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Based on the pecking order financing concept companies favor internal finance and adapt their target dividend payout ratios to their investment opportunities. Where there are unpredictable variations in profitability and investment opportunities, the internally-generated funds may be more or less than investment outlays.

If it is less and external finance is required, firms first issue the safest financing vehicle (debt instruments). Under this idea, no well-defined target capital structure prevails, because there are two equity capital types, internal and external. Internal equity financing gets top preference and external equity is last resort in the pecking order. Thus, a firm's actual debt ratio indicates its cumulative requirements for external finance (Myers and Majluf, 1884). We may quickly ignore the pecking order hypothesis if we expect it to explain everything. There are a number of cases where firms issue equity securities while they are able to issue investment-grade debt. However, if we consider the overall situations, companies heavy rely on internal finance and debt for funding their new projects. The same study by Myers and Majluf (1984) on all non-financial corporations over the decade 1973-1982 documented that internally generated funds covered about 62 percent of capital expenditures in these firms.

On the external financing side, on the remaining part, the lion's share came from borrowing. Assuming that investors do not know the actual value of assets and of the firm's development opportunities, they are unable to accurately evaluate the shares issued by the firm to finance its new investments. More precisely, if firms are obliged to finance new investment projects by issuing equity, the markdowns on share prices may be so high

that new investors will gain higher earnings than the net present value of the new project, resulting in net loss for current shareholders; consequently, even though the net present value of the project is positive, the project will be abandoned; underinvestment may be avoided by using other financing resources which are not marked down sharply by the market (e. g. internal funds, risk-free loans and even relatively risky loans). Hence, according to pecking order theory, the firm prefers to fund its investments first by internal resources, then by low-risk borrowed capital, and, only as a last resort, by equity.