The Impact of Capital Structure on Advertising Competition: An Empirical Study

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ABSTRACT

This article examines the interaction between capital structure and advertising competition. Using a sample of firms that raise significant amounts of capital, we find that firms whose financial leverage has decreased as a result of their new funding increase their advertising significantly more than firms whose leverage has increased. We also find that these firms' industry rivals respond less aggressively with their own advertising when they have more debt in their capital structure. Overall, our results support the view that financial leverage has a "dampening" effect on the intensity with which a firm chooses to compete in the product market.

B

The interaction between capital structure and the intensity of product market competition has remained an open issue in economics. While some theoretical models predict that a more levered capital structure motivates a firm to be a more aggressive competitor, others predict the opposite behavior. In this article, we examine this issue by studying how a change in the capital structure of a firm affects the intensity of its advertising competition, as well as how the capital structure of its industry rivals affects their responses. These are important questions because economists have long recognized that advertising can affect the interaction among firms in the product.

C

Our results indicate that firms that raise significant amounts of capital step up the intensity of their advertising competition against industry rivals. But more important, after controlling for other factors, we find that the subsample of these firms whose financial leverage has decreased as a result of the new funding competes more vigorously than the subsample of firms whose leverage has increased. Similarly, leverage affects the reaction of the sample firms' industry rivals.

E

We find that these firms respond to the greater advertising competition of the capital-raising sample firms in their industries by increasing their own advertising more (less) aggressively than their industry peers if their own capital structure is relatively less (more) levered than that of their industry peers. Therefore, we find that, for both the capital-raising sample firms that initiate the more intense advertising competition and for their industry rivals that respond, a firm's greater use of debt motivates it to undertake "softer" advertising competition.

D

We hypothesize that such softening of competition from the use of debt in our study is due to the intangible and nontransferable nature of the assets created through advertising. That is, because leverage increases the probability of financial distress, firms that choose high levels of debt are less aggressive in their advertising expenditures out of concern about losing the value of their investments. This may explain why we find that leverage affects the behavior of the firms in our sample even though they are not financially constrained at the time of the event. We provide some empirical evidence supporting this explanation.

A

Our study complements existing empirical work on the impact of capital structure on product market competition and contributes to it in several important ways. First, we focus on advertising, one of the key components of interfirm rivalry in product markets. The study of advertising competition has until now been limited to product market interactions. However, whether and how the financial characteristics of competing firms influence the intensity of such competition remains an issue that has not yet been explored. Second, in contrast with earlier work that has looked at the impact of leveraged buyouts (LBOs) and cases of extreme recapitalization toward high leverage, we study both the firms that increased leverage and those that decreased it, neither change being extreme.

IN GROUPS, ANSWER THESE QUESTIONS:

1. Who are the authors of this article? Where and when was it published? What are the key words?

2. What is the purpose of this study?

3. What is 'financial leverage'?

4. What sort of companies do the authors study?

5. Write an APA reference for this article.

MULTIPLE CHOICE AND OPEN-ENDED QUESTIONS (10 questions, 2 points each)

1) If a company goes into debt, what happens to its advertising?
   a) It becomes more aggressive.
   b) It becomes less aggressive.
   c) It stays the same.
   d) It does not advertise at all.
2) What is the meaning of ‘financially constraint’ in the fourth paragraph?
   a) having a lot of money
   b) receiving a loan
   c) experiencing financial difficulties
   d) not making any profit at all
3) The authors claim that their study is unique and innovative in its focus.
   a) true
   b) false
4) What is the meaning of ‘interfirm’ in the last paragraph?
   a) ‘financial’
   b) ‘beneficial’
   c) ‘within a company’
   d) ‘between companies’
5) What sort of data do the authors claim to be using to support their argument?
   a) computer models
   b) scientific experiments
   c) real-life samples
   d) philosophical theories
6) **In your own words**, explain **what** companies in debt may do.

7) **In your own words**, explain **why** the companies in debt decide to act in the way described above.

8) **In your own words**, explain what is different about this study when compared to previous studies?

9) **In your own words**, explain what assets may be created through advertising.

10) **In your own words**, describe how this article may be useful.