After the Revolution

Forty years ago, the Modigliani-Miller propositions started a new era in corporate finance. How does M&M hold up today?

Dun Gifford Jr. - CFO Magazine
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I have a simple explanation [for the first Modigliani-Miller proposition]. It's after the ball game, and the pizza man comes up to Yogi Berra and he says, 'Yogi, how do you want me to cut this pizza, into quarters?' Yogi says, 'No, cut it into eight pieces, I'm feeling hungry tonight.' Now when I tell that story the usual reaction is, 'And you mean to say that they gave you a [Nobel] prize for that?'"

--Merton H. Miller, from his testimony in Glendale Federal Bank's lawsuit against the U.S. government, December 1997

It has been 40 years since Franco Modigliani and Merton Miller first proposed that a company's value is independent of its capital structure--no matter how you slice it. Published in the June 1958 issue of The American Economic Review, "The Cost of Capital, Corporate Finance, and the Theory of Investment" laid out a set of ideas that came to be known at different times as the "bombshell assertions," the "irrelevance propositions," or simply M&M. In 30-odd pages, the authors expounded radically new ways of thinking about capital structures and markets-- ways that helped win Nobel prizes in economics for Modigliani, a professor at Massachusetts Institute of Technology, and Miller, a professor at University of Chicago Graduate School of Business.

In effect, M&M says don't try to make your shareholders wealthy by adjusting debt levels, because--at least in the somewhat idealized world in which economists operate, and sometimes in practice--it won't work. Instead, M&M argues, the company's best capital structure is one that supports the operations and investments of the business.

"An investment banker has a recap proposal for your company and he dumps on your desk a book with 100 pages of projections about earnings- per-share impact, return on assets, and all kinds of accounting numbers," explains Jeremy Stein, who teaches corporate finance at MIT's Sloan School of Management. "So you are thinking, 'Which of these [numbers] is relevant?'" What M&M tells you, says Stein, is to disregard the numbers and focus instead on how the recap would change your operating behavior.

Controversial from the beginning, at age 40 the irrelevance propositions are proving to be anything but irrelevant, still raising hackles in academic circles. Not surprisingly, critics question M&M's otherworldly assumptions--that companies don't have to pay corporate taxes, don't have to pay investment bankers to raise capital, don't have to pay lawyers when in bankruptcy, and don't withhold information from capital markets. (Such simplifying assumptions are, of course, standard practice in economic model making.)

Indeed, an entire generation of academics has been hard at work bringing M&M down from the "frictionless" world of theory to the roll- up-your-sleeves world of empirical research. What impact, these researchers have asked, do things like managerial self-interest (agency costs), insider's knowledge (information asymmetries), and the possibility of bankruptcy (financial distress) have on the value of a company? How much attention should each be given in the design of capital structure?

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The first major assault on M&M came soon after the propositions were published. The authors, critics said, clearly underestimated the tax benefits of debt, which exist thanks to the tax-deductibility of interest payments. This so-called corporate tax shield means that, for any number of companies, using more debt means paying less taxes and hence increases the value of the company. Modigliani and Miller conceded the point in a correction paper published in 1963, and brought their estimates back in line.

"We made a big mistake on the matter of how firm value is affected by interest deductibility under the corporate income tax," Miller says. "In the correction paper, we worked out the argument a little more rigorously and showed that you could create value with debt, and we came up with an estimate of how much value you could create-- though it didn't turn out to be a very high number."

To this day, however, exactly how valuable the tax shield is for investors remains a bone of contention between Modigliani and Miller: "The whole issue of taxes is a divisive one," says Modigliani. "Miller still seems to think-- something that I disagree with--that taxes make no difference. I believe that is wrong."

Where does the CFO come down on this debate?

"The availability of the tax deduction is a primary consideration when making a decision about whether you issue equity or debt," says Hank Wolf, executive vice president of finance at Norfolk Southern Corp., the railroad and transportation giant based in Norfolk, Virginia. "The tax benefit, for example, may influence the decision of how you are going to finance an acquisition or capital investment. But I think there are more important considerations, such as companywide strategic issues and overall shareholder value, that come into play." Case in point: Norfolk Southern's commitment to low debt levels proved indispensable when it needed to raise cash for its successful Conrail Inc. bid, in 1996.

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