The Effect of Uncertainty on Target Leverages: An Application on BIST Manufacturing Sector Firms

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Abstract:

This study aims to find the effect of uncertainty on the target leverage of firms. The trade-off theory of capital structure states that the optimal capital structure occurs at the point at which benefits and costs of debt are balanced. Uncertainty may increase the financial distress costs and weaken the tax benefits of debt due to the lower profits. It may also reduce free cash flows, leading to lower agency costs of equity. Especially for the countries like Turkey where uncertainty is very high, we are expecting a significant negative impact of this variable on the target leverages of the firms. But it is surprising to see that this important variable is disregarded in the previous studies especially conducted in Turkey. Using several estimators including system GMM and a rather new estimator, namely; Quasi Maximum Likelihood DPD estimator, a number of manufacturing firms that are quoted to Borsa İstanbul are analysed over 2005-2020 period. The results show that uncertainty (measured as stock return volatility) negatively affects the target leverage ratios of Turkish manufacturing firms. Besides the results of the partial adjustment models reveal that very high uncertainty firms have lower mean leverages compared to the remaining ones. Lastly, according to the results of the ANCOVA analysis uncertainty is found to be among the first three variables in the time-varying determinants of target leverage ratios.

Keywords: Uncertainty, Target Leverage**,** Quasi Maximum Likelihood DPD Estimator

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