

Effect of Owner's Equity Structure on stock Performance

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Abstract

The relationship between owner's equity structure and stock performance cannot be ignored because positive stock performance is vital for the sustainability of the company. This study is informed by Abor's (2005) research about the impact of owner's equity's structure on profitability of a company by investigating the impact on American firms listed on the New York Stock Exchange. The analyses used to estimate the functions related to stock performance (measured as profitability) with measures of owner's equity structure are correlation and regression analysis. The results of this study show a positive relationship between owner's equity structure and stock performance.

Keywords: Capital structure, equity structure, stock movements, volatility

I. Introduction

I.1 Background of the Study

For any business organization, owner's equity structure (henceforth referred to as equity structure) is a crucial factor determining success. The equity structure is important as a result of the quest to maximize the company's financial returns, and because of this, the decision has an extensive impact on the company's competitive environment. Different securities make up the equity structure of a firm. In general, there are various equity structures availed to companies such as arranging lease financing, issue convertible notes, use, warrants, sign forward contracts, issue convertible bonds, or trade bond swaps. At the same time, a company can also issue different capital structures in multiples to increase their worth (Abor, 2005, p. 438).

There are various theories, which have been postulated in an effort to explain equity structures of companies. Despite the interest in the equity structures of companies, studies in financial management have failed to postulate an optimal equity structure model. The most that researchers have established are prescriptions that only address short-term needs of a company (Abor, 2005, p. 438). The lack of an optimal model, informs the need to carry out this study. An in-depth understanding of the issue entails an analysis equity structure and its effects on the stock performance of a firm.

There are various parameters that can be used to gauge the performance of a stock, such as the daily traded volumes and movements of the share price. However, as Adlina (2015) argues, the most accurate parameter that measures the performance of a company is profitability. The researcher argues that profitability is reached when a company's income exceeds expense (Adlina, 2015). According to Adlina (2015) is the best measure of a stock's performance.

Many studies investigating the effect of equity structures on the profitability of companies have focused on industrial companies. However, there are other variables that impact service companies that do not share the same characteristic as manufacturing companies. In the service industry, financial resources set aside for building and equipment purposes are very low. If a service company leases out its assets such as building and equipment, then the total capital invested in such a scenario working capital (Gill & Biger, 2009). To analyze whether such financial patterns also affect all companies, it is imperative to carry out research that analyses companies from both the manufacturing and service industries.

This research studies the impact of equity structure on the profitability of American companies. The literature highlights various aspects that define the profitability of a company. The identification of these variables depended on profitability theories, varied equity structures, and previous empirical work. However, because there is limited literature, the choice of data has also been restricted. Hence, the group of proxy variables entails the following attributes: ratios of total, long term and short-term leverage to assets, in addition, the company's sales and size have also been highlighted. This is in Table 1.

In 2005, Abor analyzed data of companies listed on the Stock Exchange Market of Ghana. This research builds upon Abor's research by relying on data about listed companies on the NYSE.

I.2 Problem Statement

Owner equity structure being a component of capital structure generally targets to strengthen stock performance and to finance investments opportunities that need a large amount of cash that cannot be financed internally, like acquisitions and expansions. Thus, declarations of equity must signal good news to the investors because it would be perceived that the organization has identified value-adding projects to invest in. Growth of companies that use profits gotten from equity funding is positive if the profits are capitalized in positive NPV projects. On the other hand, poor investments are likely to deteriorate the performance of the stock because of the presence of profits or free cash flows if they are used to fund debts. As such, equity financed stock tend to perform poorly in the long run. Nevertheless, these outcomes for well-established stock markets cannot be general for developing markets because of the institutional variances.

From the studied researches on the relationship between owner equity structure and stock performance, using return on equity has received less attention. This research seeks to address this gap by carrying out a research on the effect of owner's equity structure on stock performance of the listed company.

I.3 Research Question

1) What is the impact of owner equity structure on performance of the stock?

I.4 Research Objectives

The objective of this research was to find out how owner's equity capital affect stock performance.

I.5 The Purpose

The purpose of conducting this research is to determine if owner's equity structure positively or negatively affect performance of the stock. The research looks into the connection between Equity structure and stock performance on how it raises cash by selling new shares which has little effect on stock performance but normally dilute existing shareholders since the firm raises cash through equity funding there is a positive item in the cash flows from funding activity sections and an upsurge of common stock at par value. If an organization raises money through debt financing, there is a positive item in the section of financing of the cash flow statement and an upsurge in the liabilities on the balance sheet. This research studies the impact of equity structure on the profitability of American companies. The literature highlights various aspects that define the profitability of a company. The identification of these variables depended on profitability theories, varied equity structures, and previous empirical work.

II. Literature Review

Roden and Lewellen (1995) analyzed equity structure and performance of a firm of these firms by evaluating 107 companies listed on the U.S. Stock market. The research relied on data from a ten-year period (1981-1990). Through regression analysis, the researcher concluded that there is a positive correlation between the leverage of a firm as a percentage of buyout.

By using DataStream (an electronic financial database), Yat, Ping, and Chi (2002) collected data about 35 players in the construction industry in Hong Kong. Through regression analysis, the research came to the conclusion that how a company performs on the securities market is correlated to its equity structure.

Abor (2005) research relied on data about twenty-two publicly traded firms listed in the Ghana Stock Exchange (GSE). The researcher came to the conclusion that (a) there is a positive correlation between short-term leverage to assets, (b) total leverage to assets, and (c) a negative correlation between long-term debt to total assets and. In addition, the research also established (1) a positive correlation between the size of the firm and its performance and (2) a positive correlation between sales growth and performance of a firm.

Mendell, Sydor, and Mishra (2006) analyzed the equity structure 20 forest companies in the US. By regression analysis, the researchers came to the conclusion that there is a negative relationship between leverage equity and performance of a stock.

The few available literatures that have investigated the relationship between equity structure and profitability have established that equity structure affects the performance of a company (profitability). The current research looks into the effects of equity structure on the stock performance of listed American companies.

II.1 Definition of Equity Structure

Equity structure is defined as the mixture owner's equity and debt used to avail financial resources to meet an organization's financial requirements. Eldomiaty (2008) argues that the selection of an equity structure is essentially a marketing plan (Eldomiaty, 2008, p. 32). The seminal work by Gersbach (2013) on equity structure, provided the basis on which future studies regarding the subject would be formulated (Gersbach, 2013, p. 243). Eldomiaty (2008) research postulated the theory of equity structure irrelevance and the researchers argued that the equity structure of a company (whether internal or external) does not affect its value on the securities market. A major limitation is that the study was based on assumptions, which fail in real life; for example, the assumption of no taxes, perfect markets, no transaction costs, and homogeneous expectations. The likelihood of financial distress, bankruptcy costs, and conducive tax returns of interest payment create a notion of an optimal equity structure whereby the value of the company is maximized, or the total cost of capital is lowered.

These costs bankruptcy, agency, and even pecking order impact the equity structure of a company. Bankruptcy costs are costs associated with the likelihood that a company would default its debt obligations. The costs may either be direct or indirect costs (Megginson, Lucey, & Smart, 2008). According to Megginson et al. (2008), direct bankruptcy costs entail administrative and legal costs in the process of bankruptcy while indirect costs are losses of the company that arise due to unwillingness of key stakeholders to engage with the company.

Agency costs are as a result of firm's reliance on debt financing on. Agency costs are brought about from the interaction of owners of the company and its administrators, and that between credit providers and company owners (Megginson, Lucey, & Smart, 2008, p. 56). The necessity to match gains and costs that arise from debt financing are as a result of the static trade-off theory demonstrated by Ghazouan (2013). The theory measures the values of a company when it has not incurred any leverage plus the current tax protection value less the current agency and bankruptcy costs value (Ghazouan, 2013, p. 629).

II.2 Asymmetry Information in Sources of Finance

Based on the argument of asymmetry information in sources of finance, Miao (2005) came up with the notion of an ideal equity structure. Companies and providers of finance are not exposed to the same information at the same time, and this brings variations in costs of finance.

After analyzing asymmetry of information in investment, Miao (2005) argued that there could be an optimal equity structure based on the concept of asymmetric information. Information asymmetry usually exists between the different sources of a company's financial resources. This asymmetry increases the cost of sourcing for capital. For example, a finance provider who works in the firm will have more information about the firm than a new equity holder as such, and the new equity investor will expect greater returns on investments. As a result, the firm will incur more finance costs when relying on external equity holders than internal ones (Miao, 2005, p. 2632).

The same argument can be used in the context of internal sources of finance and external providers. It can be argued that there is a preference list in companies with regards to financing on equity investment. The pecking order argues that the first source of finances are internal sources like ploughed back profits, assuming that information is equally shared among internal and external sources of funds. If additional funds are required, the company will turn to debt after which it issues equity to raise the remaining amount. The pecking order accurately reflects the fundamental costs associated with different financing sources (McMahon, 1994, p. 17).

The pecking order theory argues, when overvalued, most firms will sell their equities. This is because companies are assumed to always act in the best interest of shareholders and as such, they will hesitate to offer new equities unless such a transaction increases value for the current shareholder. Hence, when a new share is issued, they are assumed to slightly above the market value and to new investors, this is an overprice (Abor, 2005, p. 440).

McMahon (1994) maintains that to source for finance internally rather than rely on external sources, which are costly. Hence, based on the argument of the pecking order theory, profitable companies use less debt (external sources) than less profitable companies.

II.3 Equity structure and Profitability

Since interest payment on debt is tax deductible, it can be argued that adding new debt to the equity structure of the company improves the profitability of the company. As such, it is vital to investigate the relationship between equity structure and the performance of a stock (in this case profitability) to identify optimal equity structure decisions (Abor, 2005, p. 443).

II.4 Summary of Literature Review and Research Gaps

The literature reviewed outlined varied results as far as stock performance of equity offering companies is concerned. Some researches indicated no change in earnings for seasoned issuers whilst others presented either a negative or positive change in financial performance. The findings obtained from the researches above cannot be generalized for developing stock markets because of the variances in structures, policies as well as the fact that, rights offers have become ideal and prevalent technique of raising equity capital for extensions. The stock performance of seasoned equity providers US companies has received little attention with present researches concentrating on few companies. Such discoveries are universal to direct the investors in selecting the stocks to encompass in equity group. This research thus sought to fill this gap by establishing the effect of equity structure on stock performance.

III. Methodology

III.1 Measurement

To be consistent with other studies that have evaluated the same topic, this study is going to rely on measures used in Abor's 2005 study. Abor's study relied on non-experimental and correlational design. The study will rely on measurement is based on quantitative techniques because they highlight the vital connection between mathematical expressions and empirical observation of quantitative relationships.

To measure profitability dependent variable, the study relied on ROE as a gauge of the company's profitability.

Debt ratio was measured as the independent variable of equity structure

In addition, the study included growth, firm size, and sector as fixed attributes of corporate profitability. The proxy for firm size was the natural logarithm of sales (SIZE).

The sales growth of a company was determined as current sales less last year's over last year's sales.

For the service industry, firms were assigned the value 0 while for the manufacturing industry, firms were assigned the value 1.

Profitability = $b_0 + b_1 * (\text{SDA or LDA or DA}) + b_2 \text{ by SIZE} + b_3 \text{ by SG} + \mu_{i,t}$

b_0 was taken as the fixed attribute of the analysis

b_1 , b_2 , and b_3 were the representatives of short term leverage, size of the company, and its sales.

Balance sheet value was used to measure all variables

Profitability- measured by ROE.

III.2 Data Collection

The study established a database based on an analysis of 500 financial and accounting reports that had been released by publicly traded companies between. To get a random sample of service and manufacturing firms, the selection of companies was done online.

Out of the 500 financial reports released within the previously indicated time frame, only 272 were of importance to this research. The research used yearly cross-sectional data, and as such, 158 financial reports within the service industry resulted in 474 observations while 114

financial reports in the manufacturing industry resulted in 342 observations. Because of the random sampling technique, the selected sample is considered representative.

III.3 Definitions and Predicted Signs

The table highlights the definitions and theoretically predicted signs

Table 1: Explanation of variables and forecasted correlation

Variables	Explanation	Forecasted correlation
Short-Term Leverage	Short-term leverage over assets	+/-
Long-Term Leverage	Long-term leverage over assets	+/-
Total Leverage	Total leverage over assets	+/-
Size	the Logarithm of company's	+/-
Output	Reported Sales less past year's over past year's sales	+/-
Sector	Manufacturing company=1 Service company=0	+/-

III.4 Descriptive Statistics

Calculations of the variables relied on financial statements such as balance sheet or book values. Because most firms are sensitive with their financial information, no other value could be used to determine the market value of a company. Additionally, the performance of a company could only be estimated using book values because specific quantities regarding the market value of a company are hard to measure.

At the same time, when relying on market values in researches, there will be the concern arising from the date, which the market values refer to. As such, the current study relies on balance sheet values as of the date of the on the statement.

Table 2: Descriptive Statistics of the Variables

The Service Sector (N = 474)

Variables	Min.	Max.	Average	Std. Deviation
SDA	0.001	0.761	0.233	0.153
LDA	0.002	0.954	0.322	0.217
DA	0.065	1.163	0.554	0.190
SG	0.003	1.149	0.142	0.142
SIZE	10.000	21.350	14.954	1.904
ROE	0.017	3.065	0.265	0.293

The Manufacturing Sector (N=342)

Variables	Min.	Max.	Average	Minimum
SDA	0.041	0.483	0.210	0.091
LDA	0.012	0.733	0.281	0.154
DA	0.136	0.992	0.491	0.165
SG	0.001	0.645	0.155	0.125
SIZE	8.920	20.470	14.870	2.144
ROE	0.058	0.866	0.259	0.150

The variables were calculated;

SDA was calculated by dividing short-term leverage by assets.

LDA was calculated by dividing long-term leverage by assets.

DA was calculated by dividing by cumulative debt by assets.

SIZE was taken as the Logarithm of sales.

ROE – Return on Earnings

For the service industry, observations were: $158 \times 3 = 474$

From the financial statements, average indicators of the variables were calculated:

- short-term leverage was weighted against assets, and the value was 23.3%
- long-term leverage was weighted against assets, and the value was 32.2%
- total leverage was weighted against assets, and the value was 55.4%
- sales growth was estimated to be 14.20%
- mean profitability (stock performance) was calculated to be 26.50%
- The mean size of a firm was estimated by the logarithm of sales, and the value was 14.954 million.

For the manufacturing industry, observations were: $114 \times 3 = 342$

From the financial statements, indicators of the variables were calculated:

- short-term leverage was weighted against assets, and the value was 21%
- long-term leverage was weighted against assets, and the value was 28.1%
- total leverage was weighted against assets, and the value was 49.1%
- mean sales growth was calculated to be 15.50%
- mean profitability (stock performance) estimated by ROE was calculated to be 25.90%
- mean size of a firm was estimated by measured by the logarithm of sales, and the value was 14.870 million

The Pearson correlation technique that was used in this analysis is detailed in Table 3. The technique is used to establish the correlation between equity structure and performance of a company. It was established that the profitability of a company (measured by ROE) is positively related to short and long term debt in both sectors. The positive relationship shows that leverage (short term and total) improves the stock performance of a company in industries. This is improved preface is as a result of interest payments that are tax deductible.

Table 3: Correlation Analysis

The Service Sector (N =454)

	ROE	SDA	LDA	DA	SG	SIZE
ROE	1	0.212**	0.062	0.254**	0.010	-0.053
SDA		1	-0.518**	0.212**	0.013	0.036
LDA			1	0.726**	0.052	0.063
DA				1	0.070	0.101
SG					1	-0.124
SIZE						1

The Manufacturing Sector (N = 342)

	ROE	SDA	LDA	DA	SG	SIZE
ROE	1	0.431**	0.179	0.407**	-0.143	0.096
SDA		1	-0.170	0.391**	-0.077	0.105
LDA			1	0.841**	-0.180	-0.140
DA				1	-0.213*	-0.073
SG					1	-0.063
SIZE						1

IV. Research Findings and Results

The research established a positive correlation between short term leverage to the stock performance of a company in both the manufacturing and service sectors (see table 4). The

inferences of the study are in line with previous researchers that established a positive correlation between equity structure and profitability of companies, e.g. Abor’s research. This means that in the short term, debt ends up to be less costly. Coupled with relative low-interest rates, with short term leverage company is expected to increase its profitability levels.

Table 4 also highlights non-significant relationships between (1) firms and profitability, (2) sales growth and profitability in both industries.

Table 4: Regression Analysis

The Service Sector: Short-Term Leverage to Assets

[R2 = 0.050; SEE = 0.306; F = 2.212]

Equation (A): $ROE = 0.378 + 0.428 SDA - 0.021 SG - 0.013 SIZE$

	Coefficients	Standard Error	Standard	t	The Significant	Collinearity	Statistics
							VIF
Fixed	0.378	0.225	0.213	1.678	0.096		
SDA	0.428	0.175	-0.010	2.451	0.016	0.995	1.005
SG	-0.021	0.192	-0.081	-	0.914	0.982	1.018
				0.109			
SIZE	-0.013	0.014		0.358	0.358	0.982	1.018

The Manufacturing Sector: Short-Term leverage to Assets

[R2 = 0.162; SEE = 0.142; F = 5.303]

Equation (A1): $ROE = 0.110 + 0.620 SDA - 0.124 SG + 0.003 SIZE$

	Unstandardized Coefficients		Standard coefficients	t	Sig.	Collinearity	Statistics
	B	Std. Error	Beta			Tolerance	VIF
Constant	0.110	0.116		0.948	0.346		
SDA	0.620	0.170	0.372	3.651	0.000	0.995	1.016
SG	-0.124	0.122	-0.104	-	0.311	0.982	1.013
				1.020			
SIZE	0.003	0.007	0.048	0.473	0.638	0.982	1.011

Where,

- ROE is the dependent variable
- SDA, SG, and SIZE are the Independent Variables:

It is important to keep in mind that in the service industry, only 5.00%, (which is R²) of the variance in the degree of performance of a firm is accounted for SDA, SG, SIZE. y. On the other hand, in the manufacturing sector, only 16.2% (which is derived by R²) of the variance in the degree of performance of a firm can be accounted for by the degree of SDA, SG, and SIZE.

The study established a positive correlation between long term leverage, in the equity structure, to the stock performance of a firm in the manufacturing sector (see table 5). The inference in this study contradicts with the conclusions of other studies, which argued long term leverage, in the equity structure of the company, negatively relates to its performance to (Abor). In the service industry, the study failed to establish any important correlation between (1) the ratio of long-term debt to performance of a company (2) firm size and profitability (3) sales growth and profitability. Various reasons may have contributed to the lack of vital correlation between long-term debt and profitability such as high gearing ratio that is applied by lenders for long term debt. For example, while in the service sector the long term leverage to assets is 32.25%, in the manufacturing sector the same ratio is 28.10%. As such, the high gearing ratio erodes profitability, and as a result, the tax benefits are also eroded.

Hence, the research concludes that there is no significant correlation between (1) the size of the company and the performance of its stock and (2) the growth of sales and performance of its stock.

Table 5: OLS Regression estimates on factor affects profitability

The Service Sector: Long-Term Leverage to Assets

[R2 = 0.011; SEE = 0.312; F = 0.448]

Equation (B): ROE = 0.418 + 0.114 LDA - 0.001 SG - 0.012 SIZE

	Unstandardized Coefficients	Standard Error	Standardized Coefficients	t	The Significant	Collinearity Tolerance	Statistics VIF
Fixed	0.418	0.230		1.817	0.072		
LDA	0.114	0.133	0.076	0.858	0.392	0.998	1.002
SG	-0.001	0.196	0.000	-0.005	0.996	0.984	1.016
SIZE	-0.012	0.015	-0.072	-0.801	0.425	0.984	1.016

The Manufacturing Sector: Long-Term leverage to Assets

[R2 = 0.077; SEE = 0.149; F = 2.282]

Equation (B1): ROE = 0.113 + 0.226 LDA - 0.116 SG + 0.008 SIZE

	Unstandardized Coefficients B	Std. Error	Standardized Coefficients Beta	t	Sig.	Collinearity Tolerance	Statistics VIF
Fixed	0.113	0.127		0.884	0.379		
LDA	0.226	0.106	0.231	2.122	0.037	0.951	1.052
SG	-0.116	0.129	-0.097	-0.899	0.371	0.965	1.036
SIZE	0.008	0.008	0.112	1.042	0.301	0.973	1.027

The research established a positive relationship between equity structure and profitability.

V. Discussion

Financial leverage has been established to create tax benefits for companies, but on the other side, it also increases default risk for finance providers. Default risk can be defined as the risk associated with a company's ability to pay or default its credit. As highlighted in table 2, the service sector has higher mean long term leverage to assets than the in the manufacturing sector; in the service industry, it is 32.2% while in the manufacturing it is the same rate is 28.1%. This means that high gearing ratio erodes a company's profitability and in the long run, tax benefits are also eroded.

Although the occurrence of default is rare, typical company's rate of default is 2%. However, the default probability varies across companies and industries. According to Bierman (2003), as leverage increases, the potential returns increase, but the company's ability to service the debt also reduces (Bierman, 2003).

The workings of the manufacturing and service sectors are totally different. For example, the service industry almost has zero investment in machinery and equipment. If a service company leases out its assets such as building, then the total capital invested is mainly working capital. As such, a lender will not have enough assets to claim in case of liquidity.

It is also important for a lender to understand the ability of the borrower to meet debt obligations. This rate is estimated the debt service coverage ratio. Here also, when gearing ratios are high, the costs meeting debt obligations will increase because of increased default risk, and this negatively affects the liability of the firm. When the economy is in a dip, the sales of companies reduce and hence their financial returns. As a result, companies will start defaulting their debt obligation. As such, it is vital for lenders to thoroughly review important

financial statement (1) operating income (2) cash flows (3) value of liabilities and assets, and so on. Lenders should undertake such activities in an effort to default risk and losses.

VI. Limitation of the Study

This study is limited as it only highlights manufacturing and service firms in the U.S. Future research is required to investigate the generalizations of the current research to go beyond the American context.

VII. Conclusions

The findings of this study suggest that equity structure affects profitability. This is because, in the US., interest that accumulates on credit is exempted from tax. This research argues that companies reporting high returns usually rely on internal debt before considering external sources. In as much as the interest accumulated on credit is exempted from tax, taking more credit increases the default risk of the company. As such, the company should rely on optimal equity structure. The appropriate equity structure entails some debt but not all of it should be 100% debt. This means that it is best to rely on debt and personal equity, which in turn maximizes cost of capital.

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