Capital Structure and Supply Chain Capacity Investment

Speaker:
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Abstract:
We study a supply chain composed of a supplier and a buyer. The supplier has to make a buyer-specific capacity investment before demand uncertainty has been resolved. After the uncertainty has been revealed, the firms decide whether to trade with each other and on what terms through bilateral bargaining. We show that the supplier will borrow risky debt and invests more in capacity than if it were purely equity financed. The expanded capacity under risky borrowing is below the channel-efficient level if it is optimal to finance the capacity with a mixture of equity and debt, and above the channel-efficient level if it is optimal to finance the capacity entirely with debt. We further explore alternative contracts under which the supplier pays the buyer a lump sum to become the sole claimant of any profit generated ex post. We show that (1) the alternative contract achieves channel coordination and the supplier will not borrow risky debt if the lump sum is paid ex ante before the demand is realized; however, (2) the supplier will borrow risky debt and over-invest in capacity if the lump sum is paid ex post.

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All Interested are Welcome