Pecking Order Theory Of Capital Structure: Another Way To Look At It

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Constructing the capital structure of business organization depends on quite very many perspectives and theories. One of these outlooks is the pecking order approach to capital structure construction. The approach is yet to have seemingly homogenous test both qualitative and quantitative. The non-homogeneity posture has been traced to methodology of analysis and assumptions of adverse selection and moral hazards (Meier and Tarhan, 2007). It is the view of this author that, methodology apart, at least two other probable rationales for pecking order model are, 1) avoidance of share ownership dilution by firm managers to maintain status quo and retain the confidence of firm owners, and 2) to make managers (agents) remain on the path of efficient resource management, to maximize shareholders’ wealth and at the same time resolve agency problems between shareholders and bondholders (Jensen and Meckling, 1976 and Jensen, 1986). Concomitant to this is the possibility of adopting pecking order as fall out from the necessities of agency theory where increasing leverage is taken as a way of making managers to be cautiously responsible in the utilization of resources and incurring managerial slack expenses. In the final analysis the incidental increase in the gearing level of the firm up to the point where benefits from tax deductibility of interest on debts and bankruptcy costs are equal will maximize firm value.

Keywords: Pecking order, Theory, Capital Structure
Introduction

Preamble

Emerging from the combination of the sources of funds available to firms to finance assets and working capital is capital structure. There are wide varieties of sources of funds available to firms ranging from owners equity to different types of debts. Capital structure, therefore, is the mix of equity and debts employed by firms. This is evidenced in the balance sheet of firms. It is the mix of equity and debts that shows the leverage position of a firm. The different sources have different costs. The mix is best done, in the context of adverse selection cost and moral hazard, to minimize cost of funds. The cost of fund has the effect of setting a realistic benchmark for evaluating investments, firm performance and enhancing the firm value. When the average cost of capital is low enough, firm value is enhanced (Van Horne, 1998). In this context therefore, an appropriate capital structure and mode of formation are critical decisions for any business organization. The theoretical view is that it is possible for firms to have optimum combination of debts and equity, and those firms in the same industry could have the same capital structure (Simerly & Li, 2002).

Capital structure decisions have theoretical underpinnings that can be evaluated from economic and behavioural stand points using the trade-off theory, agency theory and pecking order theory of capital structure. The pecking order theory is behavioural in nature showing the perception and attitude of managers towards financing their activities. Efforts made to evaluate the empirical impact of pecking order theory of capital structure produced mixed result (Meier and Tarhan, 2007). The mixed result probably arose from the implicit assumptions about the hierarchy in which firms use the different sources of capital and the not too clear thoughts of firm managers in adopting pecking order to fund investments.

There is therefore the possibility of viewing the pecking order theory from the behavioural point. In this case managers of organizations from their experience and skills are likely to adopt financing options that reduces conflicts between them and the shareholders and not primarily to address issues of adverse selection and moral hazard as suggested by Meier and Tarhan (2007). The survey approach to empirical testing of the pecking order theory has shown positive results (see Meier and Tarhan, 2007). The survey method evaluated the behaviour of managers in the context of information asymmetry.
that creates problem of adverse selection and moral hazard.

**Problem Statement**

Sequel to the methodological problem of appraising the pecking order theory, it is probably important to further examine the theoretical underpinnings of the concept. This has the potential of bringing out the implicit rationale for the emergence of the pecking order theory. This discourse looks at whose interest pecking order serves and how this may affect the managerial behaviour in sourcing funds for the firm? How is flexibility in the capital structure decisions of firms achieved based on pecking order approach? Is pecking order a deliberate attempt at forming capital mix for organizations? The objective of this paper is therefore to discuss the possible inherent reasons for pecking order approach to firm financing. This approach in our view will motivate financial researchers to gain more insight into the financial logic of pecking order and therefore, further assist in identifying the methodology that becomes applicable in testing its efficacy. The study will also further equip firm managers in the process of capital structuring.

This paper is divided into three sections. Section I contains the introduction with major emphasis on the study problem, questions and objective. Section II contains the literature review where the conceptual framework and the empirical works are reviewed. Section III examines the core of the work that is the rationale for pecking order beyond what has been explicitly stated. Section IV contains the summary and conclusion.

**Review Of Literature**

**Introduction**

Many studies have developed theoretical frameworks and conducted empirical tests to explain how firms chose between debt and equity and their relative proportion in firm financing (Baker and Wurgler, 2007, Meier and Tarhan, 2007, and Dittmar and Thakor, 2007). Others like Guedes and Opler, (1996) and Krishnaswami, Spindt, and Subramanian (1999) analyse debt issues from the perspective of agency theory and costs stemming from moral hazard problems. The point is that debt, arguably, can resolve agency problems between the shareholders and bondholders on one hand, and shareholders and managers on the other (Jensen and Meckling, 1976 and Jensen, 1986). Managers are believed to have no option other than being efficient where their
organizations are significantly leveraged. This position is using leverage level to constrain managerial functions.

However, the other side of the equation is that issuance of debt instruments has a way of preserving the proportional holding of the shareholders (no immediate dilution of ownership) even though with the potential of raising the risk level. This opens the window for pecking order. On the face of this it is expected that firm managers will have the confidence of the shareholders. In addition, debt issues do not suffer excessively from problem of adverse selection unlike equity issues (Meier and Tarhan, 2007).

**Theories of Capital Structure**

Organizations finance their activities by using funds from different sources and in different proportions. There are two broad sources of long term capital available to organizations; equity and debt. It is the mix of these sources that forms the capital structure and the leverage position of the firm. It is the element of cost that leads to issues of leverage. The combination is done with the primary aim of assembling funds at the least cost possible for the purpose of enhancing the firm value. Each of these sources has different implication on the weighted average cost of capital, problem of adverse selection and moral hazard on the part of managers. For example due to information asymmetry and sensitivities of different securities, the adverse selection cost is higher in equity than debt issues (Meier and Tarhan, 2007). There are therefore theories explaining the economic and behavioural rationale for proportional assemblage of funds from the two broad sources.

The core of capital structure theory is evaluation of the basis and how financing mix can affect the total valuation of the firm and its cost of capital. The result of this will answer the question of whether or not capital structure matters (Van Horne, 1998). There are theories describing how capital structure is constructed in organizations; these are the traditional trade-off theory (static and dynamic), the pecking order theory and the agency theory (Myers, 2003). Each of these theories has different reasons and implications on the capital structure construction and benefits of a firm.

**Trade-Off Theory of Capital Structure**

Trade-off theory of capital structure, also refereed to as the traditional theory of capital structure houses two schools of thought; the fundamental and Modigliani-Miller schools. The traditional fundamental trade-off theory
of capital structure expects that firms in the same industry should have similar or identical financial gearing ratios as they attempt to maximize the tax savings. The tax advantage, among other factors, makes the effective cost of debt to be lower than the nominal cost, and eventually reduces the weighted average cost of capital. In addition, there is an optimal level of gearing where weighted average cost of capital is least. However, as gearing level rises, any tax advantage of debt is eventually outweighed by the disadvantage of increasing expected bankruptcy costs. The trade-off theory sought to establish an optimal level of gearing at which the weighted average cost of capital was minimized and the share price maximized. At this point the tax advantage derived from given level of gearing will be equal to the estimated bankruptcy costs. Despite the theoretical appeal, researchers in financial management have not found the optimal capital structure (Simerly & Li, 2002).

In contrast to the above, Modigliani and Miller (1963) argued that the total value of a firm’s securities was independent of its capital structure using the operating income approach to evaluate effect of gearing on firm value. However, this position was later modified by relaxing the zero corporate tax assumption. It was recognized that a company paying interest on its debt paid less tax, since debt interest is regarded as an expense and therefore, tax deductible. As gearing level increases, weighted average cost of capital declines to a limit. This will boost the present value of the firm’s cash flows, improving firm value and increasing the share price. However, as debt increases beyond optimal level, leading to ‘over gearing’, the risk of bankruptcy increases. Bankruptcy cost tends to outstrip the tax savings. This makes further gearing counter productive to the organization raising the level of risk and can lead to reduction in the share price. This situation will also raise the yield expectation of the ordinary shareholders.

**Agency Theory of Capital Structure**

The Agency theory of capital structure emanated from the general agency theories where principal-agent relationships were examined (Jensen and Meckling, 1976). In the attempt to moderate managerial behaviour, the issue of how financial gearing can be used to mediate in the conflicts of interest which may arise between shareholders and managers in the main, and between shareholders and bondholders arose. It is believed that between the manager and the shareholder, there is information asymmetry, with the manager having the upper hand of insider information.
Agency theories, like the traditional trade-off theories, aim at target or optimal capital structure that does not undermine the investment safety of ordinary shareholders in terms of regular income from investment, capital appreciation and ownership structure. Within the spectrum of agency theories of capital structure, it is possible to distinguish between normative agency theories and positive agency theories. A normative agency model is one which, given conflicts between parties, prescribes an optimum debt/equity ratio which maximizes shareholders’ wealth. On the other hand, positive agency model, or managerialist model, is one which seeks to predict how much debt self-seeking managers will actually employ within the constraint of optimizing shareholders’ wealth. In practice, agency theory considers short term horizon thereby not capturing the dynamic and competitive nature of the environment in addition to the long term posture of the organization (Simerly & Li, 2002).

Pecking Order Theory of Capital Structure

In the foregoing the premise has been economic consideration in constructing capital structure of a firm. The pecking order theory is more towards the behavioural consideration on the continuum of economic – behavioural thesis of financing organizational activities probably to meet the behavioral aspect of agency theory. The primary aim was not of capital structure construction but description of how managers select and make use of the different sources of funds to finance their operations. This makes pecking order more meaningful to existing firms. Although at the end of the exercise a capital structure emerges which is altered as new investment opportunities emerge. The pecking order theory of capital structure on its part gives less weight to tax considerations and predicts that companies make financing choices according to the cash available to them and the degree of external financing constraints. This is working on the endogenous and exogenous constraints in raising capital for firm expansion. Security issue decision is done in the context of information sensitivities of different securities. Thus companies in the same industry may have quite varied gearing ratios depending for example on their profitability, pattern of cash flow and degree of information asymmetry being faced.

The pecking order theory contrasts the traditional position on capital structure construction both in terms of underlying assumptions and method. Myers and Majluf (1984) devised the pecking order theory of capital structure to explain several aspects of corporate financing behaviour. Myers (1984) and
Myers and Majluf (1984) espoused the security issue decision in the context of the effects of information asymmetry on different securities. This includes the tendency of firms to rely on internal sources of funds, and to prefer debt to equity if external financing is required. Condition precedent here is that an organization must have been in existence and is profitable before pecking order can be introduced. The basic assumptions in the pecking order theory as put forward by Myers and Majluf (1984) and expanded by us are that:

(i) New shares must be issued to outsiders. The assumption is that a placing takes place directly to outsiders or that if a rights issue is used the existing shareholders sell their rights. A corollary is that the model's force may be reduced to the extent that shares are issued using the rights issue mechanism and shareholders elect to take up their rights. The model collapses if all rights are taken up by existing shareholders.

(ii) Even where rights issue is employed, the firm will incur costs which do not have the same treatment as costs on debt source. In the same vein, equity is more subject to undervaluation than debt.

(iii) Under (i) and (ii) above, the assumption is that at the end of new issues, ownership structure is altered.

(iv) Managers know more about the true value of the company's existing assets than shareholders (information asymmetry).

(v) Managers know more about the true value of the company's potential investment project.

Pecking order, as argued by Myers (1984), is one way of avoiding wealth transfer to outsiders and negative effect of adverse selection by avoiding equity issues. The argument of pecking order is that due to information asymmetry between investors and managers, adverse selection considerations make equity issues the least desirable source of financing. Since adverse selection costs are present in all external funding sources in different degrees, managers of firms rely on internal sources of funds before they consider issuing any securities. Accessing external capital markets arises only when financing needs exceed internally available funds with the inherent adverse selections costs in respect of external sources of finance, informational sensitivity of a security is correlated with its risk.

The pecking order involves a financing hierarchy where firms first exhaust their internal funds, followed by issuance of short-term securities. In that instance, companies will prefer to fund projects with internally generated cash flows and internal equity. If external funds are required, debt will be
chosen before equity since it is less subject to undervaluation. External equity will be issued as a last resort. Pecking order therefore aims at substantially maintaining existing ownership structure, improving the returns to the existing shareholders of the firm and by extension making managers of firms to enjoy the confidence of shareholders. Consequently the self interests of firm managers are also served in this process. Management of organizations in essence follows a preference ordering when it comes to financing new investments in the attempt to manage adverse selection costs and moral hazard;

(i) internal financing of investment opportunities is preferred, in part because it avoids the outside scrutiny of suppliers of capital. In addition, there is no floatation costs associated with the use of retained earnings. In this circumstance, a target dividend payout ratio that ensures some level of retained earnings is set in keeping with long-run investment opportunities.

(ii) When cash flows are insufficient to fund all desirable investment opportunities, and a “sticky” dividend policy precludes a dividend cut, resort must be made to external financing and here straight debt is preferred. Debt results in less intrusion into management by suppliers of capital and floatation costs are less than other types of external financing. Also, asymmetric information and financial signaling consideration come into play – for example debt issues are regarded as “good news” by investors. If debt is issued, this means management believes the stock is undervalued and the debt either overvalued or valued fairly by the market.

(iii) Next in order is preference stock financing, which has some of the features of debt.

(iv) Where funds from the above sources are inadequate, stocks are issued as last resort.

Van Horne (1998) opines that management of organizations makes use of pecking order in financing their investments because the method affords management the following advantages;

(a) using retained earnings first makes management to avoid the scrutiny of suppliers of capital and as well floatation costs,

(b) using debt next ensures less intrusion into management by suppliers of capital and floatation costs are less than other type of external financing,

(c) playing on asymmetric information and signaling effects, raising debt issues is regarded as “good news” by investors,
(d) debt issues signify that management believes the equity stock is undervalued and the debt whether overvalued or valued fairly by the market.

**Rational for Pecking Order**

As argued by Myers (1984), pecking order theory of capital structure is one way of avoiding wealth transfer to outsiders and managing the negative effect of adverse selection by avoiding equity issues. This implies that it is the result of these actions of managers that is seen as capital structure. Behind the expressly stated reasons of adverse selection and moral hazard for pecking order theory of capital structure, are implicit rationales. These implicit rationales ordinarily serve as the bedrock of what the body of literature has shown. Pecking order therefore has as primary objective maintenance of existing ownership structure and ensuring that managers of firms enjoy the confidence of shareholders. Pecking order is a behavioural explanation of why management follows a financing order even though the method is consistent with some rational economic arguments such as asymmetric information and signaling effect. It is also explained by the urge on the part of managers to manage floatation costs.

This is consistent with the observation that the most profitable companies within an industry tend to have the least leverage (Meier and Tarhan, 2007). The pecking order method of financing suggests that corporations do not have a well-thought-out capital structure, but rather that management follows route of least resistance that manages the adverse selection costs in financing their operations. Capital structure that results is a by-product of managerial actions and changes whenever there is an imbalance between internal cash flows and capital investment requirement.

**Summary**

Using pecking order theory to explain firms’ capital structures has its merit, but the implicit reasons for the adoption of pecking order are beyond capital formation. Pecking order addresses the intent of firm managers to maintain the ownership position of the ordinary shareholders. Where what is available by way of retained profits is not enough to finance new investments, firm managers usually exploit the debt market before recourse to equity market. Even in the equity market, the option of rights issues is first explored
before public issues.

**Conclusion**

Pecking order therefore aims at substantially maintaining existing ownership structure and ensuring that managers of firms enjoy the confidence of shareholders. In the course of doing this, existing shareholders will enjoy improved returns. These above objectives of pecking order theory of capital structure determine the behaviour of managers of firms. The economic outcomes of the pecking order should be seen as advantages arising from the behaviour of managers of firms trying to ensure job security while at the same time meeting the investors’ needs.

This study should be seen as a serious challenge to the traditional capital structure literature. One of the dramatic changes created by the expanding global economy is the increase in the rate of change within industries. We believe that as more industries are experiencing greater levels of change, we expect the use of debt-centered governance will prove less effective in the near future.

The first duty of managers is to ensure the long term survival of the organizations within its competitive environment. In a world devoted to quick fixes, and short term thinking edited by sound bites, it is difficult to take time to think through serious challenges. As the environments become more competitive, those who make the time to reach appropriate decisions will be the ones left standing.

**References**

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