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# The Capital Structure of Firms in the Finnish Forest Industry

A qualitative study of determinants for capital structure

Master's thesis in accounting  
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Abstract for master's thesis

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Title: The Capital Structure of Firms in the Finnish Forest Industry, A qualitative study of determinants for capital structure
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<p>Abstract: The determinants for capital structure in a firm has been of debate since Modigliani and Miller (1958) published their first paper stating that the capital structure does not affect the corporate value of a firm. Since then, new and more complex models and theories that better consider the real-world phenomena have been developed. However, these theories are suggesting almost opposite views on how capital structure in a firm is determined. This indecisiveness in the literature on capital structure suggest that one still is not able to determine what forces are behind the capital structure in a firm. Earlier research on the topic have suggested that this indecisiveness comes from the correlation problems that the research has faced (i.e., making the correlation between a capital structure and a distinct theory is very difficult) (Fama and French, 2002).</p> <p>Most of this previous research on the topic (Fama et al., 2002; Titman et al, 1988; Rajan et al. 1995; Michaelas et al., 1999; Flannery et al., 2006) has had a quantitative approach to their research methods (ibid.). This unbalance between quantitative and qualitative research suggests that there is a lack of research with a more qualitative approach. For testing whether a theory is in line with the practice of the firms in the real-world, qualitative research has an advantage as it gathers the thoughts and reasonings directly of the managers (Sale et al., 2002). The purpose of this paper is to analyze how firms decide upon their capital structure in the real world by taking the perspective of the practitioners in the Finnish forest industry and by doing so, see whether the reasonings of the managers are in line with any of the theories on the subject.</p> <p>The findings suggest that the managers in the Finnish forest industry have a more pecking-order-oriented view, than a trade-off oriented, when it comes to determining their capital structure. In some instances, the managers also conduct a more trade-off-oriented view in their reasonings, however, the findings suggest that that is due to the agency problems of capital and could be</p>

explained by the help of the agency theory, as the managers have direct or indirect pressures from the owners to increase leverage in the firm in these instances.

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# 1. Introduction

The capital structure of a firm has been a subject of research and a center of attention since Modigliani and Miller conducted their famous research paper in 1958 and presented their first proposition; No Magic in Leverage (Modigliani and Miller, 1958), stating that the capital structure does not affect the market value of a firm. From this groundbreaking theorem, consisting of later three other propositions and a total of three research papers (Modigliani and Miller, 1958, 1961, 1963), the discussion and interest surrounding capital structure began, and many other theories developed consequently. Today, the capital structure literature includes many theories as to how capital structure is determined in a firm, however, with great differences in their understandings and propositions.

## 1.1 Background

The core purpose of a privately owned firm is to generate profits for its owners and for a firm to be able to generate profits it needs to invest in assets with greater returns than costs. For a firm to be able to invest, financing is needed and there are three main types of financing that are available for a firm. A firm can choose to issue debt, equity or utilize retained earnings to find the means for an investment, each with its different characteristics. The capital structure of a firm is therefore the allocation among different sources of capital that the firm has decided to utilize.

### 1.1.1 The Finnish Forest Industry

The Finnish Forest is an important industry for the nation's economy. Wood processing remains an important industrial sector since the 19<sup>th</sup> century when the production of refined wood products first began. In 2019, the gross value of the Finnish forest industry's production was 31.6 billion euros. That translates to about a fifth of the total value produced by all the Finnish industries combined. In foreign trade, the forest industry consists of a fifth of all exported value and five percent of the Finnish GDP. Over time, Finland has accumulated

expertise and knowledge surrounding the forestry and forest industry and is today among the world leaders in the sector. Wood is an important and versatile raw material that is used in everything from fabrics, medicines, and chemicals to packaging and biofuels. Traditionally, sawmilling was the most important exported wooden product in Finland. Today, the most important exported products of the forest industry in Finland are pulp, paper, paperboard, packaging materials, and sawn wood (Ministry of Agriculture and Forestry of Finland, 2021).

This industry, that is important for Finland is also particularly fit as a subject for this research on capital structure, as the forest industry is capital hungry. Management is therefore used to having to think about financing in different investment situations and could provide this study with valuable insights.

## 1.2 Problem discussion

The theories on capital structure today suggest radically different propositions regarding how a firm decides upon its capital structure. The trade-off theory, one important theory on the subject, suggests that a firm will maximize debt until its risk tolerance is met, as the increased leverage will increase the return on equity (Kraus and Litzenberger, 1973). A second important theory, the pecking-order theory, in the capital structure literature suggests that a firm instead will utilize its retained earnings first, before using external capital, as the cost of information asymmetry between internal and external parties makes retained earnings less expensive than external capital (Myers and Majluf, 1984).

These theories are motivated by many different forces and suggest almost opposite views on how capital structure in a firm is determined. This indecisiveness in the literature on capital structure suggests that one still is not able to determine which forces are behind the capital structure in a firm. Earlier research on the topic has suggested that this indecisiveness comes from the correlation problems that the research has faced, (i.e., making the correlation between the capital structure of a firm and a distinct theory is very difficult) as Fama and French concluded in their research (2002).

Most of the previous research on the topic (Fama et al., 2002; Titman et al., 1988; Rajan et al., 1995; Michaelas et al., 1999; Flannery et al., 2006) has had a quantitative approach to its research methods (ibid.), using different regression analyses of large samples of panel data of the firm's financial data. This unbalance between quantitative and qualitative research suggests that there is a lack of research with a more qualitative approach, as these different approaches capture different insights and have a complementary effect on each other (Sale et al., 2002). For testing whether a theory is in line with the practice of the firms in the real-world, qualitative research has an advantage as it gathers the thoughts and reasonings directly of the managers behind the capital structure and is not just observe the output effects of these decisions of the managers in form of the financial data. Thus, research with a qualitative approach could better avoid the correlation problems as previous research has faced. True, one can never say which theory best fits the data of a sample but, and this is the main point of the argument, neither has the studies relying on quantitative studies, in this case. What a qualitative study can do, however, is provide evidence about how firms reason and argue when making decisions that affect the firms' capital structure, which can contribute to the understanding of which theory, if any, best describes firms' capital structure decisions.

Hopwood (1979) alluded to this when he argued that the legitimacy and relevance of the research dedicated towards understanding and describing accounting systems in the real world could benefit greatly by improving the understanding of the work realities as they are experienced by the management in the field. Such understanding is not possible to generate by the broad range of existing and ever-evolving quantitative research.

### 1.3 Purpose

The purpose of this paper is to analyze how firms decide upon their capital structure in the real world by taking on the perspective of the practitioners in the Finnish forest industry. By answering how the firms are reasoning and deciding upon their capital structure the findings will then be used to see if the reasonings of the managers are in line with the trade-off theory, the pecking-order theory, or other theories or forces.



Furthermore, this research paper hopes to contribute to the research pool of qualitative studies on the subject by insights from the practitioners' views and reasonings behind their allocation of capital in their firm and to help create a more balanced view on the subject.

## 1.4 Disposition

The following chapter will present the method of this paper and will give a brief understanding of how to conduct a qualitative study and how the interviews were conducted. The following chapter consists of the theoretical framework surrounding the ongoing discussion of capital structure. The fourth chapter will present the previous research done on capital. The fifth chapter will present the empirical data from the interviews with the managers in the Finnish forest industry and will be followed by the results and conclusions of this study. Lastly, there will be a Swedish summary of this research paper.

# 2. Theoretical framework

## 2.1. Modigliani-Miller Theorem

The Modigliani-Miller Theorem comes from a series of result from Modigliani and Miller's groundbreaking papers in the late fifties and early sixties (1958, 1961, 1963). It introduced ideas that all, at the time, were pioneering and is still a cornerstone of the corporate finance of today. The theorem's first proposition is that the capital structure of a firm does not, in a perfect market, affect the market value of the company. As the value of a company, according to the MM-theorem, is instead a result of its discounted future earnings to present value and its underlying assets. Miller (1991) explains this idea with a whole milk analogy where if the farmer separates out the cream, which is a more valuable product, is left with skim milk which is a less valuable product. The Modigliani-Miller theorem therefore says that there is no difference for the farmer to sell the whole milk as it is or to separate out the cream and skim

milk, as the total selling price would be the same. This idea accounts for perfect market conditions where separation costs and other market frictions is not present. To put the analogy into other words, the gains the firm will get from using more cheap debt for leverage is counteracted with the now riskier equity of the company. Therefore, according to the Modigliani-Miller Theorem the allocation of the total capital between debt and equity does not play any difference as the weighted average cost of capital for all the combinations of capital will be the same. That is the second proposition of the authors, which suggests that the level of debt in a firm does not influence the WACC, weighted average cost of capital, of a company (i.e., the calculation of the total cost of capital in which the different costs of capital are proportionally weighed) (Miller et al., 1958). Hence, the risky equity in a company with high debt drives up the capital cost of equity, as return is positively correlated with risk. The cost of equity is therefore not constant in the Modigliani-miller model, it is moving in relation to risk, as investors will demand higher return when equity is increasingly leveraged in a firm. This same relationship was demonstrated later by Sharp (1964) in his famous model of capital asset pricing, CAPM, indicating positive correlation between the risk of an investment and the demanded return of the investor.

The first proposition (Modigliani et al., 1958) of the MM-theorem is demonstrated in figure A where the cost of equity is linearly increasing and the cost of debt is remaining constant, resulting in the WACC remaining the same, regardless of the combination of capital in a company.

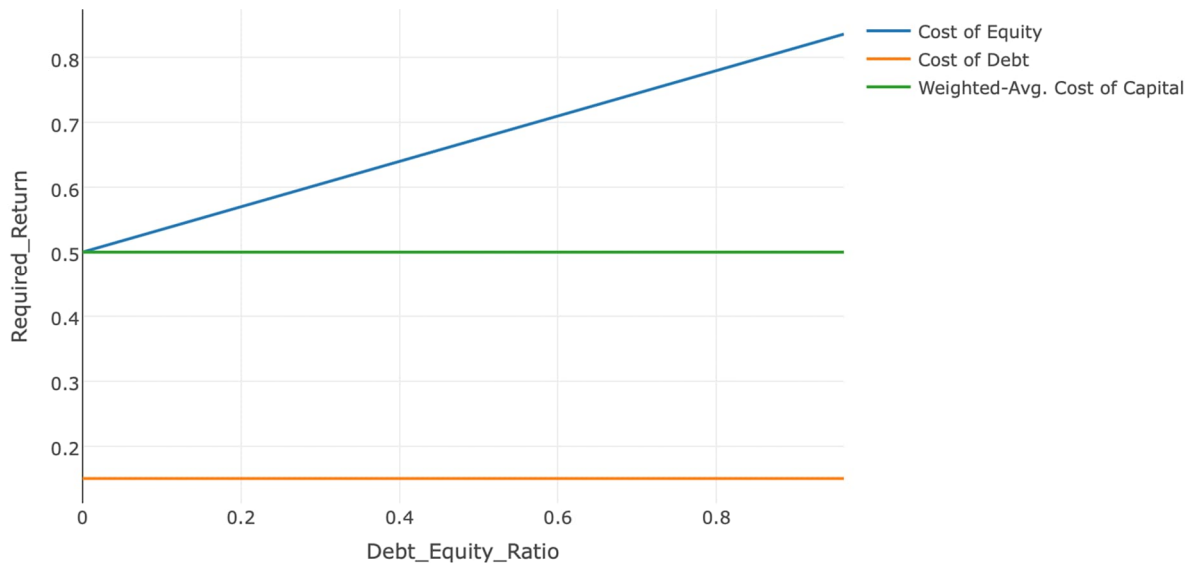


Figure A (Milken Institute, 2021). How the WACC remains the same regardless of the combination of capital in a firm, when corporate tax is excluded in the model.

These propositions do not, however, account for taxes, which is a great critique against the theorem, as its not creating a realistic scenario for their model to work in the real world. Modigliani and Miller, however, addressed this in their paper from 1963, further developing the MM-theorem and reaching completely different findings, when taxes were accounted for. Accounting for taxes, their model showed that the value of a company instead is increasing as more debt is added. This is a result of the company paying less in taxes, as the interest charges of the debt is tax deductible and is therefore decreasing the taxable income for the firm, working as a tax shield and increases the return on equity.

Return on equity is increasing as of the tax shield, then the cost of equity is no longer increasing in proportion to the added risk of a more leverage firm. Therefore, the WACC of the company can be lowered by adding more debt and hence becoming more profitable and more valuable on the market. As demonstrated in figure B where a corporate tax rate of 20 percent cost of equity of five percent and cost of debt of two percent is used. The figure is demonstrating how the WACC is being reduced as debt is increasing.

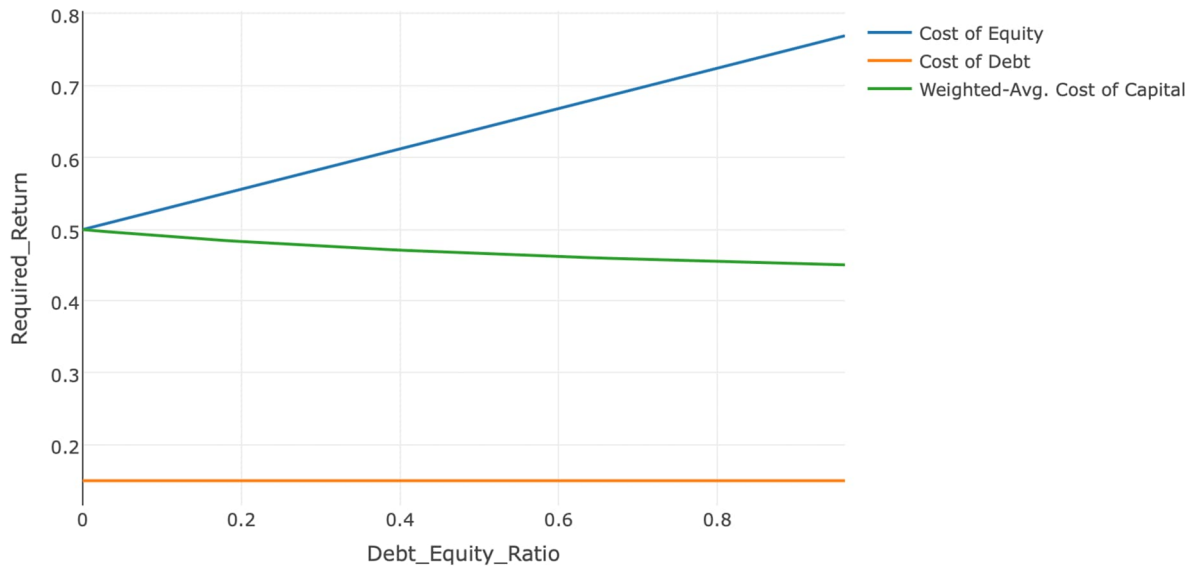


Figure B (Milken Institute, 2021). How WACC is reduced when debt increases when corporate tax is included in the model.

## 2.2 The trade-off theory

In the real-world firms are usually not financed solely on debt, even though it would be the most optimal use of the interest shield according to Modigliani and Miller (1962). The trade-off theory model is trying to make sense of this phenomenon, as there must be a cause to most firms not maximizing their debt ratio. The trade-off theory was developed from the Modigliani-Miller theorem and was first introduced by Kraus and Litzenberger in 1973. The main concept that differs from the MM-theorem is that the trade-off theory is considering the detriment of debt and not only the benefits of it. Such benefits being, what Modigliani and Miller already established in their paper in 1963, that the interest charges of debt are functioning as a tax shield, increasing the return on equity and the market value of a company. The detriment of debt is the potential bankruptcy costs and financial distress debt can cause for a company (Ghosh et al., 2017).

“If the firm cannot meet its debt obligation, it is forced into bankruptcy and incurs the associated penalties.” (Kraus et al., 1973 s. 2). Therefore, a firm’s optimal amount of debt is, according to the trade-off theory, determined by balancing between the costs and the benefits

associated with borrowing. It is a static tradeoff of the value of the deductible interest charges and the various costs of bankruptcy or financial distress. Thus, the firm is supposed to increase or decrease debt until the value of the firm is maximized (Myers, 1984). According to Myers (1984) more risky firms with volatile earnings and value of assets have a lower capacity for debt than a safe firm. The expected costs of financial distress outweigh the tax advantages of interest payments faster in such cases. When it comes to firms holding tangible assets, with an active market will borrow less than firms with specialized or intangible assets, as the expected cost of financial distress also depends on the value lost in the event of bankruptcy (Myers, 1984). Specialized and intangible assets do not have much value in a financial distress, thus there is not much value left to be claimed.

The probability of bankruptcy is increasing as the firm takes on more debt, hence there is a declining marginal benefit of debt in a company. There is also a direct cost for a firm to go bankrupt and that is also accounted for in the model. The cost of debt in the model is hence consisting of two elements, the first one the marginally increasing probability of bankruptcy and the second one is the direct cost of bankruptcy or deadweight cost of bankruptcy, that includes the legal and liquidation costs of the bankruptcy process. The most preferred capital structure according to the theory is therefore to be found when balancing between these costs of financial distress and the probability of bankruptcy with the benefits of increasing debt in a firm.

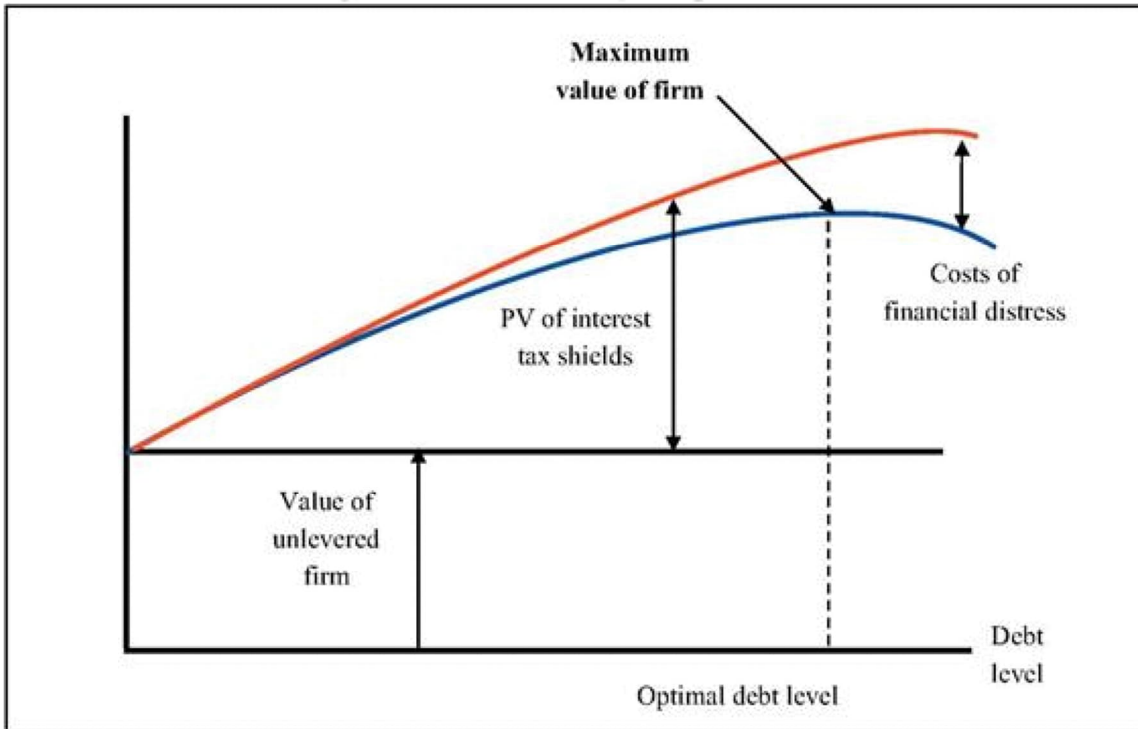


Figure C (Myers, 1984 s.3). The marginal benefit weighed against the marginal cost of one more unit of debt. Showing the optimal leverage for a firm according to the trade-off theory.

The trade-off theory model is presented in figure C. The black horizontal line is the starting point and is representing the value of a company with a debt ratio of zero. The present value of the tax shield is then added and that is represented in the diagram as the red line which shows the marginal benefits of the tax shield at a given debt ratio. The red line is increasing rapidly in the beginning, however, as the debt ratio is continuing to increase the line is peaking, after that it is decreasing. Since, the marginal benefit is decreasing while the marginal cost is increasing, which gives the curved line. It is reflecting the probability of default increasing with a higher debt ratio (Kraus et al., 1973). The blue line in the graph is representing the value of a company minus the costs of bankruptcy. The most optimal level of the debt ratio according to the theory is the point that the blue line is peaking, and the marginal cost of debt equals the marginal benefit of debt.

### 2.3 The pecking-order theory

The pecking-order theory is an important theory on capital structure and was modified by Myers and Majluf in 1984, who implemented an element of adverse selection into the theory, thus making the theory more fit for modern finance theory (Myers, 1984). Myers (1984) and Myers and Majluf (1984) stated that firms favor internal rather than external financing. Since external financing is creating a situation of adverse selection or a situation of information asymmetry that is increasing the cost of external finance. Since the manager does not want to issue external finance, in case of the manager holding favorable information, as the market's price does not yet account for the favorable information. Thus, when managers hold favorable information, the market will always value the firm's stocks lower than the actual value or the value that the market would pay if investors had the same information as the managers. In situations like these the manager, if he is on the existing stockholder's side, could choose not to issue new stocks even if the investment had a positive-NPV, if the cost of equity, or the undervalued price of the company stock, was greater (e.g., if a company would need 5M euro for an investment, but to raise that amount the firm would need to issue stocks that really are worth 6M euro). The company would therefore go ahead only if the NPV is at least 1M euro otherwise the existing stockholders would lose value to the new investors, even though the overall value of the company would increase. Thus, costly equity issues make the firm not decide to invest in opportunities that would have a positive NPV and that creates a different sort of cost for the company (Myers et al., 1984). These sorts of cost could be avoided by the firm if it could build up and use its retained earnings to cover these investments instead. However, that only works in hindsight and in some cases building up retained earnings only works if the dividend payout is cut. Due to sticky dividend policies this may not be possible. In these cases, debt is a company's best option (Myers et al., 1984).

There are advantages of debt over equity issues when a company is seeking external funding that makes the managers choose debt over equity when managers hold favorable information. If the firm can issue default-free debt then there is no adverse selection problem as there would be no pricing difference if the debtholders had the same information as the managers (Myers et al., 1984). Issuing default-free debt is therefore as good as cash in the bank according to Myers (1984). Even if there is default risk for debtor, the cost of adverse selection for debt is still lower than issuing equity (Myers, 1984). This could be explained by considering the seniority of claims to assets where debtholders are being entitled to a larger claim to assets than stockholder in the event of liquidation of the firm and therefore the risk is not as great for debt

holders (Moore et al., 1990) and hence the information asymmetry does not affect the pricing to the same extent it does for equity.

Whether the managers information is unfavorable, then issuing risky securities would instead be overvalued by the market and thus being favorable for the company (Myers, 1984). Managers would then want to take advantage of investors; equity would then be a better option than debt. “Issue debt when investors undervalue the firm, and equity, or some other risky security, when they overvalue it.” (Myers, 1984, s. 17). However, rational investors would then know that a firm only issues equity when the stock is overvalued and would otherwise use debt when the stock is underpriced. Thus, investors would be refusing to buy equity from the firm, except when the firm has already exhausted its capacity for debt and investors know that equity is the firms last chance and thus not be able to take advantage of the market. Therefore, the firm is forced to use the pecking order, and this is how Myers (1984) and Myers and Mayluf (1984) explains how the adverse selection could be used to explain the pecking order.

According to Myers does a firm’s observed amount of debt reflect its cumulative need for external finance (Myers, 1984). Highly profitable companies will therefore have a lower debt ratio than less profitable companies, as more profitable companies are able to generate higher retained earnings. Hence resulting in more investments being able to be financed internally and thus making more profitable companies less leveraged, creating a negative correlation between profitability and debt.

## 2.4 The Agency Theory

The agency theory is included in the theoretical framework as an outside theory, or method theory, as it perhaps could be used to describe the behavior of the managers in some situations that the other theories on capital structure is not able to.

The origin of the agency theory comes from the 1960s and early 1970s where risk sharing among cooperative parties were explored in the literature by economists as Arrow (1971) and



Wilson (1968). The problem they identified arises when parties have different preferences towards risk in a cooperative party. The agency theory then emerged and broadened upon this literature. The agency theory included the problems arising when parties' goals and aims differ in an agency relation (Jensen and Meckling, 1976; Ross, 1973).

The agency theory describes the relation between a party who appoints tasks and decisions, called the principal, to another party, called the agent, who are anticipated to complete the delegated tasks in the best of the principals' interests (Eisenhardt, 1989; Jensen and Meckling, 1976). This relationship is usually described using a metaphor of a contract between the agent and the principal (Jensen and Meckling, 1976). The emphasis of the agency theory comes from presumptions that the agent does not always follow the principals' best interests and thus will behave opportunistically when the opportunities arise. Especially if the interests of the principal are in direct conflict with those of the agent (Mitchell and Meacham, 2011). As the agent's and the principal's interests does not always a line with each other, an agency problem therefore occurs. One main cause of the conflict emerging is that the contracts are imperfect since not all potential and different conflicting interest can be accounted for in these contracts (Eisenhardt, 1980). The agency theory's focus is on resolving the problems that can arise in relationships between principal and agent.

According to Eisenhardt (1989) the agency problem consists of two main problems. The first agency problem occurs when the goals or desires of the agent conflict with those of the principal and that these differences in interests between the parties are difficult and expensive to measure. It is therefore impossible for the principal to verify that the agent has behaved according to the best of the principals' interests. The second agency problem that arises is the problem of sharing risk. The agent could have much different risk preferences to that of the principal and are therefore preferring different kind of action due to their differences in risk preferences (Eisenhardt, 1989).

### 3. Previous research

This chapter aims to give an overview of what empirical research have been conducted previously on the topic of capital structure in a firm.

Titman and Wessels (1988) analyses predominant theories on capital structure explanatory power. Their findings regarding the profitability attribute suggests that increases in market value of equity, due to adding profits, are not totally offset by an increase of the firm's debt. Their study aims to extend the empirical work in the field of capital structure theories. One way they want to extend the work of capital structure theories is to examine a broader set of theories that previously to this research had not been empirically tested. The data used is from 496 firms over an eight-year period from 1974 to 1982 and the variables they looked at are profitability, growth, size, collateral value, non-debt tax shields, volatility, uniqueness, and industry.

Their findings are consistent with the pecking-order theory that firms prefer internal to external financing and gives some supporting evidence that speaks for the explanatory power of the theory. However, the evidence could also be suggesting that the evidence is indicating that borrowing is increased to such extent that then leads to higher profit and thus increases the book value of equity, due to accumulated retained earnings from the added debt (Titman and Wessels, 1988). This would then mean that firms do use target debt-to equity ratios and thus would be speaking for a more debt-oriented theory like the trade of theory. Titman and Wessels (1988) concludes that their results are not conclusive, however, their study made an important empirical documentation that could be used and built upon in future papers.

A paper of Ormos et al. (2012) analyses the capital structure and the choice of financing in a random sample of firms from central and eastern European countries. The methodology used is a combination of a qualitative and a quantitative approach. Their findings suggest a pecking order driven behavior in the firms. First the authors applied a panel regression to find suggestions that strengthens either the static trade-off theory or the pecking-order theory. Then they extended the analysis with a questionnaire to find explicit and latent inclinations towards a preferred financing policy. Considerations regarding a targeted leverage ratio did not play a large role in the decisions of the firms. The largest factor that is affecting a firms debt ratio

according to the study is the amount of cash flow generated by the financed asset. While the corporate tax level, other tax-shields and the potential cost of liquidation only played a moderate role in the financing decisions.

Rajan and Zingales (1995) study determinants of capital structure by looking at financial decisions of firms in major industrialized countries during the period 1987-1990. Their study is based on financial data from more than 3 000 companies from the G7 countries (USA, Japan, Germany, France, Italy, Great Britain, and Canada). They find that firms are similarly leveraged across the G7 countries, with only the United Kingdom and Germany being less leveraged. Furthermore, they find that larger firms correlate with increased leverage in all countries except in Germany. They suggest that this is due to larger firms being better diversified than smaller firms and that lower expected bankruptcy costs enable them to increase debt. However, earlier research (White, 1993; Kaiser, 1994) argues that the bankruptcy cost in Germany is higher than other countries. The expected correlation between size and leverage in Germany should be more positive than in the other countries, instead they observe a negative correlation. They conclude that the theoretical underpinning of the correlation is still not fully understood and that more research is called for.

Fama and French (2002) test the pecking-order theory and the trade-off theory predictions by analyzing financial data for a total over 3 000 companies during the period 1965-1999. They use an average slope from year-by-year cross-selection regression that they call the Fama and MacBeth approach, used in an earlier paper by Fama and MacBeth (1973). Their findings are that although the two theories are motivated by different forces, they share many predictions regarding dividend and leverage. The one thing that speaks against the trade-off theory is that they find a negative correlation between increased earnings and leverage in a firm, an important failure according to the authors. However, one deep wound for the pecking-order theory is the large equity issues of small low leveraged growth firms. They sum up by saying that when their shared predictions are confirmed they cannot tell if it is due to trade-off forces, pecking-order forces, or forces overlooked by both models.

Michaelas et al. (1999) utilized financial panel data of a large sample of small and medium sized firms in the United Kingdom to test determinants for capital structure. Their findings are that agency and asymmetric information costs influence a small firms' debt both in the short and long term. Therefore, smaller firms with lower ratios of collateralizable assets are less leveraged as they appear riskier by financial institutes. This seemed to determine debt in a firm more apparent than the influence of tax effects of debt for a small size firm. Furthermore, they found that small firms leverage have a positive correlation to economic growth and recession.

Flannery and Rangan (2006) researched determinants for capital structure with three main hypotheses from the trade-off, pecking order and market timing theories. They looked at whether firms had a targeted capital ratio. They found that when shocked away firms relatively quickly returned to their targeted leverage ratios, suggesting that firms do have a targeted capital ratio. Furthermore, they found indicators for the pecking order and market timing theories, however, their economic effects are overpowered by a firms move towards a firm-specific leverage target.

## 4. Method

Data were gathered by conducting semi-structured interviews with five different managers from different companies in the Finnish forest industry. The interviews were held with practitioner with a managerial position and with insight into the firm's capital structure and the reasonings and decisions behind it.

The interviews conducted with the practitioners followed prewritten questions for the interviews to gather equal data and for clear distinctions and similarities to be made. The questions evolved some over time as more experience of interviewing, and testing of the questions proved some question not necessary, and the list of prewritten questions got shorter. Although, this did not affect the quality of the data received from the interviews.

The interviews were planned to be held in person and the first firm interview was conducted with the CEO of Ålands Skogsindustrier Ab. That interview was held in person on the Åland Islands. The following firm that agreed to be interviewed was the CFO of Westas Group Oy and due to the pandemic at the current time the interview was decided to be held remotely over video conference software Microsoft Teams. The following process of finding suitable and willing managers proved to be difficult and the option for the managers asked to answer my interview question in writing over e-mail was added. That seemed to have made it less of a commitment for the managers to participate and the following managers agreed to participate by answering my questions over an email conversation. These firms were Neova Group, Iisveden Metsä and Kuhmo Oy. The list of questions was then sent to the manager in a word-document and the managers filled in their answers underneath the questions. The questions open-ended nature forced the managers to motivate their answers in free-flowing text and if something needed more clarifying the manager could be asked to do so in the e-mail conversation. The interviews provided insightful answers even though the conversation was held in writing.

In total this study consists of data gathered of five different firms in the Finnish forest industry. The largest firms interviewed were Neova Group and Westas Group, in these the CFO was the manager interviewed. In the other firms of a smaller size the CEO is more involved in the financial side of the business and thus was the one participating in the interview. The interviews consisted of 10-15 deep diving questions made to gather information of their reasoning regarding different sources of capital and how their capital structure is determined in their firm. The five interviewed managers were all relevant for the research and represent opinions from different firms in the Finnish forest industry.

## 4.1 Qualitative approach

To conduct a qualitative study, requires an understanding of the paradigm of the qualitative approach. The qualitative paradigm is a stem from an idealist outlook. The ontological view of the idealism is asserting that the reality of the world depends on one's interpretation of it (Guba and Lincoln, 1994). Sale et al. (2002) proposes that qualitative and quantitative research, due

to differences in ontology, does not study the same phenomena and therefore have a complementary affect. In studies researching the capital structure of a firm most of the research have had a quantitative approach, attempting to find statistical patterns from the output data of firms' annual accounts. Qualitative research could provide new insights gathered from the input data, which is the reasonings and decisions determining the capital structure from the managers point of view.

The premise of the ontology is therefore that there is no access to reality independent of our own minds as we experience the world around us (Sale et al., 2002). Qualitative methodological foundations are therefore based on the following premises. An inquirer can only provide the person's own interpretations of the issues and the investigator can attain an understanding of this reality only through the process of descriptions of properties of an entity (Smith, 1983). The meaning of human interpretations needs to be gathered within a context, according to the paradigm there is then no objective reality (Smith & Heshusius, 1986).

A qualitative approach was adopted for this study due to it providing benefits to the nature of the research inquiry, as the ontology of a qualitative research fits well for the objectives of this paper. According to Langer (1989) knowledge from experts is required to understand the research question at a deeper level, therefore interviews with managers of the industry were chosen. Semi-structured interviews are useful when trying to understand perceptions and opinions of respondents regarding complex issues as the answer to the question is complex. The interviewer can in these cases immediately clarify information if needed to or deep dive into different parts of a topic as the interview progresses (Qu & Dumay, 2011). The list of questions will be sent to the respondent beforehand, however semi-structured interviews unfold in a more conversational manner, offering the interviewer to explore more freely important issues (Johnson & Kaplan, 1987).

Thus, the aim of a qualitative research is to investigate and acquire a deeper understanding of the phenomena with the participants point of view (Bryman, 1988). This is then achieved through rich descriptions of the phenomena through interpretations, meanings, contexts, and processes (Guba & Lincoln, 1994). Method theory is an abstract or higher-level conceptual

system that is used as a theoretical lens and originating from another field or domain. This theoretical lens offers a vocabulary and propositions that can be applied in another field or domain. Method theory can offer alternative perspectives when applied and may give the researcher new insights that would not have been possible otherwise which could lead to more general conclusions (Lukka and Vinnarie, 2014; Lukka, 2005).

## 5. Empirical Research

In this chapter the semi-structured interviews and the data gathered is presented.

### 5.1 Ålands Skogsindustrier Ab

The first interview was held with the CEO Anders Mattsson of the Finnish firm Ålands Skogsindustrier Ab. The prewritten questions were asked, and further information was gathered through spontaneous discussion. Ålands Skogsindustrier Ab is a local forest industry company on the Åland islands. The firm's turnover last year was about 18 M euro and the company has about 40 employees. They operate two sawmills and a production line for making wood chips to the pulp industry where the main markets are Finland and Sweden, but they also export to Germany and Belgium.

What is specific to the firm of being a part of the forest industry the CEO answered that since they have large capital heavy investments and not only new investments for growth but also replacement investments, they must have a long-term view when planning their capital structure. The firm cannot end up in a situation where they have reached their maximum allowed debt and not have enough cash when they suddenly need to do a replacement and buy a new 300 000-euro wheel loader. They also must plan for and have enough margins for recessions in the market and drops in demand.

The CEO was asked if the capital structure plays a role in planning and decision making or if it is more a result of other business decisions. In response the CEO said that it does play a role in their planning as the company wants to use part of the operational cashflow to pay out dividends to the owners and for bigger investments they do not have the funds or the cash flow. Therefore, debt plays an important role in the firm's financing decisions and their planning regarding the capital structure in the firm. They also have covenants in their agreements with the bank and one is that their equity ratio must be over 40%. The company has its own targets on ROE of over 10%. Thus, planning their capital structure is important to honor the covenants in their bank agreements and to increase to profitability of the firm to act in the best of the owners' interests.

The CEO was then asked to explain how their financing usually looks like in an investment situation. Mattsson replied that in smaller investment situations, around 100.000-300.000 euro, they usually can finance it with cash from the company's own funds. When it comes to bigger investments, they need external financing from the banks. The CEO said that the bank loans is a good source of external capital as of the low interest rates. It is according to Mattsson cheap capital that gives a leverage on the company's equity and increases profitability. However, the bank does not agree to borrow too much debt. As of the equity ratio covenant there is a limit for how much the firm can use debt. The firm would normally never issue shares. That would only be an option only if retained earnings and debt are not possible as a last resort option or in some other extraordinary circumstances.

The CEO was asked if Ålands Skogsindustrier Ab would be able to finance all its future investments with the operational cash flow, would the need for debt then be eliminated? Mattsson replied that the need would perhaps be eliminated but he does not think they would fully refrain from debt. As they also want to pay dividends to the owners and therefore probably would keep some debt to free up cash flows for the owners.

Mattsson was then asked which source of capital the firm would most and least prefer in an investment situation. The CEO again referred to debt as a cheap source of capital that gives a leverage on the equity of the firm. Debt allows dividends to be paid from the retained earnings.



Debt is therefore their most preferred source of capital, however, retained earnings is also sometimes also their first option in smaller investments. According to Mattsson retained earnings is an easy solution to utilize if the firm has the cash and thus is preferred in some cases over debt, as debt involve bureaucracy, negotiations with the bank, and takes time. The least preferred source of capital is issue of shares. If the company has a strong cash flow, it is not really motivated to ask of money from the owners. Ålands Skogsindustrier Ab has about 1300 owners which would involve a lot of work. Issue of shares would perhaps be an option for example in a big investment like acquisition of another company, however, not in normal operation.

The CEO was then asked if a firm financed solely by debt or solely by equity would be ideal. Regarding financing solely by debt, the CEO said it could work but would not be accepted by our bank. Financing solely by debt also means higher interest costs and higher risk in a recession. Regarding financing solely by equity, the CEO replied that it would not be ideal. Retained earnings would be used for investments and the possibility to pay dividends would be smaller.

The most ideal capital structure for Ålands Skogsindustrier Ab is according to Mattsson to have equity enough to meet the targeted equity ratio of over 40%, as is required of the bank, and then the rest would be debt as to take advantage of the leveraging benefits of debt.

Last questions were asked to find how the CEO's performance is evaluated. Mattsson replied that he is evaluated according to increases in earnings and also has an target for ROE of 10%. Mattsson also said that avoid using debt, if possible, could be one way of improving the results and thus increase earnings.

## 5.2 Westas Group Oy

Westas Group Oy is a family owed sawmill operating in Finland. One of the biggest owners is the CEO of the company. The firm is export driven where 85% of the sales are exported and

the rest of the products are sold in Finland. The main export region is Europe; however North Africa and Japan are also important export regions for the firm. Westas Group's turnover were 120 M euro in 2020 and is currently operating with two large sawmills in Turku and in Porvoo. The company is one of the bigger sawmills in Finland. The interview was held with the CFO Joonas Ilmolahti.

Ilmolahti explains how being a firm in the sawmill industry is affecting their capital structure. He explains that large capital investments are typical for the industry. Whenever the company needs to make a new investment, it is often an expensive one. Therefore, investments in new machines and larger equipment are often nothing the company can finance solely by its own cash flow. A mix between equity and debt is thus common in the industry and financing is playing a key role in the forest industry as these large investments needs much capital. Ilmolahti says that banks are often assessing sawmills with a high risk due to the market volatility that is associated with them. Therefore, it is not easy to get loans and for the firm getting bank loans is a through a drawn-out process and with many discussions with the banks. According to Ilmolahti being in the forest industry makes the capital structure often quite balanced consequently to the banks holding back the borrowing of the companies.

As there are many different theories with different views regarding how the capital structure is determined in a firm the following question was asked to understand how their capital structure is determined in practice in their firm. Ilmolahti responded that their capital structure is not a result to a strict plan, and it is not a part of their planning and decision making. Their capital structure is mostly a reflection of how much debt banks are willing to give them. In larger investments debt is needed to finance the investment, however in smaller investments and for maintenance the firm can finance it by its own generated cash flow and in such instances internal financing is used to save the debt for larger investments. That is how their investments typically are financed. As the company is a family-owned company shareholder loans are also an option in bigger investments. That could also be a demand often used by banks that the firm needs to finance some of the investment by own funds to get loans and then shareholder loans is often utilized.

Ilmolahti says that the company's most preferred source of capital is retained earnings. As it is easy to use and has no direct costs for the company. It is a low-risk source of capital for the company as it cannot put a company in to bankruptcy. The second preferred source of capital for the firm is debt, due to the low interest rates it is a cheaper source of capital. Ilmolahti says that their debt-to-equity ratio affects the interest rate offered from the bank. The least preferred source of capital is issuing equity, as they are not a listed company and that means that the owners need to put in more money into the company and that is not something that the owners want to do, unless in an extraordinary situation that would demand it.

The biggest benefit of using debt in a company is according to Ilmolahti is that if the company would not use debt as much not as many investments could be made. The company is allowed to be more competitive by debt financing and to be able to grow faster with debt as an added capital injection. An optimal capital structure to Westas Group Oy is according to Ilmolahti a sixty percent equity to debt distribution, as that is good risk management. More debt would be increasing risk in the company and the banks would not be as willing to give more loans. Ilmolahti says that it is again common in the industry to have good risk management.

The company has no requirements on how the capital should be distributed by the owner. However, the bank covenants require the firm to have strong equity. Westas Group's capital structure as of the time of the interview is good balanced, 75 percent debt to equity ratio however 55 percent of the debt is shareholders loans.

Ilmolahti's performance is evaluated more on earnings, however ROE is also of interest of the owners. But he would not say that that would be an incentive to avoid using debt, as in the long run the ability to invest more capital will increase revenues more than the added cost of interest rates.

### 5.3 IIsveden Metsä Oy

Ilsveden Metsä Oy is a medium-sized sawmill with 50 employees, established by local people in 1924 and is still running strong according to Tommy Lindström Managing director at Ilsveden Metsä Oy. The company has many shareholders, roughly 400, where nobody has the majority. So, the ethos of the company has been to keep the profit in the company and be very conservative with the dividends. This has surely helped the firm to survive in the volatile industry says Lindström. Which is why Ilsveden is pretty much the oldest sawmill company still in original ownership in Finland.

The company's strategy has been since early 1990's to constantly invest in production technology, but to avoid the biggest risks. Instead, the company is focusing on replacing old equipment and machinery to keep up with competition.

The company's turnover 2020 was about 35 M euro, with little profit. 2021, according to Lindström, will be a record year with high production of 140.000 m<sup>3</sup> ready products, which is an increase of 25% compared to the year before. Turnover will be roughly 58-59 M euro. Share of exports will increase by 80%, where the company's main export markets are Italy, Japan, France, and China. However, Ilsveden exports to a total of 25 different countries. Customer strategy focused on small industrial end users that are looking for custom-made products. This means small production batches and less efficient production; however, the trade-off is less volatility in the market cycles. The company's customer relations are long-lasting, says Lindström.

When we discussed their decisions behind capital structure, he responded that they do not actively plan their capital structure. He said that they have been among the financially more solid mills and have not taken overly big risks in the investments. However, that it is also due to the cautious nature of their banks. Lindström said that "our industry is notorious for low margins and volatility, so the banks are not willing to take too big risks either. So, we need to keep our own equity high to look convincing enough in the eyes of the banks."

Ilsveden's financing in an investment situation has traditionally been a combination of 20-25% own capital from revenue from operations which is a combination of retained earnings and a loan from Nordea Bank and Finnvera. When it comes to smaller machinery like forklifts etc. the company has used leasing agreements through Danske. In the last 5 years the company's two bigger investments, with loans of 2.2 M euro and 3.5 M euro, Finnvera and EIB (European Investment Bank) have given guarantees to Nordea to the extent the loan of 50-80% of the bank loan sum and Nordea has been the sole source of outside money.

Lindström was asked if the company could finance all its future investments with their retained would the use of debt be eliminated. He responded that that would be true, however, the forest industry is very capital intensive, and he sees no benefit with current interest rates to tie all their own money into their investments.

The benefits debt has to a company is, according to Lindström, that it enables their firm to develop their production technology faster. Waiting to accumulate own capital would have been way too slow and we they would have fallen behind of the competition regarding the technological development. And without investments the cost-efficiency would have deteriorated compared to other actors, meaning profits would have dwindled, eventually leading to bankruptcy. This has been the fallacy of many other companies in their industry, Lindström says. Another need for financing arises from the cyclical need for operating capital. This need is the greatest during Winter and Spring, with big reserves of raw material lying around. Then in Summer and Autumn the need for capital is much lower. By getting outside the short-term financing, it is much more flexible to handle these variations and we do not need to have any large own buffers.

The most preferred source of capital to the company is the retained earnings as it is the least risky alternative. Second is using debt, hence it is cheap according to the historically low interest rates and is valuable to the company as it has good availability to be used when investments arise. Lest preferred source of capital is share issues. That would not work for Ilsveden due to the diluted ownership. The owners do not take an active part in the involvement

of the company and as the dividends are low and the liquidity of the stock is low, there are no real incentive for the owners to put more money in the company.

The CEO was asked if more equity to debt or debt to equity is preferred. He said that their equity used to be above 60% to the debt before a bigger investment program that they started five years ago. Consequently, their equity ratio has dropped, however, after this year they should be back to the earlier ratio of above 60% again. That is preferable for the company, as it give a financially solid ground for the company and enables them to stay attractive to banks to secure future loans. A fifty-fifty ratio of equity and debt ought to allow flexibility for all scenarios to the company, says the CEO.

Lindström has no requirements on how the capital structure should be distributed, however, the goal for the company is to priorities and secure the long-term survivability of the company. The CEO and the other directors do not receive any bonuses based on ROE or increased earnings.

## 5.4 Neova Group

Neova Oy is a Finnish firm in the forest industry. The company was founded in 1940 and is now operating in different international markets. Neova Oy is one of many subsidiaries to the concern Neova Group. Neova Group is conducting business in the Nordic countries, in the Baltics, in Spain, Germany, the Netherlands, and in Australia, China and the USA. The concern is large with personnel of 950 people and has a turnover of 470 M euro. The largest owner is the state of Finland with has an ownership of 50,1% and the second owner is Suomen Energiavarat Oy with 49,9%.

Neova Group is divided into three different business operations; Energy, Grow&Care and New businesses. The Energy operation is producing fuels like wood, peat and pellets used as bioenergy in energy plants. This division is generating the second largest income for the concern with net sales of 246 M euro. The biggest income generating division is the

Grow&Care business operations. Neova Group is the leading producer in Europe of growing media for a professional segment as well as offering products for home gardeners and landscaping. This sector makes up 300 M euro of the concerns total net sales. The last division is the New Businesses and is using in-house development to create new products and innovations. The in-house development is based on refining peat and other natural materials into air and water purification systems, the subsidiary Novactor is a forerunner in the growing activated carbon market. This division is generating net sales of 50 M euro.

Regarding the process of how the capital structure is emerging the Director of Group Finance of the concern Erik Nieminen says that it is the company's Board of directors determines the company's capital structure and the firm's targets. However, the board is also considering the wills and views of the owners. Neova's goal is to keep the Group's equity ratios at a level that supports the Group's strategic goals. The key figures that they are monitoring are self-sufficiency, netdebt and EBITDA.

In a typical financing situation investment must be planned in such a way that the Neova Group does not become too indebted in a way that the set equity ratio and net debt targets are being jeopardized.

If the firm could finance all its future investments with its operational cash flow the company said that no loans would be needed if the liquidity position is stable. That is of course not the reality and therefore there are needs for some debt, says the CFO.

Asked on what benefits debt has to a company the CFO said that it is first to secure the working capital of the business, working as a liquidity buffer and second by being active in the capital markets is maintaining capacity for potential future financing needs, as having a good relationship with the bank is important. Furthermore, companies generally have a debt-to-equity ratio within defined limits to obtain a relatively better return on equity than if the company were debt-free.

The most preferred source of capital for the company is retained earnings. Retained earnings belongs primarily to the existing shareholders. The second most preferred source of capital is debt, that belongs to the debtors and the least preferred source of capital is a new issue of share, as that could dilute the earnings per shareholder.

When asked if more equity to debt or more debt to equity is preferred the CFO said that it depends upon the situation the company is in. If the company is in a stable situation with stable cash flow, the amount of debt may preferably be higher. However, if a company has a strong growth phase in which money is committed to investments, then equity is emphasized. We prefer the latter in current business transformation period, as it is a higher equity to debt is a more stable structure.

The Group has some requirements from the owners that affects the capital structure. The main principle is that 50% of the earnings is distributed to the owners, however, it varies from time to time. The Group's capital structure consists now of 55,2% equity to debt. The CFO is not evaluated on performance in any way.

## 5.5 Kuhmo Oy

Kuhmo Oy is a privately owned sawmill operating in Kuhmo Finland and their products are sold worldwide. The company has a concentrated ownership where the owners are involved in the management of the company. The interview was held with the CEO Tommi Ruha.

The firm has targets for their capital structure according to Tommi Ruha. The CEO said they must have adequate solidity to endure the conjunctions which are evident in the sawmilling business and to have strong enough fund to be able to invest. Their main financing is by cash flow, commercial banks and Finnvera, a Finnish state-owned financing company and they invest on average the value of their annual depreciation.



Ruha says that their financing is usually quite easy as their main commercial bank has been willing to provide financing for their standard annual investments in combination with their own cash flow. When it comes to their larger investments it has been financed by a package created with two commercial banks, Finnvera and European union regional fund subsidies.

The CEO say that they possibly would decrease their use of debt if their firm's operational cash flow increased, as due to tax regulations it is limited how much they feasibly could pay out it as more dividends to the shareholders and that would make it difficult to lean the assets. Although it is not so relevant says the CEO as the market is not necessarily so good in the future. Furthermore, Debt has benefits to their firm says the CEO. Debt has been required to finance their investments as solely with retained earnings would not been possible. Debt could sometime be used as running capital if the need for a capital injection would be needed and it improves the earnings for own capital says the CEO. However, since they are a private company, if the cash flow is good enough, they do not need much of an extra leverage in the same way it would be more crucial for a listed company.

The most preferred source of capital for Kuhmo Oy is according to Ruha Bank and Finnvera loans, as it is an easy and straight forward product which does not need a lot of bureaucracy. It has also been a cheap form of capital for the past years. Their second most preferred source of capital is shareholder loans if they need more capital for a larger investment. The least preferred source of capital is external capital loans or emissions to new shareholders. These lead or may lead to changes in the ownership and is not desired.

Ruha says that they prefer more equity to debt, when asked about it. He says that solidity between 40-55% are good. If lower than that risks in low conjunction are high and if higher the excess capital should be dividends to the owners. Kuhmo Oy's capital structure is currently very strong according to Ruha, however, they are in the middle of an 50 M euro investment and their capital structure will be more normal after that.

Tommi Ruha's performance is evaluated on increases in earnings. That, however, does not lead to decreases in debt, as the loan costs are insignificant when compared to variations in the profitability.

## 5.6 Summary of the interviews

The most optimal capital structure position in the Finnish forest industry seems to be to have a balance between the equity and the debt in the firm, according to the interviewed managers. That balanced capital ratio provides the firm with the potential for a quick loan, if the need for an investment arises, and at the same time debt is being utilized in the firm to increase productivity and to remain competitive. Furthermore, giving sufficient leverage on equity to increase profitability. The strong equity position in the firm provides stability and protects the firm in economic recessions.

The CEO of Ålands Skogsindustrier Ab said that as concerns their use of capital, debt is their most preferred source of capital in larger investment situations where retained earnings cannot solely be used, and in smaller investment situations retained earnings would be their most preferred source of capital. This reasoning is shared by the other managers as well. Their most preferred source of capital depends on the situation, where retained earnings are used in smaller investment situations and a mix of debt and retained earnings is used in larger investment situations. Share issues would only be used in an extraordinary situation and for some firms that would be very difficult or not possible due to too diluted ownership.

The reasoning behind why the managers would first use retained earnings is that it is an easy-to-use and risk-free source of capital that is already available in the firm. A second reason behind using retained earnings in smaller investment situations is according to the managers to save debt for more crucial and larger investment situations in the future, (e.g., Ilmolahti says that in smaller investment situations retained earnings are used to save the ability to use debt in a larger investment situation where debt is more crucial). However, the most important reason that they would use retained earnings over debt in some instances is that retained earnings have no risks associated with them and thus provides a stabilizing effect for the firm.

Ilmolahti says that a stronger equity position also gives a better interest rate for the firm when negotiating a loan. Mattsson says that retained earnings also could be preferred in some cases over debt, as debt involve bureaucracy, negotiations with the bank, and takes time.

When the managers were asked whether their use of debt would be eliminated if their profitability and operational cash flow increased. The managers agreed that that would eliminate their need for debt completely or at least decrease their use of debt.

Most of the managers, when having to choose, said that their preferred source of capital is retained earnings. However, they also agreed that debt is crucial for their firms in many ways. Debt is an inexpensive form of capital that thus leverages equity and increases the profitability of the firm. Nieminen said that they even have explicitly targeted leverage to have a sufficient return on equity. Debt also provides the ability for the firm to invest at a faster pace than accumulating funds internally. Ilmolahti said that debt provides the firm with extra capital injections that can be used to speed up the development process of investing in new machinery and equipment. Lindström said that debt quickens their investments in new machinery and equipment and helps their firms to increase their cost-efficiency and remain competitive in the market. Instead of accumulating the funds to invest, they can use debt and receive the funding directly. This is crucial as a more cost-efficient production means being able to undercut competitive prices or match them, without losing profits.

The firm's capital structure is also dictated by covenant agreements with banks. Ålands Skogsindustrier Ab has an equity ratio of a minimum of 40% in their covenant agreement. This does affect the capital structure directly by preventing firms from becoming too indebted. Other managers also said that they need to honor covenant agreements with the bank.

Most managers had some evaluation of their performance either by increases in earnings or return on equity or both; some also had pressure to keep paying out the same or a specific portion of the earnings as dividends to their owners.

## 6. Results and discussion

In this chapter, the results from the empirical work on how managers are determining their capital structure will be presented. The managerial reasoning will then be used in the analysis to determine whether the reasonings of the practitioners are in line with an existing theory on the capital structure or not. The different interviews held with practitioners from the Finnish forest industry suggest that their views on capital structure show some consistency throughout the different interviews. The results suggest that the capital structure in the firms is not only a product of the managers' reasonings. Forces such as the banks, the marketplace, and the owners are important forces moreover influencing the capital structure in a firm. Furthermore, the findings are suggesting that the managers are more in line with a pecking-order-oriented view than a trade-off-oriented view in their reasonings.

### 6.1 Modigliani & Miller Theorem and The Trade-Off Theory

Modigliani and Miller's theorem (1962), according to the real-world practice, is not possible as according to the managers no bank would ever issue debt to a firm with no equity and the managers was not in favor of a firm solely financed by debt, as that would be too instable in recessions.

The trade-off theory's predictions seem to be in line with the reasonings of the managers to an extent, although at times in direct conflict. The managers see the benefit of using debt in their firm as the leverage increases the return on equity, another benefit they said is that debt gives them the ability to invest at a faster pace instead of accumulating the funds internally first. Debt thus provides a capital injection on demand that could be used exactly when needed. The managers are at the same time aware of the risks of being over-leveraged and they are making a tradeoff between the added benefit and the added cost of increasing debt in their firm, which the theory is predicting.

The trade-off model is lacking in acknowledging the fact that the banks are not willing to lend more money to a firm that is too indebted, thus there is no true tradeoff for firms in the real world as there is no freedom for firms to truly express different risk preferences with a more debt-maximizing strategy. Although the interviewed firms all seemed to be satisfied with leverage within what is accepted by the Finnish banks, this still leaves a critique towards the model for not considering the financial institutes as also affecting leverage in a firm.

The most important finding speaking against the trade-off theory is the fact that the managers said that increased profitability would lead to the firm using less debt. This is a direct contradiction to what the trade-off theory would predict. Although what speaks in the favor of the theory is the comment by Ruha that it would be due to the Finnish tax regulations preventing them from paying out all increased profits and thus forcing them to decrease their lending instead.

## 6.2 The Pecking-Order Theory

The data gathered from the practitioners suggest that the pecking order theory's predictions are in line with the manager's reasonings, like the trade-off theory, to an extent. Although the pecking-order theory's predictions seem to be slightly less in direct conflict with the managers' reasoning than the trade-off theory.

When the managers had to choose, they said that retained earnings were their most preferred source of capital, and in a situation when they choose debt as their most preferred source of capital when retained earnings were not solely sufficient to use. In practice, the managers are utilizing retained earnings in small investment situations when that is sufficient and a mix of debt and retained earnings when more funding is needed. The managers all agreed that the share issue is never a preferable alternative over retained earnings or debt. Thus, the managers are following the pecking order of capital as they put retained earnings first and share issues last. This speaks directly to what the pecking-order theory would have predicted.

The fact that the managers saw leverage on equity as an important benefit of debt in their firm is one conflict between the pecking-order theory and the managers, as the theory is not predicting that firms see leverage as undesirable. The theory is also falling short when the managers said they would not want to utilize all their retained earnings towards an investment (e.g., Lindström says that they do not want to tie all their own money into investments as debt could be utilized to save retained earnings for other applications instead). Mattsson also said that debt could be used to free up retained earnings for more dividends to the owners. The same goes with Neova Group which has direct requirements from their shareholders to distribute 50% of earnings to the owners.

Furthermore, one comment that is in favor of the theory is when Mattsson said that one benefit of retained earnings is avoiding having to negotiate with the banks. That is the adverse selection problem that Myers (1984) presented, as external parties do not have access to the same information as the internal parties do.

### 6.3 The Agency Theory

The agency theory could also help explain why the managers choose not to utilize all retained earnings first before the debt was used in the firm, as that is what the pecking-order theory would have predicted and be convenient for the managers to first use the already existing capital in the firm. The agency relationship is between the managers and the owners, as the managers are appointed to serve to best of the owners' interests. This creates an agency problem of the use of capital, as leveraging the firm increases the return on equity and frees up retained earnings for dividends instead and thus is in the best of the owner's interest, however, not directly in the best of the manager's interest. The managers would perhaps if free to rule not think as much about the return on equity and to free up retained earnings for dividends, but instead reinvest more of the retained earnings in the firm.

Neova group has direct leverage targets that manager needs to follow and Nieminen says that companies generally have a debt-to-equity ratio within defined limits to obtain a relatively better return on equity than if the firm were debt-free. This defined leverage is decided by the

board and is thus directly set by the owners for the managers to follow. Another way of incentivizing goal congruence between the managers and owners is with bonuses (e.g., Mattsson had a direct ROE-target tied to his bonus). A direct outcome-oriented contract incentivizes the manager to act in the owners' interests and is thus affecting the capital structure, incentivizing a more leveraged firm. This suggests that in the instances where the managers are proving more of a trade-off-oriented behavior, the agency theory can be applied to help explain the reasons why that is.

## 7. Conclusion

The purpose of this paper is to analyze how firms decide upon their capital structure in the real world by taking the perspective of the practitioners in the Finnish forest industry and by doing so, see whether the reasonings of the managers are in line with the trade-off theory, the pecking-order theory, or other theories or forces.

To conclude this study, the findings suggest that the managers in the Finnish forest industry have a more pecking-order-oriented view than a trade-off oriented when it comes to determining their capital structure. In some instances, the managers also conduct a more trade-off-oriented view in their reasoning. However, the findings suggest that it is due to the agency problems of capital and could be explained by the help of the agency theory, as the managers have direct or indirect pressures from the owners to increase leverage in the firm in these instances to increase the return on equity.

The major finding against the trade-off theory and at the same time a win for the pecking-order theory comes from the fact that the managers said that increases in profitability would lead to a decreased need for debt, thus speaking for a major proposition of the pecking-order theory. A minor finding against to the pecking-order theory comes from the fact that the managers are using debt for leverage and not just as extra capital when retained earnings are insufficient. Leveraging equity is speaking for the trade-off theory and against the propositions of the

pecking-order theory. However, the agency theory could be applied to explain the manager's trade-off-oriented behavior and reasoning in these instances.

These conclusions assumes that the purpose of the theories, I have discussed and investigated, is to describe how companies choose their capital structure in the real world. Another premise is, of course, to say that the purpose of the theories is to describe what capital structure companies should strive for. However, this would be an unfair starting point as one of my most important findings is that the management in a firm does not in all situations have the freedom required to follow certain theories, which must be cited as a serious criticism of the applicability - and thus relevance - of these theories in practice.

The fact that a qualitative approach proved to not face the same correlational problems that much of the quantitative research has faced suggest that more testing of the managerial perspective of capital structure could help the subject to become more decisive, on the determinants of capital structure in a firm.

## 8. Summary in Swedish – Svensk sammanfattning

### 8.1 Introduktion

Kapitalstrukturen är en viktig del av ett företag och har fått mycket uppmärksamhet sedan Modigliani och Miller publicerade sin berömda forskningsartikel 1958 där de presenterade sitt första förslag; "No Magic in Leverage" (Modigliani och Miller, 1958), som säger att kapitalstrukturen inte påverkar ett företags marknadsvärde. Från detta banbrytande teorem, bestående av senare tre andra propositioner och totalt tre forskningsartiklar (Modigliani och Miller, 1958, 1961, 1963), började diskussionen kring kapitalstruktur, och många teorier utvecklades som ett resultat. Idag finns det många teorier kring kapitalstruktur som framför olika uppfattningar och förslag om hur kapitalstrukturen bestäms i ett företag. Forskningen i



ämnet är således fortfarande långt ifrån att vara överrens om vilka krafter som står bakom hur kapitalstrukturen bestäms i ett företag.

## 8.2 Bakgrund

Finlands skogsindustri är en viktig näring för den finska ekonomin. Träförädling är en viktig industrisektor sedan 1800-talet då produktionen av förädlade träprodukter i Finland började. År 2019 var bruttovärdet av den finska skogsindustrins produktion 31,6 miljarder euro. Det motsvarar ungefär en femtedel av det totala producerade värdet av alla finska industrier tillsammans. I utrikeshandeln står skogsindustrin för en femtedel av allt exporterat värde och fem procent av Finlands BNP. Finland har med tiden samlat på sig kompetens och kunskap kring skogsbruk och skogsindustri och är idag bland de världsledande inom sektorn. Trä är en viktig och mångsidig råvara som används i allt från tyger, mediciner och kemikalier till förpackningar och biobränslen. Traditionellt sett var sågverksprodukter den viktigaste exporterade träprodukten i Finland. Idag är de viktigaste exportprodukterna från skogsindustrin i Finland pappersmassa, papper, kartong, förpackningsmaterial och sågat virke (Finlands jord- och skogsbruksministerium, 2021).

Denna för Finland viktiga industri lämpar sig särskilt bra för denna undersökning om kapitalstruktur, eftersom skogsindustrin är en industri i behov av stora mängder kapital. Ledningen är därför van vid att behöva tänka på finansiering och olika typer av kapital i olika typer av investeringssituationer och skulle kunna bidra till denna studie med värdefulla insikter om hur de resonerar kring sin kapitalstruktur.

## 8.3 Problemdiskussion

De teorier om kapitalstruktur som är viktiga idag ger helt olika förslag på hur ett företag beslutar om sin kapitalstruktur. Det finns en viktig teori, avvägningsteori, som tyder på att ett företag kommer att maximera skulden tills dess risktolerans är uppfylld, eftersom den ökade hävstångseffekten kommer att öka avkastningen på eget kapital (Kraus och Litzenberger,

1973). En annan viktig teori i kapitalstrukturlitteraturen, hackordningsteorin, föreslår att ett företag istället kommer att använda sina balanserade vinstmedel först, innan de använder externt kapital. Detta beror på kostnaderna för informationsasymmetrin mellan interna och externa parter, vilket enligt teorin gör balanserade vinstmedel till det billigaste kapitalet för ett företag att använda (Myers och Majluf, 1984).

Dessa teorier är motiverade av mycket olika krafter och antyder nästan motsatta åsikter om hur kapitalstrukturen i ett företag bestäms. Denna obeslutsamhet i litteraturen om kapitalstruktur tyder på att vi fortfarande inte kan avgöra vilka krafter som ligger bakom kapitalstrukturen i ett företag. Tidigare forskning inom ämnet har föreslagit att denna obeslutsamhet kommer från de korrelationsproblem som forskningen har ställts inför, det vill säga att korrelationen mellan kapitalstrukturen hos ett företag och en distinkt teori är svår att dra, vilket Fama och French drog som slutsats i sin forskning (2002).

Det mesta av denna tidigare forskning om ämnet (Fama et al., 2002; Titman et al., 1988; Rajan et al. 1995; Michaelas et al., 1999; Flannery et al., 2006) har haft ett kvantitativt tillvägagångssätt gällande sin forskningsmetod, t.ex. att använda olika regressionsanalyser av ett stora urval av paneldata av företagets finansiella data, för att testa om de kan hitta resultat som talar för någondera teori. Denna obalans mellan kvantitativ och kvalitativ forskning tyder på att det saknas forskning med ett mer kvalitativt förhållningssätt, eftersom dessa olika förhållningssätt fångar upp olika slags insikter och har en kompletterande effekt på varandra (Sale et al., 2002). För att testa om en teori är i linje med företagets praxis i den verkliga världen har kvalitativ forskning en fördel eftersom den samlar in tankar och resonemang direkt från ledningen bakom kapitalstrukturen och inte bara tittar på outputeffekterna av dessa beslut som ledningen gjort i form av finansiella data. Därmed skulle forskning med ett kvalitativt förhållningssätt bättre kunna undvika de korrelationsproblem som tidigare forskning har ställts inför.

Hopwood (1979) berörde detta när han hävdade att legitimiteten och relevansen av forskningen som ägnas åt att förstå och beskriva redovisningssystem ininom företag skulle kunna dra stor

nytta av att försöka förstå verkligheten som den upplevs av ledningen inom området. Denna typ av förståelse är inte möjlig att generera med hjälp av enbart kvantitativ forskning (Ibid.).

## 8.4 Syfte

Syftet med denna artikel är att undersöka hur ett företag beslutar om sin kapitalstruktur i den verkliga världen med hjälp av perspektivet hos ledningen i företag inom den finska skogsindustrin. Genom att svara på hur företagen resonerar kring och beslutar om sin kapitalstruktur kommer insikterna sedan att användas för att se om ledningens resonemang är i linje med avvägningsteorin, hackordningsteorin eller helt andra krafter.

Vidare kommer denna forskningsartikel bidra till att utöka forskningspoolen av kvalitativa studier i ämnet genom insikter från ledningens åsikter och resonemang bakom sin allokering av kapital i sina företag för att bidra till att skapa en mer balanserad syn inom ämnet.

## 8.5 Teori

### 8.5.1 Modigliani-och-Miller-theoremet och avvägningsteorin

Enligt Modigliani-Millers teorem spelar fördelningen av det totala kapitalet mellan skuld och eget kapital ingen roll, eftersom marknadsvärdet av företaget och dess vägda genomsnittliga kapitalkostnaden för alla kombinationer av kapital kommer att vara densamma. Beräkningen av den totala kapitalkostnaden där de olika kostnaderna av kapital vägs proportionellt (Miller et al., 1958). Det mera riskfyllda eget kapitalet i ett företag med hög skuldsättning driver upp kapitalkostnaden för eget kapital, eftersom avkastning är positivt korrelerad med risk. Kostnaden för eget kapital är därför inte konstant i Modigliani-miller-modellen, den rör sig i förhållande till risken, eftersom investerare kommer att kräva högre avkastning när eget kapital i allt högre grad utnyttjas i ett företag.

Dessa förslag tar dock inte hänsyn till skatter, vilket är en stor kritik mot MM-teoremet, eftersom det inte skapar ett realistiskt scenario för att deras modell ska fungera i den verkliga världen. Modigliani och Miller tog dock upp detta i sin artikel från 1963 och vidareutvecklade sitt theorem och kom fram till helt andra resultat, när skatter räknades med i deras modell. Med skatter visade deras modell att värdet istället ökar och vägda kapitalkostnaden minskar i takt med att mer skuld tillkommer. Detta är ett resultat av att företaget betalar mindre i skatt, då räntekostnaderna för skulden är avdragsgilla och därför minskar den skattepliktiga inkomsten för företaget, vilket fungerar som en skattesköld och ökar avkastningen på det egna kapitalet.

I den verkliga världen finansieras företag vanligtvis inte enbart med skuld, även om det skulle vara den mest optimala användningen av ränteskölden enligt Modigliani och Miller (1962). Avvägningsteorin är en vidareutveckling från Modigliani-Miller-teoremet och introducerades först av Kraus och Litzenberger 1973. Huvudkonceptet som skiljer sig från MM-teoremet är att avvägningsteorin beaktar även skuldens nackdel och inte bara fördelar. Sådana nackdelar med skuld är de konkurskostnader och risker för finansiell nöd som stiger med skuldsättningsgraden i ett företag (Ghosh et al., 2017).

Därför bestäms ett företags optimala skuldbelopp, enligt avvägningsteorin, genom att balansera dessa kostnader mot fördelarna med att låna. Det är en statisk avvägning av värdet av de avdragsgilla räntekostnaderna och de olika kostnaderna för konkurs och ekonomisk nöd.

Risken för konkurs ökar i takt med att företaget tar på sig mer skulder, därför finns det en minskande marginell nytta av skulder i ett företag. Det finns också en direkt kostnad för ett företag att gå i konkurs som också beaktas i modellen. Kostnaden för skulden i modellen består därför av två delar, den första den marginellt ökande sannolikheten för konkurs och den andra är den direkta kostnaden för konkurs, som t.ex. inkluderar juridiska kostnader och likvidationskostnader för företaget i en konkursprocess. Den mest föredragna kapitalstrukturen enligt teorin är därför då den marginala kostnaden är den samma som den marginala nyttan med en till enhet av skuld i ett företag.

### 8.5.2 Hackordningsteorin

Hackordningsteorin är en viktig teori inom kapitalstrukturämnet och modifierades av Myers och Majluf 1984, som implementerade ett element av informationsasymmetri i teorin, vilket gjorde teorin mer lämpad för modern finasteori (Myers, 1984). Myers (1984) och Myers och Majluf (1984) menar att företag föredrar intern finansiering snarare än extern, då extern finansiering skapar en situation av informationsasymmetri som ökar kostnaderna för extern finansiering. Detta eftersom ledningen inte vill använda extern finansiering, då ledningen innehar gynnsam information om bolaget, eftersom marknadens pris ännu inte besitter den gynnsamma informationen. Således, när ledningen har gynnsam information, kommer marknaden alltid att värdera företagets aktier lägre än det faktiska värdet, det vill säga det värde som marknaden skulle betala om investerare hade samma information som ledningen. I situationer som dessa kunde ledningen, om de står på de befintliga aktieägarnas sida, välja att inte ge ut nya aktier även om investeringen skulle ha ett positivt nettonuvärde. T.ex. om ett företag skulle behöva 5 miljoner euro för en investering, men för att få in det beloppet skulle företaget behöva emittera aktier vars verkliga värde är 6 miljoner euro. Företaget skulle därför bara gå vidare om nettonuvärdet är minst 1 M euro, för annars skulle de befintliga aktieägarna förlora värde åt de nya investerarna, även om företagets totala värde skulle öka. Sålunda gör kostsamma aktieemissioner att företaget inte bestämmer sig för att investera i möjligheter som skulle ha ett positivt nettonuvärde vilket skapar en annan typ av kostnad för företaget istället (Myers et al., 1984). Dessa typer av kostnader skulle företaget kunna undvika om de istället använder sina balanserade vinster för att täcka dessa investeringar. Men det kan vara svårt att ackumulera balanserade vinstmedel om inte utdelningen sänks, vilket kan vara svårt då utdelningspolicy ofta är trögrörlig. I dessa fall är skuld ett företags bästa alternativ. (Myers et al., 1984)

Det finns fördelar med skuld framför aktieemissioner när ett företag söker externa medel som gör att ledningen väljer skuld framför eget kapital när ledningen har god information. Om företaget t.ex. kan ta ett säkrat lån, som därför innebär låg risk för skuldinnehavaren, så finns det inget problem med informationsasymmetrin. Eftersom det inte skulle vara någon prisskillnad om skuldinnehavarna hade samma information som förvaltarna (Myers et al., 1984). Att ta ett

säkrat lån är därför lika bra som kontanter på banken enligt Myers (1984) och företag väljer därför att använda sig av lån då balanserade vinster inte räcker till (ibid.).

### 8.5.3 Agentteorin

Agentteorin beskriver förhållandet mellan en part som utser uppgifter och beslut, kallad huvudmannen, till en annan part, kallad agenten, som förväntas utföra de delegerade uppgifterna enligt huvudmannens bästa intresse (Eisenhardt, 1989; Jensen och Meckling, 1976). Agenturteorin beskriver att agentens intressen inte alltid kommer vara i linje med huvudmannens intresse och därmed kommer att bete sig opportunistiskt när möjligheterna uppstår och således uppstår ett agentproblem. Särskilt om huvudmannens intressen skulle stå i direkt konflikt med agentens. (Mitchell och Meacham, 2011).

Enligt Eisenhardt (1989) består agenturproblemet av två huvudproblem. Det första agentproblemet uppstår när agentens mål eller önskemål står i konflikt med huvudmannens och att dessa intresseskillnader mellan parterna är svåra och dyra att mäta. Det är därför omöjligt för huvudmannen att kontrollera att agenten har uppträtt i enlighet med huvudmannens bästa. Det andra agentproblemet som uppstår är problemet med risktolerans. Agenten och huvudmannen kan ha mycket olika riskpreferenser och därför föredra olika typer av åtgärder på grund av deras skillnader i riskpreferenser. (Eisenhardt, 1989).

## 8.6 Metod

Data samlades in genom att genomföra semistrukturerade intervjuer med fem olika chefer från olika företag inom den finska skogsindustrin. Intervjuerna hölls med personer med chefsposition och insikter i företagets kapitalstruktur och de resonemang och beslut som ligger bakom.

Intervjuerna som genomfördes med cheferna följde färdigt nedskrivna frågor för att samla in likvärdig data och för att visa tydliga skillnader och likheter cheferna emellan. Frågorna utvecklades en del över tiden, då mer erfarenhet av intervjuer, och testning av frågorna visade att en del av frågorna inte var nödvändiga, och listan med förskrivna frågor blev kortare. Detta påverkade dock inte kvaliteten på datan som erhöles från intervjuerna.

Intervjuerna var planerade att hållas personligen och den första fasta intervjun genomfördes med VD för Ålands Skogsindustrier Ab. Den intervjun hölls på Åland. Följande person som intervjuades var CFO för Westas Group Oy. På grund av pandemin vid den aktuella tidpunkten beslutades att intervjun skulle hållas på distans med hjälp av mjukvaruprogrammet Microsoft Teams. Följande process för att hitta lämpliga och villiga chefer visade sig vara svår och möjligheten för cheferna som ombads att svara på min intervjufråga skriftligen via e-post lades till. Det verkade ha gjort tröskeln lägre för cheferna att delta och de resterande intervjuade chefer gick med på att delta genom att svara på mina frågor över en e-postkonversation. Dessa företag var Neova Group, Iisveden Metsä och Kuhmo Oy. Intervjufrågorna skickades till cheferna i ett word-dokument och cheferna fyllde i sina svar under frågorna. Frågornas karaktär tvingade cheferna att motivera sina svar i fritt flytande text och om något behövde förtydligas mera kunde chefen uppmanas att göra det i e-postkonversationen. Intervjuerna gav insiktsfulla svar trots att konversationen hölls skriftligt.

## 8.7 Empirisk data

Den mest optimala kapitalstrukturpositionen enligt cheferna i den finska skogsindustrin är att ha en god balans mellan eget kapital och skulder i företaget. Den balanserade kapitalstrukturen ger företaget möjligheten att bli beviljad mera lån, om ett investeringsbehov snabbt uppstår, men samtidigt utnyttjas en skuldnivå i företaget på ett effektivt sätt för att öka produktiviteten för att förbli konkurrenskraftig och för att öka rentabiliteten på eget kapital. Det starka egna kapitalet i företaget ger samtidigt en stabilitet och skyddar företaget i ekonomiska lågkonjunkturer.

Ålands Skogsindustrier Ab:s VD sa att när det gäller deras kapitalanvändning är skuld deras mest föredragna kapital i större investeringssituationer där balanserade vinstmedel inte enbart kan användas och i mindre investeringssituationer är balanserade vinstmedel den mest föredragna källan av kapital. Detta resonemang delas även av de andra cheferna. Deras mest eftertraktade kapitalkälla beror på situationen, där balanserade vinstmedel används i mindre investeringssituationer och en blandning av skuld och balanserad vinst används i större investeringssituationer. Aktieemission skulle endast användas i en extraordinär situation och för vissa företag skulle det vara mycket svårt eller inte möjligt på grund av ett alltför utspritt ägande.

Resonemanget bakom varför cheferna först skulle använda balanserade vinster är att det är en lättanvänd och riskfri kapitalkälla som redan finns tillgänglig i företaget. En annan anledning till att använda balanserad vinst i mindre investeringssituationer är enligt cheferna att spara på skuldanvändningen för större investeringssituationer i framtiden. Ilmolahti säger till exempel att i mindre investeringssituationer används balanserad vinst för att spara möjligheten att använda skuld till en större investeringssituation där skuld är mer avgörande.

Den viktigaste orsaken till att använda balanserade vinster framför skuld är för att balanserad vinst inte har några risker förknippade med sig och därmed ger en stabiliserande effekt för företaget. Ilmolahti säger att en starkare position av eget kapital också ger en bättre ränta för bolaget vid förhandling om ett lån. Mattsson säger att balanserade vinster också i vissa fall skulle kunna föredras framför skuld, eftersom skuld innebär byråkrati, förhandlingar med banken och tar tid.

När cheferna tillfrågades om deras användning av skuld helt skulle elimineras om deras lönsamhet och operativa kassaflöde ökade, var cheferna överens om att det i alla fall skulle miska deras behov av skuld i företaget.

Cheferna när de var tvungna att välja deras mest eftertraktade kapital sa de flesta att det är balanserade vinstmedel. Men cheferna var också överens om att skulder är avgörande för deras



företag på många sätt. Skuld är en billig form av kapital som på så sätt ökar räntabilitet på eget kapital. Nieminen sa att de till och med har en tydligt krav på hävstång av ägarna för att få tillräcklig avkastning på eget kapital. Skuld ger också möjligheten för företaget att investera i en snabbare takt än att ackumulera medlen internt. Ilmolahti sa att skulder ger företaget extra kapitaltillskott som kan användas för att påskynda utvecklingsprocessen för att investera i nya maskiner och utrustning. Lindström sa att skulder påskyndar deras investeringar i nya maskiner och utrustning och hjälper deras företag att öka sin kostnadseffektivitet och förbli konkurrenskraftiga på marknaden. Istället för att ackumulera balanserad vinstmedel för att investera kan de använda skulder och få finansieringen direkt.

Bolagets kapitalstruktur dikteras även av covenantavtal med banker. Ålands Skogsindustrier Ab har t.ex. en soliditet på minst 40% i sitt covenantavtal. Detta påverkar kapitalstrukturen direkt genom att förhindra att företag blir för skuldsatta. Andra chefer sa också att de måste uppfylla sådana överenskommelser med banken.

De flesta chefer har en viss utvärdering av sin prestation antingen genom att företaget ökar sina vinster, att avkastningen på eget kapital ökar eller båda. Vissa chefer hade också ett tryck av ägarna att fortsätta betala ut samma dividend som tidigare år eller en specifik procentandel av vinsten som utdelning.

## 8.8 Resultatdiskussion och slutsatser

De olika intervjuerna som hölls med chefer från den finska skogsindustrin tyder på att deras resonemang kring kapitalstrukturen visar på en viss konsensus cheferna emellan. Resultaten tyder på att kapitalstrukturen i företagen är en produkt av flera faktorer, t.ex. av bankerna, marknaden och ägarna. Vidare visar resultaten på att chefernas beteende är mera i linje med hackordningsteorin än avvägningsteorin.

Syftet med denna uppsats är att analysera hur företag beslutar om sin kapitalstruktur i den verkliga världen genom att använda sig av perspektivet och resonemangen från ledningen inom

den finska skogsindustrin. Sedan med hjälp av insikterna från det se om chefernas resonemang stämmer överens med avvägningsteorin, hackordningsteorin eller andra teorier eller krafter.

Resultaten tyder på att ledningen i den finska skogsindustrin har en mer hackordningsorienterad än en avvägningsorienterad syn när det gäller att bestämma sin kapitalstruktur. I vissa fall har cheferna också en mer avvägningsorienterad syn i sina resonemang, men resultaten tyder då på att det beror på agentproblemet hos kapital och kan förklaras med hjälp av agentteorin, eftersom cheferna har direkta eller indirekta påtryckningar från ägarna att öka hävstångseffekten i företaget och räntabiliteten på eget kapital.

Det stora bakslaget för avvägningsteorin och samtidigt en vinst för hackordningsteorin kommer från det faktum att cheferna sa att om lönsamheten skulle öka i företaget skulle det leda till ett minskat skuldbehov, vilket talar stort för hackordningsteorin. Ett litet bakslag mot hackordningsteorin kommer från det faktum att ledningen använder skulder för hävstångseffekten och inte bara som extra kapital när balanserade vinster är otillräckliga. Att utnyttja skuld för hävstångseffekt på eget kapital talar för avvägningsteorin och mot hackordningsteorin. Dock kan agentteorin användas för att förklara chefers avvägningsorienterade beteende och resonemang i dessa fall.

De ovannämnda konstaterandena förutsätter att teoriernas, som jag har diskuterat och undersökt, syfte är att beskriva hur företag väljer sin kapitalstruktur i den verkliga världen. En annan utgångspunkt är förstås att syftet med teorierna är att beskriva vilken kapitalstruktur företag borde sträva efter. Detta skulle dock vara en felaktig utgångspunkt då en av mina viktigaste upptäckter inom denna studie är att ledningen i ett företag inte i alla situationer har den frihet som krävs för att följa en viss teori, vilket måste föras fram som en stor kritik mot användningen - och då relevansen - av dessa teorier i praktiken.

Det faktum att ett kvalitativt tillvägagångssätt inte stötte på samma korrelationsproblem som mycket av den kvantitativa forskningen har ställts inför, tyder på att mer forskning om

ledningens perspektiv på kapitalstruktur skulle kunna föra ämnet närmare en större beslutsamhet över vilka determinanter som påverkar kapitalstrukturen i ett företag.

## APPENDICES

### 1. The Interviews

The following is the notes gathered from the interviews with the managers.

#### 1.1 Ålands skogsindustrier Ab

1. Could you tell me a little about Ålands skogsindustrier Ab?

We are a local forest industry company on the Åland islands. Our turnover last year was about 18 m€ and we have about 40 employees. We operate two sawmills and a production line for making wood chips to the pulp industry. Our main markets are Finland and Sweden, but we also export to Germany and Belgium.

2. How does the fact that you are a sawmill industry company impact your choice of capital structure?

Since we have large investments, not only new investments for growth but also replacements, we must have a long-term view and planning on our capital structure. We cannot end up in a situation where we have maximum debt, not enough cash and suddenly need to do a replacement and buy for example a new 300.000-euro wheel loader. We also must plan for and have enough margins for recessions in the market.

3. There are many different theories with different views regarding how the capital structure is determined in a firm. I am wondering, how does this work in practice? Does

capital structure play a role in planning and decision making or is it more a result of other business decisions?

It does play a role in our planning. The company wants to use part of the cashflow to pay dividends to the owners and for bigger investments we don't have the funds or the cash flow, we must borrow the money from the bank. We have, however, covenants in the agreement with the bank and one is the equity ratio (must be >40%). The company has its own targets on ROE (>10%).

4. How does your financing usually look in an investment situation?

Smaller investments (100.000-300.000 euro) are usually financed with cash from the company's own funds. For bigger investment's we need bank loans. The bank loans are "cheap money" and gives a leverage on ROE. However, the bank does not agree on too high loans (equity ratio is a covenant) so there is a limit. The last option would be a share issue if the two first options are not possible.

5. If your company could finance all future investments with your operational cash flow, would the need for debt be eliminated?

The need would perhaps be eliminated but I don't think we would fully refrain from bank loans. We also want to pay dividends to our owners so we would probably keep some bank loans.

6. What is your firm's most preferred source of capital (retained earnings, debt, or *share issue*?) in an investment situation? Why?

Debt is "cheap money" and gives leverage on ROE. It allows dividends to be paid from retained earnings.

7. Which is the second preferred source of capital? Why? Retained earnings (sometimes also our first option in smaller investments).

It is an easy solution if we have the cash. Bank loans involve bureaucracy, negotiations with the bank and takes time.

8. Which is the least preferred source of capital? Why?

Issue of shares. If the company has a strong cash flow, it is not really motivated to ask for money from the owners. We have about 1300 owners which would involve a lot of work. Issue

of shares would be an option for example in a very big investment like acquisition of another company.

9. Are there benefits of using debt in a company? Why or why not?

Debt is “cheap money” and gives leverage on ROE. The negative side of debt is that it weakens our result (interest costs) and it also increases risk. Too high debt can lead to financial problems in a recession in the market or if interest rates go up. Because of the equity ratio limit from the bank debt cannot grow too high. You can say that the bank makes sure that our debt and risk does not grow too high.

10. Would a firm financed solely on debt be ideal? Why or why not?

Could work but would not be accepted by our bank. Higher costs (interest costs) and higher risk in a recession.

11. Would a firm financed solely on equity be ideal? Why or why not?

No. Retained earnings would be used for investments and the possibility to pay dividends would be smaller.

12. What is an optimal capital structure in your opinion?

In our case it is equity enough to have an equity ratio  $>40\%$  (requirement from the bank), as high accounts payable and other non-interest-bearing liabilities as possible. The rest bank loans.

13. Do you have requirements on how the capital structure should be distributed?

We have covenants in the agreement with the bank and one is the equity ratio (has to be  $>40\%$ ). The company has its own targets on ROE ( $>10\%$ ).

14. How does your capital structure look like now?

About 60% equity ratio.

15. Is your performance evaluated on increases in earnings or increases in return on equity?

Both. ROE should be  $>10\%$  and the earnings as high as possible.

16. If you are evaluated on increased earnings. Would avoiding using debt if possible be one way of improving the results?

Yes, that could be one way

## 1.2 Westas Group Oy

1. Could you tell me a little about Westas Group Oy?

Westas Group OY is operating in the sawmill industry in Finland and is a family-owned company where the CEO is also an owner. The company sales are mainly export driven where 85% sales are abroad and the rest is sold in Finland. Europe is the company's main targeted market. Although North Africa and Japan are also important for the company. Company turnover was in 2021 102 M euro and 22,7 M euro in profit. The company own two sawmills, one is 50 km from Turku and the other is in Porvoo.

2. How does the fact that you are a sawmill industry company impact your choice of capital structure?

It has a large effect on the company, as it is a very capital intense industry where they continuously need much capital for their investments. The sawmill industry is typically linked with a higher risk by the banks as of the volatile market they operate in. That means it is not always easy to lend money from the banks.

3. There are many different theories with different views regarding how the capital structure is determined in a firm. I am wondering, how does this work in practice?

Does capital structure play a role in planning and decision making or is it a result of other factors?

They don't have strict plans; it is up to the banks. Basic situation cashflow is used, but typically when there is a bigger investment situation the company needs the banks in order to get a loan.

4. How does your financing usually look in an investment situation?

First, they use cash, then debt if they need more capital. They also plan the liquidity and market situation. Maintenance needs annual investments these are typically financed by operational cash flow. Bigger investments need debt. Also, shareholder loans are an option for the company to use as the owner is closely involved with the operations. In larger investments the banks demands that the company also use of their own funds either from operational cashflow or as shareholder loan.

5. If your company could finance all future investments with your operational cash flow, would the need for debt be eliminated?

The company would still need capital for working capital and for raw materials and therefore still be in need of more capital.

6. What is your firm's most preferred source of capital (retained earnings, debt, or share issues) in an investment situation? Why?

Cash flow, it is easy to use, no financing costs. Risks are low.

7. Which is the second preferred source of capital? Why?

Debt, it has lower costs than equity, low interest rates. Their debt-to-equity ratio has an effect on their interest rates.

8. Which is the least preferred source of capital? Why?

Issuing shares, not publicly listed company which means that the owners must put in more money and that is up to them if they have or not have money to put into the company. It is up to the owner's own strategy.

9. Are there benefits of using debt in a company? Why or why not?

There are benefits, if they do not use debt, they would not be able to invest as much. It is optimal for the with mix of both capitals. Debt allows them to invest in optimal times and not only when they have strong cash flows.

10. What is an optimal capital structure in your opinion?

Optimal would be 60% equity to debt, as more equity gives stability. That is good risk management. And banks are happy when the company has a strong equity ratio. They need more equity to debt in their industry, to lower risks and to get loans from banks.

11. Do you have requirements on how the capital structure should be distributed?

Noting specific from the owners only covenants from banks that requires a strong equity position of the company.

12. How does your capital structure look like now?

Good balanced, 75% debt to equity ratio. Although share holder loans make up 55% of the company debt.

13. Is your performance evaluated on increases in earnings or increases in return on equity?

More on earnings. Roe also interesting from the owners point of view.

14. If you are evaluated on increased earnings. Would avoiding using debt as much as possible be one way of improving the results?

Not necessarily, as the added productivity of using debt could also improve the result.

15. Is there some Finnish firm in the forest industry you could recommend me to interview next?

Loviansaha, Koskisen group.

### 1.3 Iisveden Metsä Oy

1. Could you tell me a little about your company?



Medium-sized sawmill, established by local people in 1924 and still running strong. Roughly 400+ shareholders, nobody has the majority. So, the ethos has been to keep the profit in the company and be very conservative with the dividends. This has surely helped us to survive in this volatile industry. We are pretty much the oldest sawmill company still in original ownership.

Strategy has been since early 1990's to constantly invest in production technology, but to avoid the biggest risks. No aggressive M&A stuff here.

Turnover 2020 was about 35 M euro, profit 0. 2021 will be a record year with production above 140.000 m3 ready products (about 25% increase compared to 2020), turnover roughly 58-59 M euro. Export makes up 80% of their sales, main export markets are Italy, Japan, France, China but in total 25 countries. Customer strategy focused on small industrial end users seeking for custom-made products. This means small production batches and less efficient production, but the trade-off is less volatility in the market cycles. Customer relations are long-lasting. About 50 employees.

2. Is your capital structure (allocation between equity and debt) a result of planning and decision making? If not, what determines your capital structure?

Frankly speaking no big planning here. We have been among the financially more solid mills and have not taken overly big risks in the investments. But it is also due to the cautious nature of the banks. Our industry is notorious for low margins and volatility, so the banks are not willing to take too big risks either. So, we need to keep our own equity high in order to look convincing enough in the eyes of the banks.

3. How does your financing usually look like in an investment situation?

Traditionally (say last 15 years) it has been a combination of 20-25% own capital (revenue from operations, no share emissions etc.) and the rest combined between Nordea Bank + Finnvera. Smaller machinery (forklifts etc.) has been bought with leasing agreements through Danske Bank.

Last 5 years in our two bigger investments (loans of 2.2MEUR and 3.5 MEUR) Finnvera and/or EIB have given guarantees to Nordea to the extent of 50-80% of the bank loan sum and Nordea has been the sole source of outside money.

4. If your company could finance all future investments with your operational cash flow, would you then have no need for debt?

Well, basically yes. But we operate in a very capital-intensive industry so with the current interest rates I cannot see it beneficial for the company to tie all our own money to the investments.

5. What are the benefits of debt in your firm?

Until now it has been the catalyst for developing the production technology. Waiting to accumulate own capital would have been way too slow and we would have lagged behind in the technological development. And without investments our cost-efficiency would have deteriorated vs. other actors, meaning our profits would have dwindled, eventually leading to bankruptcy. This has been the fallacy of many a company in our industry.

Another need for financing arises from the cyclical need for operating capital. The need is the greatest during winter and spring, with big reserves of raw material lying around. Then in summer/autumn the need for capital is much lower. By getting outside short-term financing, it is much more flexible to handle these variations and we do not need to have so large own buffers.

6. What would be the most preferred source of capital (retained earnings, debt, or share issues) in an investment situation? Why?

As previously said, in our perspective the combination of own capital + debt from banks is optimum. But of course as we are not seeking to maximize dividends to the shareholders, own earnings are the least risky alternative.

7. Which is the second preferred source of capital? Why?

Bank loans are my number 2. Historically low interest rates (secured by swap agreements), rather good availability of money, meaning that we can invest when the need arises.

8. Which is the least preferred source of capital? Why?

share issues don't work for us. Owners are not involved in the company, the dividends they are low, and shares are not easily saleable due to strict company regulations. So, there is no real incentive for the owners to put more money in the company.

9. Would you prefer to have more equity than debt, or the other way around in your firm?

Our equity ratio has been last year around 40%. It used to be above 60% before a bigger investment program we started 5 years ago. After this year we should be above 60% again. We need to be financially solid in order to be attractive for the banks. So, we need both equity and debt. 50:50 ratio should be workable and allow for flexibility in all scenarios.

10. Do you have requirements on how the capital structure should be distributed?

No company policy here. Just being cautious and trying to make long-term survivability secured.

11. How does your capital structure look like now?

It is around 40% equity to debt.

12. Is your personal performance evaluated on increases in earnings or increases in return on equity?

No. No formal incentive programs applied. The employees get extra bonuses based on production records and when earnings are high, but "top" management does not. Mind you, everybody in Iisveden is a director.

13. If you are evaluated on increased earnings. Would avoiding using debt as much as possible be one way of improving the results?

Not applicable.

14. Is there some Finnish firm in the forest industry you could recommend me to interview next?

Depends on your research reliability/validity needs. If you want to include some bigger private sawmill, then for example Kuhmo Oy might be a suitable target. Say hello to MD Tommi Ruha from me.

## 1.4 Neova Group Oy

1. Could you tell me a little about your company?

Neova Oy is a Finnish firm in the forest industry. The company was founded in 1940 and is now operating in different international markets. Neova Oy is one of many subsidiaries to the concern Neova Group. Neova Group is conducting business in the Nordic countries, in the Baltics, in Spain, Germany, the Netherlands, and in Australia, China and the USA. The concern is large with personnel of 950 people and has a turnover of 470 M euro. The largest owner is the state of Finland with has an ownership of 50,1% and the second owner is Suomen Energiavarat Oy with 49,9%.

2. Is your capital structure (allocation between equity and debt) a result of planning and decision making? If not, what determines your capital structure?

The company's Board of Directors determines the company's capital structure and targets, also taking into account the views of the owners. Neova's goal is to keep the Group's equity ratios at a level that supports the Group's strategic goals. The key figures to be monitored are self-sufficiency and netdebt / ebitda.

3. How does your financing usually look like in an investment situation?

Investments must be planned in such a way that the Neova Group does not become so indebted that the set equity ratio and net debt / EBITDA targets are jeopardized.

4. If your company could finance all future investments with your operational cash flow, would you then have no need for debt?

In principle, in that case, no loan is needed, but to ensure liquidity position there will be some debt.

5. What are the benefits of debt in your firm?

To secure a) adequate working capital for businesses, b) liquidity buffer and c) by being active in the capital markets, maintaining capacity for potential future financing needs. Furthermore, companies generally have a debt-to-equity ratio within defined limits in order to obtain a relatively better return on equity than if the company were debt-free.

6. What would be the most preferred source of capital (retained earnings, debt, or share issues) in an investment situation? Why?

In this order: retained earnings, debt, and issue of shares. Retained earnings belong primarily to existing shareholders, debt to debtors. New issue of shares (if new owners) dilutes the earnings per shareholder.

7. Would you prefer to have more equity than debt, or the other way around in your firm?

The question is difficult because the ratio of equity to debt can vary depending on the situation of the company. If the company is in a stable situation with stable cash flow, the amount of debt may be higher. If, for example, a company has a strong growth phase in which money is committed to investments, then equity is emphasized. We prefer the latter in current business transformation period.

8. Do you have requirements on how the capital structure should be distributed?

Main principle is that 50 % of earnings is distributed to owners, but it may vary time to time.

9. How does your capital structure look like now?

Equity ratio 55,2 %

10. Is your personal performance evaluated on increases in earnings or increases in return on equity?

No, it is not.

## 1.5 Kuhmo Oy

1. Could you tell me a little about your company?

Kuhmo Oy (ltd.) is privately owned Sawmill. The owners are all private persons and largely present at the management. Thought the company is not typical family company. All production is in one location Kuhmo Finland and the products are sold all over the world.

2. Is your capital structure (allocation between equity and debt) a result of planning and decision making? If not, what determines your capital structure?

Planning yes in the strategic targets. To have adequate solidity to endure the conjunction which are evident in sawmilling business and also strong enough to invest. Main financing. Has been cash flow, Commercial banks and Finnvera. We have traditionally invested approx. the value of annual depreciation.

After the MBO 2014 the solidity was lower than desired and at the current situation solidity is “too strong”.

3. How does your financing usually look like in an investment situation?

Usually, financing has been quite easy. Our main Commercial bank has been willing to provide financing to the standard annual investment- ie. these are financed by cash flow and bank loans. To the larger investments a package has been created with two commercial banks, Finnvera and EAKR subsidy (until 2021 Kuhmo Oy was mid-cap company, and it was possible to apply European union regional fund subsidies).

4. If your company could finance all future investments with your operational cash flow, would you then have no need for debt?

Probably so it would be. Due to the tax regulation, it is limited how much company can feasibly give dividends to the shareholders – i.e., it is not so simple to lean the assets. Thought I do believe the market is not necessarily so good in the future that financing everything with cash flow is relevant.

5. What are the benefits of debt in your firm?

It has been required to finance the investments and sometimes also for purposes of running capital. Of course it improves the earnings for own capital.

But since we are private Company – if the cash flow is good enough, we do not need debt.

6. What would be the most preferred source of capital (retained earnings, debt, or share issues) in an investment situation? Why?

Bank /Finvera loan. It is easy and straight forward product which does not need a lot of bureaucracy. It has also been relatively cheap in the past years.

7. Which is the second preferred source of capital? Why?

Capital loans from the existing shareholders – if available it required volume.

8. Which is the least preferred source of capital? Why?

External Capital loans or emission to new shareholders. These lead or may lead to changes in the ownership (at a moment it is not desired).

9. Would you prefer to have more equity than debt, or the other way around in your firm?

If so simplified – yes more equity than debt. Basically, solidities betw 40 – 55 % are all right. if lower than that risks in the low conjunction are high. If higher than that the excess capital should be divided to the owners.

10. Do you have requirements on how the capital structure should be distributed?

Of course, it can be theoretically planned and it is good to have a target - see the answer 9. In practice there are some other business targets and regulation as well as the market itself which can put you to a different position.

11. How does your capital structure look like now?

Very Strong. We have much free cash and some debt – note we are in the middle of 50 million € investment program.

12. Is your personal performance evaluated on increases in earnings or increases in return on equity?

To increase the earnings (as mentioned in the current systems it is feasible to give dividend to certain extent – due to the taxation of the shareholders).

13. If you are evaluated on increased earnings. Would avoiding using debt as much as possible be one way of improving the results?

No. At least until now the loan costs are insignificant when compared to variations in the profitability.

14. Is there some Finnish firm in the forest industry you could recommend me to interview next? I believe you will find suitable firms by yourself better.

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