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Interaction between Financial Risk Management and Value of the Firm among Private Equity Firms in Frontier Markets: A Theoretical Perspective

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Abstract

Purpose: The study attempts to establish a theoretical basis for the interaction between financial risk management and value of the firm among private capital firms.

Design and Methodology: The study was based on a theoretical review of the interaction between financial risk management and value of the firm focusing on the applicability of agency theory, trade-off theory and credit metrics model in anchoring capital management risk, liquidity risk and credit risk

Findings: The study shows that although private equity firms are not publicly listed, they face financial risks associated with defaults on loans advanced, volatility of interest rates, liquidity management and capital management. The agency theory explains the role of capital management risk and liquidity risk by incurring agency costs to deter the management from engaging in activities hindering achievement of wealth maximization goal. Similarly, companies balance between threat of bankruptcy and tax benefits of debt by finding an understanding between the advantages and the disadvantages that come with debt as outlined in the trade-off theory while credit metrics model help firms to quantify credit risk on loans, fixed income instruments, commercial contracts.

Practical Implications: Private equity firms must constantly be engaged in risk mitigation activities by extensively evaluating their financial, legal and business environments. The management of private equity companies must also always try to balance between the threat of bankruptcy and the tax benefits of debt in the formulation of capital structure by finding a compromise between the benefits and costs of raising debt. The management should also carefully consider credit risks during the credit appraisal and credit awarding process by using appropriate credit appraisal models such as credit metrics model.

The Significance of the Study: The conclusions reached in this study significantly impacts the perspective of the management with regard to risk management particularly in the banking sector which is predominantly adversely affected by credit risk, liquidity risk and capital management risks. Consequently the management would be in a better position to manage their risks using appropriate models and improve organizational efficiency and performance.