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The Impact of Corporate Strategy on Capital Structure
Empirical Evidence from Jordan

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The Impact of Corporate Strategy on Capital Structure

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"تأثير الاستراتيجية على هيئة رأس المال: دراسة عملية من الأردن"

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Abstract:

Corporate Product Strategy and finance are two important concepts need to be examined in depth. It is necessary to match strategy and investment plans with financing requirements, in order to achieve long term goals. This study provides a link between capital structure and strategy through analyzing the impact of different corporate strategy on capital structure determinants. In fact, an attempt has been made to examine the nature of the relationship between debt ratio and the determinants of capital structure (Profitability, Size, Growth opportunity, Tangibility and Earning risk) under four major types of corporate product strategy (Single, Dominant and Diversification Product strategies) applied by 57 Jordanian industrial companies listed in Amman Stock Exchange for the period 2003-2010. This study used Pooled and Panel analysis methods in line with One Way ANOVA test. The results have delivered some insights on the capital structure of Jordanian industrial firms, and prove that choosing a certain corporate strategy affect the capital structure decision. The study also found that most of the Jordanian Industrial companies included in the sample followed the Single Product Corporate Strategy, while this study recommends that these firms should follow the Related Diversification Corporate Strategy to get the maximum use of debt financing. The results presented in this study may lean support either to the pecking order theory or to the tradeoff theory.

Key words: Corporate Strategy, Capital Structure, Diversification, Amman Stock Exchange, leverage, Capital Structure determinants.
تأثيرات استراتيجية الطرح على هيكل رأس المال: دراسة عملية من الأردن

الملخص

تعد القرارات الاستراتيجية والتمويلية من أهم القرارات التي تحتاج إلى دراسة عميقة قبل اتخاذها، ويأتي تطبيق القرارات الاستراتيجية والخط الاستراتيجية مع متطلبات التمويل، ضرورة حتمية من أجل تحقيق الأهداف على المدى الطويل.

تقدم هذه الدراسة حلقة وصل بين كل من هيكل رأس المال والقرارات الاستراتيجية من خلال تحليل أثر هذه القرارات على محددات هيكل رأس المال استنادًا للعلاقة المتوقعة بين نسبة الدين ومحددات هيكل رأس المال (الربحية والحجم والفرص النمو، الخطوة، الملموسية) لأربعة أنواع رئيسية من استراتيجيات الانتاج (استراتيجية المنتج الواحد، استراتيجية المنتج الممحم، استراتيجيات التوقيع) التي تطبقها (57) شركة من الشركات الصناعية المدرجة في بورصة عمان في الفترة 2003-2010.

تستعرض هذه الدراسة أساليب تحليل مختلفة كتحليل البيانات التجميعية وتحليل السلاسل الزمنية المقطوعة بالإضافة إلى تحليل التباين باتجاه واحد من أجل اختبار الفرضيات المطروحة، ويمكن اعتبار ما توصلت إليه هذه الدراسة من نتائج قاعدة أساسية لفهم بعض خصائص هيكل رأس المال الخاص بالشركات الصناعية الأردنية، بالإضافة إلى اثباتها أن اختيار استراتيجية معينة يؤثر في اختيار الشركات الصناعية الأردنية لهيكل رأس مالها كما أظهرت النتائج أن استراتيجية المنتج الواحد هي الاستراتيجية الأكثر اتباعًا في الشركات الصناعية الأردنية المدرجة ضمن عينة الدراسة وأن انتهاج استراتيجية التوقيع هو أفضل وسيلة لتحقيق التوازن واستغلال مصادر التمويل الخارجي على أكمل وجه، وقد تم مقارنة النتائج المقدمة بما توصلت إليه كل من نظرية أولويات التمويل ونظرية المقابلة.

الكلمات المفتاحية:

استراتيجية الطرح، هيكل رأس المال، استراتيجيات التوقيع، سوق عمان المالي، التمويل بالدين، محددات هيكل رأس المال.
Dedication:

To the three pillars of my life: My parents, my brothers, my family & friends. Without you, my life would fall apart.

My Parents:
This Research Paper is lovingly dedicated to my respective parents who have been my constant source of inspiration Thank you for your unconditional support in my Academic & Practical life. I am honored to have you as my parents. Thank you for giving me a chance to prove and improve myself though all my walks in life. Without your love and support this project would not have been made possible.

Mom, you have given me so much, thanks for your faith in me, and for teaching me that I should never surrender. Daddy, you always told me to “reach for the stars.” I think I got my first one. Thanks for inspiring my love for transportation. We made it!!

My brothers:
Hoping that with this research I have proven to you that there is no mountain high as long as god is on our side. I promise I will be always there for you all until you fulfil your dreams.

My family and Friends:
Thank you for believing in me; for allowing me to further my experience. You have been the wind beneath my wings until I completed this work. Please don’t ever doubt my dedication and love for you.

*I wish that this accomplishment would make you all proud of me “,*

Yours,

Olla I, Abu kejleh
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Yours,

Olla I, Abu hejleh
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CHAPTER ONE: INTRODUCTION & OVERVIEW

1.1 Introduction:

Corporations are the biggest private organizations in the known history of the mankind. They display a highly developed ability to survive and maintain their institutional continuity in complex, quickly changing environment and their future behavior is an important issue for many financial decisions is related to predicting the future possible behavior of corporations. In this new era, where both financial crises reflections and technological innovations are growing at a fast pace leading to a more challenging globalized world surrounded by uncertainty (Grundy, 1996). Corporations are facing a change in their form, structure and strategies. These changes are undertaken through decisions made by managements who should know not only how to choose the right Corporate Strategy, specifically the Corporate Product Strategy which is the type of strategy this study is interested in, and Capital Structure that insures the long-term survival of the corporation, but also to know how to avoid conflicts that may appears as a result of these chooses (Balakrishnan et al., 1993). It’s important to understand the impact of different corporate strategies on the mixture of the capital structure which is the core of this study. In fact Corporate Product Strategy and Capital Structure are two concepts that have long been controversial, since they impact on many other aspects of business and financial management.

The idea of joining strategy literature and financial literature to address the capital structure question arose in two ways. Financial scholars, unable to agree on a desirable mix of debt and equity, have called for managerial inputs. Likewise, strategy scholars have called for inputs from functional areas such as finance. The product of this joint review is a set of propositions suggesting that a strategy perspective might help to explain the capital structure decision
Research into the Capital Structure of the firms has been the subject of extensive empirical investigation; however, there is a surprising lack of agreement about the factors that affect the capital structure decision. The survey by (Harris and Raviv, 1991) and the empirical study by (Titman and Wessels, 1988) are commonly cited as sources for basic empirical facts about capital structure decisions. The above two classic papers illustrate the problem of disagreements this study implying at. This also supported by the research made by (Frank and Goyal, 2003) who examine the effect of 39 factor expected to affect the Capital Structure decision of publicly traded U.S firms. Because of this, there is an extreme need to look at the Capital Structure from another perspective such as the one suggested by some financial scholars, (Long and Malitz, 1985; Narayanan, 1988) who stated that managerial perspective is necessary to fully understand the Capital Structure. (Barton and Gordon, 1988) took these suggestions in consideration and lead them to propose that Corporate Strategy may provide a behavioral basis for understanding the Capital Structure. This proposition was approved by an empirical study using US data for the period between 1970 until 1974.

It’s worth noting that Corporate Strategy has been a central topic for many studies since the work of (Ansoff, 1958). The costs and benefits derived from the various corporate strategies were the main interest examined mainly for their ability to create firm’s value (Rumelt, 1974). On the other hand, studies on the interaction between Corporate Strategies and capital structure started to become of interest based on the fact that adopting a new strategy requires major changes in capital structure, this changes may cause the selected strategy to be less attractive, this was clearly proven by (Hax and Majluf, 1983). Holding all of these indicators together the idea of this paper was born.
According to all this, it’s confirmed that the process of starting up and developing a business is not just an adventure, but also a real challenge. In order to help entrepreneurs with this, it is essential to create favorable business environment. Ensuring easier access to funding, making legislation clearer and more effective and developing an entrepreneurial culture and support networks for businesses are all instrumental as far as the setting up and growth of businesses are concerned (Flannery and Rangan, 2006).

In the present paper, the role of Corporate Product Strategy, (Single, Dominant, Related & Unrelated Diversified firms), in the capital-structure choices is analyzed. The study was carried out in the context of research on capital-structure determinants in order to answer the following question (How does Corporate Product Strategy influence Capital Structure?), which has attempted to explain the effects of Corporate Product Strategy on financial choices. In particular, this study aim to explore if applying a certain Corporate Product Strategy would have any impact on capital structure choices of the Jordanian Listed Industrial Companies by using Debt Ratio as an independent variable. In fact, this study would expand prior research on Capital Structure by linking it to Corporate Product Strategy and taking the Jordanian market as a case of study for 8 years period.

Jordanian Industrial Companies were classified and grouped according to the type of industry they belong to and which type of Corporate Product Strategy they apply. The sample was sorted into three groups according to the cluster analysis approach (Single firms, Dominant firms, related-diversified firms and unrelated diversified firms). Regarding to the Capital Structure determinants the researcher selected five determinants (Profitability, size, Growth Opportunity, Tangibility and Earning Risk). This research analyses the relationship between different capital structure determinants and the Debt level in the Capital Structure of the sampled firms taking in consideration that