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Armen Hovakimian, Tim Opler and Sheridan Titman

The Journal of Financial and Quantitative Analysis

Vol. 36, No. 1 (Mar., 2001), pp. 1-24 (24 pages)

Published By: Cambridge University Press



<https://doi.org/10.2307/2676195>

<https://www.jstor.org/stable/2676195>

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# The Debt-Equity Choice

Armen Hovakimian, Tim Opler, and Sheridan Titman\*

## Abstract

When firms adjust their capital structures, they tend to move toward a target debt ratio that is consistent with theories based on tradeoffs between the costs and benefits of debt. In contrast to previous empirical work, our tests explicitly account for the fact that firms may face impediments to movements toward their target ratio, and that the target ratio may change over time as the firm's profitability and stock price change. A separate analysis of the size of the issue and repurchase transactions suggests that the deviation between the actual and the target ratios plays a more important role in the repurchase decision than in the issuance decision.

## I. Introduction

Traditional corporate finance models suggest that firms select optimal capital structures by trading off various tax and incentive benefits of debt financing against financial distress costs. While there is support for these tradeoff models in the empirical literature, recent evidence suggests that a firm's history may play a more important role in determining its capital structure. For example, highly profitable firms often use their earnings to pay down debt and, as a result, are usually less levered than their less profitable counterparts (see, for example, Titman and Wessels (1988)). In addition, firms tend to issue equity following an increase in stock prices, (see, for example, Masulis and Korwar (1986) and Asquith and Mullins (1986)), implying that firms that perform well subsequently reduce their leverage

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## Journal Information

The Journal of Financial and Quantitative Analysis (JFQA) is published bimonthly in February, April, June, August, October, and December by the Michael G. Foster School of Business at the University of Washington in cooperation with the Arizona State University W. P. Carey School of Business and Universit...

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