Impact of Market Timing on the Capital Structure of Russian Companies

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ABSTRACT

Prior research on market timing theory in relation to developing markets only analyzes equity issuance and provides contradictory results. Using a sample of large Russian companies in nonfinancial sectors between 2008 and 2015, this paper analyzes both equity and debt market timing to explore the impact of market timing on firms’ capital structure. To test the robustness of the results, we use several proxies for both timing types and include Russian-specific control variables of corporate governance and ownership. The results show that Russian companies time the debt market to attract extra capital if the value of the interest rate in the current period is lower than the rates in previous periods. The net debt issued decreases when interest rates are high, which indicates debt market timing. Consistent with previous studies, we find that Russian companies do not time the equity market. Added corporate governance factors suggest that younger boards of directors prefer debt financing to equity issuance, as well as more experienced ones. State ownership is negatively connected with leverage.

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Introduction

Capital structure refers to the way a company finances its current operations and growth through a combination of equity and debt capital. In recent years, the choice of capital structure to maximize a company’s market value has become one of the most significant challenges facing corporate finance. The increasing interest in capital structure has led to the development of a range of theories explaining how companies choose a particular combination of debt and equity and which factors influence this choice. While some traditional theories are employed only for efficient markets and rational agents, behavioral theories provide a more realistic explanation of corporate finance decisions.

The traditional theories of capital structure, such as the trade-off and pecking order theories, assume that managers act rationally, meaning that they make financing decisions based on a comparison of the costs (e.g., agency or adverse selection costs) and the benefits of different sources of capital. These theories imply that capital markets are efficient, so a company cannot benefit from switching between equity and debt financing. However, recent research has criticized these assumptions because they fail to explain real-life situations.

One of the most recently discussed behavioral theories on capital structure is the market timing theory. According to market timing, corporate financing decisions and, therefore, a company’s capital structure are strongly related to market conditions, particularly market values and their fluctuations. Baker and Wurgler (2002) define capital structure as the

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cumulative outcome of a manager’s attempts to time the capital market. Market timing implies that a company can exploit a “window of opportunity”; in other words, it can raise additional capital when market conditions are favorable for a specific type of capital.

Although considerable research has been devoted to the market timing by companies in developed markets, less attention has been paid to developing markets. It is reasonable to suppose that the practice of market timing can benefit companies from developing countries because they operate in emerging capital markets, which are less efficient and face a higher level of information asymmetry. However, recent papers on emerging markets have found contradictory results. Although Russian companies supposedly rely more on debt financing, the few studies that examine market timing in relation to Russian companies do not confirm whether equity market timing can explain their behavior. These results can be explained by low liquidity and the underdevelopment of the Russian equity market.

Because two types of capital exist, market timing can take two forms. Timing the equity market refers to the practice of issuing shares at high prices and then repurchasing them at low prices. Timing the debt market refers to the practice of issuing debt when the cost of debt is low compared to historical levels. Although debt market timing may be a significant factor in the debt–equity choice of firms in developing markets, the issue is not resolved as previous empirical research concentrates on developed markets. This paper fills this gap in the literature by investigating the influence of both debt and equity market timing on the capital structure of large companies operating within the developing Russian market.

An exploration of Russian companies is interesting for several reasons. First, Russian financial markets were created after the transition from a planned economy to a market economy under crisis conditions (Goriaev & Zabotkin, 2006). Specific features of the Russian economy make it incomparable with other developing markets, and thus its exploration can be regarded as a special case. Second, the Russian equity market is characterized by the high level of informational asymmetry (Davydov & Váhämäki, 2013). This makes market movements unpredictable and limits the ability of managers to time the market effectively. Third, the bond market in Russia is much more developed than the equity market (Lazareva, Rachinsky, & Stepanov, 2008). Consequently, we argue that debt market timing should be examined as a possible explanation for why Russian companies choose a capital structure.

We analyze a sample of Russian listed companies between 2008 and 2015. Although the initial sample contained 219 companies, missing data decreases our sample considerably to 790 firm-year observations. Our results show that debt market timing influences a company’s capital structure. The results prove the supposition that Russian companies usually prefer to use bonds, rather than equity, to secure external finance. A test of net debt issued confirms the importance of debt timing. However, rate changes in the bond market do not explain net equity issued. Our results suggest that Russian companies do not time the equity market. Retained income and debt changes explain book leverage. We find that governance factors, such as the average age of boards of directors and directors’ average experience, influence capital structure. Specifically, state ownership is negatively connected to leverage. Also, Russian companies with a higher market-to-book ratio have lower market leverage. However, these results do not provide sufficient evidence for the equity market timing hypothesis, as historical values are not included. Overall, the results suggest that Russian companies do not need to time equity market because they have other channels of obtaining finance.

We contribute to the literature in several ways. First, we test both equity and debt market timing practices. We add to the scant literature on the timing of the equity market in Russia. In addition, this study is the first paper to test debt market timing using Russian data. Of particular significance, unlike previous approaches, we test debt and equity market timing with the same equations. This method allows us to identify the influence of debt market timing in relation to issued equity. Second, the paper contributes to the current debate on the influence of corporate governance and governmental ownership on the capital structure within emerging markets. By including variables to check the robustness of our results, we determine whether the unique characteristics of the Russian business environment influence market timing.

The remainder of this paper proceeds as follows. Section 2 reviews the literature on market timing to summarize the findings of previous empirical research and choose the measures for debt and equity timing. We also describe the main features of the Russian economy and its financial markets in this section. Section 3 presents the main research framework, including the hypotheses, variables, and the empirical model. Section 4 describes the sample used for empirical testing. Section 5 presents the main findings for the debt and equity timing theories. Section 6 presents robustness checks, and Section 7 concludes the paper with a summary and discussion of the main results as well as future research suggestions.

2. Theoretical background

2.1. Market timing in developed markets

Many economists consider market timing theory from a behavioral perspective, which assumes that investors or managers are irrational and that capital structure affects their perceptions of a company’s value. According to marketing time theory from a behavior perspective, managers will issue shares when they believe that market prices for shares are irrationally high and then repurchase shares when they believe that market prices are unusually low (Baker & Wurgler, 2002; Jenter, 2005). However, some economists such as Frank and Goyal (2009) argue that market timing theory can be interpreted not only behaviorally but also as the dynamic version of the traditional optimizing theory of capital structure, which includes time-varying factors, such as adverse selection costs. Nevertheless, market timing theory differs from traditional theories in that it implies a strong persistent effect of market values and their fluctuations on capital structure. No traditional theories
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