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Strategic Financing Decisions: External Vs Internal Sources

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Abstract

The ability of a firm to meet its strategic objectives of value maximization is crucial for it to survive in a dynamic environment full of competition and volatile markets. Financing plays a key role in ensuring that a firm at any point in time has enough financial resources to fund its investments and general operations. With the question of financing, firms are faced with the decision to determine the most appropriate source of finance between internal and external financing. Due to cost implications, the pecking order theory advocates for firms to use internal funds before going for external finances. The purpose of this paper is to review the literature on external and internal finances from the demand side to determine the reasons as to why firms chose either source of finance or both and to check the validity of the pecking order theory. The findings of the review revealed that alongside the cost of finance as advocated by the pecking order theory, there are other factors that determine the choice of finance; firm size, industry, risk, firm life cycle, networking relationships, managerial and board characteristics. The presence of these factors does not rule out the pecking order theory, it is still relevant however, it cannot be used as a rule of thumb.

Key Words: *Financing Decision, Internal Financing, External Financing, Pecking order theory.*

Introduction

Financing decisions revolve around the sources of funds that a firm need to finance its investments and the allocation of funds to specific projects (Eka, 2018). Financing decisions are among the major strategic decisions of a firm (Nohong, Munir, & Hakim, 2021). Financial strategy is a collection of choices made with the intention of meeting the expectations of lenders and investors while creating favorable economic and competitive conditions. It seeks to optimize a company's value through effective resource and capital structure use, as well as to guarantee profitability and financial stability (Ferri & Ricci, 2021). Wheelen et al. (2017) described financial decisions as methods for achieving and maintaining business competitiveness and positioning an organization as a world-class organization.

Companies need to carefully consider the trade-offs between debt and equity financing in order to make well-informed financing decisions. It is necessary to consider elements including the company's long-term viability, risk tolerance, and financial standing (Kaur & Kaur, 2021). According to (Doumpos and Zopounidis, 2014), there has been a significant shift in the framework of financial decision-making over the past few decades. An organization's financial decisions and business strategy must collaborate well to create value and a competitive edge so that it can take advantage of the fluctuations in the market it serves.

Al Muhairi and Nobanee (2019) emphasized that financial decisions are extremely important in the company since various organizational activities and elements that contribute to corporate failure may be addressed through an effective decision-making process in the form of adequate strategies and financial management. Excellent decision-making assists the organization in driving long-term growth and achievement of organizational goals.

Peprah and Ayaa (2022). Businesses can utilize both internal sources or external sources of finance with a difference in performance between the organizations that use external funds and those that use internal funds. (Nguyen & Canh, 2020). The pecking order theory of Myers and Majluf (1984), argued that firms will seek finance by following the order of internal funds first before going for external funds, that is utilizing retained earnings if not enough, go to debt and use equity as the last resort. This paper will review the literature by focusing on the demand side to determine if the pecking order theory holds for firms when seeking funds to finance their investments to achieve organizations' strategic objectives.

Literature Review

Almeida and Campello (2010) studied the connection between internal funds denoted by profitability and external funding represented by the issuance of debt in relation to the pecking order theory. Their results showed that internal funding had a negative relationship with the choice of external funding for large firms that paid large dividends and their debts rated. Such firms were least likely to experience a high cost of external funding. On the other hand, for small firms that had low payout and unrated debts, external financing had no effect on internal funds. The study was conducted under conditions of variable macroeconomic movements that tighten the financing constraints. Greater complementarity was therefore established between internal and external financing for constrained firms as a result of interdependence in their financing and investment choices.

In the study of Hogan and Hutson (2005), the capital structure of new technology-based firms was determined. Findings for small businesses showed that internal funds were the main source of funding in the new technology-based firms, such that debt was rarely used but equity financing was the prime source of external funding. It was noted that the founders of software companies have a strong preference for outside equity to debt. However, their capital structure could not be clearly explained by financing constraints due to the presence of information asymmetries from the lenders (banking sector).

Lee, and Xiao (2021) found that policy risk had a significant negative effect on corporate financing, suggesting that firms facing high political risk are less likely to use external financing. For different financing strategies, they found that the risks had a greater influence on debt financing than on equity financing Recommendations were made for policymakers to carefully consider the impact of policy changes on corporate financial behavior and make more efforts to stabilize macroeconomic policy. Managers need to identify and adjust appropriate financial strategies to help them perceive policy changes.

Lee (2019), sought to answer the question as to whether firms' reliance on external finance played a remarkable role in determining their growth and whether the availability of loans enhanced the growth of financially dependent firms. Findings revealed that firms that depended largely on external finances grew slowly than others therefore increasing bank lending helped firms to solve the unfavorable effects that financial dependence had on the growth of firms. It was clear in this study that firms that are in need of external funds experience faster growth when there is an adequate supply of credit. A similar study by Zetlin-Jones and Shourideh (2017) on external financing, showed that external funding is more extensively used by private firms than public firms. Another important aspect of financing to be considered is networking relationships as reported by Ceptureanu, Ceptureanu, & Herteliu (2019). They studied the financing patterns of MSEs in accessing external finance. MSEs who had good networking relationships with financial stakeholders were able to access equity financing through Venture capital and other external stakeholders but not bank financing.

Zhang et., al. (2021) examined manufacturers' and capital-constrained retailers' green supply chain (GSC) financing decisions to establish a Stackelberg game model under decentralized and centralized decision-making. The study found that regardless of the retailer's financing method, the ideal wholesale price of a manufacturer lowers when the loan interest rate rises. If the store opts for trade credit financing, the best retail pricing, green marketing efforts, and order quantity are unimportant in terms of the financing interest rate. The ideal retail price rises when the merchant chooses bank loan financing, while the optimal order quantity and overall profit fall.

The results of Mohamed, Ahmad, and Adonia, (2021) on the financing of firms in developing countries showed that managerial characteristics had a great impact on the choice of financing. Managers prefer internal financing to external financing depending on their internal growth intention, network ties with financing stakeholders, and owner's age and experience.

Liu, Li, & Chen (2020) studied firms listed in the Chinese A-share market to determine how cash holdings had evolved over time and their effect on R&D investment after the 2008 financial crisis. Results showed that firms with higher R &D held more cash reserves due to economic volatility that resulted from unstable monetary conditions. The sensitivity of R&D investment during the 2008 crisis was a result of precautionary motives. It is therefore noted that firms tend to adjust their financial resource decisions according to the external environmental changes they face as well as cash holding policies.

Wang, Chen, Liu, and Tang, (2020) sampled SME firms listed on the China National Equities Exchange and Quotations, to study the financing preferences of the board secretary as a result of their financial expertise from the perspective of behavioral finance. The board secretaries who had financial expertise preferred external financing over internal financing. This is due to external influence mechanisms where the board secretaries due to their financial experience are able to attract financial analysts and institutional investors thereby minimizing the degree of information asymmetry. From a behavioral finance perspective, experience reduces the degree of overconfidence such that the board secretary can act with objectivity using facts. This improves the company’s use of external funding and reduction in the sensitivity of investment cash flow.

Conclusion

Firm financing decisions are significant in maintaining the health of the organization. Several empirical studies have been reviewed to determine the reasons why different firms use different sources of finance. While the pecking order theory gives a sequence of financing order according to the cost of each source of finance, such that retained earnings are considered before debt and equity, literature gives mixed results on the choice of finance by different firms. Findings revealed that contrary to the cost argument of the pecking order theory, there are several other factors that determine a firm’s choice of finance. It's established that large firms, technology-based firms, high-growth firms, private firms, and firms with well-established network relationships with financial stakeholders. Other factors included the financial expertise of the board and external environmental effects such as financial crises. Although the review was not exhaustive, it can be established from the review that different firms’ choices of finance differ depending on the situations at hand. This does not rule out the pecking order theory of capital structure, it applies in some cases but cannot be used as a rule of thumb.

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