ULB

The Pecking Order Theory

- Developed by S. Myers (1984)
- Starts with *asymmetric information*:
  - Managers know more than outside investors
    - Use equity if stock overvalued
    - Use debt if stock undervalued
  - Issuing equity is a signal of overvaluation =>stock price drops
- Main implication: stock issues costly
- Order of preference for financing:
  - 1.Internal funds
  - 2. Debt
  - 3. Stock issue

Consider the following story:

The announcement of a stock issue drives down the stock price because investors believe managers are more likely to issue when shares are overpriced.

Therefore firms prefer internal finance since funds can be raised without sending adverse signals.

If external finance is required, firms issue debt first and equity as a last resort.

The most profitable firms borrow less not because they have lower target debt ratios but because they don't need external finance.

Implications of the pecking order theory

- Firms do not have target debt ratios
- Debt absorbs difference between retained earnings and investments
    - Debt increases when investments > retained earnings
    - Debt decreases when investments < retained earnings

Aside: dividends and capital structure

- Capital structure and dividends are linked. Remember statement of cash flows