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Partial Adjustment toward Target Capital Structures

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ABSTRACT

The literature provides conflicting assessments about how firms choose their capital structures, with the “tradeoff”, pecking order, and market timing hypotheses all receiving some empirical support. Distinguishing among these theories requires that we know whether firms have long-run leverage targets and (if so) how quickly they adjust toward them. Yet many previous researchers have relied on empirical specifications that fail to recognize the potential impact of adjustment costs on a firm’s observed leverage. We estimate a relatively general, partial-adjustment model of firm leverage and conclude that firms *do* have target capital structures. The typical firm closes about one-third of the gap between its actual and its target debt ratios within one year. “Targeting” behavior explains far more of the observed changes in capital structure than market timing or pecking order considerations.

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