

# **REVIEW ON DYNAMIC CORPORATE INVESTMENT AND FINANCIAL DECISIONS**

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## **ABSTRACT**

In this paper we investigate the vulnerability of expenditure to the availability of internal funding using the hierarchy of corporate finance approach. We characterize and test these consequences using corporate data for the empirical consequences of this approach for dynamic investment models. In the presence of convex cost of adaptation, the model we estimate is based on the Euler equation for optimal accumulation of capital. One of the key issues in corporate finance theory is the relationship between corporate investment and financial decisions. This paper focuses to develop management strategies to maximize company profits for reasonable investments and financing. As a choice tool for optimum investment strategies and optimal capital structure, we build a restrained optimization model. We cover model continuous time-contingent claims first, with models for real options and static and dynamic models for capital structures. We move on to models of corporate finance focused on complex investment difficulties in discrete terms. We cover the simple model with no funding and more comprehensive versions, with characteristics such as costly outside financing, cash keeping, secure and risky debt. We have a simple, streamlined show with a lot of intuition for any layout. Throughout our work we show how these model models respond to questions regarding the effects on investment by financial constraints, corporate leverage levels, leverage adaptation speeds and market timing, among others. Finally, the structural evaluation of business finance models is reviewed and explained by us.

**KEYWORDS:** internal funding, restrained optimization model, corporate finance theory

## **I. INTRODUCTION**

### **1.1 Background and motivation**

The trilogy of company decisions is known as corporate venture , financing, and payout decisions (see Wang, 2010) and they are accepted to impact business execution extensively. In existing writing, they have pulled in extraordinary consideration (for example Denis and Osobov, 2008; Almeida and Campello, 2007; Frank and Goyal, 2003; Baker and coll., 2002, among many). With an end goal to expand their organization's worth and in this way the benefits of investors, organizations utilize inner and external funds for funding their investment projects. Internal funds are reflected primarily by retained income as well as investments without cash; and external funds mainly apply to new debt and equity proceeds. Thus, both real (i.e. non-financial) and financial decisions must be made by managers. Real decisions concern the optimum amount of investments in capital; while financial decisions concern the funding of the desired investment, and two financial options need to be determined. One is the decision to pay dividends, that is, how much money generated internally should be paid out to shareholders as dividends that would otherwise be reinvested. The other is international funding, i.e. the amount of foreign funds a business requires to raise for investment from global capital markets.

Although much has been done to research the organizational actions of corporations, the three corporate decisions are usually regarded individually and systematically, rather than as a whole. However, Modigliani's (1958) and Miller's (1961) works separately present the theory of separating income, the theorem of irrelevance of capital structures and the theorem of irrelevancy of dividends (hereinafter Modigliani-Miller 's theorems). The Modigliani-Miller theorems illustrate that a company's domestic and external funds are the perfect substitute for its business environment, and thus its best investment level should be determined solely by its actual considerations and entirely independent of financial decisions. There must therefore both be a capital structure and a dividend payment choices which do not impact on the value of the company and are irrelevant to the wealth of shareholders and do not suggest interdependencies within a perfect market environment between corporate decisions. Thus, every one of the three corporate choices has been generally and seriously investigated in the current corporate account writing, yet we think minimal about the communications that may exist among them.

In the course of the most recent 20 years, research on unique corporate money has seen emotional development in both hypothetical and exact headings. A few interrelated components have prompted this progression. In the first place, in spite of the fact that it has for some time been perceived that most money related choices include characteristically powerful collaborations (for example Lintner 1956), the advancement of techniques important to handle various significant unique issues has slacked. In any case, propels in stochastic powerful advancement

strategies, unforeseen cases resource evaluating investigation, game hypothesis, and dynamic venture demonstrating have opened roads for the productive investigation of dynamic issues in corporate fund. Second, there has been contemporaneous improvement in auxiliary experimental strategies. Third, specialists have accessed more and fundamentally more excellent information, just as to drastically better processing power, which makes dissecting such information conceivable in a sensible measure of time. These assets have permitted specialists to pay attention to dynamic models and exact strategies and, all the more significantly, to pose all the more requesting inquiries from the information and techniques. Fourth, it is step by step turning out to be more clear that static models and the instinct they suggest frequently neglect to clarify even basic, first-request adapted realities. Interestingly, a powerful worldview permits the formalization and investigation of new inquiries that are either immaterial or difficult to address in a customary set-up.

Given this foundation, the objective of this review is triple. In the first place, we wish to clarify the models and procedures utilized in this writing as essentially as could reasonably be expected, with the objective of making the writing increasingly available. Huge numbers of the distributed papers in powerful corporate fund contain models with numerous subtleties. Despite the fact that detail adds to the authenticity and thoroughness of the exploration, the unintended outcome is that the models seem, by all accounts, to be secret elements with numerous indistinct moving inner parts. Actually, the instinct behind the models utilized in this writing is straightforward, and our objective is to uncover this effortlessness. All things considered, we don't profess to offer an out and out and complete diagram of dynamic hypothetical and experimental models in unique corporate money. We additionally don't profess to be thorough, exact, or nonexclusive. Or maybe, we offer an instinctive introduction with considerably less numerical formalism than has been utilized in the papers we review. For specialized subtleties and formal confirmations of numerous outcomes, we allude perusers to the fitting examinations.

## **II. DYNAMIC CONTINGENT CLAIMS MODELS**

We continue with an informal and intuitive debate that highlights the essence and contribution of the models of complex contingent claims to our understanding of corporate finance. We then discuss the basic structure and useful implications of a number of practical models as basic building blocks.

### **2.1 Introduction**

Examination that investigates dynamic unforeseen cases models sits at the crossing point of advantage valuing and corporate account. It has been dependent upon especially fast improvement lately. These models acquire from broad hypothetical advancements in related fields, for example, resource estimating, macroeconomics, and stochastic procedures. To see how these models work conventionally and how they differ from other hypothetical structures in corporate account, note that they start with the affirmation that any cases on corporate income streams are subordinates on basic firm worth or firm incomes. This implies we can apply choice estimating techniques to esteem these cases, expecting at first that all money related and venture choices by financial specialists are fixed. Without a doubt, the efforts by Black and Scholes (1973) were initially planned for portraying the evaluating of corporate protections, for example, warrants as opposed to trade exchanged alternatives. In his adage, Merton (1974) affirms that "while alternatives are exceptionally particular and generally insignificant budgetary instruments . . . a similar essential methodology could be applied in building up an evaluating hypothesis for corporate liabilities by and large" (p. 449).

The specific idea of the basic factors relies upon the particular application (e.g., stock cost operating at a profit Scholes model; firm worth, firm incomes, or costs of firm yield and contribution to other corporate money settings). These hidden factors are generally the natives of the model as in their advancement is (at any rate halfway) exogenous to dynamic by monetary specialists, and they comprise alleged state variables.<sup>2</sup> To esteem corporate protections, the model commonly requires indistinguishable contributions from a standard alternative valuing model, including a law for the time variety of state factors that represents the conveyance of future incomes. (Operating at a profit Scholes model, it is a geometric Brownian movement process at the stock cost.) It is valuable to relate this set-up to its partner in a regular static model. In the last mentioned, the conveyance of a benchmark one-period return on a speculation venture is commonly given exogenously; as a characteristic "condition-of-the-world" variable, it along these lines fills a need like a law for the time variety of an exogenous state variable in a powerful system. The greater part of the sources of info are additionally not special to a powerful issue; for instance, there is a notable connection between a basically one-period binomial choice evaluating model and the constant time Black-Scholes model, with a tight connection between the boundaries that show up in these arrangements. The innately unique nature of the state variable procedure operating at a profit Scholes-Merton system (in the first arrangement, stock cost) is an undeniable explanation behind including "dynamic" for the sake of these models. Progressively significant justification for such a name incorporate the adaptability of this structure, which empowers us to consider the interrelation of specialists' choices at different focuses in time, as will become more clear in our resulting conversation. A second basic component of these models is the target capacity of a solitary leader (e.g., investors, directors, focal organizers)

or numerous chiefs (e.g., principals and specialists, oligopolists, value takers in a serious industry). This component speaks to a urgent takeoff from subsidiaries models, however not really from resource evaluating models on the loose. A target work sums up the wants of the financial agent(s) being referred to and can be communicated concisely by joining certain unexpected cases. For instance, investors need to augment the estimation of their value, though a generous focal organizer has the worth weighted utility of the considerable number of specialists as a primary concern. Since the model is dynamic, the target capacity can change inconspicuously after some time to mirror the changing financial condition (an element ordinarily precluded in one-period corporate money models yet talked about finally in writing on contracting). For instance, these models can abuse differences between ex risk and ex post targets of chiefs and normally offer ascent to sensible irreconcilable situations. They additionally permit the chief's character to change after some time, as an element of the express factors' advancement. For instance, equityholders settle on the first association's money related structure, however debtholders can choose the course of activities in case of a default.

A third part is the detail of the arrangement of instruments, known as controls, that are accessible for the leader to expand the goal work, just as the arrangement of limitations forced on these controls. For instance, equityholders boost value an incentive by picking the association's current and future venture and budgetary strategies, subject to a constrained risk condition. The exact arrangement of control(s) relies upon the idea of a specific application. In one of the models we consider in detail later, equityholders pick the measure of obligation first, and the planning of default later.

## **2.2 Real Options and Dynamic Investment**

One of the principal utilizations of choice estimating models to financial choices offered ascend to another exploration territory known as genuine alternatives. A significant part of the dynamic unexpected cases worldview, the genuine choices system initially alluded to exercises in the "genuine" blocks and concrete or non-monetary world, for example, corporate speculation arrangements (subsequently the name "genuine"). Examination by McDonald and Siegel (1985, 1986) and Brennan and Schwartz (1985) spearheaded the field. For instance of a genuine alternative model, just as our first unforeseen cases arrangement, we consider a changed variant of the venture issue concentrated by McDonald and Siegel (1985, 1986). As we continue, we additionally casually present important specialized hardware.

### ***Corporate financing theories***

The clarification of corporate financing conduct is strongly bantered in corporate account. Modigliani and Miller (1958) give the establishments to present day corporate financing speculations. They demonstrate that, in an effective market with no expenses, exchange costs, chapter 11 expenses and data asymmetry, the estimation of an organization isn't identified with how the organization is financed. As such, inner assets and outer assets are ideal substitutes for an organization to fund its venture, and therefore financing choices are superfluous to the organization's worth. Modigliani-Miller's unimportance suggestion has been commonly acknowledged as right. The emphasis of examination on corporate financing choices has moved to inquiries concerning how certifiable inconveniences adjust the ideal capital economic situations, and whether showcase defects cause an organization's an incentive to rely upon its corporate financing decisions. The principle contending speculations of corporate financing dynamic incorporate exchange off, hierarchy, advertise timing and office hypotheses.

## **III. CORPORATE DECISIONS, FINANCIAL CONSTRAINTS AND UNCERTAINTY**

### **3.1 Empirical proxies for uncertainty**

The essential difficulties of setting up the relations among vulnerability and corporate choices are to recognize the sources and to measure the degrees of vulnerability related with organizations' future possibilities (Carruth et al., 2000). There is an extensive discussion in regards to how vulnerability ought to be caught exactly. Until this point, no agreement has been reached about the best act of estimating vulnerability in exact examinations. Various wide methodologies have been utilized in the current writing to build intermediary measures for vulnerability, yet none of them shows up without its specific issues and reactions. This segment, along these lines, sums up the most regularly utilized experimental proportions of vulnerability in the current writing, which may furnish us with direction in detailing intermediary measures for vulnerability.

#### **3.1.1 Output volatility**

Yield unpredictability gauges the variety in the normal income from a venture. In the observational writing, yield unpredictability is commonly characterized as the varieties in item value, item request or all out deals, which can be considered as outcomes of interest side stuns. As per the neoclassical venture model, an organization's benefit is a raised capacity concerning the yield cost. Expanded yield instability, accordingly, raises the normal present estimation of future benefit and urges the organization to embrace venture openings (see, for instance, Hartman, 1972; and Abel, 1983). Henley et al. (2003) measure industry-wide item value vulnerability utilizing a moving standard deviation of the maker value list of the comparing part. Be that as it may, the utilization of recorded unpredictability has been broadly scrutinized for being in reverse looking and neglecting to convey vulnerability data for future periods. While trying to devise a superior intermediary for

vulnerability, Ghosal and Loungani (1996) expect that organizations endeavor to figure their item costs utilizing an autoregressive (AR) model. They contend that the flighty piece of the stochastic procedure can be utilized to figure an increasingly sensible measure that catches yield cost stuns. In like manner, they figure a moving standard blunder of the gauging residuals, and use it as the intermediary for yield value vulnerability.

### 3.1.2 Input volatility

Information instability estimates vulnerability concerning the costs of work, crude materials and other on-going working costs that stretch out after some time once a venture is submitted. Information instability measures are relied upon to catch the gracefully side vulnerability. By accepting a fixed capital-work proportion for a given degree of innovation, Huizinga (1993) considers the genuine pay as an intermediary for the on-going working cost. Appropriately, he builds a bivariate autoregressive contingent heteroscedasticity (ARCH) model to appraise the restrictive standard deviation of quarterly genuine compensation, which is then utilized as an intermediary for vulnerability related with input costs in a model of total speculation. Other than this, Huizinga (1993) develops another intermediary for input vulnerability dependent on the instability of material costs. It is seen that total venture shows up as contrarily connected with

both genuine pay and material value unpredictability. The outcomes likewise demonstrate that any single instability measure at total levels is probably not going to enough catch the different elements of vulnerability looked by an organization.

### 3.1.3 Profit volatility

Benefit factors take the two deals and expenses into thought, and along these lines the variety in benefit means both information and yield vulnerabilities. In this way, benefit instability is normally viewed as an increasingly broad and progressively conceivable intermediary for vulnerability that conveys data increasingly pertinent to an individual organization's corporate choices. The standard deviation of the capricious part of benefit has been broadly utilized in observational investigations as an intermediary for vulnerability. For instance, Ghosal and Loungani (2000) set up an essential autoregressive gauging condition revenue driven variable, and measure vulnerability utilizing the standard deviation of the estimating residuals. In any case, it is archived that the principle worry about intermediaries for vulnerability got from the estimating residuals is that they are probably going to be touchy to the particular of the gauging models (Carruth et al., 2000). In this manner, it is imperative to complete different determination tests to guarantee that the gauging model is effectively indicated and measurably satisfactory.

### 3.2 A data asymmetry-based progression of-reserves structure for corporate conduct

To legitimize the key associations among corporate speculation, financing and payout choices, we get a model from an organization's progression of-reserves character, for example an organization's employments of assets must rise to its wellsprings of assets. In view of stylised fiscal reports, an organization's primary sources and employments of assets character can be communicated as follows,

$$\Delta FA + \Delta CA + DIV = \Delta LD + \Delta SD + \Delta EQU + PRO + DEP$$

where FA speaks to fixed resources, CA current resources, DIV profits paid to investors, LD long haul obligation, SD transient obligation, EQU normal and favored stock (restrictive of held income), PRO net gain after duty, DEP devaluation recompenses, and  $\Delta$  the adjustment in a variable from  $t-1$  to  $t$ . The progression of-reserves personality expresses that organizations raise assets from outside obligation ( $\Delta LD$  and  $\Delta SD$ ), outer value ( $\Delta EQU$ ) just as inside created income (PRO and DEP), and spend it on interest in resources ( $\Delta FA$  and  $\Delta CA$ ) and profit payout (DIV). The superseding requirement introduced in Equation above is that the employments of assets must rise to the wellsprings of assets. On the off chance that the capital markets are adequately blemished, organizations need to think about the accessibility of inward and outside assets close by their speculation and payout choices, to such an extent that the arrangement of corporate choices might be resolved together and ought to be seen as a synchronous and reliant procedure. The progression of-reserves personality determined in Equation above can likewise be reparameterised into the accompanying structure,

$$INV + \Delta CA + DIV = NDF + \Delta SD + \Delta EQU + PRO + DEP$$

## IV. MODELLING CORPORATE INVESTMENT, FINANCING AND PAYOUT BEHAVIOUR

### 4.1 Corporate investment equation

The venture condition indicated in this theory depends on a straightforward Q model, which is then stretched out by including the income variable, utilized as an intermediary for inner monetary limitations, and obligation financing and profit payout factors that may possibly influence speculation spending as per the progression of reserves system under data asymmetry. Furthermore, so as to experimentally address the speculation vulnerability vagueness, an intermediary for vulnerability is incorporated too. Thusly, the speculation condition is determined as follows,

$$\frac{INV}{K_{it}} = \alpha_0 + \alpha_1 \frac{NDF}{K_{it}} + \alpha_2 \frac{DIV}{K_{it}} + \alpha_3 \frac{CF}{K_{it}} + \alpha_4 Q_{it} + \alpha_5 \frac{INV}{K_{it-1}} + \alpha_6 UNC_{it-1} + \varepsilon_{it}$$

where INV speaks to the gross speculation, NDF net new obligation financing, DIV profit payout, CF income, Q the proportion of market to book estimation of complete resources, UNC the proportion of vulnerability, and  $\varepsilon_{it}$  a blunder term. A slacked venture variable is likewise included to catch the dynamic structure of the speculation choice as inferred by numerous observational examinations around there (see, for instance, Guariglia, 2008; and Lensink and Murinde, 2006). Likewise, the corporate choices are thought to be made toward the start of every year, and along these lines a slacked vulnerability variable is incorporated to intermediary for the impression of vulnerability when organizations settle on corporate choices toward the start of each financial year for the year ahead, for example administrators structure their impression of vulnerability toward the start of the year t (or end of year t-1) as indicated by the data set accessible, and afterward conclude how to back and dispense their assets for the year t. The utilization of a slacked vulnerability variable, in this manner, decreases the chance of utilizing more data in displaying corporate conduct than supervisors really have when they settle on their choices (see, for instance, Baum et al., 2008). The entirety of the corporate choice and income factors in Equation 3.7 are scaled by start of-period capital stock (K), so as to control for organization size and to lessen heteroscedasticity issues that may some way or another emerge in the organization level information. We pick the start of-period esteem as the deflator dependent on the presumption that all the key corporate choices are made toward the start of each financial year (see, for instance, Bulan, 2005). Scaling by capital stock instead of absolute resources or deals is done in light of the fact that capital stock is generally increasingly stable after some time and less inclined to be mutilated by financial conditions, in this manner the corporate arrangements can be better secluded (see, for instance, Bond and Meghir, 1994).

**4.2 Debt financing equation**

In the soul of the writing on the financing chain of command with topsy-turvy data, we indicate the financing condition based on hierarchy hypothesis (see, for instance, Bharath et al., 2009; Frank and Goyal, 2003; and Shyam-Sunder and Myers, 1999). In like manner, the net measure of obligation gave by an organization is required to be driven by the organization's financing deficiency, which can be sensibly caught by the direct blend of venture, profit and income factors as indicated by its bookkeeping definition (Shyam-Sunder and Myers, 1999).<sup>16</sup> It is all around recorded that hierarchy hypothesis is just mostly effective in clarifying organizations' financing choices, and its illustrative force can be altogether improved by including a few elements proposed by different speculations (see, for instance, Leary and Roberts, 2010; and Bharath et al., 2009). As needs be, we alter the severe hierarchy model by controlling for stylised influence factors, for example, organization size and resource substantial quality factors, which are utilized to intermediary for organizations' capacity to access to outside capital market and their guarantee esteem, individually. Vulnerability is likewise included on account of its possible impact on financing choice. In this way, the financing condition is determined as follows,

$$\frac{NDF}{K_{it}} = \beta_0 + \beta_1 \frac{INV}{K_{it}} + \beta_2 \frac{DIV}{K_{it}} + \beta_3 \frac{CF}{K_{it}} + \beta_4 TAN_{it} + \beta_5 SZ_{it} + \beta_6 UNC_{it-1} + \mu_{it}$$

where TAN is resource substance; SZ speaks to organization size. Enormous organizations will in general have a notoriety of low default chance, with simple access to outside capital markets. Unmistakable resources are simple for untouchables to esteem, moderating the issue of data asymmetry and bringing down the hazard premium of acquiring. Accordingly, organizations with both enormous size and elevated level of unmistakable resources ought to have the option to convey more obligation. Moreover, more prominent vulnerability is probably going to compound the level of data asymmetry among insiders and outside capital markets, which thus may create a progressively critical cost disservice of outer obligation financing or even outcome in credit apportioning. Organizations, in this manner, are probably going to be required to pay a higher premium for new

acquiring or be denied advances. In like manner, we estimate a negative impact of vulnerability on the net measure of obligation gave.

**4.3 Dividend payout equation**

The corporate payout condition is displayed based on the flagging speculation of data asymmetry. Since the current exact proof recommends that no single hypothesis can completely clarify the profit puzzle (see Frankfurter and Wood, 2002), we use extra organization attributes factors, for example, possession structure and money related life cycle stage, to clarify profit payout conduct. These components are by and large accepted to be the essential determinants of profit strategy, as indicated by the stylised facts.<sup>17</sup> Again, we incorporate the intermediary for vulnerability into the condition also. The profit model is determined as follows,

$$\frac{DIV}{K_{it}} = \gamma_0 + \gamma_1 \frac{INV}{K_{it}} + \gamma_2 \frac{NDF}{K_{it}} + \gamma_3 \frac{CF}{K_{it}} + \gamma_4 OWN_{it} + \gamma_5 \frac{RE}{TE_{it}} + \gamma_6 UNC_{it-1} + v_{it}$$

where OWN is insider possession structure; RE/TE is a held income to-add up to value proportion, an intermediary for an organization's budgetary life cycle stage. Income and held profit to-add up to value proportion are relied upon to effectsly affect profit payout, while insider proprietorship is required to have a negative impact. The connection among vulnerability and profit payout, in any case, isn't so obvious. It is sensible to contend that,

with topsy-turvy data, directors alter profit payouts upward or descending just on a perpetual change in their business condition. In the event that the possibilities are unsure, supervisors may decide to sit tight for more data as opposed to alter profit strategy promptly, inspired by a paranoid fear of sending incorrectly data to the business sectors. In the event that this contention is bolstered by experimental proof, vulnerability may hose the reaction of profit payout to income. It is similarly conceivable to contend that an organization's possibilities are less unsurprising under vulnerability, so supervisors' trust in keeping up profit payouts at sureness level will crumple.

**V. CONCLUSION**

In general, a significant exercise to be gained from this illustrative model is that that different corporate speculation measures act rather diversely in observational examinations. As an outcome, the aftereffects of exact investigations show high affectability to the decision of corporate venture measures. All the more correctly, particular ends as for organizations' speculation conduct are probably going to be drawn when various proportions of corporate venture are utilized in investigations. This overview has endeavored to cover the expansive zone of dynamic corporate money. One exercise that rises is that the field is phenomenally various. For instance, we have secured three expansive territories—unforeseen cases models, discrete-time financing and venture models, and basic estimation—and every territory is especially extraordinary regarding the kinds of investigative gadgets it utilizes. Basic estimation can be performed on either class of hypothetical models, however the two classes of hypothetical models are unmistakable. Therefore, now, a concise examination is all together. Unforeseen cases models offer two significant points of interest over discrete-time venture models. To start with, they permit the evaluating of cases, being founded on methods created in the subsidiaries estimating writing. Speculation based models, interestingly, have just barely begun to be utilized to value claims by means of the expansion of an evaluating portion (Gomes and Schmid 2010). Second, unique unforeseen cases models take into account unbounded firm development in view of the homogeneity property that permits huge firms to be thought of as scaled up renditions of little firms. Venture based models, interestingly, concentrate firm conduct in a limited arrangement of potential qualities for the state factors. Accordingly, while they are amazingly helpful for contemplating proportions (influence proportions, speculation rates, and so forth.), they are less valuable for concentrating long haul development, as they can, best case scenario, be deciphered as speaking to changes around long haul deterministic patterns.

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