

“Do firms have leverage targets? The effect of market conditions on capital structure adjustments. Empirical analysis of European firms.”

Bachelor Thesis
in Corporate Finance

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Executive summary

I follow the research procedure adopted by Frank and Goyal (2004) using the Vector Autoregression framework. I will investigate several capital structure theories, including the trade-off theory, the market timing theory and Welch's theory (2004).

As many researchers, including Frank and Goyal (2004), concentrate on data from the United States only, I will investigate European data (1980 – 2010) of non-financial firms and also look to find evidence that supports the practice of leverage targeting and trade-off theory.

I then broaden the study by creating subsets of firms distinguished by a country's membership in an economic union (European Union), membership in an economic and monetary union (Euro area), firm's size (micro, small and medium-sized enterprises (SMEs), and larger companies).

Descriptive statistics suggest that in case of all datasets, levels of debt and equity are highly and significantly correlated. Changes in log levels of both, debt and market value of equity, seem to be stationary and close to zero. In result the average market leverage ratio seems to be stationary. Data suggests that leverage is mean reverting.

The Vector Autoregression Framework finds that in case of all investigated datasets either the lagged level of debt or the lagged level of equity or both, have a significant effect on current level of debt, and apart from the set of initial Euro zone firms, also on the current level of equity. Coefficients in case of the whole data set, European Union (EU27) and the initial Euro zone are consistent with the trade-off theory.

In all investigated cases either the lagged level of debt or the lagged level of equity or both, have a significant impact on current adjustments on the debt market. That is evidence against Welch's (2004) theory.

Evidence for market timing theory is found only in case of micro, small and medium-sized enterprises.