Corporate Restructuring and Firm Value: Review of Evidence

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Abstract

Corporate restructuring is a key area in strategic management, finance and organizational theory. Although various fields have contributed to the literature, numerous restructurings have failed in practice, which has resulted in vast criticism of the process. Results from empirical performance investigations of restructurings reveal adverse spectrum of conclusions. While some companies have been very successful in their restructuring efforts, others have destroyed shareholder value. This paper reviewed this evidence concluding that corporate restructuring and firm value is yearning for more research as a result of inconclusive and mixed results of the empirical studies.

Section One

Corporate restructuring is the fundamental change in a company's business or financial structure with the motive of increasing the company's value to shareholders or creditors. Corporate restructuring encompasses a broad array of activities that include changes in ownership, asset structure, and/or capital structure of a company. It is divided into two parts: financial restructuring and operational restructuring. While financial restructuring relates to changes in the capital structure of the firm, operational restructuring relates to changes in the business model of a firm, with the aim of increasing overall shareholder wealth (Jayadev, 2008).

Restructuring may involve reducing or renegotiating the firm's debt, cutting operating expenses, altering the firm's portfolio of businesses by selling or acquiring assets, or changing the firm's equity ownership structure. Often restructuring is undertaken in response to an extreme financial crisis, when the firm's very survival may be at stake. But more generally firms restructure even in good economic times to improve their financial performance, exploit new strategic opportunities, and improve their public market valuations (Stuart, 2010). A company may adopt one or more of the financial strategies such as sale and lease back of assets, new equity finance and debt restructure. Some companies also resort to more unusual methods of conserving cash, such as offering preferred stock to certain employees in exchange for a portion of their salary as suggested by Davies, Boczko and Chen (2008).

Higgins (2009) states that a number of takeovers and restructurings, especially those involving mature, slow growth businesses, are driven in part by the desire to make more extensive use of interest tax shields. The tax deductibility of interest expense reduces a company's tax bill and hence may add value. The value of interest tax shields in leveraged restructurings rests on qualitative weighting of the indicated tax savings against the costs of financial distress. Restructuring affects senior executives because they probably have invested much of their own resources in the equity of the newly restructured company, their own material well being is closely tied to that of the business. Hence, the huge debt service burden restructuring frequently creates forces management to generate healthy cash flows or face bankruptcy. Another possible enhancement in restructurings rests on the perception that public companies are not always run solely for the benefit of owners. In this view, value can be created by gaining control of such firms and refocusing the business on the single goal of creating shareholder value. Preferred-for-common exchange offers have no tax consequences. Copeland, Weston and Shastri (2005) argue that preferred-for-common exchange offers provide an indirect test of the interest tax shield hypothesis because preferred dividends are not tax deductible.

Masulis (1980) finds a statistically significant positive 3.3% common stock return for debt-for-preferred offers. Pinegar and Lease (1986) find a statistically significant 4.05% positive common stock return for leverage-increasing preferred-for-common exchange offers. The equity return for leverage-decreasing exchange offers is a significantly negative 0.73%. Pinegar and Lease also find that preferred shareholders experience a significant 6.58% positive return during leverage decreasing exchange offers, although total firm value (equity plus debt plus preferred) is estimated to decrease. They conclude that their results are consistent with the signaling hypothesis (firm value decreases) and with the expropriation hypothesis (preferred stock value increases).

Ross (1977), Heinkel (1982) and Noe (1988) suggest that increasing leverage, by acquiring debt should, have positive implications for firm value and performance. In general, these theories ascribe a signaling or disciplinary role for debt. Since increasing debt would also increase bankruptcy and liquidation costs, only managers who expect better future performance will choose to issue debt. The agency model of Jensen (1986) suggests that since debt sales bring additional cash into the firm, this could exacerbate agency problems. Alternatively, if firms use the debt issue proceeds to address the gap between investments needs and internal sources of funding, this would not necessarily lead to an increase in excess cash within the firm. The periodic interest payments on debt would then commit managers to pay out excess free cash flow. Hence, debt issues could reduce agency costs, and have positive effects on firm value. However, some studies have shown that debt has a negative effect on firm profitability.

Booth et al. (2001) developed a study attempting to relate the capital structure of several companies in countries with extremely different financial markets. They concluded that the variables that affect the choice of the capital structure of the companies are similar, in spite of the great differences presented by the financial markets. Besides, they concluded that profitability has an inverse relationship with debt level and size of the firm. The capital structure decision is crucial for any business organization. The decision is important because of the need to maximize returns to various organizational constituencies, and also because of the impact such a decision has on a firm's ability to deal with its competitive environment. The capital structure of a firm is actually a mix of different securities. In general, a firm can choose among many alternative capital structures. It can issue a large amount of debt or very little debt. It can arrange lease financing, use warrants, issue convertible bonds, sign forward contracts or trade bond swaps. It can issue dozens of distinct securities in countless combinations; however, it attempts to find the particular combination that maximizes its overall market value (Abor, 2007).

Statement of the problem

The restructuring strategy used was a reduction of the firm debt through an exchange of debt for preferred stock therefore increasing the preferred stock in the firm. Modigliani and Miller (1958) demonstrated that in a perfect capital market the value of a firm is independent of how that firm is financed. The exchange of debt for preference shares as way of reducing the leverage in the firm; preferred stock is presumed behave as debt than equity. From the change in the firm's cash flow for instance the interest costs and dividends paid by the company. The exchange of debt for equity, the preferred stock requires payment of dividends like common stock. Preferred stocks have somewhat greater risk than debt because of their junior position as source of finance. This makes for a higher yield. The effect on the cash flows by the new dividends commitment by the company to their lenders was undertaken in the study. Besides the changes in levels of debt and equity, other restructuring strategies such as change in management and change in operations of the firm were taken into account in examining the restructuring effect on firm value.

Section Two

Literature Review

This section describes the concept of corporate restructuring, from a theoretical review on restructuring by various authors. Further the researcher provides a review of related empirical studies to the intended research and concludes with a research gap. Corporate restructuring is a key area in strategic management, finance and organizational theory. Although various fields have contributed to the literature, numerous restructurings have failed in practice, which has resulted in vast criticism of the process (Singh, 1993). Results from empirical performance investigations of restructurings reveal adverse spectrum of conclusions. While some companies have been very successful in their restructuring efforts, others have destroyed shareholder value (Muller-Stewens, Schafer and Szeless, 2001).

Some of the theories that are relevant to the study of corporate restructuring are; incentive structure and monitoring costs, information or signaling and transactions costs (Weston, Mitchell and Mulherin, 2004), interest tax shields and free cash flow (Higgins, 2009). A number of takeovers and restructurings, especially those involving mature, slow growth businesses, are driven in part by the desire to make more extensive use of interest tax shields. The tax deductibility of interest expense reduces a company's tax bill and hence may add value (Higgins, 2009). Higgins adds that the value of interest tax shields in leveraged restructurings rests on a qualitative weighting of the indicated tax savings against the costs of financial distress. A reduced tax bill isn't especially attractive when the added debt frightens customers, drives away creditors and emboldens competitors.

It is illustrated by Jensen (1986) that restructuring fundamentally changes the world of two million senior executives because they probably have invested much of their own resources in the equity of the newly restructured company; their own material well-being is closely tied to that of the business. Moreover, the huge debt service burden restructuring frequently creates forces management to generate healthy cash flows or face bankruptcy. The carrot of ownership and the stick of possible financial ruin create significant incentives for management to maximize free cash flow and spend it for the benefit of owners. In addition to interest tax shields and incentive effects of high leverage, a third possible enhancement in restructurings rests on the perceptions that public companies are not always run solely for the benefit of owners. Value can be created by gaining control of such firms and refocusing the business on the single goal of creating shareholder value.

Alchian and Demsetz (1972) suggested that the essence of a firm is team production where the joint production of the firm's assets exceeds the feasible output of the assets in separate uses. In such a setting, the monitoring of inputs is important and is performed by the residual claimants of the firm- the shareholders. An important monitoring function is assessing the performance of the firm's management. Jensen and Meckling (1976) offered a similar model of the firm that incorporates the interaction among managers, stockholders, and bondholders. In their model, the optimal scale of the firm is determined by the monitoring and bonding costs of writing contracts among these interacting parties. The concepts by Alchian and Demsetz (1972) and Jensen and Meckling (1976) suggest one reason why corporate divestitures might create wealth. If the divestitures improve managerial incentives or better enable shareholders to monitor managerial performance, then the separation of a corporation into different pieces can improve the efficiency of operations and thereby increase the combined value of assets.

On the importance of information in corporate valuation, Myers and Majluf (1984) pointed out that in the modern corporation, managers often know more about a firm's investments opportunities than outside investors do. In this setting of asymmetric information, management actions regarding financing or restructuring can convey information about firm value to investors. Nanda (1991) extended the model of Myers and Majluf (1984) to a particular form of restructuring, an equity carve-out. Nanda (1991) noted that equity carve-outs have two aspects. Carve-outs create new public entity but also raise money for the parent. Nanda (1991) suggested that carve-outs also convey the further piece of information that the parent firm has chosen not to raise money by issuing its own shares. Nanda predicted that the announcement of an equity carve-out would convey positive information to the market about parent firm's value. The irrelevance propositions of Modigliani and Miller (1958, 1961) alert the corporate manager that random changes in corporate organizational structure cannot be expected to be wealth enhancing. Subsequent conceptual analysis suggested that incentive changes or information revelation are two plausible sources of wealth creation from corporate restructuring.

In addition to addressing why restructuring has wealth implications, related theoretical research provides a framework to assess why restructuring takes place at all. Coase (1937) modeled the choice to contract within a firm or across a market as a function of transaction costs. An implication of his model is that restructuring will occur when change forces such as technology alter the relative costs of using the market vis-à-vis operating within a firm. Subsequent analyses by Williamson (1975) and Klein, Crawford and Alchian (1978) proposed that an important factor in the choice between market transactions and firms is the presence of specialized assets. They predicted that the more specialized assets are, the more likely it is that vertical integration will occur. Findings indicated that transactions costs are an important determinant of corporate restructuring. The two most important theories to prove the value potential of corporate restructurings as asserted by Achleitner (2000), Charifzadeh (2002), Weston, Chung, and Siu (1998) are the management efficiency hypothesis and the information hypothesis. The management efficiency hypothesis posits that the management of large corporations is generally unable to address the unique peculiarities of each segment in diversified corporations.

Its performance is therefore inferior to smaller specialized firms. Consequently, management should restructure the corporation by bundling corporate resources in its core expertise. The information hypothesis posits that the information that investors get about the separate businesses of conglomerates is low. Consequently, financial market participants often penalize them with a conglomerate discount in the valuation (Weston, Chung, and Siu, 1998). After a restructuring, more information about the individual business unit is processed, which lowers the conglomerate discount and increases shareholder value (Huemer, 1991).

Preferred-for-common exchange offers have no tax consequences. Copeland et al., (2005) argue that preferred-for-common exchange offers provide an indirect test of the interest tax shield hypothesis because preferred dividends are not tax deductible. Masulis (1980) finds a statistically significant positive 3.3% common stock two-day announcement return for 43 debt-for-preferred offers. Pinegar and Lease (1986) find a statistically significant 4.05% positive common stock return for 15 leverage-increasing preferred-for-common exchange offers. The equity return for leverage-decreasing exchange offers is a significantly negative .73% (30 observations). These results favor the signaling hypothesis over the tax hypothesis but cannot be used to reject the tax hypothesis because it may still be relevant to those types of exchange offer where the interest tax shield is affected. Pinegar and Lease also find that preferred shareholders experience a significant 6.58% positive return during leverage decreasing exchange offers, although total firm value (equity plus debt plus preferred) is estimated to decrease. They conclude that their results are consistent with the signaling hypothesis (firm value decreases) and with the expropriation hypothesis (preferred stock value increases).

Ross (1977), Heinkel (1982) and Noe (1988) suggest that increasing leverage, by acquiring debt should, have positive implications for firm value and performance. In general, these theories ascribe a signaling or disciplinary role for debt. Since increasing debt would also increase bankruptcy and liquidation costs, only managers who expect better future performance will choose to issue debt. The agency model of Jensen (1986) suggests that since debt sales bring additional cash into the firm, this could exacerbate agency problems. Alternatively, if firms use the debt issue proceeds to address the gap between investments needs and internal sources of funding, this would not necessarily lead to an increase in excess cash within the firm. The periodic interest payments on debt would then commit managers to pay out excess free cash flow. Hence, debt issues could reduce agency costs, and have positive effects on firm value. However, some studies have shown that debt has a negative effect on firm profitability.

Fama and French (1998), analyzing the relationship among taxes, financing decisions, and the firm's value, concluded that the debt does not concede tax benefits. Besides, the high leverage degree generates agency problems among shareholders and creditors that predict negative relationships between leverage and profitability. Therefore, negative information relating debt and profitability obscures the tax benefit of the debt. The lessons from the theoretical research for corporate restructuring are two-fold. First, a corporate manager cannot improve firm value by arbitrarily chopping a company into pieces. Second, the theory guides analysis of restructuring towards factors such as information and transaction costs as possible sources of wealth creation (Weston, Mitchell and Mulherin, 2004).

Model on Restructuring

Modigliani and Miller (M&M) model on capital structure will be the model adopted in the study. Besides looking at Modigliani and Miller work, will also look at other extensions of the model by various authors. The study will then build on the model by considering the variables of the research as illustrated in the conceptual framework.
Before 1958 the cost of capital was thought to possess a *U* shape. The argument was follows. Since equity is more risky (and thus more costly) than debt, a firm can reduce its cost of capital by issuing debt in exchange for equity.
As the debt-equity ratio of the leveraged firm increases further, default risk becomes larger and, after some point, debt becomes more expensive than equity (Levati, Qiu and Mahagaonkar, 2007). Then Modigliani and Miller (1958) demonstrated that in a perfect capital market the value of a firm is independent of how that firm is financed. They tested the propositions on oil and electricity utility industries. The results showed that there is little evidence of a relationship between leverage and the cost of capital.

In a follow-up study, Miller and Modigliani (1961) adopted a two-stage instrumental variable procedure to estimate the cost of capital for a sample of large US electric utilities for the years 1954, 1956, and 1957. They find no evidence for "sizable leverage or dividend effects of the kind assumed in much of the traditional literature of finance" (Levati, Qiu and Mahagaonkar, 2007).

The heart of their analysis was argued that in a world of zero transaction or information costs, the value of a firm is independent of its choice of debt or equity or its dividend policy (Weston et al., 2004). Modigliani and Miller (1958, 1961) demonstrated that when expected operating cash flows are constant, the amount of debt a company carries has no effect on its value and hence should be of no concern to value-maximizing managers or their shareholders. In their words when cash flows are constant, capital structure decision is irrelevant. Indeed, M&M irrelevance proposition is to demonstrate that under certain conditions, financing choices have no effect on value – despite their importance to individuals. The cash flows M&M refer to are the annual-after-tax amount available for distribution to owners and creditors, or earning –after-tax plus interest expense. The proposition tell us that financing decisions are important to the extent that they affect expected cash flows, and that the best financing choice is the one that maximizes these cash flows (Higgins, 2009).

However, the opposition to the MM theorem comes from many angles. Weston (1963) tests the theorem using the same sample of electricity utility industries as used by Modigliani and Miller (1958), but for the year 1959 rather than for the years 1947 and 1948. His multiple regression analysis indicates that leverage does have an influence on a firm's cost of capital when earnings growth is taken into account. Robichek et al. (1967) extend the analysis of Miller and Modigliani (1961) to the years 1955 and 1958–64. They conclude that MM's results are a consequence of circumstances prevailing at the time of their study. Davenport (1971) uses data on three industry groups (chemicals, food, and metal manufacturing), and his results were indicative of a U-shaped cost of capital with respect to leverage.

Financial Strategies used to Restructure

Firms take a range of strategies in corporate restructuring. The financial strategies used to restructure as defined by Davies, Bockzo and Chen, (2008) are as listed below:

Special dividend, share buy-back and new investments: A company may have too little debt because it has remained equity financed for some time. This may have been deliberate company policy, even if it may have been misguided. Such a company can re-balance its levels of debt and equity in three ways. If a company has high level of equity compared to its level of debt, and assuming it has the cash available, it may pay out a special dividend far in excess of normal levels, which enables shareholders to reinvest their funds (Davies, Boczko and Chen, 2008). Alternatively, it may undertake a share buy-back. In a share buy-back a company a company buys back its shares on the open market, and cancels them in its balance sheet and therefore reduces equity and increases its gearing. If a company has a comparatively low level of debt and therefore a high level of equity then it can use that equity to invest in value-enhancing new projects.

Sale of assets: This is defined as the sale of a division, subsidiary, product line, or other assets directly to another firm. In an asset sale, the transferred subsidiary or division is absorbed within the organizational structure of the buying firm. The payment in this form of divestiture is usually in cash, although the payment in some asset sales is in the stock of the buying firm (Weston et al., 2004). Companies may sell surplus assets to raise cash, and if the assets are non-core assets then this may be a simple method to action.

Sale and lease back of assets: If a company has no assets surplus to its requirements then it cannot sell off its assets without affecting the company's operations. If the company has assets, which are being used for its core activities, it may still sell them to raise cash but then lease them back (Davies, Boczko and Chen, 2008).

New equity finance: Cash may be raised from new investors through an issue of new equity or from existing equity shareholders.
A deep discount rights issue may be most appropriate for raising equity from existing shareholders. With a rights issue the company is more assured of raising the level of new finance (Davies, Boczko and Chen, 2008).

Convertible debt: An alternative to straight equity is a convertible debt, providing advantages with regard to the company's earnings per share and is cost of financing. Earnings per share are not immediately affected if such additional finance is provided, as there is no initial increase in the number of ordinary shares in issue. Since the cost of debt, is generally lower than the cost of equity and has the benefit of the tax shield, then the cost of financing may also not be significantly increased, if at all. There is also the advantage of some downside risk protection for the shareholders (if the share price falls) and also an upside opportunity to make the risk worthwhile (if the share price should rise) (Davies, Boczko and Chen, 2008).

Debt Restructure: Debt restructuring by bankers and other creditors can be quite complex. However, debt restructuring basically involves either extension, composition, or a combination of the two. In an extension, the failing company tries to reach an agreement with its creditors that will permit it to lengthen the time it has to meet its obligations (Moyer, McGuigan and Kretlow, 1998). In a composition, the firm's creditors accept some percentage amount less than their actual original claims, and the company is permitted to discharge its debt obligations by paying less than the full amounts owed. The percentage a company's creditors will agree to in the event of a composition is usually greater than the percentage they could net if the company had to sell its assets to satisfy their claims. If a company's creditors feel that the company can overcome its financial difficulties and become a valuable customer over the long run, they may be willing to accept some form of composition. Corporate debt restructuring can take many forms directed to the debt and capital structure of a firm (Laryea, 2010); it can include debt rescheduling, interest rate reductions, debt-for-equity swaps and debt forgiveness. To be successful in securing the longer term viability of corporate, debt restructuring will often be accompanied by operational restructuring addressing the structure and efficiency of the firm's business through closures and reorganization of productive capacity

Empirical Studies

Lie, Lie, and McConnell (2010 provided a comprehensive study of exchange offers by distressed firms. Their sample comprised 126 firms in the US that announced debt-reducing exchange offers during the time period 1980 to 1994. They addressed two queries. They asked why firms perform debt-reducing offers and also inquired about information provided by offers. Lie, Lie and McConnell (2010) found that, of the debt for equity swaps that they examine, the 3-day net-of-market returns are –3.1% (mean) and –2.7% (median) at the announcement date. These negative returns are attributed to the signal that the firm's financial condition is below the market's expectation. Furthermore, it is assumed that management is attempting to preserve value for shareholders by reducing the chance of bankruptcy. Considerable other research has also found the same effect at the announcement date.

Their findings were that firms perform debt-reducing exchange offers to stave off further financial distress. The bad news was that the announcement of the debt-reducing offer conveys financial weakness to the market. They concluded that debt-reducing exchange offers represent actions by management to avoid chapter 11 filings and thereby preserve value for stakeholders. The price decline was attributed to a signaling effect: the market is informed that the firm's financial condition is worse than expected. From a research by Carpentier (2006) on the valuation effects of long-term changes in capital structure to test the irrelevance proposition whereby changes in capital structure do not affect firm value. The long-run effect of changes in capital structure on firm value is examined, using a sample of 243 French firms over the period 1987-1996 using bivariate tests and multivariate regressions. The study analyzes the long-term relationship between financial structure changes and value, and to propose a direct test for the irrelevance proposition.

Findings were that the null hypothesis cannot be rejected. No evidence is found to support a significant relationship between the changes in debt ratios and the changes in value. To assess the strength of this finding, control for reversion towards the target debt level induced by the static trade-off theory is introduced. Similar results were obtained. This empirical investigation demonstrates that the irrelevance proposition cannot be rejected. Bivariate and multivariate tests do not show a significant relationship between changes in value and changes in leverage. With all things being equal, changes in capital structure apparently do not explain changes in the value of the sample of French firms. The lack of relationship is observed even when the direction of change in financial structure is accounted for. The firm's movement to or away from its sectoral target level does not alter this conclusion. The lack of a relationship between debt and value affirms the propositions of Modigliani and Miller (1958) and Miller (1977). The more plausible explanation was that while a cross-sectional relationship between value and debt may exist, the numerous factors that affect firm value in the long run overshadow the debt-value relationship. Carpentier (2006) agrees that the relationship between leverage and value, in both the short run and the long run, warrants more extensive analysis.

Levati, Qiu and Mahagaonkar conducted a computerized experiment in 2007 at the Friedrich-Schiller University of Jena (Germany) with a total of 78 participants, all being students. The experiment was designed to test the Modigliani-Miller theorem. In their research, they asked experimental subjects to evaluate the equity of firms with different capital structures separately over different markets. Each firm was placed in a separate market, thereby excluding arbitrage among the firms.

Applying a general equilibrium approach and not allowing for arbitrage among firms with different capital structures, they found that, in accordance with the theorem, participants well recognize changes in the systematic risk of equity associated with increasing leverage and, accordingly, demand higher rate of return. Yet, this adjustment was not perfect: subjects underestimate the systematic risk of low-leveraged equity whereas they overestimate the systematic risk of high-leveraged equity, resulting in a U-shaped cost of capital. A (control) individual decision-making experiment, eliciting several points on individual demand and supply curves for shares, provided some support for the theorem. When the leverage of a firm increases, the systematic risk of the firm's equity increases as well. From the results, Levati, Qiu and Mahagaonkar (2007) identified some strength and some weaknesses of Modigliani and Miller's approach. On the one hand, subjects recognize the increased systematic risk of equity when leverage increases, and thus demand a higher return for bearing this risk. On the other hand, the regression results are supportive of a U-shaped cost of capital curve, suggesting that subjects tend to underestimate the riskiness of low-leveraged equity and to overestimate the riskiness of high-leveraged equity.

Abor (2007) examined the effect of debt policy (capital structure) on the financial performance of small and medium-sized enterprises (SMEs) in Ghana and South Africa. This study examined the relationship between capital structure and performance of SMEs in Ghana and South Africa during a six-year period, 1998-2003.The reason for the study was that previous studies, especially on large firms, showed that capital structure affects firm performance. Though the issue had been widely studied, largely missing from this body of literature was the focus on SMEs. Panel data analysis was used to investigate the relations between measures of capital structure and financial performance. Statistically there was significant positive relationship between Tobin's q and two measures of capital structure (short-term debt and trade credit) but indicated significantly negative relations between the Tobin's q and long-term debt, and total debt ratio. It also showed that in the presence of control variables, capital structure has a significant influence on the performance of SMEs.

Findings were that using various measures of performance, capital structure influences financial performance, although not exclusively. By and large, the results indicated that capital structure, especially long-term and total debt ratios, negatively affect performance of SMEs. This suggested that agency issues may lead to SMEs pursuing very high debt policy, thus resulting in lower performance. The empirical results indicated that short-term debt is significantly and negatively related to gross profit margin for both Ghana and South Africa. The results showed that long-term debt has a significantly positive relationship with gross profit margin for both countries. The relation between total debt ratio and gross profit margin was found to be significant and negative. The results also revealed a statistically significant and negative association between trade credit and gross profit margin for both Ghana and South Africa. In the case of Ghana, the results showed significantly negative relations between all the measures of capital structure and return on assets. In the South African sample, the results revealed significantly positive relationships between return on assets and short-term debt, and trade credit. Abor (2007) concludes that the negative relationships imply that SMEs generally are averse to use more equity because of the fear of losing control and therefore employ more debt in their capital structure than would be appropriate. Apart from the problems SMEs face in acquiring equity, one reason for increasing debt use may be to avoid agency conflicts. Employing debt excessively is likely to result in high bankruptcy cost which could negatively affect performance. SMEs that pursue very high debt policy compared to the industry average should also consider increasing the equity component in their capital structure in order to avoid the negative effects of excessive debt on performance.

NIC Securities research presented an investor note on Uchumi Supermarkets (UCHUMI) in view of the company's relisting on the NSE to commence trading on 31st/May/2011. In their opinion UCHUMI's return to profitability was a milestone in the capital markets history of Kenya. Uchumi went under receivership and suspension in 2006 .Its share price stood at Sh14.50 a piece before its suspension from trading on the Nairobi Stock Exchange (NSE) in mid 2006. Uchumi was required by the regulators CMA to meet various preconditions to facilitate the company's relisting on the NSE. These preconditions entailed a balance sheet restructuring to clean up the company's books of the debt burden that led to insolvency. UCHUMI issued 85,426,614 new shares of par valus Kes 5/- Per share to redeem 100% shareholder and suppliers debentures worth Kes 498.5 Million and converted the Kes 350 Mn GoK loan to share capital An analysis of Uchumi's financial performance showed that Uchumi's revenues had grown by a CAGR of 12.26% over the last 3 years while EBITDA, Operating and Income margins have been reversed from negative in 2007 to above 5% in 2010. EBITDA margins since FY 2008 had averaged above 5% which indicates that Uchumi's performance had stabilized and thus setting a platform for improvement all else equal.

Shareholder returns also increased in tandem with improvements in value as EV/EBITDA was expected to reach 7.81 in FY 2011. Capex levels rapidly increased from Kes 16.95 Mn in FY 2007 to an estimated Kes 198.85 in FY 2011 which underlines the growth prospects that the UCHUMI brand offers future investors. EPS had grown by CAGR of 108.59% over the last 3 years having come from losses in 2006 and 2007 leading to expectations of continued stellar performance in a non leveraged post relisting business environment. Debt levels were also minimized by both the return to profitability and the balance sheet restructuring that converted debt to equity. Shareholder returns have also increased in tandem with improvements in value.

Other empirical studies suggesting that a firm's value changes significantly in response to changes in the capital structure include Masulis (1980), Dann (1981), Masulis and Korwar (1986), Pinegar and Lease (1986), Graham and Harvey (2001), and Arzac and Glosten (2005).These studies and, generally, most of the works rejecting the MM theorem rely on some kind of market imperfections. Masulis (1980 and 1983) examined these capital structure changes and concluded that the changes in value are consistent with the tax shield effect of debt and a wealth transfer effect. Fama and French (1998), analyzing the relationship among taxes, financing decisions, and the firm's value, concluded that the debt does not concede tax benefits. Besides, the high leverage degree generates agency problems among shareholders and creditors that predict negative relationships between leverage and profitability. Therefore, negative information relating debt and profitability obscures the tax benefit of the debt.

Other studies have concluded that the announcement of a debt for equity swap is a signal by management that the firm's future prospects have deteriorated to the point that the probability of bankruptcy is considerable Introducing bankruptcy risk and taxes into the model does create a trade off on debt, where additional debt creates benefits (in the form of tax savings) and costs (in additional bankruptcy costs) and can affect value of the firm (DeAngelo and Masulis, 1980). By the same token, the seemingly independence of the capital structure from the leverage ratio may be due to a relationship between leverage and other factors influencing the cost of capital, e.g., earnings growth may offset the effect of leverage on the cost of capital (Weston, 1963). Myers (2001) rightly admits that the MM theorem "is exceptionally difficult to test directly". Unambiguous experimental evidence of the theorem seems therefore much-needed before we can be confident about the impact of the capital structure on the firm's value. Firms restructure to remain competitive and to respond to the change forces in the economy.

From the empirical reviews above, the focus was on the effects of changes in capital structure on the performance, returns and firm value. Locally, the researcher has not found studies on the study of the effect of changes in capital structure on the firm value, the only research found focused on the performance of the company. Other researchers also note that there is need for more extensive analysis.

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