JOURNAL ARTICLE

Debt Financing and Financial Flexibility Evidence from Proactive Leverage Increases

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David J. Denis, Stephen B. McKeon

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Abstract

Firms that intentionally increase leverage through substantial debt issuances do so primarily as a response to operating needs rather than a desire to make a large equity payout. Subsequent debt reductions are neither rapid, nor the result of proactive attempts to rebalance the firm's capital structure toward a long-run target. Instead, the evolution of the firm's leverage ratio depends primarily on whether or not the firm produces a financial surplus. In fact, firms that generate subsequent deficits tend to cover these deficits predominantly with *more* debt even though they exhibit leverage ratios that are well above estimated target levels. Our findings are broadly consistent with a capital structure theory in which financial flexibility, in the form of unused debt capacity, plays an important role in capital structure choices.

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