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Financing decisions: who issues stock?☆

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Abstract

Financing decisions seem to violate the central predictions of the pecking order model about how often and under what circumstances firms issue equity. Specifically, most firms issue or retire equity each year, and the issues are on average large and not typically done by firms under duress. We estimate that during 1973–2002, the year-by-year equity decisions of more than half of our sample firms violate the pecking order.
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1. Introduction

The modern corporate finance literature focuses on two competing models to explain the financing decisions of firms. In the tradeoff model, firms identify optimal leverage by weighing the costs and benefits of an additional dollar of debt. The benefits of debt include, for example, the tax deductibility of interest and the

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reduction of free-cash-flow agency problems. The costs of debt include potential bankruptcy costs and agency conflicts between stockholders and bondholders. At the leverage optimum, the benefit of the last dollar of debt just offsets the cost.

Myers (1984) advocates an alternative theory, the pecking order model. The pecking order arises if the costs of issuing risky securities—transactions costs and especially the costs created by management's superior information about the value of the firm's risky securities—overwhelm the costs and benefits proposed by the tradeoff model. The costs of issuing risky securities spawn the pecking order: firms finance new investments first with retained earnings, then with safe debt, then risky debt, and finally, but only under duress, with outside equity.

The pecking order sequence for financing decisions leads to a prediction about capital structures. Specifically, variation in a firm's leverage is driven not by the tradeoff model's costs and benefits of debt or equity, but more simply, by the firm's financing deficit (dividends plus investment outlays minus earnings). Quoting Myers (1984), "The crucial difference between this and the static tradeoff story is that, in the modified pecking order story, observed debt ratios will reflect the cumulative requirement for external financing—a requirement cumulated over an extended period".

In short, Myers (1984) presents the pecking order model as a theory both about how firms finance themselves and about the capital structures that result from pecking order financing. Subsequent tests of the model follow these two routes. For example, Shyam-Sunder and Myers (1999), Fama and French (2002), and Frank and Goyal (2003) test the model's predictions about the securities firms issue to cover financing deficits, while Titman and Wessels (1988), Rajan and Zingales (1995), Shyam-Sunder and Myers (1999), Fama and French (2002), and Huang and Song (2003) test the model's predictions about capital structures.

This earlier work mainly uses cross-section regressions to test the pecking order model. Cross-section regressions measure average responses of financing decisions and capital structures to variables such as growth and profitability (the ingredients of the financing deficit). But average responses may conceal important details relevant for judging the model. We take a more direct approach. We test pecking order predictions about financing decisions by examining how often and under what circumstances firms issue and repurchase equity. We uncover what seem to be pervasive contradictions of the model.

The first important result is striking evidence against the pecking order prediction that firms rarely issue stock. As motivation for the pecking order, Myers (1984) emphasizes that aggregate net new issues of equity are small relative to net new debt. It is also well-known that seasoned equity offerings (SEOs) are rare. But the aggregate level of equity financing and the scarcity of SEOs are misleading. In addition to SEOs, firms issue equity in mergers and through private placements, convertible debt, warrants, direct purchase plans, rights issues, and employee options, grants, and benefit plans. During 1973 to 1982, on average 67% of our sample firms issue some equity each year, and the proportion rises to 74% for 1983 to 1992 and 86% for 1993 to 2002. During much of the sample period, however, repurchases by some firms offset the equity issues of others, and aggregate annual

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