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Do Capital Structure Models Square with the Dynamics of Payout?

Shiqi Chen[1] and Bart M. Lambrecht[1,2]

[1]Judge Business School, University of Cambridge, Cambridge CB2 1AG, United Kingdom; email: sc884@jbs.cam.ac.uk, b.lambrecht@jbs.cam.ac.uk

[2]Centre for Economic and Policy Research, London EC1V 0DX, United Kingdom

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Abstract

We explore whether theoretically the target leverage and pecking-order models can be reconciled with payout smoothing. Investment absorbs a significant part of income and asset volatility if the firm follows both a payout target and a net debt ratio (NDR) target. A positive (negative) NDR amplifies (dampens) shocks in assets. Slow adjustment toward the NDR target facilitates payout smoothing. Under strict pecking-order financing, income shocks are absorbed primarily by changes in net debt. More payout smoothing implies a stronger negative relation between debt and net income. Shocks to assets in place need not affect current payout.