DID THE GREAT RECESSION CHANGE THE CORPORATE BORROWING PATTERN? A STUDY BASED ON CANADIAN FIRMS.

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ABSTRACT

This paper investigates whether the Great Recession altered the capital structure determinants of firms. We use panel data of 208 Canadian non-financial firms listed on the Toronto Stock Exchange (TSX) from 1999 to 2016 and perform econometric analysis. We compare the corporate borrowing pattern in three phases: the pre-recession (1999 to 2006), during the recession (2007 to 2009), and the post-recession (2010 to 2016). We find that the significance of growth prospects, collateralizable assets, and profitability varies across all three phases while making corporate borrowing or capital structure decisions. Our research is distinctive because it examines the determinants of capital structure for a specific country and how it can change with the economic situation.

Keywords*: Capital structure, Debt ratio, Non-financial, Recession, Determinants*

1. INTRODUCTION

Financial resources are essential to a firm's stability, so capital structure decisions are crucial. Firms thoroughly analyze debt and equity options (or the optimal combination) for financing their operations and growth. There are advantages and disadvantages associated with both debt and equity. Hence, thoughtful capital structure decisions are necessary for business continuity.

Modigliani and Miller offered the idea of optimal capital structure (originally in 1958 and revised in 1963). It became the foundation for the Trade-off Theory. Agency Theory (presented by Jensen and Meckling in 1976) and Pecking Order Theory (propounded by Donaldson in 1961 and reestablished by Myers and Majluf in 1984) extended the concept of capital structure.

The Great Recession (2007 to 2009) was a dreadful and unforgettable period that devastated the economy and the financial world's functions for at least a few years. We examine whether the Great Recession changed the factors affecting firms' capital structure decisions. This paper adds value to the existing knowledge on capital structure by comparing the capital structure determinants across Canadian non-financial firms in the pre-recession (1999 to 2006), during the recession (2007 to 2009), and the post-recession (2010 to 2016) phases.

2. PREVIOUS STUDIES

The Nobel Prize-winning professors Modigliani & Miller (1958) are the earliest academicians to argue the significance of capital structure to a firm's potential. They state that financing choices cannot change a firm's worth in an ideal capital market without taxes, transaction costs, and information asymmetry. Modigliani & Miller (1963) modified the idea of optimal capital structure and counted the function of tax shield in determining capital structure. Per the improved concept, firms may use debt for tax shields, reducing WACC, and increasing firm value. They further indicate that debt transaction costs would correspond to the tax advantages of debt borrowing. Thus, capital structure preferences would not affect firms' value, even in an imperfect capital market that includes taxes and transaction costs.