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Joint Production and Financing Decisions: Modeling and Analysis

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Xiaodong Xu (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=440123)

Northwestern University - Department of Industrial Engineering and Management Sciences

John R. Birge (https://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=11862)

University of Chicago - Booth School of Business

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Abstract


This paper develops models to make production and financing decisions simultaneously in the presence of demand uncertainty and market imperfections. While the Modigliani and Miller propositions demonstrate that a firm's investment and financing decisions can be made independently in a perfect capital market, our models illustrate how a firm's production decisions are affected by the existence of financial constraints. We analyze the interactions between a firm's production and financing decisions as a tradeoff between the tax benefits of debt and financial distress costs. Our numerical examples illustrate that a traditional all-equity manufacturing company can improve its performance significantly by making real and financial decisions together. The results illustrate greater firm value sensitivity to production decisions than to financing decisions and that low-margin producers face significant risk in not coordinating production and financing decisions.

Keywords: Production decisions, financial constraints, capital structure, debt capacity

JEL Classification: C61, G31, G32

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Condition (18) is satisfied; hence, $V(x, D)$ is a concave function of (x, D) so that

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