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ACCEPTED MANUSCRIPT

Capital structure and corporate reaction to negative stock return shocks

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Abstract

This study investigates firms' capital structure decisions around significant drops in stock price. We present evidence that firms usually repurchase equity to boost stock prices following these shocks, rather than retiring debt to rebalance their capital structures, even though buybacks cause their capital structures to deviate farther from the previous levels. We also show that managerial incentives and firms' historical financial policies (e.g., high cash holdings or almost zero leverage) play more important roles in determining how firms react to stock price shocks than do managers' desires to maintain optimal leverage.

JEL classification: G3; G32

Keywords: Financing; Capital structure; Tradeoff theory; Market timing; Share repurchase

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1. Introduction

We investigate how extreme daily stock return movements with long-lasting effects affect the long-term corporate financing decisions of firms. When a firm's stock price plummets, its market leverage levels increase significantly. While theories on capital structure imply firms' active responses to market leverage changes, previous studies of firms' financing behavior find

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