

STRATEGIC ASSETS, CAPITAL STRUCTURE, AND FIRM PERFORMANCE

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Abstract

Possession of strategic assets is a necessary condition for sustained competitive advantage. This condition is, however, not sufficient. Firms require financial management capability to realize the rents present in their strategic assets. The firm-specific nature of strategic assets implies that they be financed primarily through equity; other less specific assets should be financed through debt. Firms are likely to suffer increased costs and decreased performance if they do not adopt suitable governance structures in their transactions with potential suppliers of funds.

INTRODUCTION

The recently developed “resource-based view of the firm” seeks to focus the attention of researchers and managers alike on the unique and hard-to-copy strategic assets of the firm [7, 61]. Firms earn economic rents from these assets when there is an initial level of asymmetry in resource endowments, there is imperfect mobility of these assets, the market for these assets is imperfect, and competitors cannot easily obtain similar assets [2, 6, 7, 20, 24, 48]. Strategic assets provide the firm with a source of steady stream of rents so that it gains a sustained competitive advantage over its rivals.

While researchers in this area have a general agreement over the characteristics of strategic assets (albeit adopting slightly different terminology occasionally), more rigor is required to understand how firms translate the value of strategic assets to economic rents. Differences in the perspectives adopted by researchers generate different implications regarding the source of sustained competitive advantage [56]. For instance, Barney [7] suggests that such advantages depend “in a critical way, on the resource endowments controlled by the firm” (p. 116). Thus, it is the stock of strategic assets that are important in determining the firm profitability level. Managers should focus on the exploitation of already controlled resources to obtain economic rents for the firm. On the other hand, a slightly different viewpoint is put forward by Dierickx and Cool [7]—managers need to build strategic asset stocks “through a pattern of expenditures or flows” (p. 1509). In other words, while it is strategic asset stocks that generate rents for the firm, managerial decisions should additionally focus on strategic expenditures (read implementation) that lead to the accumulation of stock¹.

The two perspectives lead to differing implications regarding organizational capabilities. Capabilities have been defined as the capacity of a firm to deploy its resources to achieve a desired end [2, 21]. The first viewpoint focuses mainly on the resource endowments of firms, ascribing little importance to functional areas. The second perspective, on the other hand, suggests that whereas resources generally reside at the corporate level, capabilities that are present in various functional areas of the firm, such as marketing, purchasing, and finance, are also important in understanding and predicting firm performance. The first version of the resource-based view tends to include firm capabilities as part of their resources [7, 48]. The second model, on the other hand, supports the notion that capabilities are separate from resources and equally important to obtain the value from the idiosyncratic

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resources of a firm [2, 20, 24, 56]. In other words, for two firms possessing identical stock of resources, the first model predicts equal performance levels for both. As per the second model, however, there may be differences in the levels of rents accrued due to differential ability to manage resources. In such cases firm capabilities have the potential to become sources of Ricardian rents.

This paper investigates the relationship between the financial management capability of a firm and its competitive advantage. Specifically, it is argued that the capital structure decision of firms are important in realizing the gains from their valuable and idiosyncratic resources. For a firm, the nature of its assets predicts efficient ways of organizing transactions. Varying characteristics of assets imply different levels of the optimal mix of debt and equity financing. If the transactions with suppliers of finance are not organized as per these predictions, the ability of firms to obtain a competitive advantage over their rivals may be impaired [36]. It is suggested, therefore, that the capabilities in managing financial policies are important if a firm is to realize gains from its specialized resources; poor capital structure decisions lead to a possible reduction/loss in the value derived from strategic assets.

Strategic Management Research and Capital Structure

A firm's capital structure refers to the mix of its financial liabilities. As financial capital is an uncertain but critical resource for all firms, suppliers of finance are able to exert control over firms [58, 59]. Debt and equity are the two major classes of liabilities, with debtholders and equityholders representing the two types of investors in the firm. Each of these is associated with different levels of risk, benefits, and control. While debtholders exert lower control, they earn a fixed rate of return and are protected by contractual obligations with respect to their investment. Equityholders are the residual claimants, bearing most of the risk, and, correspondingly, have greater control over decisions.²

Questions related to the choice of financing (debt versus equity) have increasingly gained importance in management research. Traditionally examined in the discipline of finance, these issues have gained relevance in the past few years, with researchers examining linkages to strategy and strategic outcomes. Bettis [13] argued that modern financial theory and strategic management are based on very different paradigms, resulting in opposing conclusions. He called for more integrative research to resolve the controversies. Strategic management scholars exhibit disparate opinions regarding the possibility of such integration. Oviatt [46] suggested that a theoretical integration between the two disciplines is indeed possible, and that transaction cost economics and agency theory provide possible avenues. In contrast, Bromiley [16] believed that the scope for integration is limited, if at all possible. According to him, strategy researchers should neither import empirical results from finance, nor should they work towards integration of strategic and financial research. Therefore, while strategy should expand its domain to study areas traditionally considered in finance, researchers should be careful to maintain a strategic perspective (p. 92).

Some management researchers have viewed capital structure decisions as arising from the preferences of various stakeholders such as managers [9, 10], board of directors [59], and institutional investors [17]. Other researchers have viewed capital structure as an antecedent to firm strategy, such as diversification into new businesses [18, 19]. While these studies have definitely contributed to some understanding of the linkages between strategic management and capital structure, they have largely ignored some basic issues confronting researchers and managers alike, namely: Does it matter how firms finance their assets? and do different modes of financing make a difference?

While anecdotal evidence suggests that the amount and type of financing should be closely tied to a firm's strategy [31, 32] few researchers have looked at the strategy/financing interaction [55]. A firm consists of a bundle of resources, some of them able to contribute to sustainable competitive advantage [47]. The financial management function of a firm - including its capital structure decision - deals with the management of the sources and uses of finances. Firms enter into transactions with suppliers of finance (be they debtholders or equityholders) when raising capital for strategic assets. The right to partake of the cash flows generated from the assets lies with these suppliers. The debt-to-equity ratio of a firm determines how these cash flows will be shared between debtholders and equityholders. In other words, if firms are set up to maximize equityholder's wealth, then the proportion of cash flows disbursed to debtholders becomes important. The different types of financing, however, are also associated with different levels of costs. An examination of the net benefit of a firm's assets should incorporate these cost differences along with the value of such assets [6].

This paper suggests that the efficient set of transactions, as indicated by an optimal debt-to-equity ratio, is determined by the nature of strategic assets in the firm. Therefore, those firms that succeed in setting up the efficient set of transactions will be able to realize the full value of these assets. On the other hand, firms that are not able to determine and/or organize their transactions efficiently (as per asset requirements) will suffer a decline in performance. This decline arises from a decrease in the net benefits available from strategic assets. Consequently, superior financial management (matching capital structure to resources) can provide a firm added benefit over its competitors.

THE ROLE OF FINANCIAL POLICY IN COMPETITIVE ADVANTAGE

Strategic Assets, Firm Specificity and Capital Structure

Resource-based theorists have developed certain characteristics of assets that generate sustained competitive advantage, naming them as strategic assets. One common feature underlying the various descriptions of strategic assets is their *firm-specific* nature. Barney [7] proposed that, in addition to being valuable, resources should possess the key attributes of being rare, imperfectly imitable, and nonsubstitutable. Similarly, Dierickx and Cool [24] argued that these assets are nontradable, nonimitable, and nonsubstitutable. Strategic assets of a firm are often invisible [37], the result of the pattern of collective learning in that firm [49], or arise from unexpected events that create potential rents in the presence of isolating mechanisms [54]. The effects of such resources are not easily interpretable due to causal ambiguity and social complexity [7, 54].

A firm succeeds by developing strategies that cultivate its unique core competencies [49] or build on its dominant logic [30]. That is, for superior performance, these strategies exploit a firm's strategic assets. The conditions of imperfect mobility and imperfect tradability imply that no other *user* exists which can realize the same level of rents from the strategic assets as the current firm [20, 48]. Moreover, the greater the value of certain assets to that firm, the higher is their degree of firm-specificity [2, 48, 53]. Thus, a firm with a sustained competitive advantage gains value through the possession of rent-generating specific assets.

The financing decision—mix of debt and equity—represents a fundamental issue faced by financial managers of a firm. The study of capital structure has traditionally been carried out by finance researchers. Modigliani and Miller [53] were the first to raise the question of the relevance of capital structure for a firm. They argued that, under certain conditions, the choice between debt and equity does not affect firm value, and, hence, the capital structure decision is “irrelevant.” The conditions under which the irrelevance proposition holds includes, among others, assumptions such as no taxes, no transaction costs in the capital market, and no information asymmetries among various market players. Financial theorists have since provided several possible explanations for the financing decision. Major hypotheses include tax effects, signalling effects, bankruptcy effects, agency issues, and industry effects³. The focus of most of the capital structure explanations is on the factors that lead to the determination of the financing mix for a firm, given a certain expected stream of cash flows. No attempt is made, however, to explain how a firm can gain an advantage from its capital structure decision.

Current research in both strategic management and finance has begun to examine the relationship between firm strategy and its capital structure [52]. In finance, work by Brander and Lewis [15], Gertner, Gibbons, and Scharfstein [29], and Williamson [65] suggests that the two aspects of a firm may be closely linked with each other. Balakrishnan and Fox [5, p. 3] state that a “firm's ability to manage its relationships with lenders... becomes a key source of competitive advantage”. Most theories of capital structure, however, ignore the role of the suppliers of finance. To examine the capital structure-strategy linkage, the debt-to-equity ratio can be viewed as arising from the transactions of a firm with these suppliers [65]. As per transaction cost economizing [62, 64], efficiency considerations demand that governance structures be aligned with transactions based on the nature of assets.

In the case of firms possessing strategic assets, the financial management function is likely to gain importance. Firm managers may need to consider the financial policies that govern the utilization of specific assets. Capabilities are required such that the value present in resources is extracted [2, 21]. In other words, the amount of rents arising from the specific assets of a firm will be moderated by its capital structure. Thus, financial strategy, especially a firm's leverage decision, can have the ability to impact its performance. For instance, Seth [57] found that the value created from unrelated acquisitions was directly proportional to the amount of debt utilization. Differences in the rights of equityholders and debtholders, and the resulting impact on financial decisions are examined in the following sections.

Debt and Equity as Alternate Governance Devices

In the presence of uncertainty, bounded rationality, and opportunism, contracts that completely safeguard a investment cannot be designed [62]. This leads to organizing costs for the firm, as is the case for other economic activities. These organizing costs are a function of the institutional and environmental constraints [67, 68]. The choice between two governance structures will depend on the comparative costs for organizing a particular transaction, for instance, financing a particular investment. As Williamson [62] has argued, it is the characteristics of assets under consideration that affect costs under alternate governance structures.

The variation in the benefits of the two instruments and in their ability to monitor and evaluate managerial actions imply that debt and equity can be considered as alternate governance structures [12, 65]. A firm has the option to choose either one when financing a new investment. The debt-to-equity ratio, therefore, is the result of transactions with potential debtholders and equityholders. These transactions come about with the formation of (explicit or implicit) contracts that delineate the benefits and recourse available to the suppliers of finance [38]. The benefits available represent the property rights due to their claims over the return streams (from the assets). The recourse available is in the form of their control rights over managerial actions.

The financing structures of debt and equity can be compared with respect to the characteristics of control and property rights. The debt instrument carries with it fixed rules and covenants that usually monitor the lending process. The repayment schedule of the principal loan amount and the interest payments are stipulated in the contract, with debtholders having primary claim over the firm's cash flows from the assets. The firm is often required to meet liquidity tests to ensure that the lender's investment is not jeopardized. These characteristics imply that debt has strong property rights, making it similar to the market exchange mechanism [66, 67]. Equity owners, on the other hand, have a residual claimant status over the cash flow from asset earnings and asset liquidation. That is, they obtain the cash flows that are left after paying off more senior claims such as debt. Thus, equityholders have weaker property rights, similar to hierarchical control [66, 67].

The control rights of the two instruments are, however, reversed. The equity contract is not for a fixed period but runs for the life of the firm. The board of directors is present to closely monitor and evaluate managerial actions, ensuring that the investment of equityholders is protected. The board has the authority to monitor internal performance, approve significant decisions, decide on managerial compensation, and replace managers if it deems so necessary [26]. The instrument of equity emphasizes continuous behavior control [35] providing equityholders with stronger control rights. Debtholders are limited in their ability to interfere with firm operations so long as the contractual stipulations are satisfied. That is, they have much lesser ability to control managerial actions in ensuring that assets are utilized efficiently. They can step in only when a firm defaults on its repayment schedule or not meet its promised obligations. Hence, debt is characterized by weaker control rights.

The preceding discussion suggests that debt and equity are alternate governance structures that can be used to finance a firm's assets. As shown in Table 1, they possess widely different characteristics with respect to the benefits provided to the supplier of finance, and the rights afforded to the supplier in ensuring that the investment is utilized efficiently. These characteristics indicate that debt is more akin to the market system of organizing, whereas equity is similar to the hierarchical system. The differences in control and property rights suggest that debt and equity may be suitable for financing different types of investments⁴.

Asset Specificity and the Debt/Equity Choice

According to transaction cost economizing, the choice between alternate governance structures is likely to turn on the nature of assets under consideration in the transaction [64]. As debt and equity represent two ways of organizing the financial structure of a firm, and they possess differential abilities, specificity of the assets is likely to be a determining factor in the choice between the two. As discussed below, debt financing is suitable for low specificity assets, and equity is preferred when the level of specificity is high.

Firm assets are utilized to generate a stream of cash flow over time. Suppliers of finance desire that these assets generate an adequate rate of return, defined by the interest rate on debt or the cost of equity capital. Due to several reasons, however, it is possible that this may not be the case. Firm managers may seek to maximize their own benefits leading to increased agency costs and decreased firm value [38]. Some actions may also benefit old equityholders at the expense of new debtholders (the "asset-substitution" problem, Myers [44]). Finally, other decisions may simply reflect poor managerial judgements. Any or all of these circumstances are likely to lead to a

downward deviation from the expected returns. When the suppliers of finance observe signs of the beginning of any these circumstances, it is to their advantage to interact with managers and prevent value reduction. This implies the need for adaptation between these two economic agents. Market modes of governance, such as debt, are proficient in price-based adaptation, whereas hierarchical structures, such as equity, are superior for adaptation through coordination [67]. The complex activity of coordination, however, increases the bureaucratic cost of the hierarchical governance structure [67].

TABLE 1
Characteristics of the Two Financing Instruments.

Associated Characteristics	Financing Instruments	
	Debt	Equity
Property rights (i.e., benefits)	Strong (fixed returns)	Weak (residual claimants)
Control rights (i.e., available recourse)	Weak (only on default)	Strong (continuous monitoring)
Use of price controls	High	Low
Use of behavior controls	Low	High

Consider the case of inefficient utilization of a firm's assets. Due to their low control rights, debtholders can exercise their pre-emptive claim and push the firm into bankruptcy only when it defaults on the contract. That is, they are unable to prevent the ongoing inefficient actions and possible value loss. In case these assets are highly firm-specific, they would not be as valuable to the another *user*. Thus, the value obtained from asset liquidation (after bankruptcy) would be extremely low, and lenders will recover only a small fraction of their initial investment. The loss in investment will be greater, the higher is the level of asset specificity. Therefore, debtholders will generally be unwilling to invest in investments with highly specific assets [65]. And if they do so, they would charge very high interest rates, i.e., more than that is warranted by the riskiness of the investment. Therefore, assets which require firm-specific actions to generate value will generally not be associated with financing with low control rights, such as debt. Rather, this instrument will be used for low specificity assets.

For assets that are not redeployable outside the firm, financing that has stronger control rights and enables suppliers of finance to exert more influence over the firm will be preferred. As discussed earlier, equity financing is the mode that enables equityholders to exert influence and monitor managerial decisions continuously through the board of directors. Therefore, they are able to take immediate corrective action when they spot the initial signs of inefficient utilization of resources. When control is to be exerted, the equityholders, as residual claimants, have the right to revise the employment terms of managers [1]. For instance, if some managers do shirk in the utilization of assets, they may be replaced by the board to prevent further value reduction. Thus, equity is the form of financing more suitable for high specificity projects [65]. As Klein, Crawford, and Alchian [39] suggest, the owners of specialized assets should also be the residual claimants of the rents from them. They can successfully adapt by bringing about the desired changes through coordination with firm managers. While such a form of coordination is more expensive than coordination through price-based systems [67], it is also likely to result in greater value to equityholders. Put another way, the loss in value of firm-specific assets will be very high if market adjustments are relied on for the required adaptation.

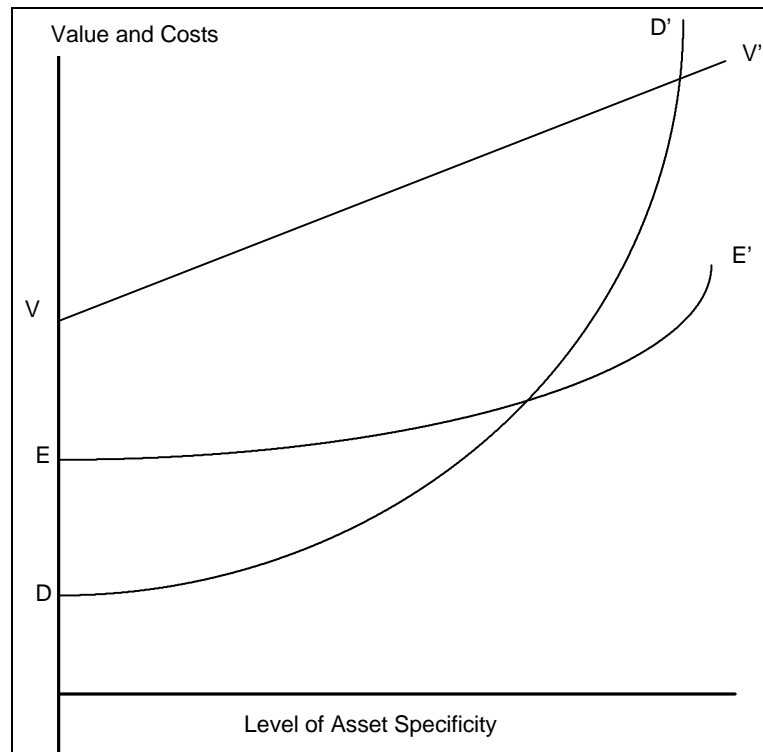
To summarize, when compared to equity, debt is less interfering with low governance properties. It is, thus, similar to the "market control" as a means of organizing. Equity is more akin to "hierarchical control" through the presence of board of directors. The choice between debt and equity for financing an investment depends on the characteristics of the assets being financed⁵. The key determining feature is the ratio of liquidation value of assets to the purchase value; this ratio is inversely related to the level of specificity. A low ratio leads to the failure of the

debt instrument market [4]. In these cases equity is the preferred mode as it provides a superior governance function. Therefore, low specificity assets are likely to be financed via debt, whereas high specificity assets are more likely to use equity financing.

The above analysis suggests that there is a correspondence between asset specificity and the capital structure decision. Two additional remarks are required here. First, it may seem that projects with strategic assets should be financed only through equity, and other projects only through debt. However, along with such strategic assets, some *normal resources*, necessary to realize rents, are also required [20, p. 275]. These resources tend to be easily imitable and are tradable. Therefore, the mix of idiosyncratic and normal resources determines the mix of debt and equity. Secondly, the preceding analysis appears applicable only for project-level financing. That is, the choice of financing a particular project would be independent of other characteristics of the firm. New investments, however, often have the potential to alter the cash flows of previous investments (through scope economies, for example). In such cases, the cash flows of new and old investments are not independent of each other and the value created is different from a simple addition of the two. Such a scenario indicates that there is a different level of firm-specificity associated with the new investment than implied by its “stand-alone” examination. The financing decision should, therefore, consider the final level of specificity, and the resultant debt-to-equity ratio would depend on the proportion of strategic assets and normal resources in the firm (rather than a specific project).

Empirical support for the relationship between resource specificity and debt financing has been found by Balakrishnan and Fox [5] in their test of the transaction cost hypothesis. R&D intensity has often been used as a measure of intangible and firm specific knowhow [34]. That is, it is an indicator of strategic assets in the firm. Balakrishnan and Fox found that the R&D intensity of a firm was negatively related to the leverage of the firm. They also found that firm-specific effects were much more important than industry effects in explaining capital structure across firms. The negative relationship between R&D and leverage was also found by Baysinger and Hoskisson [11]. Finally, Titman and Wessels [60] found that a firm’s leverage was negatively related to product uniqueness, a measure of firm specificity.

FIGURE 1
Value of Strategic Assets and Governance Costs



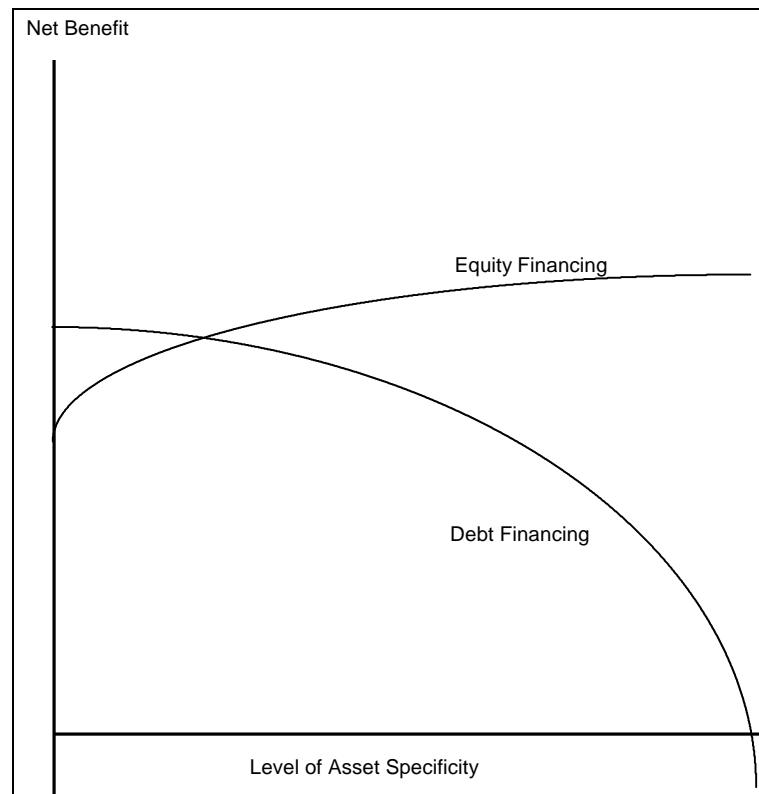
PERFORMANCE IMPLICATIONS

What does the above discussion imply for firm performance? Resource-based theorists have often made the assumption that the possession of strategic assets, by definition, leads to sustainable rents for the firm [14]. Often ignored, however, are the concurrent firm activities needed to extract these rents [21]. In other words, it is important that these resources be efficiently managed to ensure that the potential gains are indeed realized. This entails an examination of not only the potential value of the assets, but a look also at the costs needed to acquire these assets [6]. Thus, the governance cost associated with financing instruments becomes an important factor.

The relationship between value potential and the governance costs of different financing choices is depicted in Figure 1. The line VV' represents the value potential inherent in the strategic assets to be financed. That is, it represents the maximum value that can be gained from the utilization of such assets. As seen in the figure, it is an increasing function of the level of specificity of these assets (depicted on the X-axis), indicating the positive association between value and specificity. Line DD' is the governance cost of the debt instrument and EE' represents the same for equity financing. The market-based system of organizing, i.e., debt is likely to be cheaper when specificity is low due to the absence of bureaucratic costs. However, as described in Williamson [66, 67], the rate of increase in governance costs, with respect to increasing specificity, is higher for debt than equity. This is because equity is more efficient in adaptation through coordination, a process imperative with increasing specificity. The result is that equity becomes a cheaper governance system at high levels of specificity.

Figure 2 depicts the net value added to the firm from its strategic assets. This is determined by the difference between the value potential and governance cost, i.e., by the vertical distance between VV' and either DD' or EE' in Figure 1. It is seen that for lower levels of specificity, the net benefit obtained from debt financing is greater than

FIGURE 2
Net Benefit of Using Debt vs. Equity Financing



that possible via equity. The relationship is reversed at higher levels of specificity with equity financing demonstrating higher value addition. Thus, the utilization of an inappropriate governance structure leads to a reduction in the net benefit that can be obtained from the assets. As the governance costs are non-zero at all levels of specificity, the full value potential of the assets may never be realized. Maximization of the value extracted, thus, requires a careful selection of the governance mechanism⁶; a selection that turns on the characteristics of the assets.

Actual capital structure decisions usually do not involve financing via debt or equity alone; rather a mix of the two is chosen. As discussed previously, the mix is likely to depend on the relative proportion of idiosyncratic and normal resources. As the proportion of the former increases, the level of asset specificity also increases. Akin to Figure 2, the net benefit that arises from varying debt-to-equity ratios can be plotted for each level of specificity. Theoretically, it is possible to use any debt-to-equity ratio for any level of specificity. However, the net benefit will vary across these choices. The maximum net benefit will be derived at one particular ratio, which would then be the optimum capital structure for that asset specificity level. This process can be repeated for all levels and an optimum capital structure is obtained for each. This is illustrated in Figure 3, which indicates the optimum capital structure and the corresponding benefit at different specificity levels. The envelope of maximum values of net benefits, therefore, denotes the greatest value that can be extracted from the strategic assets. At low levels of asset specificity, the optimum will approach all debt financing, while equity financing is likely to be the optimum at the other end. Intermediate levels of specificity would utilize intermediate debt-to-equity ratios. The usage of ratios other than that depicted herein would mean that the net benefits would be lower than the envelope. Some supporting evidence for this proposition was found by McConnell and Servaes [40]. For low growth firms, presumably those with lesser asset specificity, the debt-to-equity ratio was positively associated with firm value. Thus, increasing use of debt financing improved performance of these firms, consistent with Figure 3. On the other hand, high growth firms, i.e., those with higher specificity, exhibited a negative relationship between debt financing and performance.

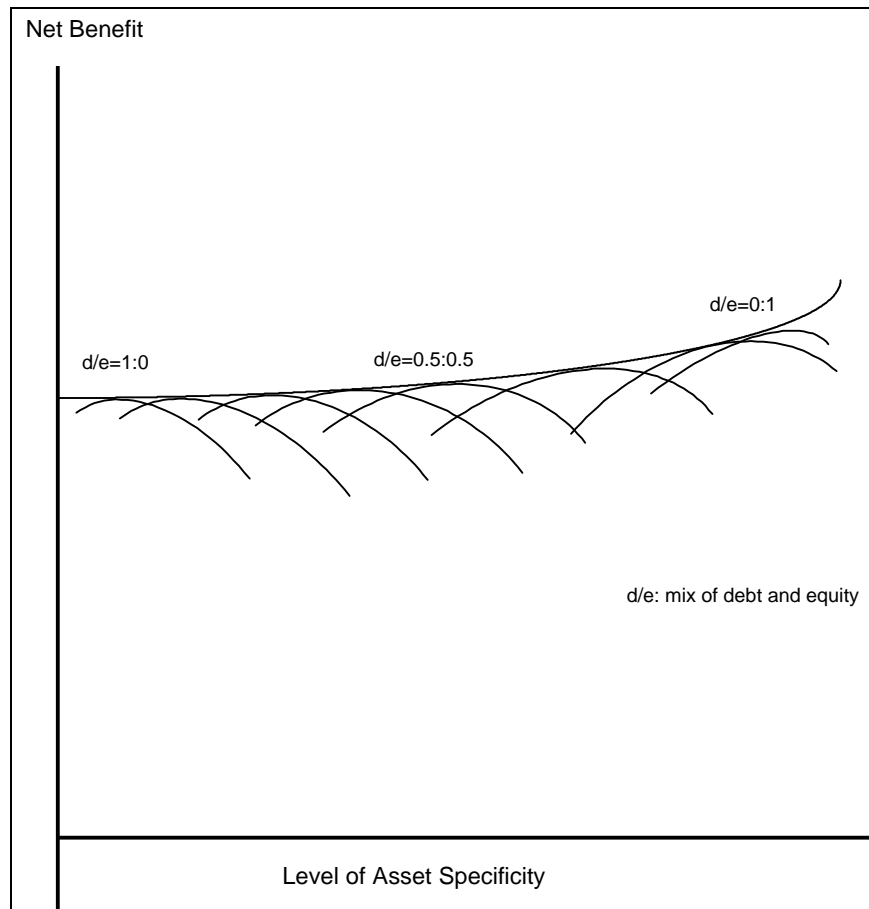
The resource based view of the firm proposes that unique and specialized resources are necessary if a firm is to secure a sustained competitive advantage. The utilization of these specialized resources, however, imposes constraints on the firm concerning an efficient mix of debt and equity in its financing structure. Poor capital structure policies that do not meet these constraints are likely to lead to a reduction in returns. Therefore, capital structure policies are likely to be important to a firm in obtaining the rents generated through the resources it possesses. To ensure the sustained competitive advantage, capabilities concerning the financing structure are necessary to extract rents from idiosyncratic resources.

Capital Structure: Imitability and Substitutability Considerations

The discussion in the preceding sections suggests that strategic assets, i.e., those with higher specificity, should be financed through equity. A deviation from this relationship can lead to higher organizing costs, resulting in poor performance. In an equilibrium situation, it would be expected that firms would tend to select the efficient organizing mode. Even if a firm has selected an unsuitable governance structure, it can recognize this shortcoming by looking at its rivals and alter its capital structure. Consequently, all firms would be securing the maximum possible gains obtainable from their valuable resources. The net outcome would be competitive parity among firms in the industry, rather than a competitive advantage for any one. The resultant implication is that capital structure decisions are unimportant, at least from the viewpoint of a sustainable competitive advantage.

In the context of the arguments presented herein, two issues become relevant. First, it is not the intent of this paper to suggest that capital structure decisions can become a *source* of sustainable competitive advantage. Rather the aim is to demonstrate the importance of financial policy in realizing the value present in a firm's valuable resources. As noted by Rappaport [51, p. 91], "[t]he value-creation process...depends on the translation of competitive dynamics into sustainable cash flows". Therefore, a necessary condition for the value inherent in strategic assets to lead to increased firm value is suitable capital structure decisions. This does not imply that financial policies, within themselves, can create value for the firm. Or, "it is a company's strategy and its managerial and financial ability to implement that strategy that are of critical importance, not financial policies per se" [25, p. 171]. In fact, Collis [21] has argued that organizational capabilities by themselves can never be a source of sustainable competitive advantage; nevertheless their understanding is critical in extending the resource-based view of the firm. Consequently, it can be concluded that well-managed financial policies are a necessary, but not a sufficient condition for firms to obtain a sustained competitive advantage.

FIGURE 3
Net Benefits Utilizing Different Mixes of Debt and Equity
at Different Levels of Specificity



The second issue deals with the strategic choices made by firms. The decisions taken by managers are often not based on efficiency considerations, but arise from the interplay of power and politics within the organization [66]. The decisions depend on the initial endowments of the firm, the power of decision makers, and varying preferences among its constituents. The interaction among these factors leads to a complex network of resources in the firm [14]. If the outcomes from this network do not correspond to the governance devices as predicted by transaction cost theory, there is likely to be a decrease in firm performance⁷. It may not be possible to alter the debt and equity mix due to the need to satisfy the conflicting claims of all constituents. Such a firm, therefore, will not be able to realize the full potential of its strategic assets, and exhibit a sustained competitive disadvantage. Put another way, those firms for which the leverage outcome after meeting the needs of all constituents matches closely the debt-to-equity mix as predicted by transaction cost theory will exhibit a sustained competitive advantage⁸.

One point, not explored in this paper, deals with substitute governance mechanisms. Can debt or equity be replaced by other forms of financing that also exhibit similar governance properties? The theory discussed in this paper revolves on the role of debtholders and equityholders as public sources of finance. It is possible, however, that firms can build relationships with private suppliers of finance, such as banks [22, 23]. The development of such relationships would then lead to an alteration of the control and property rights. Firms are able to negotiate transactions more easily with private sources. Moreover, the prospect of repeated transactions leads to different motivation and incentives for both parties [59]. The generally large investments of private suppliers provides them with a greater incentive to monitor firm managers. Often, they have representatives on the firm's board, providing them with greater ability for continuous monitoring, even for debtholders [42]. The need for mutual cooperation

initiates long-term relationships that can also lead to the development of trust between the two parties, which itself may lead to sustained competitive advantage for the firm [8]. It is possible, therefore, that firms using private sources of financing would exhibit different debt-to-equity ratios than those utilizing public capital markets.

CONCLUSION

This paper was directed towards providing a theoretical integration between strategic management and modern financial theory. Although its conclusions are in agreement with Bromiley [16] that strategy research should expand to include managerial decisions traditionally explained by financial theory, it is further contended that integration is also possible, mainly due to recent developments in both disciplines. This paper related conceptual arguments regarding a financial policy decision—capital structure—to the resource-based perspective of competitive advantage to examine some implications for firm performance.

As suggested by Oviatt [46], transaction cost theory provided a route to integrate modern financial theory with strategic management. Both Bettis [13] and Bromiley [16] believed that the twin concepts of efficient capital markets and the capital asset pricing model (CAPM) were the major hurdles for such an integration. The discussion in this paper indicates that recent research in finance has moved away from these assumptions. The transaction cost approach to capital structure is based on the concept of market failure for specific assets and the lack of information to debtholders about managerial motives and future actions. This shift has enabled researchers in both disciplines to think about issues within a common framework. Thus, while capital structure decisions may be “irrelevant” in an efficient capital market [43], it is the *imperfections* that become more important when considering the financing decision [41]. Although CAPM may be a suitable model when the assets are tradable, the approach breaks down in the case of firm-specific assets [53]. Risk estimation is not possible in such cases, making it difficult to value the associated projects with a cost-benefit-risk analysis.

This paper has explored the role of financial management in generating superior performance for a firm. The basic thesis is that the possession of a source of sustained competitive advantage is not sufficient to obtain improved value. Rather, the financial policies of a firm should be in harmony with its source of economic rents. A competitive advantage without such a capability cannot generate superior performance. Sound financial management provides firms with the capability to obtain the economic rents present in their strategic assets. Performance differences observed across firms are likely to be a function of the heterogeneity in strategic assets controlled, as well as the capability to deploy resources.

The decision regarding capital structure has been traditionally explained through financial theory. Herein, it has been argued that this decision is related to firm strategy. The strategy adopted by firms to gain a competitive advantage over other firms requires the use of specialized resources. Such a strategy, in turn, affects their financial policies. Firms cannot earn returns inherent in their resources if the capital structure is not consistent with strategy. Consequently, it is not sufficient for a firm to *possess* resources that generate sustained competitive advantages; its financial policies are important in *realizing* the potential rents.

ENDNOTES

1. These two perspectives parallel the discussion by Schulze [56] regarding the “strong-form” and “weak-form” viewpoints of the resource-based view.
2. The difference in control rights and property rights indicate that the two liability classes are alternate institutional arrangements. This point will be explored in more detail later.
3. The literature in this area is too extensive to be reviewed here. Moreover, several excellent reviews exist (for instance, see Harris & Raviv [33] and Myers [45]).
4. Debt and equity represent only a broad categorization of the several financial instruments utilized. It is likely that these instruments can be represented within a framework of property and control rights. For instance, high-yield (“junk”) bonds are subordinated or unsecured debt instruments. Being debt, they have a low level of control. Because of their unsecured status, however, they are also unlikely to recover a significant portion of their investment in the event of bankruptcy. That is, they share similarities with equity [27]. This apparent anomaly, of low control and property rights, is resolved by granting them stronger claims on earnings streams in the form of high returns.

5. The relationship between capital structure and asset specificity presumes certain rights available to different classes of lenders. These rights will depend on the institutional setup present in the economic system. For instance, the relationship is likely to be of a very divergent nature in Japan where banks (debtholders) are accorded a different set of control and property rights (see Aoki [3], Berglöf [12], Gerlach [28]).
6. It should be emphasized that utilization of an inappropriate mechanism does not necessarily lead to a net loss in value from the investment. That is, the firm may still exhibit an increase in value. This increase will, however, be lower than what would have occurred with the use of the theoretically predicted governance structure. The net benefit will be negative when the governance costs exceed the value potential.
7. Hennart [36] provides several examples where only some firms in an industry recognized efficient governance modes, hence, gained a sustained competitive advantage over their rivals
8. It can be argued that the investors of an underperforming firm may disinvest and seek out other firms to obtain better returns. However, competition in the capital market ensures that investors cannot buy into any firm so as to obtain greater than market returns. Moreover, since the buyers of the underperforming firm's stock would seek at least market returns for themselves, investors cannot sell their stock at any price greater than the current value. Thus, any reduction in the abnormal returns obtainable from a firm's assets due to a poor financial policy cannot be made up by investors through the disinvestment of its stock.

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