Corporate Financing
Ownership and Control

The theory of residual rights of control assumes that the efficient allocation of the residual rights can be achieved by the transfer of the assets on which the control is exercised

$\Rightarrow$This transfer requires that the transferor is compensated.

EXAMPLE:

- assume to be in a situation of non-integration and to have a significant increase in the buyer's marginal benefit of the ex-ante investment.
- All assets must be allocated under buyer's control

⇒the assets controlled by the seller are transferred from him to the buyer.

⇒The seller needs to be compensated for such transfer

⇒it is possible to get the efficient allocation of residual rights of control only if the buyer is able to compensate the seller,

- if the buyer has no liquidity constraints.

- The liquidity constraint to which the parties are subject, requires that the theory of residual rights of control is integrated with a theory of the financial structure.

- We analyse a theory of the firm's financial structure that is consistent with the GHM's approach
- Company's financing is a mechanism for the allocation of the residual rights of control.

How to select the firm's optimal financial structure?

To start:

Modigliani–Miller Theorem→ **capital structure irrelevance principle**

Modigliani, F. and M. Miller (1958), The Cost of Capital, Corporation Finance and the Theory of Investment, *American Economic Review*, 261-97.

The Irrelevance Theorem →in a competitive credit market the firm's financial structure has no impact on its market value

- Firms' decisions about investment projects are taken by comparing the expected benefits and costs of the project

- The necessary money to finance the investment project can be found by the firm:
    - its own funds;
    - in the financial market:
        - Through equity
        - Through debt

The use of each of these three sources (own funds, equity, debt) may require different costs

$\Rightarrow$problem of finding the optimal combination of the three different sources.

In the absence of own funds → to find the optimal allocation of equity and debt.

Modigliani-Miller

- assumption of perfect capital markets→ **perfect information**
- firm cannot change its value by changing the distribution of its profits, as it is not possible to increase the size of a cake cutting it into slices of different size.
  It is only changing the ingredients, ie. by changing the total profit available for distribution that the firm is able to change its market value.

- According to Modigliani-Miller, the choice of the capital structure has no implications in terms of efficiency and so there is no reason to expect that one rather than the other prevail.

=> No systematic choice of the firms' capital structure should emerge.

- Instead, many empirical studies have shown the presence of regularity.

- Some works: the assumption of perfect information is completely unrealistic and misleading

- We analyse those models that in the firm's choice about its capital structure consider the **presence of asymmetric information.**

- → In these models the financial structure chosen by the firm is considered as a tool to mitigate the effects of asymmetric information between the parties.

- Jensen, M. and W. Meckling (1976), “Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure “, *Journal of Financial Economics* 11, 5-50.

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- Myers, S. and N. Majluf (1984), “Corporate Financing and Investment Decisions when Firms Have Information That Investors Do Not Have”, *Journal of Financial Economics* 13, 187-221.

  → **ADVERSE SELECTION**