Exploratory Note 22

Myers and Majluf – Peking Order Theory

**INTRODUCTION**

In a very influential article published several decades ago in the *Journal of Financial Economics*, Stewart Myers and Nicholas Majluf (1984) present an alternative, asymmetric information-based theory of capital structure. The particulars are briefly set out in this second note of the evening—followed by a discussion of the importance of signaling in the marketplace.

**MYERS AND MAJLUF – PECKING ORDER THEORY**

According to Myers and Majluf, firms prioritize their sources of capital—identified as internal financing (retained earnings), debt, and new equity—according to their costs: cheaper sources will be utilized first, followed by those which are more expensive. The authors also posit a direct relationship between informational asymmetries and capital cost. This is the core of pecking order theory.

Internal financing (retained earnings) is considered by Myers and Majluf to be the cheapest source of financing. Why is it inexpensive?

Debt is next. Why? Consider informational asymmetries.

Finally, equity. Why is it so expensive? Again, consider asymmetries in information.

**THE IMPORTANCE OF SIGNALING IN THE MARKETPLACE**

Pecking order is attractive in its logic and simplicity; however, it has not been found to be all that representative of reality in most empirical studies, though there are exceptions. Nevertheless, informational asymmetries are a big issue in economics in general and finance in particular as they can lead to a breakdown in markets and, therefore, inefficient allocations. This leads us to the matter of signaling, which may explain some of the deviation between the predictions of pecking order theory vis-à-vis reality.

What is signaling in the context of economic and financial actions?

In large publicly-traded firms, how does the market tend to view new stock offerings? Is the signal likely to be viewed negatively or positively? Why? Does this seem to line up with pecking order theory?

For emerging firms that are going public, how does the market tend to view such offerings? Is the signal likely to be viewed negatively or positively if the founders maintain a lot of stock? Why? What about if the founders only retain a small proportion of the stock? Does this seem to line up with pecking order theory?

For established firms, is the issue of debt likely to be taken as a positive or a negative signal? Why? Does this seem to line up with pecking order theory?

But what if the money is borrowed from insiders? For instance, during the last financial crisis, VCs lent quite a bit of money to their portfolio companies. Why? How do you think this signal is likely to be interpreted by the market? Does this seem to line up with pecking order theory?

**CONCLUSIONS**

Stakeholders are constantly interpreting signals—real or perceived—that are derived from firm-level actions—as such, signaling is necessarily an issue of first-order importance for entrepreneurs as it is critical to the management of stakeholder expectations.