



# Preference hierarchies for internal finance, bank loans, bond, and share issues: evidence for Dutch firms

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## Abstract

We estimate the incremental financing decision for a sample of some 150 Dutch companies for the years 1984 through 1997, thereby distinguishing internal finance and three types of external finance: bank borrowing, bond issues, and share issues. First, we estimate a multinomial logit model, which confirms several predictions of both the static trade-off theory and the pecking order theory as to the determinants of financing choices. Next, we estimate all possible ordered probit models to determine which financing hierarchy fits the data best. The results suggest that Dutch firms have a unique most preferred financing hierarchy: (i) internal finance, (ii) bank loans, (iii) share issues, and (iv) bond issues.

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## 1. Introduction

Ever since the seminal contribution of [Modigliani and Miller \(1958\)](#), who show that under special circumstances (including the absence of frictions and taxes, and perfectly

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working capital markets) there is no optimal capital structure, one of the more intriguing challenges in corporate finance is to provide a satisfactory explanation as to why in practice some firms finance incremental investments with debt while others do so with equity. Over the years, several explanations for this empirical fact have been given that, broadly speaking, can be grouped in two schools of thought. The first is the traditional *static trade-off theory*. This view holds that a firm chooses that debt–equity mixture that optimizes its value. The resulting ‘optimal capital structure’ is determined by trading off the costs and benefits of equity and debt, including tax shields, financial distress, and agency costs of debt and equity.

The second line of reasoning is that there is a *pecking order* as to the type of financing preferred by managers. When making their incremental financing decision, Donaldson (1961) observed that firms appear not to target specific capital structures. Rather, they choose a type of capital according to a preference order: (i) internal finance, (ii) debt, and (iii) share issues. Myers and Majluf (1984) explain Donaldson’s observation by referring to the inherent asymmetry of information associated with acquiring external finance. Insiders (owners and/or managers) know more about the firm’s value than outsiders (investors) do. The former avoids issuing equity when they believe that shares are undervalued. The latter, realizing the former’s reluctance to issue undervalued shares, would thus interpret a share issue as conveying unfavourable information as to the value of the firm. As a result, share issues are typically followed by a decrease in valuation of the issuing firm’s assets. Insiders are therefore reluctant to raise equity capital and prefer to accumulate retained earnings in order to fund incremental investments.<sup>2</sup>

Which of the two hypotheses regarding the financing behaviour of firms is more relevant remains an empirical question. Most tests of the static trade-off theory consist of estimating models that relate firms’ characteristics to their capital structure, measured by the ratio of debt over assets (or some transformation of this ratio, such as debt over equity). Depending on which exogenous variables are found to be statistically significant, the potential determinants of firms’ target debt ratios are to be accepted or rejected (for an overview of this literature see, e.g. Harris and Raviv, 1991).

There are however at least two drawbacks to this approach. First, debt ratios represent the proportion that debt takes in all accumulated liabilities since the firm’s birth. In some sense, it is a snapshot of a firm’s complete history of financing choices at a particular point in time. Information on the *timing* of acquiring debt or issuing equity is ignored. Second, internal equity (e.g. retained earnings) and external equity (obtained with share issues) are not distinguished in typical debt ratios. This distinction is essential however when considering the effect of asymmetry of information on incremental financing choices.

The second route of investigation, especially as to the validity of the static trade-off theory, involves estimating discrete choice models of firms’ *incremental* financing decisions. The focus here is on establishing the relevant determinants for the *choice* of financing type. A pioneering example of this approach is the study of Marsh (1982). He finds that UK companies are heavily influenced by market conditions and the past history

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<sup>2</sup> Alternative explanations for the preference for internal finance over external finance include those referring to the higher transaction cost associated with acquiring external finance (e.g. Donaldson, 1961).

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