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Capital Structure Decisions and the Optimal Design of Corporate Market Debt Programs

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Abstract

This paper provides a joint quantitative analysis of *capital* structure decisions (debt versus equity) and *debt* structure decisions (fixed-rate debt versus floating-rate debt or inflation-linked debt) in a continuous-time setting. We show that optimizing the debt structure has an impact on capital structure decisions, and leads to increases in leverage ratios compared to a pure fixed-rate debt program. We also find that for realistic parameter values, jointly optimizing the debt and capital structures generates a significant increase in firm value with respect to a situation where only the capital structure is optimized.

Keywords: capital structure, debt structure, inflation risk, interest rate risk

1. Introduction

While asset allocation decisions are relatively well understood from the theoretical standpoint, with a range of prescriptions available in complex situations involving, among other things, a stochastic opportunity set or the presence of parameter uncertainty, our understanding of liability management decisions is comparatively much more limited. Two separate strands of the corporate finance literature have in fact been primarily concerned with optimal liability structure for a firm: the dynamic capital structure literature, which has abstracted away from debt allocation decisions so as to better focus on optimal capital structure decisions in tractable quantitative settings, and the risk management literature, which has studied the desirability of hedging and the form of optimal hedging in isolation from the capital structure problem.

On the one hand, the early capital structure literature has stated that corporate financing policy and the choice of liability structure is irrelevant in the absence of contracting costs and taxes; this is the fundamental insight from the Modigliani-Miller theorem [43]. Hence, the introduction of frictions provides one natural possible justification for a non-trivial capital structure choice that is based on the trade-off between the tax

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