Corporate Finance, Module 17, “Optimal Corporate Borrowing” (chapter 18)

Illustrative Test Questions

(The attached PDF file has better formatting.)

Question 17.1: Pecking Order

According to the pecking-order theory of corporate financing, which of the following is true?

1. Firms prefer external financing over internal sources of funds.
2. Firms adjust their target dividend payout ratios to their investment opportunities, while trying to avoid sudden changes in dividends.
3. Firms issue safer securities before they issue risky securities.

A. 1
B. 3
C. 1, 2
D. 2, 3
E. 1, 2, 3

Answer 17.1: D

Statement 1: Firms prefer internal financial (retained earnings) to external financing (new equity or debt).

Statement 2: Firms try to keep dividend payout ratios steady, since a drop in the dividends may be viewed as a poor omen by stock market analysts. To avoid an unintended drop in the dividend, firms avoid raising the dividend unless they are sure they can maintain the higher dividend level. This is a common interpretation of firms’ dividend actions, though we can not opine with certainty on this topic.

Statement 3: Issuing risky securities, like new issues of common stock, may be viewed as a poor omen by stark market analysts, who may bid down the stock price. Firms tend to issue safe securities before risky securities, since the safe security is less likely to cause a decline in the stock price. The pecking order hypothesis presumes that firms issue debt, then debt-like instruments like redeemable preferred stock, then hybrid securities like convertible debt, then common stock.

Question: Isn’t debt more risky to the firm that new issues of stock, since failure to meet a debt obligation can lead to bankruptcy?

Answer: The term *risky* and *safe* here use the perspective of the investor. To the investor, bonds are safe and common stocks and risky.

Question 17.2: Pecking Order

What is the preference order for the following options (from most preferable to least preferable) according to the pecking order theory?

1. Convertible bonds (a mix of equity and debt)
2. Equity (common stock)
3. Internal financing
4. Corporate debt

A. 1, 2, 3, 4
B. 3, 2, 1, 4
C. 2, 3, 4, 1
D. 3, 4, 2, 1
E. 3, 4, 1, 2

Answer 17.2: E

The pecking order theory assumes that firms prefer internal financing; if external financing must be used, firms choose the safest form first. Debt is safest; equity is most risky; convertible bonds are mid-way between bonds and equity.

Question: What is a convertible bond?

Answer: A convertible bond can be exchanged for common stock on certain dates and at certain conversion ratios, subject to certain constraints. They are like debt if they are not converted and like common stock if they are converted.

Question: What about preferred stock? Are they like debt or equity?

Answer: Preferred stock are also a mix of equity and debt. Preferred stock received set dividends, like the set coupon payments on bonds, but they have the legal characteristics of stock shares.

{*Note:* For the final exam, know that convertible bonds and preferred stock are a mix of debt and equity. The final exam does not test more specific attributes of these assets.}