Survey

What Managers Think of Capital Structure Theory: A Survey

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■ This survey examines the extent managers use the assumptions and/or inputs of capital structure models generated by academicians in making financing decisions. Modigliani and Miller [14] showed that capital structure decisions do not affect firm value when capital markets are perfect, corporate and personal taxes do not exist, and the firm's financing and investment decisions are independent. However, when one or more of the MM assumptions are relaxed, many authors demonstrate how firm value may vary with changes in the debt-equity mix. Most frequently, the optimal capital structure maximizes firm value by simultaneously minimizing external claims to the cash flow stream flowing from the firm's assets. Such claims include taxes paid to the government by the firm and its security holders; bankruptcy costs paid to accountants, lawyers, and the firm's vendors; and/or agency costs incurred to align managerial interests with the interests of capital suppliers.

Until recently, the capital structure debate was mainly a theoretical one, with the relevance or irrelevance of financing decisions turning on the modeler's willingness to accept the existence of significant market imperfections. (See Miller [12], DeAngelo and Masulis [2], Kim [9], Haugen and Senbet [6], Titman [25], Jensen and Meckling [8], Fama [5], and Smith and Warner [22] for different perspectives on the relevance of the market imperfections in the preceding paragraph.) However, empirical evidence, summarized nicely by Smith [21], now strongly indicates that changes in a firm's capital structure can affect firm value. Thus, the

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focus of the debate has shifted from whether capital structure decisions matter to why they matter.

One explanation of why security prices respond to announcements of capital structure change is that firms are moving closer to (or farther from) their optimal or target capital structures, as defined by the models alluded to above. A second explanation is that capital structure decisions are irrelevant but that the information they convey concerning the firm's investment opportunities causes security holders to revise their expectations of the firm's prospects.

This study augments market studies of capital structure change that seek to disentangle the above two interpretations by reporting results of a survey that was sent to chief financial officers of each of the Fortune 500 firms for 1986. Although this is not the first to report survey results on capital structure issues, it makes important extensions to its precursors. In contrast to Donaldson's [4] classic study which analyzed the financing practices of 25 major firms, this study reports results for 176 firms from the Fortune 500 list. Further, this survey deals more extensively with capital structure theory than did the survey of Scott and Johnson [19].

I. Capital Structure Theories

The capital structure models considered here can be classified conveniently into three groups: models that imply an optimal combination of long-term funds, models that imply an optimal hierarchy in raising funds, and models that imply neither of these approaches. Myers [16] labels models in the first and second categories as "static tradeoff" and "pecking order" models, respectively. Those terms are adopted in the brief discussion below.

A. Static Tradeoff Models

In general, static tradeoff models predict that firms maintain a target debt-equity ratio that maximizes firm value by minimizing the costs of prevailing market imperfections. The earliest of these models (e.g., Kraus and Litzenberger [11], Scott [20], and Kim [9]) balance the corporate tax advantages of debt against the cost disadvantages of bankruptcy. Later refinements also incorporate personal taxes and non-debt tax shields (e.g., Miller [12] and DeAngelo and Masulis [2]).

Agency cost theories, though not categorized by Myers, share many of the features of the tax-cum-bankruptcy cost models. In Jensen and Meckling [8], for example, the value of the firm is maximized when total agency costs of debt and external equity are minimized. To minimize total agency costs, managers issue both debt and equity and agree to restrictive covenants written into bond indentures (as in Smith and Warner [22]). Hence, firms' unique optimal capital structures involve a balance of debt and equity, even though neither corporate nor personal taxes are assumed to exist.

B. Pecking Order Hypothesis

Myers and Majluf [17] extend Donaldson [4] by assuming that the firm is undervalued because managers have, but cannot reveal, information that the market lacks concerning new and existing investment opportunities. Managers avoid issuing undervalued securities by financing first with internal equity and then with external claims that are least likely to be mispriced. Internal equity is the most preferred source, external equity is the least, and straight and convertible debt are in the middle.[1]

C. Other Models

Like Myers and Majluf, Miller and Rock [13] develop a model in which internal funding strictly dominates external sources. However, unlike Myers and Majluf, Miller and Rock make no distinction between the types of external funds raised because all such sources signal to the market that internal sources have fallen short of projections. Hence, the Miller-Rock model represents the capital structure category in which neither an optimal combination nor an optimal hierarchy of external sources is implied.

The predictions of the foregoing models follow directly from the assumptions used to develop them. The Myers-Majluf and Miller-Rock models assume that corporate taxes do not exist; static tradeoff models assume that investors and managers have equal information about real growth opportunities. Although such assumptions make the models tractable, they oversimplify the conditions under which managers make

[1] Hierarchies also could be derived using the Jensen [7] free cash flow hypothesis or the Ross [18] signaling model. The hierarchies in the Jensen and Ross models would run from debt (and preferred stock) to common stock. The assumptions about investment opportunities in Ross [18], Myers and Majluf [17] and Jensen [7] are not the same, however. Ross assumes that the investment decision has already been made but that the market does not understand the true value of the firm; Myers and Majluf assume that because the firm is undervalued managers may refuse to undertake even positive NPV projects; and Jensen assumes the market knows that all positive NPV projects have already been undertaken and that managers must be monitored to keep them from wasting free cash flows.

financing decisions. Thus, the results reported below are unlikely to support any of the models above to the exclusion of the others. Nevertheless, the survey responses indicate that the pecking order hypothesis is more descriptive of how financing decisions are made in practice than are either of the other two alternatives. More descriptive still, however, are conventional financial planning principles.

II. Sampling Procedures

A list of the Fortune 500 firms for 1986 was obtained from the April 27, 1987 edition of *Fortune* magazine. *Standard and Poor's Register of Directors and Executives* was then used to find the names and addresses of the chief financial officer of each firm. A cover letter was enclosed with each questionnaire requesting that the chief financial officer or the officer most familiar with financing procedures answer the nine-question survey.[2]

No attempt was made to identify specific firms that participated. Thus, cross-classifying financing preferences with firm size, industry, or ownership structure is not possible. The reason for proceeding in this manner was to protect the anonymity of the respondents. Conceivably, the decision improved the candor with which the questions were answered and increased the number of usable responses (176) received.[3]

Moreover, some generalizations are possible even if specific firms that participated in the survey are not identified. First, since the Fortune 500 list includes only industrials, there are no utilities and no financial corporations in the sample. Thus, firms that are most heavily regulated and whose financing decisions are least likely to convey new information to the market are excluded. Second, most firms in the sample are large. Only 15 of the entire Fortune 500 list for 1986 had market values of $100 million or lower. Therefore, although financing preferences may differ by firm size, the sample essentially eliminates the variation attributable to the smallest market value firms.

The bias toward large, successful firms in the sample does limit the inferences that can be drawn. Sampling from a single point in time may impose further restrictions. However, the bias that exists may make the permissible inferences more interesting. For example, large successful firms should have more flexibility than smaller firms to alter their financing mix in response to the enactment of the Tax Reform Act of 1986. Hence, if tax laws are dominant determinants of a firm's capital structure, successful firms will alter their financing mix to increase after-tax cash flows. Similarly, because ownership of the sample firms is likely to be disperse, managers should have incentives to limit the agency costs they bear. Thus, both the tax and the agency cost biases favor a target capital structure over a financing hierarchy.[4]

IV. Sample Results

A. Static Tradeoff vs. Pecking Order and Other Models

Despite the aforementioned biases, 68.8% (121/176) of our survey respondents indicated a preference for the financing hierarchy.[5] Rankings of six sources of long-term funds by respondents who expressed this preference are summarized in Exhibit 1. For each source, the percentage of responses within each rank, the percentage of respondents who did not rank the source, and the mean of the rankings are given. Higher means imply higher preferences.

As indicated, 84.3% of the respondents ranked internal equity as their first choice, while 39.7% ranked external equity as their last choice. The respective mean

[2]A copy of the survey is given in the appendix. Respondents were not specifically asked to state their positions with the firms. Consequently, actual decision makers may not have responded in some cases. To the extent that is true, respondents may have answered according to what they think financing policies should be rather than what they are. However, given the inconclusiveness of capital structure theory, it is not clear what the policy should be. Hence, how this potential bias affects the results is unknown.

[3]In total, 203 responses were received. However, 17 firms explained that they no longer respond to survey requests because of increased demands on managerial time, and 10 firms were not publicly traded.

[4]Although agency cost arguments can support either a target capital structure (Jensen and Meckling [8]) or a financing hierarchy (Jensen [7]), the success of the Fortune 500 firms suggests that positive NPV opportunities still exist. Therefore, the costs of free cash flow discussed by Jensen should be less important than the costs discussed in Jensen and Meckling.

[5]Some of the answers were inferred from the responses to question 2. Respondents who expressed a preference for maintaining a target debt-equity ratio were instructed not to answer question 2. Therefore, when question 2 was answered but question 1 was not, an 'intended' response to question 1 was assumed. When only direct answers to question 1 are used, 66.7% (80/120) of the respondents indicated that they follow a financing hierarchy. Because the results for this and other questions are insensitive to these inferences, both direct and inferred answers are reported.

Exhibit 1. Preference Rankings of Long-Term Sources of Funds Among U.S. Industrial Firms that Follow a Financing Hierarchy[a]

Sources by Order of Preference	Percentage of Responses Within Each Rank							
	First	Second	Third	Fourth	Fifth	Sixth	Not Ranked	Mean[b]
1. Internal Equity (Retained Earnings)	84.3	7.4	2.5	0.8	2.5	0.8	1.7	5.61
2. Straight Debt	14.9	71.9	5.0	5.0	1.7	0.8	0.8	4.88
3. Convertible Debt	0.0	2.5	43.0	31.4	9.9	3.3	9.9	3.02
4. External Common Equity	0.0	9.9	23.1	19.0	1.7	39.7	6.6	2.42
5. Straight Preferred Stock	0.0	4.1	16.5	15.7	37.2	14.0	12.4	2.22
6. Convertible Preferred Stock	0.0	2.5	3.3	15.7	33.1	33.1	12.4	1.72

[a]In total, 121 firms indicated they follow a financing hierarchy, while 47 indicated they seek to maintain a target capital structure. These estimates include both direct and inferred answers. When only direct answers are used, the numbers following the financing hierarchy and target capital structure are 80 and 40, respectively. The percentages given in the table are immaterially different from the percentages that obtain for the 80 firms.

[b]Means are calculated by assigning scores of 6 through 1 for rankings from 1 through 6, respectively, and by multiplying each score by the fraction of responses within each rank. A score of 0 is assigned when a source is not ranked.

rankings for the common equity alternatives are 5.61 and 2.42. Similarly, straight debt dominates convertible debt. The mean ranks are 4.88 and 3.02. For debt and common equity, therefore, the pattern depicted in Exhibit 1 conforms to the Myers-Majluf [17] predictions—managers who follow a financing hierarchy prefer internal equity, then straight debt, then convertible debt, and finally new common stock.[6]

On the other hand, the rankings of straight and convertible preferred stock are more difficult to interpret. Straight preferred is more popular than convertible preferred, as the respective mean ranks of 2.22 and 1.72 indicate. But, judging from those means, preferred stock financing of any sort is less appealing than financing with external common stock. This finding is inconsistent with the pecking order hypothesis as it currently stands.[7]

[6]If managers move to the target capital structure by following a hierarchy, these two concepts need not be mutually exclusive. However, the process envisioned by Myers [16] and the responses above seem to imply that most managers do not even seek the target capital structure because the process is dynamic, not static.

B. Specific Capital Structure Models and Planning Principles

A better understanding of the relative significance of specific capital structure theories can be gained by examining managers' rankings of 11 inputs and/or assumptions often found in theoretical models. Exhibit 2 summarizes those rankings. The format is the same as the format for Exhibit 1; the percentages here, however, are based on the full sample.

Information Conveyance Models Of all the inputs in Exhibit 2, the projected cash flow of the assets to be financed (4.41), avoiding dilution of common shareholders' claims (3.94), and the risk of the new asset (3.91) have the highest mean ranks. Since two of these factors relate to the new project, the findings strongly suggest that corporate managers evaluate investment and financing decisions simultaneously. Hence, these decisions are not independent and security price reactions to capital structure changes may reflect a

[7]This finding may indicate that industrial managers resort to preferred stock mainly for specialized needs, such as acquisition or reorganization. (See Dewing [3, pp. 131–134].)

Exhibit 3. Relative Importance of Various Financial Planning Principles in Governing Financing Decisions of Major U.S. Industrial Firms

Planning Principle by Order of Importance	Percentage of Responses Within Each Rank[a]						
	Unimportant	2	3	4	Important	Not Ranked	Mean[b]
1. Maintaining financial flexibility	0.6	0.0	4.5	33.0	61.4	0.6	4.55
2. Ensuring long-term survivability	4.0	1.7	6.8	10.8	76.7	0.0	4.55
3. Maintaining a predictable source of funds	1.7	2.8	20.5	39.2	35.8	0.0	4.05
4. Maximizing security prices	3.4	4.5	19.3	33.5	37.5	1.7	3.99
5. Maintaining financial independence	3.4	4.5	22.2	27.3	40.9	1.7	3.99
6. Maintaining a high debt rating	2.3	9.1	32.4	43.2	13.1	0.0	3.56
7. Maintaining comparability with other firms in the industry	15.9	36.9	33.0	10.8	2.8	0.6	2.47

[a]These estimates are based on 176 responses.

[b]Means are calculated by assigning scores of 1 through 5 for rankings from "unimportant" to "important," respectively, and by multiplying each score by the fraction of responses within each rank. A score of 0 is assigned when a source is not ranked.

guide the selection of each funding source. Significant correlations are reported in Exhibit 4.[11] The funding source, the factor that is significant, and the direction of the relation are listed in the first through third columns, respectively.

For internal equity and convertible preferred stock, no significant correlations exist. The lack of variation in the preferences reported in Exhibit 1 for these sources may explain this finding.[12] In contrast, the negative relation between managerial preferences for external equity and avoiding dilution of common shareholders' claims suggests that dilution deters new equity issues. Straight debt is used to maximize security prices; none of the theoretical factors, however, has a significant correlation. Preferences for convertible debt relate negatively to the importance attached to expected cash flows from new assets and positively to maintaining the long-term survivability of the firm. These relations suggest that managers concerned about 'hanging' the convertible because of cash flow shortages in early stages of an asset's life nonetheless issue the debt if the investment is crucial to the firm's long-run survivability. Finally, the negative correlation between the preference for straight preferred stock and the importance assigned to maintaining comparability with other firms is consistent with the explanation (given in footnote 7) that preferred stock is used mainly for specialized needs.

Although the above explanations are plausible, they are also almost certainly oversimplified. By definition, the judgment required to make sound financing decisions implies that managers balance the need to avoid dilution against (for example) the need to grow and to maintain financial flexibility. Hence, multiple factors bear on the financing choice, and several financing alternatives may be considered simultaneously. Perhaps such complexities explain why managers are guided more by planning principles than by the implied precision of our theoretical models.[13]

[11]The significance level is 0.05. Obviously, more correlations are significant at the 0.10 level; however, interpreting those correlations is more difficult because higher significance levels induce more "noise."

[12]The same argument explains why maintaining financial flexibility in Exhibit 3 is uncorrelated with any of the financing sources in Exhibit 1. Over 94% of the respondents ranked maintaining financial flexibility as being very important (i.e., as a 4 or a 5). The lack of variability in the responses concerning internal equity and financial flexibility suggests something akin to an identity: internal equity is the most preferred source because it provides the greatest flexibility.

[13]It is possible that planning principles frequently cause managers to finance their firms in ways predicted by capital structure models even though the principles—not the models—provide the motivation. For example, Kim and Sorensen [10] present evidence that supports Myers [15] and many of the tax-cum-bankruptcy cost models. However, the irresponsiveness of most managers in this sample to changes induced by the Tax Reform Act illustrates why knowing the motivation for financing decisions is important.

Exhibit 4. Significant Correlations Between Managerial Preferences for Funding Sources and the Perceived Importance of Capital Structure Model Inputs and/or Financial Planning Principles[a]

Funding Source	Capital Structure Input or Planning Principle	Direction of Relationship
Internal Equity	None	NA
External Common Equity	Avoiding Dilution	Negative
Straight Debt	Maximizing Security Prices	Positive
Convertible Debt	Cash Flow Survivability	Negative Positive
Straight Preferred	Comparability	Negative
Convertible Preferred	None	NA

[a]The correlations are calculated with the nonparametric Spearman rank statistic, and the significance level is 0.05.

D. Financing Decisions and Other Sources and Uses of Funds

The importance of capital structure decisions (in general) relative to other decisions managers make can be assessed by examining responses relating to firms' sources and uses of funds. When presented with an attractive new growth opportunity that could not be undertaken without departing from the target capital structure or financing hierarchy, cutting the dividend, or selling off other assets, 82.4% of the managers indicated they would deviate from their target capital structure or financing hierarchy. In contrast, 1.7% said they would cut the dividend, and 3.4% said they would forgo the investment opportunity. The remainder said they would sell off other assets or pursue some combination of all the alternatives. Thus, the financing decision is the most flexible of all the sources and uses of funds constraints. That is, it is least binding. To the extent this is true and to the extent motivations for capital structure changes are complex and imprecise, interpreting common stock price responses to unanticipated capital structure changes will continue to pose difficult challenges to finance researchers.

IV. Conclusion

Corporate managers in this sample are more likely to follow a financing hierarchy than to maintain a target debt-equity ratio. Further, models based on corporate and/or personal taxes and bankruptcy and other leverage-related costs are not as useful in determining the financing mix as are models that suggest that new financing reveals aspects of the firm's marginal asset performance. However, the importance managers attach to specific capital structure theories is not related to managerial perceptions of market efficiency. Thus, most managers do not overtly signal firm value through capital structure adjustments. In general, financial planning principles are more important in governing the financing decisions of the firm than are specific capital structure theories. Moreover, the capital structure decision, per se, is less binding than either the investment or the dividend decision of the firm.

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Appendix

The following is a reproduction of the survey sent to chief financial officers.

Instructions Please answer the following questions as they relate to decisions you make in raising new long-term funds.

1. In raising new funds, your firm

a. Seeks to maintain a target capital structure by using approximately constant proportions of several types of long-term capital simultaneously. (Answer questions 3 through 9.)

b. Follows a hierarchy in which the most advantageous sources of funds are exhausted before other sources are used. (Answer questions 2 through 9.)

2. Rank the following sources of long-term funds in order of preference for financing new investments (1 = first choice, 6 = last choice).

Rank

a. ___ Internal equity (retained earnings)

b. ___ External common equity

c. ___ Straight debt

d. ___ Convertible debt

e. ___ Straight preferred stock

f. ___ Convertible preferred stock

3. Please indicate the relative importance of the following considerations in governing your firm's financing decisions. On a scale of 1 to 5, where 1 = Unimportant and 5 = Important.)

a. ___ Maximizing prices of publicly traded securities

b. ___ Maintaining financial flexibility

c. ___ Ensuring long-term survivability of the firm

d. ___ Maintaining financial independence

e. ___ Maintaining comparability with firms in the industry

f. ___ Maintaining a high debt rating

g. ___ Maintaining a predictable source of funds

4. Approximately what percent of the time would you estimate that your firm's outstanding securities are priced fairly by the market?

a. More than 80 percent of the time

b. Between 50 and 80 percent of the time

c. Less than 50 percent of the time

5. Given an attractive new growth opportunity that could not be taken without departing from your target capital structure or financing hierarchy, cutting the dividend, or selling off other assets, what action is your firm most likely to take?

a. Forgo the growth opportunity.

b. Deviate from the target capital structure or financing hierarchy.

c. Cut the dividend.

d. Sell off other assets.

6. Indicate the relative importance of the following factors in governing your firm's financing decisions. (On a scale of 1 to 5, where 1 = Unimportant and 5 = Important.)

a. ___ The corporate tax rate

b. ___ Personal tax rates of your debt and equity holders

c. ___ The level of depreciation and other non-debt tax shields

d. ___ Costs of bankruptcy

e. ___ Voting control

f. ___ Restrictive covenants of senior securities

g. ___ Projected cash flow or earnings from the assets to be financed

h. ___ Riskiness of the assets to be financed

i. ___ Avoiding dilution of common shareholders' claims

j. ___ Avoiding mispricings of securities to be issued

k. ___ Correcting mispricings of outstanding securities

7. Other things held constant, the Tax Reform Act of 1986 will have the effect of

a. Increasing your firm's after-tax cash flows.

b. Decreasing your firm's after-tax cash flows.

c. Leaving your firm's after-tax cash flows unchanged.

8. As a result of the Tax Reform Act of 1986, your firm is likely to

a. Increase the proportion of debt used in the capital structure.

b. Decrease the proportion of debt used in the capital structure.

c. Leave the proportion of debt used in the capital structure unchanged.

9. If your firm does not plan to alter the proportion of debt currently used in its capital structure as a result of the Tax Reform Act of 1986, which of the following explanations most closely corresponds to your reasons?

a. Tax laws could be changed again soon.

b. Changes have already been made in the capital structure in anticipation of the Tax Reform Act of 1986.

c. The precise implications of the Tax Reform Act of 1986 are not clear.

d. Other factors are more important than tax laws in determining your capital structure.