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Seize the moment: Opportunism in Australian capital markets ☆

SzeKee Koh [a,*], Robert B. Durand [a], Iain Watson [b]

[a] *University of Western Australia Business School, Australia*
[b] *University of Queensland Business School, Australia*

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This paper examines theories of capital structure using a dataset of listed Australian companies from 1993 to 2005. Companies appear to have target leverage but they take advantage of favorable firm characteristics to achieve these targets. Issuers issue debt when they are profitable. When firms are profitable and perform well in the market, they will issue both debt and equity.

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"…the wise general in his deliberations must consider both favorable and unfavorable factors…—Sun Zi".[1]

1. Introduction

What determines the financing decisions of a company? What triggers the use of debt vis-à-vis issuing equity? Research into these questions presents a variety of results and does not permit us to draw a consistent picture. Academics have investigated various capital structure theories such as trade-off, pecking order, agency and market timing, in a number of different institutional settings (e.g., America and Australia). Furthermore, recent research has challenged the robustness of inferences by research

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* Corresponding author at: M250 (Accounting and Finance), 35 Stirling Highway, Crawley, Western Australia, 6009, Australia. Tel.: +61 8 6488 1816; fax: +61 8 6488 1047.

E-mail address: SzeKee.Koh@uwa.edu.au (S.K. Koh).

[1] Griffith (1971) page 113.

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suggesting that firms have target leverage (Shyam-Sunder and Myers, 1999; Chang and Dasgupta, 2009[2]). Hence, the existing empirical evidence on capital structure is mixed, leaving one of the central questions in corporate finance unanswered.

One of the reasons for the absence of a satisfactory answer is due to the fact that a number of competing theories share the same predictions. For example, the trade-off and market timing hypotheses predict that a negative relationship exists between the market-to-book ratio and the leverage of a firm. This implies that if external finance is raised, firms will issue equity (instead of debt) when their market performance is high. Therefore, any analysis that finds that equity issuance is associated with high performance is inconclusive as to which theory best explains the data. We employ a methodology that allows us to test the capital structure decisions in a setting where competing theories of capital structure do not share the same predictions. We group firms into four categories. The first three groups consist of external fund raisers and we sub-categorize them into issuers of debt, equity and dual issuers (those who issue debt and equity concurrently). The fourth group consists of firms that do not raise any external funds (i.e., they do not issue debt or equity).[3] These four categories represent the entire set of strategies open to firms.[4] To model each strategy, we then utilise a common set of explanatory variables that are widely accepted in the corporate finance literature. Using common explanatory variables to explain *all* of the four possible capital raising strategies simultaneously, provides an opportunity to compare and contrast competing explanations for competing theories. For example, both trade-off and market timing hypotheses predict that firms issue less debt when their market performance is high. Therefore, there is a problem in the interpretation of the market-to-book ratio when analyzing the decision to issue debt or equity: a negative relationship between issuing debt and firms' market-to-book ratio is consistent with the predictions of both trade-off and market timing. By performing a logistic regression on dual-issuers against equity issuers, the market timing effects will be held constant and should be insignificant when modeling the choice of the dual versus equity issue. Any effects on the market performance variable observed can be attributed to trade-off hypothesis.

Using a sample of listed firms from the Australian Securities Exchange (ASX) between 1993 and 2005, we separate our data into the four groups introduced in the preceding paragraph (issuers of debt, equity, dual issuers and firms that do not issue debt or equity). We explore the determinants of the type of financing that Australian companies utilize. We also consider how firms adjust their capital structures dynamically. Our analysis enables us to understand why, and when, firms choose to use external financing.

Our analysis of Australian companies demonstrates that firms behave opportunistically when raising funds. Managers seize the moment to exploit firm characteristics that facilitate a particular capital-raising strategy at a particular time. In the long run, firms appear to have a target debt ratio which is determined by various tradeoffs between the costs and benefits of debt versus equity. Therefore, managers act opportunistically to achieve strategic goals.

2. Literature review

There are many reasons behind the choice of securities when firms require funding. Previous research offers various, but competing, models to explain this financing decision: trade-off theory, pecking order theory and market timing. We discuss each of these.

In the trade-off model, firms identify their optimal leverage by weighing the costs and benefits of an additional dollar of debt (Modigliani and Miller, 1963; Jensen and Meckling, 1976; Myers, 1977; Stulz, 1990; Hart and Moore, 1995; and Ross, 1977). The benefits of debt include, for example, the tax

[2] We discuss Shyam-Sunder and Myers (1999) and Chang and Dasgupta (2009), and their implications for this study, in the following section.

[3] Therefore, we assume that not raising capital (that is, having a passive capital structure strategy) is also a decision undertaken by a firm's management.

[4] It can be argued that another capital raising strategy is to issue hybrid securities such as convertible debt. In this paper, convertible issues are not captured separately from the four capital raising activities (issuers of debt, equity, dual issuers and firms that do not issue debt or equity). If a sample firm issues only convertible debt in a fiscal year, the firm will be grouped as a debt issuer (if the net debt issued exceeds 5% of the book value of the total assets).

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