The relative influence of competitive intensity and business strategy on the relationship between financial leverage and performance

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Abstract

This study empirically investigates the effects of competitive intensity and business strategy on the relationship between financial leverage and the performance of firms. Based on a sample of US manufacturing firms, this study confirms the hypothesis that the cost of debt is higher for product differentiation firms than cost leadership firms. Furthermore, the results indicate that competitive intensity has a negative effect on the leverage-performance relationship, suggesting that competition acts as a substitute for debt in limiting manager’s opportunistic behavior. These findings reinforce the need to consider moderating factors such as strategic choice and the environment in which a firm operates when investigating the effects of leverage on performance.

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1. Introduction

Ever since Modigliani and Miller (1958) proposed that capital structure is irrelevant in determining firm value, the theory of capital structure has been studied extensively. According to this “irrelevance proposition”, a firm cannot change the total value of its securities just by splitting its cash flows into different streams because the firm’s value is determined by its real assets, not by the securities it issues. Jensen and Meckling (1976) oppose this proposition in arguing that the amount of leverage in a firm’s capital structure affects managers’ choice of operating activities and that these activities in turn affect the performance of the firm. Ever since Jensen and Meckling (1976) acknowledged the possibility of this influence, researchers have

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