

THE CAPITAL STRUCTURE CHOICE: NEW EVIDENCE FOR A DYNAMIC TRADEOFF MODEL

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Most academic insights about corporate capital structure decisions come from models that focus on the trade-off between the tax benefits and financial distress costs of debt financing. But empirical tests of corporate capital structure indicate that actual debt ratios are considerably different from those predicted by the models, casting doubt on whether most companies have leverage targets at all. In particular, there is considerable evidence that corporate leverage ratios reflect in large part the tendency of profitable companies to use their excess cash flow to pay down debt, while unprofitable companies build up higher leverage ratios. Such behavior is consistent with a competing theory of capital structure known as the "pecking order" model, in which management's main objectives are to preserve financing flexibility and avoid issuing equity.

The results of the authors' recent study suggest that although past profits are an important predictor of observed debt ratios at any given time, companies nevertheless often make financing and stock repurchase decisions designed to offset the effects of past profitability and move their debt ratios toward their target capital structures. This evidence provides support for a compromise theory called the *dynamic tradeoff model*, which says that although companies often deviate from their leverage targets, over the longer run they take measures to close the gap between their actual and targeted leverage ratios.

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