Capital Structure and Systematic Risk in the Philippine Setting

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Abstract

The classic or traditional approach to thinking about capital structure is that there does exist an optimal capital structure in a world of non-perfect capital markets, where there are corporate and personal taxes, and where bankruptcy costs exist with risky debt. This paper's preliminary empirical tests on the relationship between financial leverage and firm risk (as measured by Beta) seem to support the classic or traditional approach to thinking about capital structure, which proposes that there does exist an optimal capital structure. Tests for the relationship between Beta and Leverage reveal a significant, negative relation between leverage and unlevered Beta, indicating that higher operating risk levels should not spur further borrowings. This paper attempts to empirically test the relationship between risk, as measured by firm Beta, and financial leverage.

Key Words: Capital Structure, Systematic Risk, Beta, Bankruptcy, Debt, Equity.

JEL Classification: D24, G32, G33

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Estructura de Capital y Riesgo Sistemático: El Caso de las Empresas Filipinas

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Resumen

El enfoque clásico o tradicional sobre la estructura de capital asume es que existe una estructura de capital óptima en un mundo donde los mercados de capitales no son perfectos o eficientes, además de que hay impuestos corporativos y personales, así como la existencia de costos de bancarrota por el riesgo de la deuda. La evidencia empírica que se desprende de éste artículo sugiere que la relación entre el apalancamiento financiero y el riesgo de la empresa medido por la Beta parece soportar el enfoque clásico acerca de que existe una estructura de capital óptima. Las pruebas estadísticas para la relación entre beta y el apalancamiento revelan una relación significativa y negativa entre la Beta apalancada y la Beta desapalancada, por lo que se infiere que a niveles más altos de riesgo de operación no debería estimular otros préstamos. El artículo se concentra en probar empíricamente la relación entre el riesgo (Beta) y el apalancamiento financiero.

Palabras Clave: Estructura de Capital, Riesgo Sistemático, Beta, Bancarrota, Deuda, Capital.

Clasificación JEL: D24, G32, G33

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1. Introduction

The classic or traditional approach to thinking about capital structure is that there does exist an optimal capital structure in a world of non-perfect capital markets, where there are corporate and personal taxes, and where bankruptcy costs exist with risky debt.

Copeland and Weston (1988) review the possible reasons for an optimal mix of debt and equity, assuming: bankruptcy costs, the hypothesis that debt-equity mix decisions signal or convey information to the market, and effects of agency costs on capital structure. They likewise review empirical tests of capital structure, presenting, among others, studies that attempt to explain observed financial leverage as a function of: the firm's tax rate, its non-debt tax shields, its potential for agency costs, its operating leverage, and its systematic risk.

With regard to systematic risk, we would expect increased risk to be associated with higher leverage. If the classic or traditional approach were true, we would expect that for a sample of firms with the same operating risk there would be no increase in systematic risk with higher financial leverage. This paper attempts to empirically test the relationship between risk, as measured by firm Beta, and financial leverage.

2. Literature Review

A number of papers have demonstrated capital structure relevance, thus refuting the Modigliani-Miller capital structure irrelevance theorem. Harris and Raviv (1991), on summarizing theories of capital structure put forth until then, point to several articles associating leverage with different endogenous factors, such as: firm value, default probability, extent of managerial equity ownership, target premium, probability of successful takeover, and interest coverage ratio and the probability of reorganization following default. They likewise review other empirical evidence not directly related to any theoretical result, such as the result that

leverage decreases with return volatility. Concretely, Bradley, Jarrell and Kim (1984) find that firm leverage ratios are negatively related to the volatility of firm earnings —measured by the standard deviation of the first difference in annual earnings, scaled by the average value of total assets— if the costs of financial distress are non-trivial. They do this via both simulations and cross-sectional studies.

Heinkel (1982) develops a separating equilibrium in an asymmetrically informed capital market where investor expectations about individual firms are shown to depend upon the capital structures of the firms. His model assumes that all debt is risky and shows that the present value of a given debt repayment promise does depend on the characteristics of the issuing firm. As a result, the signaling equilibrium directly involves the amount of risky debt sold by a firm. While practically no U.S. finance studies have shown any link between firm capital structure and measures of firm risk, if Heinkel's contention were true, empirical tests would show some relationship between debt ratios and risk level, say, firm Beta. This is what the current paper attempts to do.

Yu (2003) attempts to explain patterns of capital structure in Philippine firms and to verify if the theories developed in economically advanced countries apply to Philippine firms. Using firm-specific data on Philippine listed firms from 1996 to 2000, the study found that, using the total-debt-to-equity definition for leverage, proxy measures for profitability and 'past' growth opportunities (average annual growth rate of total assets) negatively related with leverage, while firm size and 'future' growth opportunities (price-to-book ratio) positively related with leverage.

Following after the idea that leverage may relate to *riskiness* (cf. *supra*), this paper will attempt to draw an empirical relationship, using Philippine data from 1996 to 2001 taken from the Philippine Corporate Handbook, between firm debt ratio (total-debt-to-equity ratio) and firm *BETA*, as follows:

$$DEQ = \alpha_0 + \alpha_1 BETA$$

Where: DEQ = Total debt-to-equity ratio
BETA = firm β

Since Yu (2003) has found that profitability, 'past' growth opportunities, firm size and 'future' growth opportunities are largely determinants of capital structure in the Philippine setting, this paper also tests the following model:

$$DEQ = \alpha_0 + \alpha_1 BETA + \alpha_2 PRICE\_BK + \alpha_3 ROA + \alpha_4 LTA\_TA + \alpha_5 LOG\_REV$$

Where:
- DEQ = Total debt-to-equity ratio
- BETA = firm β
- PRICE_BK = Market-to-book value per share ratio
- ROA = Net income before taxes and minority interest over total assets
- LTA_TA = Long-term assets over total assets
- LOG_REV = Log of Revenues

Nguyen and Bernier (1988), however, found that firm BETA, in turn, is influenced by certain factors, such as: market power, degree of operating leverage of the firm, stock's duration (approximating the firm's revenue growth), and the independent influence of financial leverage on levered Beta. In linear form:

$$BETA = \beta_0 + \beta_1 MP + \beta_2 OL + \beta_3 DUR + \beta_4 DEQ$$

Where:
- BETA = firm β
- MP = Market Power (measured here by Q [q-proxy] [1])
- OL = Operating Leverage
- DUR = Stock's Duration
- DEQ = Total debt-to-equity ratio

[1] For the Philippines, q-proxy ([D + MC] / [D + SE]) shall be used in place of Tobin's q, since there exists no available compilation of Tobin's q figures either at the industry or the firm level (cf. Aquino [2003]).

The study of Nguyen and Bernier suggests that systematic risk seems to decrease with market power, implying that powerful firms may have lower costs of capital. Also, a firm's degree of production technology has a nonzero risk-reducing impact while its revenue growth [approximated by the stock's duration] and financial leverage tend to generate a higher risk level.

Using this model by Nguyen and Bernier, we shall show a potential simultaneity between DEQ (debt-to-equity ratio) and BETA. In cases like this, an appropriate specification of the relationship between DEQ and BETA would be a pair of simultaneous linear equations that could be estimated by two-stage least squares (2SLS). This paper likewise attempts to test this particular relationship.

3. Data and Methodology

This study uses the Philippines Corporate Handbook of October 2002, which contains financial and stock market information on companies listed on the Philippine Stock Exchange, including summary of their business activities, 5-year financial summary and ratios, share prices, and company betas. The Corporate Handbook publishes equity (or levered) betas. Each firm's beta was computed by regressing weekly returns of an individual stock against weekly returns of the Phisix, proxy for the overall market for the past 5 years up to June 2002.

Data used do not include: those for companies in the banking and finance sector, those for companies with less than 4 years' track record, and those whose betas were not given (due to irregular or non-existent trading in their shares). (Appendix "A" gives a listing of the firms in the sample.)

Tests were made for both equity (levered) Betas and asset (unlevered) Betas. Unlevered Beta is computed from levered Beta using the following formula [2]:

[2] Copeland, Thomas E. and J. Fred Weston. *Financial Theory and Corporate Policy. 3rd Ed.* Addison-Wesley Publishing Company, 1988. Chapters 13 and 14. p. 459.

$$\beta_L = \left[1 + (1 - t_c)\frac{D}{E}\right]\beta_U$$

Where: β_L = levered Beta

β_U = unlevered Beta

t_c = corporate tax rate

D = amount of Debt for every firm

E = amount of Equity for every firm

For unlevered Betas, an average corporate tax rate of 33.5% was used, given the progressive decline in the tax rate from 35% to 32% within the period 1996 to 2001 under study. "Debt" in "Total-debt-to-equity ratio" was defined as in Yu (2003), that is to say, as short-term plus long-term debt.

Table 1 shows some descriptive statistics of some of our variables.

Table 1:

N=146	Total-Debt-to-equity ratio	Levered Beta	Unlevered Beta	Price-to-Book	Return on Total Assets (%)	Fixed & LT Assets to TA	Reve-nues (Php mn)
Mean	1.3316	0.7411	0.5442	2.0976	2.0370	0.6554	4,564.45
Median	0.4887	0.7120	0.5082	0.9363	1.0942	0.6733	780.62
Maximum	44.5323	2.4290	1.8605	35.7632	18.5517	0.9992	90,598.83
Minimum	0.0000	-0.316	-0.1951	-9.1532	-13.0933	0.1173	0.00
Std. Dev.	4.2478	0.5237	0.4183	4.3208	4.3366	0.1939	12,645.25

4. Empirical Results

Tests on the $DEQ = \alpha_0 + \alpha_1 BETA$ model show that results for the relationship between **debt ratio** and **equity (levered) Beta** for 146 Philippine companies are insignificant while results for the relationship between **debt ratio** and **asset (unlevered) Beta** are significant at the 5% level of significance, as follows:

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	2.674211	0.856137	3.123577	0.0022
UBETA	-2.467051	0.962997	-2.561846	0.0114
R-squared	0.059007			

* In both cases (levered and unlevered betas), the data exhibit heteroskedasticity [3]. Hence, White's heteroskedasticity statistics are selected. The coefficient, α_1, for unlevered *beta* (UBETA) is negative, which means that, as the operating risk of the firms increases, there exists lesser inclination to borrow, or lesser inclination for the companies to be lent to. This looks intuitive, since the firm would not be expected to borrow more (or be lent to) when the operating risk (as measured by asset *beta*) is already quite high.

This is the classic or traditional proposition in capital structure theory, viz., that indeed levels of debt financing are closely related to risk. The resulting relationship is, however, negative. Note that the resulting significant relationship is with unlevered (asset) Beta, not with levered (equity) Beta, which may be interpreted to mean: that some other risk —presumably financial risk (measured by levered or equity Beta)— relates positively with debt levels, while the risk of the firm's after-tax operating cash flows (measured by unlevered or asset Beta), will go the opposite direction. This, however, goes contrary to theory, since unlevered Beta is not expected to change as long as the firm does not change its business risk, that is to say, an increase in leverage will increase the levered Beta, but the unlevered Beta should stay constant (Copeland and Weston [1988]). This finding may reveal something about changed business risks —risks of portfolios of projects held— in Philippine firms. This likewise reveals a lot empirically about *inseparability of the investment and financing decisions* in the Philippine setting.

[3] F-stats and significance results for White's test are as follows (non-significant f-stats means reject H_0 of absence of heteroskedasticity in the data):

F-statistic	1.898021	Probability	0.153621
Obs*R-squared	3.775458	Probability	0.151415

Following the model of Yu (2003), which looked for determinants of capital structure among Philippine firms and found that profitability, 'past' growth opportunities, firm size and 'future' growth opportunities are some of the determinants, we incorporate **Beta** into the model. We test the single equation:

$$DEQ = \alpha_0 + \alpha_1 UBETA + \alpha_2 PRICE\_BK + \alpha_3 ROA + \alpha_4 LTA\_TA + \alpha_5 LOG\_REV$$

We get the following results:

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.134828	2.179301	-0.061868	0.9508
UBETA	-1.218634	0.546570	-2.229604	**0.0288**
PRICE_BK	-0.017120	0.073481	-0.232982	0.8164
ROA	-0.152891	0.045577	-3.354594	**0.0013**
LTA_TA	-0.556810	0.838771	-0.663840	0.5089
LOG_REV	0.275329	0.162681	1.692452	0.0948
R-squared	0.194292			

Unlevered Beta turns out significant (as predicted, cf. *supra*) and negatively related to Leverage. Return on Assets (ROA) turns out significant as well and negatively related to capital structure, which also turned out significant in the study by Yu (2003). The reason given for this is the dominant theory which says that leverage seems to decrease with increases in profitability (Pecking Order Hypothesis), although certain circumstances may also cause it to increase with increases in profitability.

Revenues (Log_Rev) is significant only at the 10% level. In the Yu study, it was significant even at the 1% level, and was explained by the theory that firm size (measured by total sales, among others) is expected to be positively related to leverage on the grounds that larger firms may be more diversified, enjoy easier access to the capital markets, receive higher credit ratings for their debt issues, and pay lower interest rates on borrowed funds. Our results show a positive relationship between Log_Rev and leverage, which is consistent with theory.

Given the potential simultaneity between DEQ (debt-to-equity ratio) and BETA, as found by Nguyen and Bernier (1988) in their functional equation *Beta = f (MP, OL, DUR, DEQ)* (cf. *supra*), we test for the following system of simultaneous equations using 2SLS:

$$Eq^n 1 : UBETA = \alpha_1 + \alpha_2 MP + \alpha_3 OL + \alpha_4 DUR + \alpha_5 DEQ$$

$$Eq^n 2 : DEQ = \alpha_6 + \alpha_7 UBETA + \alpha_8 PRICE\_BK + \alpha_9 ROA + \alpha_{10} LTA\_TA + \alpha_{11} LOG\_REV$$

Where:
- α_1 = constant of the 1st Equation
- α_2 = coefficient of the measure of market power (Q-proxy)
- α_3 = coefficient of Operating Leverage
- α_4 = coefficient of the measure of stock's duration
- α_5 = coefficient of Financial Leverage (total debt-to-equity ratio)
- α_6 = constant of the 2nd Equation
- α_7 = coefficient of Unlevered Beta
- α_8 = coefficient of Price-to-Book ratio
- α_9 = coefficient of Return on Assets
- α_{10} = coefficient of Long-term-Assets-to-Total-Assets
- α_{11} = coefficient of the log of Revenues

We get the following results (with "C" replacing "*α*"):

	Coefficient	Std. Error	t-Statistic	Prob.
C(1)	0.711179	0.060077	11.83772	0.0000
C(2)	-0.005371	0.017994	-0.298493	0.7656
C(3)	-0.370743	0.122907	-3.016458	0.0028
C(4)	-0.565900	0.498465	-1.135285	0.2573
C(5)	-0.024229	0.008171	-2.965123	0.0033
C(6)	3.724506	1.332383	2.795372	0.0056
C(7)	-2.543685	0.845799	-3.007434	0.0029
C(8)	0.271005	0.104097	2.603380	0.0097
C(9)	-0.255398	0.080945	-3.155212	0.0018
C(10)	-1.498841	1.891878	-0.792250	0.4289
C(11)	3.84E-09	2.70E-08	0.141913	0.8873
Equation: UBETA = C(1) + C(2)*Q + C(3)*OL + C(4)*DUR + C(5)*DE				
Equation: DE = C(6) + C(7)*UBETA + C(8)*PRC_BK + C(9)*ROA + C(10)*LTA_TA + C(11)*LOG_REV				
Instruments: C(1) C(6) Q OL DUR PRC_BK ROA LTA_TA LOG_REV DE UBETA				

It turns out that OL (*Operating Leverage*), Debt-to-equity ratio (*Financial Leverage*), Unlevered Beta, Price-to-Book Ratio, and ROA (*Return on Assets*) are significant variables in this system of two simultaneous equations.

The explanation for the negative relationship between Debt-to-equity ratio (*Financial Leverage*) and Unlevered Beta is the same as above, that is to say, as the operating risk of the firms increases, there exists lesser inclination to borrow, or lesser probability for the companies to be lent to. The significance of *Return on Assets* is likewise as stated *supra*.

For the significance of *Operating Leverage* (ratio of fixed assets to total assets), we refer to previous studies on the impact of *OL* on Beta which have been subject to wide disagreement. Since the finding here is a *negative* relation between *OL* and unlevered Beta, we refer to the study by Nguyen and Bernier (1988) which found that a firm's degree of production technology (measured by *OL* which they defined to be ratio of fixed assets to total assets) has a nonzero risk-reducing impact. As

for *Price-to-Book Ratio*, Darwin (2003) had already found that "future" growth opportunities are positively related to leverage.

5. Conclusion

This paper's preliminary empirical tests on the relationship between financial leverage and firm risk (as measured by Beta) seem to support the classic or traditional approach to thinking about capital structure, which proposes that there does exist an *optimal* capital structure.

Tests for the relationship between Beta and Leverage reveal a significant, negative relation between leverage and unlevered Beta, indicating that higher operating risk levels should not spur further borrowings.

Extending this idea to the study of determinants of capital structure among Philippine firms by Yu (2003), by incorporating **Beta** into the model, results show that unlevered Beta continues to be a significant determining factor for leverage in the Philippine setting. The link between ROA and leverage has been retained, as was found in the earlier model.

Testing for the system of simultaneous equations

$$Eq^n 1 : UBETA = \alpha_1 + \alpha_2 MP + \alpha_3 OL + \alpha_4 DUR + \alpha_5 DEQ$$

$$Eq^n 2 : DEQ = \alpha_6 + \alpha_7 UBETA + \alpha_8 PRICE\_BK + \alpha_9 ROA + \alpha_{10} LTA\_TA + \alpha_{11} LOG\_REV$$

Using 2SLS reveals that leverage and unlevered Beta do simultaneously affect each other significantly and negatively. In addition, Operating Leverage impacts unlevered Beta significantly and negatively, while Return on Assets impacts leverage negatively and Price-to-Book (representing growth opportunities) impacts leverage positively.

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Appendix A: List of Companies in the Sample

AAA	Asia Amalgamated Holdings Corp.
ABA	Abacus Cons. Res. and Hold'gs, Inc. "A"
ABS	ABS-CBN Broadcasting Corporation
AC	Ayala Corporation
ACR	Alsons Consolidated Resources, Inc.
AEV	Aboitiz Equity Ventures, Inc.
ALI	Ayala Land, Inc.
AMC	Alaska Milk Corporation
ANS	A. Soriano Corporation
APC	APC Group, Inc.
ARA	Araneta Properties, Inc.
ATI	Asian Terminals, Inc.
ATN	ATN Holdings, Inc. "A"
B	Baguio Gold Holdings Corporation
BC	Benguet Corporation "A"
BCI	Bacnotan Consolidated Industries, Inc.
BEL	Belle Corporation
BHI	Boulevard Holdings, Inc.
BPC	Benpres Holdings Corporation
BRN	A Brown Company, Inc.
CA	Concrete Aggregates Corp. "A"
CAC	CADP Group Corporation
CAT	Central Azucarera De Tarlac
CBC	Cosmos Bottling Corporation
CDC	Cityland Development Corporation
CEI	Crown Equities, Inc.
CEU	Centro Escolar University
CHI	Cebu Holdings, Inc.
CMP	C and P Homes, Inc.
CMT	Southeast Asia Cement Holdings, Inc.
CYBR	Cyber Bay Corporation
DGTL	Digital Telecommunications Phils., Inc.
DHC	Acesite (Phils.) Hotel Corp.
DIZ	Dizon Copper Silver Mines, Inc.
DMC	DMCI Holdings, Inc.
EEI	EEI Corporation
ELI	Empire East Land Holdings, Inc.
EPHI	Edsa Properties Holdings, Inc.
EURO	Euro-Med Laboratories Phil., Inc.
EVER	Ever Gotesco Resources and Hold'gs, Inc.
FAIR	Fairmont Holdings, Inc.
FCC	Fortune Cement Corporation
FDC	Filinvest Development Corporation
FER	Leisure and Resorts World Corporation
FEU	Far Eastern University, Inc.
FLI	Filinvest Land, Inc.
FPH	First Phil. Holdings Corp.
FYN	Filsyn Corporation "A"
GEI	Global Equities, Inc.
GLO	Globe Telecom, Inc.

GO	Gotesco Land, Inc. "A"
GPH	Grand Plaza Hotel Corporation
HI	House of Investments, Inc.
ICT	Int'l Container Terminal Services, Inc.
ILI	Interphil Laboratories, Inc. "A"
IMP	Imperial Resources, Inc. "A"
ION	Ionics, Inc.
IPO	iPeople, Inc.
IRC	Interport Resources Corporation "A"
JDI	Jardine Davies, Inc.
JFC	Jollibee Foods Corporation
JGS	JG Summit Holdings, Inc.
KEP	Keppel Philippines Properties, Inc.
KPH	Keppel Philippines Holdings, Inc. "A"
KPM	Keppel Philippines Marine, Inc.
KPP	Kuok Phil. Properties, Inc.
LAND	City and Land Developers, Inc.
LC	Lepanto Consolidated Mining Co. "A"
LFM	Liberty Flour Mills, Inc.
LIB	Liberty Telecoms Holdings, Inc.
LMG	LMG Chemicals Corporation
LND	Fil-Estate Land, Inc.
LSC	Lorenzo Shipping Corporation
MA	Manila Mining Corporation "A"
MAC	Macroasia Corporation
MAH	Metro Alliance Hold'gs and Eqts. Corp.
MB	Manila Bulletin Publishing Corp.
MBC	Manila Broadcasting Company
MC	Marsteel Consolidated, Inc. "A"
MED	MEDCO Holdings, Inc.
MEG	Megaworld Corporation
MEP	Matsushita Electric Philippines Corp.
MER	Manila Electric Company "A"
MHC	Mabuhay Holdings Corporation
MHI	Magnum Holdings, Inc.
MIC	Multitech Investments Corp.
MJC	Manila Jockey Club, Inc.
MMI	Mariwasa Manufacturing Corp.
MPC	Metro Pacific Corporation
MRC	MRC Allied Industries, Inc.
MUSX	Music Corporation
MVC	Mabuhay Vinyl Corporation
NN	Negros Navigation Company, Inc.
OM	Omico Corporation
OPM	Oriental Pet. and Minerals Corp. "A"
OV	The Philodrill Corporation "A"
PCOR	Petron Corporation
PCP	Picop Resources, Inc.
PEP	Premiere Entertainment Productions, Inc.

PF	San Miguel Pure Foods Co. Inc. "A"
PHC	Philcomsat Holdings Corp.
PHES	Phil. Estates Corporation
PLTL	Pilipino Telephone Corporation
PMT	Primetown Property Group, Inc.
PNC	Philippine National Const. Corp.
PO	Polar Mines and Development Corporation
PPC	Pryce Corporation
PRC	Philippine Racing Club, Inc.
PTT	Philippine Telegraph and Tel. Corp.
PWR	East Asia Power Resources Corporation
PX	Philex Mining Corporation "A"
RCM	Republic Cement Corp.
REG	Republic Glass Holdings Corp.
RFM	RFM Corporation
RLC	Robinson Land Corporation
RLT	Philippine Realty and Holdings Corp.
SEVN	Philippine Seven Corporation
SFI	Swift Foods, Inc.
SGI	Solid Group, Inc.
SINO	Sinophil Corporation
SMC	San Miguel Corporation "A"
SMDC	SM Development Corporation
SMPH	SM Prime Holdings, Inc.
SOC	South China Resources, Inc.
SPI	SPI Technologies, Inc.
SPM	Seafront Resources Corporation
STN	Steniel Manufacturing Corporation
SWM	Sanitary Wares Manufacturing Corp.
TA	Trans-Asia Oil and Energy Dev't Corp.
TDY	Tanduay Holdings, Inc.
TEL	Phil. Long Distance Telephone Co.
TFC	Phil. Tob. Flue Curing and Redry Corp.
UCC	Union Cement Corporation
UNI	Unioil Resources and Holdings Co., Inc.
UP	Universal Rightfield Prop. Hold'gs, Inc.
UPM	United Paragon Mining Corporation
URC	Universal Robina Corporation
UW	Uniwide Holdings, Inc.
V	iVantage Corporation
VITA	Vitarich Corporation
VUL	Vulcan Industrial and Mining Corporation
WEB	Philweb Corporation
WGA	William, Gothong and Aboitiz, Inc.
WIN	Wellex Industries, Inc.
WPI	Waterfront Philippines, Inc.
ZIP	Zipporah Realty Holdings, Inc.