Signalling Theory

- Signal is a message **credibly** conveying information from informed to uninformed players
  - It is credible
    - if it is in the player's interest to tell the truth
    - it is too costly to mimic (to lie) by others

Capital structure and signaling

- Assumptions:
  - Managers have better information about a firm's long-run value than outside investors
  - Managers act in the best interests of current stockholders
- Managers can be expected to:
  - Issue stock if they think stock is overvalued
  - Issue debt if they think stock is undervalued
  - As a result, investors view a common stock offering as a negative signal -- managers think stock is overvalued

Capital structure and signaling (CONT...)

- **Signaling theory**, suggests firms should use less debt than MM suggest
- This unused debt capacity helps avoid stock sales, which depress P_0 because of signaling effects