Investment-Based Trade-Off Theory*

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August 31, 2017

Abstract
This paper develops a novel trade-off theory of capital structure. When frequent re-balancing activities of firm leverage are restricted due to capital structure stickiness (or refinancing frictions), optimal capital structure reflects current and future investment profitability. That is, optimal leverage crucially depends on asset growth and tax rate, which yields various capital structure equilibria, such as all-debt, all-equity, and debt-equity financing, by balancing the tax benefits of debt and the cash benefits of equity. The model endogenously generates low and zero leverage and also offers insights into the determinants of leverage life cycle patterns observed in practice.

JEL Classification Numbers: G13, G31, G32, G33.

Keywords: Capital Structure, Debt, Equity, Firm Investment, Low Leverage, Zero Leverage.

*Preliminary. Comments are very welcomed and please do not circulate without the authors’ express permission.
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