

Comparing Capital Structure Policy between Computer Sciences Corporation and Hilton Worldwide Holdings Inc.

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Abstract: The capital structure policy between information technologies giant Computer Sciences Corporation and largest hotel chains Hilton Worldwide Holdings Inc. are different. Computer Sciences prefers equity financing and Hilton Worldwide has a preference towards debt financing. There are financial advantages and disadvantages for Computer Sciences to fund its capital with equity, vice versa for Hilton Worldwide. It is necessary to make an appropriate capital structure decision for companies. Firms should optimize capital structure with both debt financing and equity financing. Firms should minimize uncertainties and financial risks of losing control over its capital structure.

Key words: Capital structure, Computer Sciences Corporation, Hilton Worldwide Holdings Inc.

1. Synopsis

The synopsis of the capital structure policy between information technologies giant Computer Sciences Corporation and largest hotel chains Hilton Worldwide Holdings Inc. has demonstrated as huge difference in their capital structure decisions. Computer Sciences showed a preference towards equity financing while Hilton Worldwide showed a preference towards debt financing. There are financial advantages and disadvantages for Computer Sciences to fund its capital with equity, vice versa for Hilton Worldwide. The financial advantages and disadvantages for either equity or debt-based capital did not exist in theoretical perspectives, as it is assumed that the market is perfectly competitive with equal business risk and perfectly frictionless with no third-party interruptions like government taxes, transaction costs and legal fees, hence regarding-less of how the capital structure pie is cut will not matter, it is the size and profits that matter. However, there are different interruptions in real world, hence there are more factors to be considered and it is necessary to make an appropriate capital structure decision. Hence, it is critical to explore in what situations the funding capital with equity is cheaper, funding capital with debt is cheaper, and in what situations debt financing could amplify the investment opportunities and threats for Computer Sciences and Hilton Worldwide.

2. Critical issues

The critical issues are huge disparities between capital structure and firm value of Computer Sciences and Hilton Worldwide, which are due to contradictions between practical and theoretical perspectives on capital structure (Sukumaran, 2016^[1]; Ardalan, 2017^[2]). The first capital structure theory, Net Income Approach states that increase debt financing will reduce weighted cost of capital and increase values for organization, as loan interest rates are cheaper than dividend payouts (Borochin and Yang, 2017^[3]; Zhou and Reesor, 2015^[4]). The funding of capital with debt is cheaper than equity financing, and debt financing can amplify the investment opportunities and threats. The net income approach is applicable in real world with existence of business risk, government taxes and transaction cost, however to a certain extend. The fiscal year-end 2014 of Hilton Worldwide has higher debt-to-book equity at 2.47 as compared to Computer

Sciences at 0.91. The advantages of net income approach adopted and gained by Hilton Worldwide, but not Computer Sciences, are gaining tax benefits as government gave tax discounts for debt holder, the reduced financial distress due to low profit volatility, reduced direct and indirect transaction costs incurred during paying dividends to equity holders, and increased profit stability. Moreover, as shown in capital asset pricing model (CAPM), the risk from debt financing is not dissipated but it has channeled to equity shareholders of Hilton Worldwide, at good economic times more wealth is created for equity holders bearing additional risk from debts financing of Hilton Worldwide (Shahid and Felimban, 2016^[5]). However, if there is economic downturn, shareholders will bear higher risk of losing money, which reduce market and shareholders' confidence to invest in high-risk shares of Hilton Worldwide. Also, Hilton Worldwide has to bear dead-weight cost of financial distress like legal fees in case of failing to pay debts on time.

The second capital structure theory, Net operating income approach states that increase debt financing will not affect weighted cost of capital, since increase in debt financing increase financial risks and cost of equity for equity shareholders. Modigliani and Miller approach is similar to Net operating income approach, that funding capital with debt will not be cheaper than equity financing, nor debt financing can amplify the investment opportunities and threats (Ezirim, et al., 2017^[6]). Net operating income approach is applicable in real world too, however to a certain extend. The advantages of net income approach adopted and gained by Hilton Worldwide, but not Computer Sciences, are since Hilton Worldwide is operating in a substantial investment in hotel properties, the value of such high asset tangibility will be least affected at times of financial distress. Moreover, Hilton Worldwide with high debt will not face any negative side of financial threats if there is economic downturn, sales drop, or employee turnover rate. Hilton Worldwide with high debt will not face high profit volatility, nor high potential for growth opportunities. However, these advantages are only applicable to Hilton Worldwide who is operating in a lesser dynamic industry, having more tangible assets, and assets are easier to value, as compared to Computer Sciences.

In order to get the best of both world from both practical and theoretical perspectives for both Hilton Worldwide and Computer Sciences, there is the third capital structure theory, Traditional approach states that increase debt financing will reduce weighted cost of capital and increase values for organization in short term, but will not affect weighted cost of capital in long term, and will increase weighted cost of capital and reduce values for organization in longer term (Investopedia, 2017^[7]). Traditional approach explains debt financing for Hilton Worldwide is cheaper for short term, while equity financing for Computer Sciences is cheaper for short term. This is due to both Hilton Worldwide and Computer Sciences have to take accounts of distortive tax policies favoring debt financing in initial stage, cost of financial distress for having out-of-control debt financial in subsequent stage, transaction costs for hiring bank institutions to raise funds and pay dividends, nature of business in terms of level of tangible assets, flexibility in value of assets, potential growth opportunities, profit volatility, and types of business as business like Hilton Worldwide with seasonal capital needs may tend to use more debt than secular businesses with more stable need like Computer Sciences (Tosun, 2016^[8]; Hoover, 2016^[9]). At initial stage, debt financing^[8] is cheaper for Hilton Worldwide, however as financial risk increases in subsequent stages, the value of Hilton Worldwide reduced due to reduced interest rates coverage, increased transaction costs, and the cost of capital became more expensive for lesser equity holders to shoulder. At initial stage, equity financing is cheaper for Computer Sciences, however as financial distress increases in subsequent stages, the value of Computer Sciences reduced due to reduced number of skillful workers, reduced customer due to being affected by financial distress concerns, and reduced profits.

3. Recommendations

The recommendations applicable for each Hilton Worldwide and Computer Sciences are the organization should optimize capital structure with both debt financing and equity financing. The organization should ensure its capital structure is flexible without agreeing on restrictions laid out in its debt funds. These theoretical approaches gave the organization theoretical insights on financial management. However, assumptions made in these theories are not perfectly practical in real world, these capital structure theories assumed that there are no taxes and business risk

is constant. Hence, the capital structure decisions should show high flexibility as its optimal capital structure. The organization should use debt financing according to its capacity and coverage to payback debts in short period of time. The organization should minimize uncertainties and financial risks of losing control over its capital structure.

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