing.

3.7.1 The low leverage puzzle

The negative relation between leverage and profitability is widely acknowledged in the literature, and contradicts predictions of among others the trade-off theory (Myers, 1984). Not surprisingly Minton and Wruck (2001) find that conservative firms follow a pattern that is consistent with the pecking order theory, as these firms tend to be highly profitable and experience large cash balances that are used to fund investment outlays. However, it is argued that the pecking order theory cannot nearly explain all aspects of firm behaviour (Myers, 1984) and thus more insight into the problem is needed. Pure pecking order predicts that the firm would empty all internal funds before turning to external capital, after which debt financing is preferred over new equity issues (Myers, 1984; Minton and Wruck, 2001). Financially conservative firms however are said to follow a pecking order style policy where they do not empty all internal funds before seeking external funding, and hence do not seek to diminish possible problems of adverse selection as advocated by pure pecking order (Minton and Wruck, 2001). Moreover, conservative policies appear to be transitory, as most financially conservative firms tend to abandon these policies in favour of capital structures allowing more debt. Also conservative firms tend to store debt capacity, preparing for future needs. If future cash balances are reduced or investments increase they have enough flexibility to cope and increase long-term debt (Minton and Wruck, 2001).

Although financial conservatism is found not to be industry specific but is evident across all types of firms, low leverage policies are generally more pervasive in industries that possess certain characteristics. In line with predictions of the trade-off and stakeholder co-investment theories conservative firms often operate in industries sensitive to financial distress (Minton and Wruck, 2001; Frank and Goyal, 2009). Firms holding high levels of intangible assets thus tend to borrow less, implying that leverage is dependent on the type of assets the firm holds (Myers, 1984).

3.7.2 Zero debt and dividend payouts

Dang (2013) goes one step further, investigating firms that persistently adopt zero-leverage policies. He finds that whether the firm pays dividends or not is crucial for the motives of not using debt. While non-dividend paying firms generally avoid debt due to financial constraints, dividend-paying firms place value in preserving financial flexibility and mitigating underinvestment. As the latter firms tend to be large and profitable and hence not experiencing

significant financial constraints, the zero leverage decision becomes a voluntary and quite strategic decision (Dang, 2013). The matter is also discussed in Strebulaev and Yang (2013) who on the same note obtain the somewhat unanticipated result that a surprising amount of zero-debt firms pay dividends, and that these many times are substantially higher than those of their levered equivalents. This can be explained by the fact that the interest payments of levered firms are substituted for dividend payouts. Moreover unlevered dividend-paying firms tend to be more profitable and cash intense than the industry averages, and in contrast to general low leverage firms whose policies are largely transitory, zero debt policies are often quite pervasive (Strebulaev and Yang, 2013).

4. Empirical results

In this section we will present the findings from our empirical material that was of interest for our study. All information below was retrieved from the four interviews conducted, and the findings from each interview are presented as separate sections. Due to the semi-structured nature of the interviews and the subsequent variation in answers the following sections do not entirely follow the interview template but instead the information regarded as important for the study has been extracted and organised in a logical sequence. A comparison and summary of the empirical material is then provided in the results section.

4.1 Company 1 - Law firm - *Interview with Chief Financial Officer*

Company 1 is completely partner owned and branches under a principal company, in which all of the invoicing takes place. Clients purchase services from the principal company, which are then executed by the operating company. The principal company has no actively operating business activity but handles all financing decisions, and financing is thus completely separated from the operational activity. When asked if the company has a pronounced financial strategy, the CFO expresses that they aim at speeding up billing and payments from the clients, which traditionally in the industry can be a very slow process, in order to become more financially flexible.

Virtually all profit accrued during the year is distributed as dividends to the partners, after which the partners are immediately obliged to lend a portion of their dividend to the principal company where the money is needed to finance operational costs and investments. Completely emptying the company of liquid assets each year is also expressed as a being part of their financial strategy. The partners receive favourable terms for their loans and receive higher interest than that offered by the bank. They have the possibility to retrieve their capital, but when the company is in need of liquid assets the CFO is in position to deny their requests. Similarly, when the company holds an unnecessary amount of cash, they can oblige the partners to withdraw their money as to not incur unnecessary interest expenses. This strategy is not necessarily the most economic but allows the company to maintain their financial flexibility and avoid exposure towards the bank. They argue that they would much rather pay interest to their own partners than to the bank as this means a tax advantage for the partners, since tax on interest income is low. Partners on the other hand incur risk when lending their private money but are compensated by the high interest. Lending also becomes an incentive to work harder as the possibility to retrieve their cash is directly related to performance. Moreover the dividend policy and yearly emptying of the company ensures that partners get the money that they have been working for now rather than later, which is considered to be a fair and just solution.

The company has no long-term loans; instead, they have credit in the bank in the form of an overdraft facility¹ that is used as a buffer when partner loans are insufficient. They hold liquidity that can keep them afloat for about 1-2 months in order to maintain flexibility and cater for unexpected events. The use of this credit is directly related to the yearly dividend payouts and subsequent partner loans. Financing decisions are, depending on the scope of the investment, made either in the executive team, the board of directors or during annual meetings. Practically all investments are technology-related and not considered to be of any substantial cost, and computers and other technology related equipment often go on leasing contracts, spreading the cost of these investments. Larger investments are highly unusual and are attributed almost entirely to the change of premises, and the company recently engaged in this sort of investment when moving their activity to a more central location. When making these sorts of one-time investments, the limit of the overdraft facility is renegotiated with the bank since the funding needed is impossible to retrieve from partnership loans. Otherwise the company is careful with over-using their credit and would never issue new shares for financial reasons.

When asked of why the company does not use long-term debt instead of continuously obliging their partners to lend their money, the CFO explicitly expresses that even if it from a financial perspective might be more beneficial for the company to borrow from a bank, the firm is willing to make financial decisions that favours partners more. The partners benefit from the high interest and the reduced risk of not taking on long-term debt. Also, their dividends will not be negatively affected by the reduction in distributable profit that would result from having interest obligations towards the bank. On the question of how employees would react to external bank loans, the CFO states that they most likely would be hesitant if the money would not be actively used in the company. Moreover, as the overdraft facility already is a direct obligation to the bank putting employees private money at risk, additional loans would not be looked upon positively. Neither does she see the point in borrowing just for the sake of it when the firm is already coping liquidity wise. She also questions whether the bank would at all be willing to lend money to a company that engages in emptying the firm of all financial assets every year.

There are no capital structure theories in mind when making financing decisions. If their financial strategy, or lack of strategy happens to be consistent with any theory, it is above the CFO's knowledge and not intentional. When addressing the issue of using debt as a means to increase market value she says that this does not apply to them as there is no market for their stocks and hence absolutely no interest in signalling to the market with higher stock prices. Therefore there

¹ A credit agreement with an upper limit negotiated with the bank, which can be used as a liquidity reserve to cover short term financing needs. The credit is normally connected to the firm's bank account (Tegin, 1997)

are no reflections or strategic considerations on how to increase the value of the company when making financial decisions. In conclusion the CFO mentions that they in general have to be utterly careful when dealing with the company's finances because there are a lot of people that are directly affected by how the money is spent, given that the company is financed the way it is. Consequently, her actions as CFO are greatly influenced by others in the company.

4.2 Company 2 - Law firm - Interview with Chief Executive Officer - partner

Company 2 is also completely partner owned and branching under a principal company that handles all customer contact and invoicing. The corporate structure is largely a consequence of tax reasons but the company is still autonomous in its financing decisions. The company is emptied of all financial resources every year and dividends are distributed to the partners of the firm, after which any money left in the company is negligible rounding amounts.

Dividends are decided upon at the annual meeting but not paid out immediately, instead they are distributed over the year to match investment needs. This way the company does not have to engage in outright partner loans but instead create a form of short-term credit in retaining dividend payments. New shares are never issued for financing reasons. They do not want to involve partners in financing but believe that they should get paid as soon as possible without having their dividends tied up in the company. In planning the investment horizon and matching outlays with the dividend payouts the firm can limit its need for external financing. One-time big investments are avoided; they try to keep investments at roughly the same level every year as to not have the partners affected by what time period they were operating in the company. Partners will undoubtedly be disturbed if investments fluctuate too much, and hence they greatly affect the firm's financing decisions as they can refuse to approve of investments that would claim too much of the year's profit. Moreover the substantial dividend payments that completely empties the company financially performs the function of keeping the stock price down, which enables new partners to buy in at a low cost. Similarly the selling of shares is not intended to be value creating but instead the partners profit from dividend payments during their employment.

The company has no long-term debt and the only debt-like obligation is a credit in the form of an overdraft facility. This, he expresses, is kept at reasonable and optimally low level and is mainly used to bridge any liquidity gap more than to finance big, sudden expenditures. The overdraft facility it is needed in terms of keeping the financial flexibility since the market for the firm's services is quite seasonal. Since there are still expenses in the form of wages and rent that have to be paid during the whole year, the overdraft facility and held-back dividend payments are used as a buffer. When asked if he believe if it is possible for them to acquire a loan the CEO states that despite having little security to provide for loans, they would probably be better

received than many other service firms. Law-firms are to a great extent framed by ethical rules, which could result in an occupational ban if they were to do something faulty. He also argues that they actually could be appealing for the bank since they let them handle great sums in the form of client funds, and that the employees of the company could personally be acquired as clients.

When asked why they choose to maintain such low leverage the CEO says that they do not want any liabilities towards the bank but instead maintain financial flexibility, and by limiting the use of debt they can limit their risk exposure. The main risk is employees leaving, which if they had liabilities towards the bank would mean that they would be left with costs that do not match revenues. Law firms face higher risks than other service firms, as their clients are not bound to the firm but can choose to leave with their respective counsel, thus making employees particularly valuable. Therefore financial flexibility is utterly important. Moreover there are no major investments that require financing, but even so they would still never finance any of the necessary investments with borrowed funds, as it would simply feel wrong. The CEO states that he does not think that the employees at all reflect on how the company is financed. If so, he says, it is probably the partners who might react if their dividend payment is deferred with regard to the current liquidity situation. He also says that faced with the choice of personally financing investments or approving of a bank loan they would probably prefer not having to contribute themselves, and in that sense their private perception of risk affects their view on risk in the firm. However, he does agree that the investment climate of the firm is directly affected in the sense that investments happen quite a bit slower than otherwise optimal, as there is a need to maintain a steady level in outlays in order to keep partners satisfied.

The CEO explicitly says that their financial strategy is not based on any specific model or theory, nor is it used as a strategic medium. A reason for this is the fact that they have no interest what so ever in increasing the value of the company and sending signals to the market, if anything, they would like to reduce the value of the company to justify the low share prices that are offered to new partners. Their goal is instead profitability and long-term results along with creating a good environment so that employees will thrive and generate good results. Lastly, he states that their capital structure is a passive medium in the sense that they have the shares required for their ownership structure and can focus on yearly profitability and dividend payouts.

4.3 Company 3 - Consulting firm - Interview with Chief Financial Officer

Company three offers consulting and financial advising services. They have a parent company that handles all financing and is owned by partners, all of whom are active employees in the operating firm. In the consulting industry it is vital to maintain a strong and good reputation and also to retain the statutory independence towards your clients. The CFO expresses that high

competence matters little if you have no credibility, as clients are only interested in making business with reliable and renowned firms. Consequently, the company has to consider the risk aspect carefully when engaging in new assignments and especially when acquiring new clients, as it is vital to as a first step verify that the company indeed is independent towards the new customers. Next, the company has to carefully review the risk factor the new client could constitute as they do not want to be associated with clients that might put them in a bad light or that engages in ethically questionable activities.

The firm has no bank loans or obligations but rather try to as far as possible finance their investments internally. They had an overdraft facility and are no strangers to the concept but tries to avoid it. Nevertheless, because of the seasonal distribution of their business, the company must have excess liquidity to cover financing needs when business is slow, which is solved via partnership loans. The partnership loans are fully voluntary and offered on favourable financial conditions and paying an attractive interest. This system works well in the sense that the investment opportunities of the employees on a personal level are regulated, as independence towards clients must be maintained. If the firm acquires a client in which a partner, or an employee active in an engagement with the client, owns shares they have to be sold regardless of what financial loss it may cause the partner. This could cause dissatisfaction if the ownership in the client company was meant as a long-term investment for the employee. Therefore the CFO states that the interest works as a compensation for the fact that partners do not have many options in terms of alternative investments. Nevertheless, the voluntary nature of these loans mean there is always a theoretical risk of not raising enough funds to keep the company afloat. This has not been a problem during his time as CFO but could theoretically be solved by postponing dividend payments. Another possible issue with this approach is that when offering interest to a partner you finance this by using part of the company's profit, which in turn could affect dividend payments to other partners. This is expressed as a fine balancing act where they try not to dissatisfy anyone. The company finds it to be of big importance to keep the employees satisfied, which is evident in many aspects, from the taste of the coffee to the fact that they are situated in a central and attractive location. When taking in new partners, the company does not issue new shares but instead reallocate the existing ones. The CFO says that the company offer partners a relatively high share price. This is a deliberate decision intended to ensure that the employees will have to show that they believe in the company and that they are willing to work for the benefit of receiving dividends.

The CFO does not believe that they would face any problems in being granted a bank loan, as the company's track record is good. Neither does he believe that partners would be adverse to

debt financed investments by principle, but that it would depend on what type of investment the funds was intended for. When discussing the investment needs in general the interviewee expresses that they do not make a lot of investments that show on the balance sheet, but when they do, the main expenditures are mostly in the form of new software. The company is marked by the fact that they operate in a highly competitive market and he expresses that “you cannot tell the staff to run faster so you must find other ways to streamline your operations”. Therefore keeping up to date with recent technology is of utmost importance, but could also be very costly.

When asked of why the company choose not to take on debt, he states that it is mainly due to the low investment needs and since capital must be actively used for something he sees no use in bank loans. Depositing the money in a bank in return for interest that still would not exceed the interest paid for loans makes it non profitable. He states that the reason for this financial strategy is not directly referable to risk avoidance but intended to maintain control and financial flexibility, which outweighs the possible perks of a bank loan. The company structure contributes to the reduction of risk. Finally, he says that the company does not actively use or have capital structure theories in mind when deciding on how to finance investments. On the subject of increasing company value by using debt he says that they are not interested in any value enhancing activities as ownership lies with the employees. Consequently there is no benefit in increasing market value per se, as they have no interest in the outside world.

4.4 Company 4 - Advertising agency - Interview with Chief Financial Officer - partner

Company four is an advertising agency that is part of an international group where the parent company has a majority of the shares in the firm (55%), while the remaining 45% is owned by actively working employees. Thus the partners of company have minority ownership and receive dividends but have less authority over financial decisions. The company is characterized by an American business climate, which is hierarchical and much different from the Swedish working environment. They apply for a budget each autumn that is approved by the parent at the beginning of the following year. However, the CFO tries to actively adapt the business climate to suit Swedish workers and the Swedish working environment better.

Company four can make use of a collected cash pool that consists of funds retrieved from all of the affiliates in Europe. This is the only debt-like obligation the company has, and it is used as a buffer when liquidity is low. Cash flows for the company and industry in general are described as being quite fluctuating, not only in regard to the season but also on a yearly basis depending on what clients have been acquired, especially since terms of payments are negotiated separately for each assignment. Liquidity is often relatively high at the beginning of the year as the company receives prepayments from clients, after which it decreases gradually and is especially low during

early autumn, subsequent to dividend payouts. The industry is in general described as being highly dependent on the economy as marketing and advertising is a cost that almost always is primarily cut in companies when the economic climate is bad. The CFO states that they have been quite lucky in times of economic adversity and have not been greatly affected by recessions. The interviewee expresses that advertising agencies differ from other knowledge-based firms in the sense that they often take care of complete processes for clients, from strategic market analyses to finished products. This entails dealing with suppliers and thereby having to make allowances for the balancing of incoming and outgoing payments. Consequently, the accounting department has to work close with production managers to make sure that the in- and outgoing payments are matched well.

When discussing dividend payouts, the CFO explicitly expresses that they are meant to benefit the partners and not the parent company, as she believes the profit made during the year should be distributed to those contributing to the success of the company. Dividends are severally distributed between partners and are thus not directly relatable to performance. The fact that the company is completely emptied each year is not in line with the parent company's policies but has been negotiated by the CFO and approved because of the stable and profitable results the company shows. On the same note, she was not initially approved as a partner since she has authority over dividend payouts and other financial decisions, but due to the excellent results the Swedish subsidiary shows the parent granted her partnership status as an exception. Moreover, she expresses that she would naturally never make dividend decisions that would affect the operational activity of the company, and that she would consider it an option to defer dividend payouts if the company would not be coping liquidity wise.

The interviewee also shared her previous experiences of working as CFO in a law firm in which she was subordinate to a managing partner who had own incentives to retrieve as much money as possible and not wanting to postpone dividend payments for investment purposes. She expressed it as being difficult to properly do her job, since it meant being in control of the company's funds but ultimately lacking authority. She could not deny partners to retrieve their dividends but just strongly advise them to be cautious with the company's funds. "The partners' attitudes and influence then become extremely important" she stated. As partners were accustomed to collecting their money at wish, the task of managing the company's finances became quite difficult and resulted in the company often being at the limit of their overdraft facility.

Returning to discussing the activities of the advertising agency, the interviewee does not believe that the company's avoidance of debt is attributable to the risk preferences of the employees, but rather a consequence of their low investment needs. The company has virtually no investment

outlays except for monthly salary payments and the occasional replacement of technology-related equipment, which is not considered being a substantial cost. Their most relevant financial challenge instead lies in balancing accounts receivables and accounts payable in order to maintain an adequate liquidity level.

She also expresses that the firm have no interest in increasing the value of the firm by taking on debt, since they already have the ownership structure they want and need and hence have no interest in the market. Neither do they engage in issuing new shares for financial reasons, but instead reallocate the existing shares when taking in new partners. Lastly, she believes that the risk in knowledge-based companies in general would be lower than in manufacturing companies if they were to find themselves in financial distress. She argues that in times of distress manufacturing companies will hold much fixed capital and may be left with obligations towards the bank. Knowledge-based companies however will experience much more flexibility in the sense that they have the possibility to, however awful it may sound, dispose of assets quickly if the need would arise. In that respect, she believes that knowledge-based companies are actually more adaptable to economic fluctuations than many other companies.

4.1 Summary of empirical findings

All of the interviewed firms are unlisted limited companies, and in various ways structured as partnership firms. However, as the majority of shares in company four are foreign-owned, they have no immediate authority over financing decisions. Nevertheless all firms exhibit similar financial policies in the sense that they all aim at completely emptying their company of liquid assets at the end of each accounting year, paying virtually all net profit as dividends to partners. Moreover, due to the nature of the companies' business they all possess little tangible assets and experience low investment needs, as personnel is by far the most substantial cost and investments are mostly attributed to minor technology related assets. More costly investments mainly involve the change of premises, which is a rather rare occurrence.

In three out of four interviews it was explicitly expressed that an increase in the value of the company is in no way in the company's interest. On the contrary, their aim is to keep share prices low and thus continue enabling partners to acquire shares a low cost. Being able to motivate low share prices is necessary, as tax authorities have begun questioning whether this can be justified. Becoming partner means securing substantial future income in the form yearly dividends, which would imply much higher actual share value than the par value. Therefore none of the companies aligned with the idea of using debt as a means for value creation. On the same note, neither of the companies claimed to follow or even consider any theory within capital structure. Three of

the respondents also stated that if it would appear so, it is not of their knowledge and not resulting from any active decision.

In two of the companies it was clear that some financial decisions were indeed made in a way that favour partners instead of what technically would have been most advantageous for the firm. This statement was agreed upon by the interviewees but manifested itself differently across the firms. Company one actively chose to borrow money from partners at higher interest than that offered by the bank, which they agreed was not the most profitable course of action, but as it benefits partners they deemed it to be a good decision. Company two however did not want to personally involve their partners in the firms financing by borrowing from them, but instead chose to distribute dividend payments over the year to match planned investments. This, they said, slows down the investment climate and hinders flexibility in investments but is necessary to keep partners satisfied. Moreover, even though it was not as explicitly manifested in the other companies, it is evident that employees do affect financial decisions. Keeping employees happy is of utmost importance as the firm is completely dependent on their performance for future success. As expressed by the interviewee in company three: “many decisions are made solely for the purpose of keeping our employees happy, from the taste of the coffee to the decision to locate our premises in the city centre”, as they believe that content employees contribute to a prosperous company. Moreover they too offer partners to lend money on favourable terms as there, due to regulations in the industry, are little other options for placing money. In company four however, not being fully self-sufficient in their financing decisions, the matter manifests itself a bit differently. In the international market for advertising agencies there is no tradition of such high dividend payouts as we see in the Swedish equivalents. Nevertheless the CFO has, although not without struggle, managed to negotiate the same terms for dividend payouts to partners as they would receive in a Swedish firm. This, she argues, is intended to keep partners pleased and is approved by the parent for as long as they continue to generate good results.

All respondents regard the use of long-term debt as outright unnecessary and explain their low leverage mainly by the fact that they have such low investment needs. As the interviewee of company one says, it is difficult to justify taking on debt just for the sake of it, as they do not actively need it to finance investments. Moreover, the perception of risk in the four companies is expressed a bit differently. Two of the respondents do not at all assign the reluctance to use debt financing to risk avoidance, while the others admit that there is a policy in the company of avoiding risk in general, which permeates the attitudes and decisions of the entire firm and hence also financing decisions. However, the avoidance of debt financing is more attributed to maintaining financial flexibility and to the fact that they simply do not need to engage in any

long-term obligations for financing purposes. Two of the firms do use some external financing in the form of the overdraft facility which implies being open to external financing, but these are only short term obligations used to bridge any liquidity gaps that cannot be financed internally.

It should also be noted that the companies' view of the theoretical definition of risk in their industry is somewhat different than one might expect. When addressing the issue of the risk of having little tangible assets, the CFO of company four says that this structure actually allows for more flexibility. Their biggest asset, the employees, is also the biggest cost, and even though they have little collateral for debt they also have the possibility to dispose of most of their costs in the event of distress. In this sense they are much more flexible than others and have greater ability to move money around than companies with fixed assets. Also, all of the firms have money in a parent or principal, meaning that they are somewhat ensured against risk.

5. Analysis

This section will answer the research questions from the first chapter by providing an analysis of the empirical material with regard to the theories discussed in the literature review.

5.1 Explanations for low leverage in knowledge based firms

5.1.1 Utilisation of the interest tax shield

The primary meaning of the work of Modigliani and Miller (1958, 1963) is that the firm can affect its market value by altering the capital structure, due to the tax benefits of interest payments. This is a well-recognized theory but nevertheless it is very theoretical, and little support was found for this proposition among the interviewed firms. They do admit to the potential benefits of the interest tax shield but all firmly state that it is of no interest to them. This, they argue, is because increasing market value is solely for the purpose of signalling to the market and would only be of interest if there was a possibility of acquisition. As these firms are partnership companies and in most cases fully owned by their employees there is no interest whatsoever in the market or potential buyers. Consequently, as opposed to the predictions of Modigliani and Miller (1963) knowledge-based firms tend not to use debt as a strategic value-enhancing tool but rather value the ability to maintain financial flexibility.

5.1.2 Views on distress costs and the optimal capital structure

None of our companies had actively considered the matter of distress costs as an offsetting factor to potential tax benefits of leverage (Kraus and Litzenberger, 1973, Miller, 1977). One of the respondents was not even familiar with the concept, implying how little theories actually matter in decision-making. However, the fact that theories are not actively considered does not mean that firms do not to any extent comply or agree with these. Prior studies attach the magnitude of indirect costs of distress largely to the lack of tangible assets; hence in line with the trade-off theory companies in industries sensitive to financial distress would employ lower levels of debt (Frank and Goyal, 2009). This is applicable on knowledge-based companies as they have little tangible assets and their value mainly lies in human capital and clientele, resulting in higher risk of bankruptcy and implying less leverage. Nevertheless the respondents do not wish to assign their low levels of debt to risk of bankruptcy, as they do not feel that they currently are in any position where a moderate increase in leverage would severely increase risk. This is partly explained by the effect of the corporate structures on the firms finances, as letting parents or principals handle cash activities means that in the event of distress money is separated from operational activity and hence somewhat secured. Moreover, the firms claim to have few creditors to satisfy in distress, as their main expenditures are salaries and rent. The trade-off theory balances tax benefits and distress cost, and as the companies' feel that distress is not

imminent right now, the immediate implication would be that they should take advantage of the interest tax shield. However, as stated by Myers (2001), the trade-off theory fails to explain the fact that many profitable tax-paying firms use conservative policies and operate at low debt ratios. As stated in the previous section the tax benefits of debt are of no interest to the companies of this study as they are not in any way interested in increasing neither share prices nor market value. Therefore the discussion of distress costs and their offsetting effect on tax benefits in relation to debt levels becomes irrelevant for these companies.

Another implication of the trade-off theory is that there would be an optimal capital structure for a firm where tax benefits are offset by costs of financial distress (Shyam-Sunder and Myers, 1999). The interviewed companies do not claim to strive towards any optimal debt level, although their tendency to forcibly limit their use of debt can be interpreted as an explicit strategy. This decision, however, is not due to considering zero debt as an optimal capital structure, but rather that they simply do not need debt to finance any investments. Hence all interviewees find their current capital structure to in a sense be optimal for their current needs.

5.1.3 Financing preferences and information asymmetry

The firms all argue that they have very low investment needs, and being quite profitable they manage well with internally generated funds. This apparent preference for using retained earnings to finance investments shows much more evidence of the pecking order theory than the previously discussed trade-off theory (Myers and Majluf, 1984). According to the theory, due to information asymmetries that arise when external capital is sought firm prefers to seek the least risky form of funds in the form of retained earnings, and hence completely emptying this source before seeking other alternatives (Myers, 2001; Myers and Majluf, 1984). However, there is a divergence between the firms' behaviour and the implications of the pecking order theory as they choose to pay large dividends with funds that according to the information asymmetry perspective should be used to finance investments. Instead the firms often choose to turn to riskier types of funds for financing investments before emptying all of their internal funds, which contradicts the theory. When retained earnings are insufficient to finance both dividend payouts and investments they do seek external financing, but common for all firms is that they never make use of long-term debt or issue new equity for financing reasons. In this particular respect they, in line with the information asymmetry perspective of the pecking order theory, seek the least risky form of external financing such as partner loans or overdraft facilities, before long-term debt. They admit to the possibility of long-term bank loans if the need would arise, but are quite resolute about never issuing new shares.

The pecking-order theory as previously stated contradicts the trade-off theory in that it does not support the concept of an optimal capital structure and that it overrides the importance of using debt for valuation purposes in favour of the risk perspective of debt (Myers, 1984). The firms interviewed do not believe in any optimal debt level, and are more interested in maintaining financial flexibility and not engaging in liabilities with outsiders than to increase share prices. Hence the pecking order theory provides better explanations for the capital structure of knowledge-based firms, as it emphasizes the factual importance of risk of different types of funds over a theoretical value enhancing effect of debt (Shyam-Sunder and Myers, 1999). Moreover the pecking order theory implies that firms that are financially stable with much excess cash will use lower leverage, as retained earnings suffice for their financing needs. On the same note it states that profitable firms with much cash but little investment needs will pay higher dividends than others, in order to reduce cash levels (Strebulaev and Yang, 2013). All of these statements suit the sample of knowledge-based firms very well, and hence we find more support for the pecking order theory than the trade-off theory in explaining capital structure decisions of knowledge-based firms, although some deviations are undeniably evident.

5.1.4 Low leverage due to financial conservatism

Knowledge-based companies do keep lower levels of debt than what is predicted by major theories, a fact that is in accordance with what Minton and Wruck (2001) say about financially conservative firms. As with the majority of conservative firms, knowledge-based companies act in a sensitive industry with little asset tangibility, but being stable and profitable they would not be in any immediate risk of distress if they were to increase leverage. Minton and Wruck (2001) also state that firms with lower leverage than predicted by theories tend to follow a pecking order style policy. Support for this claim is found in the interviewed firms as neither tends to, as found in the previous section, empty all internal funds before seeking external financing. Instead they pay a substantial amount of dividends, and to manage liquidity wise throughout the year they turn to external sources such as partner loans or overdraft facilities. Moreover unlevered dividend paying firms are often found to be more profitable and cash intense than the average firm, a description that aligns well with the actions of knowledge-based firms. Furthermore Minton and Wruck (2001) find that low leverage is largely a transitory policy. This cannot be said for knowledge-based companies however, as they persistently maintain low levels of debt and have no incentives of increasing their permanent debt levels in the near future. Nevertheless, although this may be inconsistent with general low leverage firms, as Strebulaev and Yang (2013) find, firms adopting zero-debt policies tend to stick to their strategies and not shift to a less conservative strategy. This finding also aligns well with the policies of our interviewed firms.

5.2 Factors influencing the leverage decision - partners and other employees

5.2.1 The effect of the partnership structure

Knowledge-based companies are largely partner owned resulting in management and ownership not being separated, and as partners make or influence decisions information asymmetries consequently become less of a problem than in traditional limited companies. These information asymmetries are central in the agency theory, which deals with issues arising when managers and shareholders have differing objectives (Fama and Jensen, 1983). A main implication of the theory is that firms acting in industries more susceptible to agency problems should use lower levels of debt (Jensen and Meckling, 1986). In this respect the agency theory poorly explains actions of knowledge-based firms, as they would be classified as less exposed to agency issues, but still choose to maintain their low leverage. Theoretically, possible agency costs would be eradicated when partners and executives have same interests as the firm, as partners will strive to contribute to the firm's success and thus receive the benefit of high dividends. As Myers (2001) states, when decision-makers are also owners they will bear the full costs of their actions and hence agency costs such as for instance monitoring costs will decrease. However, as the remaining employees in a knowledge-based company are also highly responsible for firm success but do not receive the benefit of dividends, they subsequently do not have the same incentives for value maximising. Therefore they may not fully strive towards minimizing costs and maximising income resulting in divergence of incentives. Moreover, the theoretical lack of agency costs may be offset by the fact that individual partners could have incentives of their own. As the CFO of company four says, she once worked with a managing partner who had a personal incentive to receive as much cash as possible immediately and hence tried to influence financing decisions to suit his personal needs, which might not benefit the firm in the long run. This is also evident in company two where the CEO expresses that incentives of partners may depend on what phase of their career they are currently in. Senior partners who intend to resign in the near future may wish to defer large investments into the future as investing now would decrease imminent dividend payouts.

The free cash flow hypothesis of the agency theory says that the firm should reduce managerial waste by reducing the excess cash at hand, mainly by increasing leverage and incurring interest obligations (Jensen, 1986). However, reducing free cash can also be accomplished by paying high dividends, which is consistent with the actions of knowledge-based firms. This is in line with the general course of action in zero-debt firms who are found to pay substantially higher dividends than their unlevered equivalents (Strebulaev and Yang, 2013). This can be interpreted as exchanging interest payments to the bank for dividend payouts to the partners, as implied by the free cash flow hypothesis (Jensen, 1986). In this sense, the agency theory provides explanations for the actions of the interviewed firms. Nevertheless, it should be noted that managerial waste as

an agency cost is a relatively small problem in knowledge-based companies as they have very little investment opportunities and hence almost no opportunities to waste excess cash, and consequently they have little need for monitoring investment activities.

5.2.1 Partners and employees as stakeholders

Knowledge-based firms most valuable asset is their human capital, as they depend highly on their employees for success. Employees are ultimately responsible for acquiring and keeping clients, thus generating revenues for the firm. As previously discussed, the leverage decisions of the firm may be affected by a reluctance to cause a stir among those contributing to the firm's success. This is the main implication of the stakeholder co-investment theory, which emphasizes the need for considering more than the shareholders interests when making financial decisions, as increased risk in terms of increased leverage could possibly alarm cautious stakeholders, making them less willing to contribute (Frank and Goyal, 2003). As predicted by the theory, knowledge-based companies do maintain low levels of debt. These firms operate in a highly specialized, unstandardized industry with specialized staff and low asset tangibility, factors that are quite unique for the individual firm and may be lost in bankruptcy. Companies that are highly dependent on firm-specific investments should therefore theoretically use less debt, as these investments will lose value in the event of distress. This is indeed reflected in the interviewed companies' view of long-term debt. Although none of the firms claimed to actively consider the risk aspect of debt capital, when discussing the matter it became evident that neither of them look upon bank loans positively. They emphasize the disadvantages of exposure towards the bank, claiming that these would exceed possible advantages. This implies a form of risk aversion, although not as explicitly expressed as might be expected.

It becomes evident that in practice the companies do not actively consider risk preferences of employees when making financial decisions, neither do they believe that employees themselves worry about these risks. Nevertheless when examining their course of action more closely it becomes evident that they many times act in favour of the employees rather than what would theoretically be of more benefit to the firm. The empirical data clearly showed that all of the firms in various ways act accordingly, in terms of offering higher interest to partners, slowing down the investment climate and paying such high dividends in general. As quoted by one of the respondents; "you are constantly extremely risk oriented, just not in direct connection with the employees risk preferences". Moreover, the previously discussed reluctance to utilise the benefit of the interest tax shield can also be related to this matter. This was partly attributed to a wish for rather paying interest to partners than to the bank, which demonstrates an inclination towards serving partners rather than external actors.

Another aspect in which it becomes quite clear that the main purpose of the firm is to benefit partners is the payout policy, which is based on a fairness principle where you as a partner should benefit from the money you have accrued to the company now, not in the future. For most firms this requires the lowest possible share prices as to ensure that you do not profit from trading shares but rather reap profit from dividends, and consequently debt financing is avoided. Nevertheless, as these firms aim at paying as high dividends as possible they must often turn to alternative sources to finance investments, and hence they do not empty all internal sources before seeking external financing. Neither are the dividend policies, in contrast to the theory, sticky (Myers, 2001) but companies strive to maximise payouts each year, and thereby conflicting objectives arise as well as a need for bridging the liquidity gap between dividend payouts and investments. This shows a divergence between the firms' behaviour and the implications of the previously discussed pecking order theory as they choose to pay large dividends with funds that according to the information asymmetry perspective should be used to finance investments. Instead, this shows an inclination towards primarily pleasing partners.

Overall, the stakeholder co-investment theory provides a good supplementing view of the capital structure choices of the interviewed companies. Although the firms claim not to actively consider the risk preferences of their employees, it becomes evident that many of their actions are permeated by a reluctance to cause a stir among employees, or to a greater extent partners. Many decisions made are made in favour of employees, seeing as they are immensely important for firm success. Moreover, due to the nature of the market in which these companies act the risk factor is weaved into every aspect of their work. As the respondent of company three says, risk is always imminent in their business and hence they are extremely risk oriented in everything they do.

In conclusion, based on the interview results it becomes clear that the low leverage decisions of knowledge-based companies are mainly attributed to the low investment needs, and that the avoidance of debt is not a direct result of a desire to decrease risk. Nevertheless when needs for external financing arise the firms still actively avoid long-term debt. Instead of increasing leverage, which theoretically would be an option as the companies are stable and profitable and would hence be approved by the bank, they choose alternative solutions. This is expressed as a wish for maintaining financial flexibility and limit exposure towards the bank, which in itself is a form of risk aversion. Only one company actively uses a debt-like obligation to actually cover investments, while another uses it mainly to bridge liquidity gaps but tries to keep it at a low level. This overdraft facility however is only a short-term liability, which has an upper limit negotiated with the bank that can be raised or lowered at will within the given boundaries.

6. Conclusion

The purpose of this thesis was to analyse and explain the underlying factors of capital structure decisions in knowledge-based firms. Due to the reliance on human capital and the importance of the partnership structure for managing purposes, we wished to investigate whether the firms' financing decisions could directly or indirectly be influenced by the partners' and to a lesser extent other employees' perception of risk. This we aimed to achieve by answering two research questions, which will be done in the following section.

- ❖ Why do profitable and financially stable knowledge-based companies choose to take on virtually no debt even though theories state that they would benefit from leverage?

Non-dividend paying firms tend to avoid debt due to financial constraints, while the decision not to take on debt for a profitable, stable dividend-paying firm is highly strategic and aimed towards maintaining financial flexibility. This statement is very suitable in explaining why the interviewed knowledge-based firms persistently choose to avoid long-term debt. Looking at historical cash flows, they are all profitable and stable and hence in no immediate risk of financial distress but nevertheless shun leverage. Dominant theories such as the trade-off theory would actively assign this to risk aversion, an explanation that receives little actual support by managers. Instead decision makers argue that the main reason for avoidance of debt is the lack of investment opportunities combined with a wish for maintaining financial flexibility and avoiding exposure towards the bank.

Furthermore, while our study sees no immediate advantages of debt financing in the form of interest tax shields, shareholders actually do enjoy tax benefits on a personal level due to the lower tax rate on dividend income. Thus they can create their own value enhancing activities by dividend payouts. The interest tax shield is aimed at increasing market value, which is of interest to outside investors and enables shareholders to profit from trading shares. However, as partnership companies have no interest in outside investors but are owned by active employees, shareholders instead profit from maximising dividend income during their time as partners. Increasing leverage and incurring interest obligations would thus mean less ability to pay dividends, and hence dividends become an incentive to limit long-term debt.

- ❖ To what extent are risk preferences of partners and remaining employees considered when making financing decisions?

The strive towards maximising dividend payouts can be directly asserted to a wish for pleasing the partners of the company and ensuring that they are rewarded for their efforts on a

continuous basis. However, regarding the question of whether employees affect financing decisions, none of the firms' representatives explicitly agreed that this was an aspect actively taken into consideration but rather claimed that employees hardly are aware of how the company is financed. Partners may however be directly affected by financing decisions if they have engaged in partner loans or the firm has other debt-like obligations that will be prioritized in the event of bankruptcy. In that respect partners would react negatively if the company was to take on debt. Moreover, they can also be affected when current liquidity is insufficient and their dividends are deferred, and thus they advocate the use of a stable investment climate.

All firms admit that financing decisions have to be made with caution, as partners may be reluctant to approve of unnecessary investments that would require external financing. Moreover decisions are often indirectly influenced by the preferences of the partners, which becomes evident when a firm chooses to borrow from partners at a higher interest than what would be offered by the bank, or limits flexibility in decisions as to not alarm partners and interfere with dividend payouts. This implies a risk awareness that can permeate decision making and can be linked to partners in the sense that the firm wants to continue being able to pay as high dividends as possible to their employees, and not cause any stir by making sudden investment decisions. In conclusion, the interviewee of company one can be quoted: "Debt should be actively used in the company, and since there is no need for this in our company we see no use in increasing leverage just for the sake of it." Rather, our study shows that knowledge-based companies aim at maximising dividend payments to the current partners, ensuring that they receive what they work hard for when they have earned it.

Lastly, we have in our opinion managed to fulfil the purpose of the thesis and answer the research questions, although some of our findings were not in line with what was initially anticipated. For instance, the risk preferences of the firms' employees were considered to a much lesser extent than what was at first believed. Nevertheless the design and implementation of this study has been suitable for the purpose set out, and the qualitative approach and use of interviews as method for gathering data has been beneficial as it allowed for collection of information that would otherwise not have been possible. As no similar studies specifically concerning capital structure in knowledge-based firms have been carried out in Sweden, the basis and findings of this study might provide an inlet to a continued discussion of this topic. Below we will present further related topics that we feel will benefit from further investigation.

6.1 Suggestions for further research

During the work with this thesis a number of interesting topics have arisen that unfortunately do not fit within the scope of this study. Therefore, as suggestions for further research we propose the following topics:

- ❖ The impact of the individual CFO on the firms financing decision.
- ❖ Further investigate the implications of the partnership structure and individual partner's ability to influence decisions. Another interesting aspect to consider is the possibility of conflicting interests between partners.
- ❖ Examine how the controversial payout policies of knowledge-based companies affect financing and valuation.

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Appendix 1

Interview template

The template below was sent out to the interviewees in Swedish but was translated for the purpose of this thesis.

Financial strategy

- What is the current financial strategy of your company?
- What is the reason for the company's low leverage?
- Do you consider your current level of debt to be optimal?

Financing of investments

- What type of investment needs does the company have and how do you choose to finance these?
- Do you ever consider using external funds, such as long-term bank loans, issuing of new shares, or partner loans?

Employees influence on financing decisions

- Increase in debt levels means higher risk for the company. How would partners and employees respond to the increased risk of additional leverage?
- Could the fact that ownership and management are not separated due to the partnership structure affect financing decisions?
- Do employees affect or restrain your financing decisions in any way?
- Virtually all your profit is distributed to the partners. Is your capital structure affected by your dividend policy?

Conformance with theories

- Do you admit to following any theory within capital structure?
- Taking on debt can increase the value of the company. What is the reason for not taking advantage of this opportunity?
- Distress costs is considered to be a reason for not using the tax shield to protect your earnings. What would you say is the most significant distress cost in your industry?

These are the topics we wish to address during the interview and we hope that they can form a good basis for discussion.