Review Article

The importance of capital investment and debt financing in deriving shareholders' value; A literature survey

Abstract

Shareholders' value is the most important goal and an integral part of the companies' strategic decision-making process. When a corporate performs well and creates value for its shareholders, it benefits the whole economy. The past studies concluded that efficient decision making in the areas of capital investments and debt financing can ensure high financial performance and shareholders' value creation. This paper thoroughly reviews the literature on impact of capital investment and debt financing decisions on shareholders' value. Capital investment is a very important managerial decision because it increases company's economic profit. However, past studies found that not every time the capital investment results in increasing the value as it may vary with the level of investment. Moreover, debt financing lowers the free cash flows due to the payment of fixed interest payments, thus lowering shareholders' return and value. Therefore, this paper recommends the need of further research to better understand the effect of capital investment and debt financing decisions on shareholders' value.

Keywords: Shareholders' value, capital investment, debt financing, economic value added, capital expenditure.

Introduction

The businesses in almost every field are giving much importance to the shareholders approach. In recent years, the companies are gradually shifting their focus from the traditional concept of just measuring the financial performance to more on the creation of shareholders' value. The investors make investments with a hope to obtain maximum returns and consider several other things prior to investing their funds. Therefore, in the corporate world, a strong belief has been developed for maximizing the shareholders' value due to its various economic benefits. A company is said to be adding value to the shareholders' invested capital, if the return comes out to be bigger than its cost (Nakhaei & Hamid, 2013).

The managers play a major role in making a company competitive and attractive to the investors. This can be achieved if the managers make efficient decisions and invest wisely (Shakina, Molodchik & Barajas, 2017). The shareholders lose their trust in the company when the management does not meet their expectations. The aim of this study is twofold, firstly to shed light on the most important corporate measures which impact the shareholders' value and secondly to emphasize on the effectiveness of economic value added as the most efficient managerial tool for shareholders' value estimation. This new approach started to strengthen as new value based measures like economic value added emerged. The investors relied on such tools due to their ability to measure the value based performance as well as to aid decision making (Kurmi & Rakshit, 2017). There is a substantial literature present that sheds light on the factors influencing the performance of the firms but a very few research studies have focused on the performance in terms of shareholder value creation.

The origin of the shareholders' value concept can be traced back to 1970 when Milton Friedman gave his stockholders' theory also known as Friedman Doctrine according to which the only responsibility of a company is to make profits for itself and its shareholders. This concept achieved great attention in the early 1980s by the corporate executives for improving economic performance (Rappaport, 1981 and 1983). The company's focus started to shift from traditional accounting performance measurement to the shareholders' wealth creation in the early 1990s. The approach of just measuring the financial performance through financial ratios was just profit oriented (Erica, 2018). Afterwards in 1999, Organization for Economic Cooperation and Development principles made it mandatory for the companies to create value for shareholders and made it a part of their business objectives. Shareholders who are the primary owners of a company require an adequate value added to their invested capital. Therefore, the managers being the agents of the shareholders need to devise such strategic policies that will not destroy shareholders' wealth (Effiong, 2019). Those performance measures are needed which can align the managerial decision making with the firm's objectives (Bhasin, 2017).

The shareholders' value is given much importance over other success factors or measures of a company because when the company develops an overall value the other factors will follow. Therefore, the objective of all the business activities is to build value for the shareholders in order to keep the business running. The objective of this paper is twofold; firstly to determine the most important managerial decisions affecting the shareholders and firm and secondly to suggest economic value added as a best proxy for measuring shareholders' value. In the past literature, mostly the impact of profitability and performance measured by return on assets (ROA), return on equity (ROE), market price per share (MPS) and earnings per share (EPS) on shareholders' value was studied. However, not much evidence is found on the clear understanding of the relationship between the capital investment and debt financing decision with the shareholders' value.

Basically, a company has three major financial decisions to make in order to run its business operations namely, financing, investing and the asset management. The shareholders want their investments to be at minimum risks and require value addition for them, therefore, these three areas need to be managed efficiently (Ali, Zhang & Azeem, 2019). Shareholders' value being a corporate policy is used by management as an instrument for assessing investment and financing strategies. These two decisions are vital for the overall performance of the company. The financing decision is a part of the company's Capital Structure which includes the combination of various financing alternatives available to a company (Saleem, 2013). On the other hand, the investment decision is taken place with the purpose of business expansion. In the past studies, the focus has been mainly put on the effect of corporate performance in terms of profitability on shareholders' value. A careful and thorough review of the past literature shows the need to examine the effects of capital investment and debt financing decisions on shareholders’ value which have been ignored. Therefore, this study attempts to focus on these two decisions in particular.

Review of the Literature

Shareholders’ value

The concept of Shareholders’ value creation is multidimensional in nature and highly misunderstood. This complex construct has given rise to the formation of many shareholder value creation frameworks (Thompson, 1967). Due to the increased complexity and growing importance of the firm’s relationships with its stakeholders especially shareholders, the firms have become socially responsible. Firms are striving hard to create sustainable value and to seek the interests of its shareholders. This approach can help lower the business risk and increase value creation in the long run (Salvioni & Gennari, 2017). Friedman proposed the neoclassical position, according to which the main responsibility of the company is to use its resources for maximizing its profits and complying with the law and ethical customs. A company can fulfill this objective when the capital value of owners or shareholders is maximized. When this value maximization is achieved the contribution of the company to society will be optimized according to Friedman. Any business activity that hinders the company to maximize shareholders’ value is not acceptable as it results in the misallocation of resources (Miralles-Quirós, Miralles-Quirós & Hernández, 2019).

The idea of shareholders’ value has emerged from Business Economics and refers to a meticulous manner of calculating the value of investment. Shareholder value is basically targeted towards an investor who wants to diversify the risk associated with his investments in company’s shares. The basic principle of running a business successfully is to keep its investors satisfied by giving them privilege in seeking their interests which is to maximize their wealth. This shareholders approach is backed by the principal-agent relationship. The principal here are the shareholders whereas the agents are the management which is running the company. The managers act as agents for the shareholders, make decisions on the latter’s behalf and help the investors in their investment affairs and offer value to them (Alcock et al., 2013). It is also a known fact that unlike other stakeholders of the company, the shareholders’ rights are not secured properly (Brandt & Georgiou, 2016).

Over the time, with the advancement of research in the field of corporate finance, the driving factors of shareholders’ value have shifted from the traditional accounting measures towards more refined tools. Previous literature discussed the concept of shareholders’ value from different aspects of the overall corporate performance and issues. A thorough review shows that majority of the past research is done to find the best value driving indicators for shareholders’ value (Kumar, 2020; Kurmi & Rakshit, 2017; Chatopadhayay & Rakshit, 2010; Panigrahi, 2017). In majority of the studies (Chaleeda, Tunku and Anas, 2019; Khan et al., 2017) accounting profit measures were used as a proxy for the shareholders’ value. The accounting profit includes the following financial indicators; Earnings per share (EPS), return on assets (ROA), return on investment (ROI), and return on equity (ROE). Moreover, measures like market capitalization, and dividend per share (DPS) were also used but they were not found to be efficient measures (Iqbal & Zhuquan, 2015).

The famous economist, Rappaport in 1998, postulated that a company's earnings do not give the true picture of the firm's performance and value. This is because it overlooks the concept of time value of money and relies just on the accounting principles. Another aspect revealed is that the managers should not pursue other goals while maximizing the shareholders value otherwise they would get deviated from this ultimate goal of the company. While pursuing this goal, the managers expect rewards and incentives in return for their services (Kumar, 2020). EVA is found to be an efficient measure of the performance and it is suggested that EVA should be used for measuring the long term value for the shareholders (Nagamani, 2016). Despite of this fact, the companies are not interested in preparing or publishing EVA reports (Ashraf, 2018).

Economic value added is a technique firstly introduced by the General Motors Corporation and lately by a US-based consulting firm, Stern & Stewart Company in the 80s. This measure is found to be superior to the others because it includes the cost of capital along with the profits (Isuwa and Terzungwe, 2018). The study of (Shad and Lai, 2015), took EVA to measure the shareholders' value. EVA was found to determine the economic profit efficiently. It was further suggested that EVA should be used for measuring the long-term value for the shareholders. The study of Shah (2019), examined the creation of shareholders value for Indian Companies by taking dividend and capital structure as the independent variables and EVA as a proxy for shareholders' value. In another study of Nagamani and Abirami (2016), the relationship between the company's performance and shareholders' value has been analyzed banking industry. The performance is measured by Net profit and Shareholders' value is measured by Economic Value added. The net profit is found to be significantly impacting the economic value added.

Capital Investment

Capital investment of a company is a very important decision taken by the manager as it involves the investment in the fixed assets of company for making profits. The past studies have shown mixed findings on the effect of capital investment on shareholders' value. This does not necessarily mean that it will always result to be fruitful for the company. According to the findings of Lu, Hwang and Lin, (2016) the shareholders keep their investments in the firm's shares in accordance to the capital investments done by the firm. The shareholders find more value for their shareholdings when a firm adopts an investment policy which has low capital expenditure and low external financing cost. It is found that the capital investments affect the profitability positively. While keeping the debt in the picture, the relationship of capital investments with the corporate performance shows different results. It also suggested that firms which rely more on external debt for acquiring capital investments face a decline in the performance (Vaicondam & Ramakrishnan, 2018). The capital investment is comprised of three elements namely, capital expenditure, operating expenditure and finance expenditure.

Capital expenditure

Capital expenditure is a major element of the capital investments made by the corporate. Capital expenditure is defined as the expenses incurred by the company to buy or upgrade the physical or fixed assets. The companies incur the capital expenditures for the purpose of investments. The capital expenditures are taken place when the companies have free cash flows available. These investment decisions are directly associated with the cash and financing decisions of the companies. The capital expenditure done by a company increases the revenue and profitability gains and enhances the overall performance of the company (Turner & Hesford, 2019).

Operating expenditure

The operating expenditure is the expenditure carried out for the operations of the company and is recorded against the profits of the same period (Valipour, Moradi & Karimi, 2012). When the investment in the fixed assets increases, the operational expenditure also increases. The operating expenditure increases the need of capital in the company and reduces its liquidity.

Financial expenditure

The finance expenditure is the cost which is related to the external financing like interest or other similar costs that are recorded on accrual basis in the financial statements. The finance expenditure is carried out with the capital expenditure made by the company. The external funding which is done for capital expenditures increases the financial costs of the company. Capital investment involves financial risk which can put the survival of a company in danger. The shareholders always favor profitable investment opportunities available to a company. Their final decision depends wholly on the return available on any investment.

The shareholders use the returns and risk associated with an investment to evaluate its viability. The capital expenditure affects the current as well as the future earnings. That is why managers have to do the proper capital budgeting and accurate forecasting to avoid the over and under investments in the fixed assets (Bishal, Bhagwat & De Bruine, 2019). Firms which are capital intensive and avail investment opportunities are set towards growth and increase shareholders value. These decisions also bring agency conflicts between the managers and the shareholders. It requires the managers of the firm to work efficiently and make the policies of the firm in its best interests. (Nishant, Teo and Goh, 2017) are of the view that when firms announce the new capital investments especially in the field of information and technology, it results in greater profits and returns. Moreover, the shareholders react positively to company's investments which result in positive market returns because the shareholders think that the firm has good future prospects and the trade for its share increases.

Debt Financing

Financing decision means the way a firm finances its assets and operations either by debt and equity. These two sources are used to fund the business activities, capital expenditures, acquisition of assets and investments. Debt financing is an important source of financing through which companies can get funds from investors in the form of public bondholders, and financial institutions, such as banks. The companies doing debt financing are more vulnerable to the risks due to the payment of fixed interest expense. But if the interest is low, debt becomes cheaper and easily accessible (Wang, 2019). The debt that a company takes for financing its capital expenditures actually lowers the free cash flows available for the shareholders to be enjoyed as the dividends. This debt is also used as a disciplinary tool by the managers and is also a result of the conflict between the managers and the shareholders (Bruslerie, 2016). Thus, the above discussion indicates that debt financing lowers the value for shareholders.

Financial leverage

The companies which have high financial leverage have low value for its shareholders (Panaretou, 2013). According to the Pecking Order Theory, companies having a greater profit do not depend much on the external financing. When the financial leverage increases it decreases shareholders' value (Chen and Chen, 2011). The investors react negatively to high leveraging by the firms so financial leverage has a negative relationship with the shareholders' value (Rahman, Serrano & Lambkin, 2017). However, if companies take debt for making investments in research and development activities for improving the quality, the investors react positively towards it (Asogwa et al., 2020). The past studies show inconclusive findings which lays the foundation for more thorough examination of the effect of debt financing in the context of shareholders' value.

Conclusion

The review of the past studies on the effect of capital investment and debt financing reveal that the empirical results gave inconclusive and mixed findings. Thus, the above inconsistent findings laid the basis for this study. This paper reported the findings of the past empirical studies to clearly understand the concept of shareholders' value and how the capital investment and debt financing decisions influence it. The concept of shareholders' value has been studied broadly by the researchers and academicians until present. The main objective of the company is to maximize the value and wealth of the shareholders. The management of the company needs to implement the financial management functions efficiently and carefully as any financial decision made could impact the other decisions of the firm. Moreover, in the literature economic value added (EVA) is found to be a best measure of the shareholders' value. By adopting EVA, the companies can enhance their corporate performance, motivation of management and market value. According to this measure a company creates value for its shareholders if the rate of investment return is greater than the cost of capital showing that the cost of capital covers the investment risk. The shareholders' value is embedded in the price of the common stock which is affected by the capital investment and financing decisions of the company. Therefore, a well-balanced arrangement of the capital investment and financing decisions is required for the maximization of the value of the company and its shareholders.

COMPETING INTERESTS DISCLAIMER:

Authors have declared that no competing interests exist. The products used for this research are commonly and predominantly use products in our area of research and country. There is absolutely no conflict of interest between the authors and producers of the products because we do not intend to use these products as an avenue for any litigation but for the advancement of knowledge. Also, the research was not funded by the producing company rather it was funded by personal efforts of the authors.

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