Financial Flexibility and the Puzzle of Capital Structure

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Abstract

To explain the low-leverage puzzle, we propose a flexibility-adjusted tradeoff model that integrates the motive of cash savings into the traditional tax/distress model. This model shows that when firms foresee the expected value of cash holdings is high, value-maximizing firms would rather keep lower debt ratio to preserve or improve their future ability to accumulate cash flow. We further provide empirical evidences on how expected value of cash holdings affects firms' leverage target. Instead of discussing the adjustment costs, our theoretical and empirical evidences show that the low-leverage puzzle could result from overestimation of the target. After accounting for the expected value of cash in estimating target leverage, we do find that the leverage target is lower than that estimated by regression without cash value considerations. We thus suggest that the motive of cash savings helps explain why firms prefer greater leverage conservatism in recent empirical findings, consistent with the growth of firms' propensity to hold cash over the last two decades.

JEL Classification: G31; G32; C61
Keywords: Capital structure dynamics; Optimal capital structure; Low-leverage puzzle; Financial flexibility; Cash flow savings.