Overconfident managers and capital structure in the hospitality firms

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Abstract

One of the fundamental questions in corporate finance is what determines firms' financing decisions. Capital structure varies greatly among firms in the real world and, the determinants of the capital structure still largely remained unexplained. In the traditional financial theories, several approaches have been developed to explain how firms make their financing decisions. Myers and Majluf (1984) introduced the asymmetric information approach to explain corporate financing choices when managers are assumed to have inside information that outside investors do not have. The pecking order theory (Myers & Majluf, 1984; Myers, 1984) describes that managers prefer internal over external financing and debt over equity if external financing is needed. This occurs because managers perceive issuing equity to be overly costly while perceiving issuing debt to be less costly and using internal funds to be costless. The trade off theory states that the target debt ratio of the firm is determined by balancing debt tax shields against financial distress costs (Myers, 2001). It predicts that large firms with tangible assets tend to have higher leverage. Shyam-Sunder and Myers (1999) examined the financing behaviors of the 157 U.S. firms and found that debt issues were used to finance deficit of these firms supporting the pecking order theory. Although the pecking order theory largely contributes to explain how firms make financing choices empirical evidence has been to some extent contradictory. For instance, previous studies found evidence that contradicts the pecking order theory (Fama & French. 2002; Frank & Goyal, 2003, Goyal, 2007). Thus, more robust evidence is required to explain why firms make different financing choices.

It is only recently that psychological and behavioral features have been considered as an important factor in the corporate decision making processes. Roll (1986) contends in his hubris theory that managerial overconfidence could affect corporate decisions. Several other researchers attempted to explain why optimal debt levels are not achieved in some firms by associating managerial overconfidence with financing decisions (Heaton, 2002; Malmendier & Tate, 2005; Malmendier et al., 2008). Specifically, several studies emphasized that overconfidence could influence investment decision making processes. Hackbarth (2006) maintained that overconfident CFOs tended to choose more aggressive debt policies because they underestimated the volatility of their firms' cash flows. Ben-David et al. (2007) associated overconfidence with corporate policies and found that 1) overconfidence was positively related to debt leverage 2) the use of long-term debt was higher for firms with overconfident CFOs. It is posited that overconfident CEOs prefer debt over equity because they believe issuing new equity will destruct the value of existing shareholders (Malmendier et al., 2007; Malmendier & Tate, 2005; Heaton, 2002). Malmendier and Tate (2008) analyzed the effect of overconfidence on acquisition decisions and found that overconfident CEOs perceived issuing equity to be costly even when the valuations of their firms by investors were correct. In sum, it has been argued that overconfident CEOs will display the preferences for debt over equity financing.

In this paper, therefore, we contend that managerial overconfidence could help us better understand one of the fundamental questions in corporate finance; why firms choose different capital structures. Further, we extend the previous studies on the financing decisions by characterizing companies based on the pattern of capital structure in relation to manager overconfidence. By characterizing the companies we expect to discover whether there is any consistent pattern in capital structure and financial performance of hospitality firms with regard to manager overconfidence. Therefore, the findings of this paper will fill a critical gap in the hospitality literature on the capital structure and provide meaningful explanations for the use of different financing means when considering behavioral aspects of management.

The data of this study will include publicly traded U.S. lodging and restaurant companies between 1999 and 2009. In order to determine the relationship between overconfidence and financing decisions a multiple regression will be conducted using debt-to-equity ratio as a dependent variable. Our main independent variable is overconfidence. Malmendier and Tate (2005) developed three overconfidence measures based on the personal portfolio decisions of CEOs. We will use expense ratio as a proxy for agency cost in order to distinguish the effect of overconfidence from traditional agency theory. Expense ratio is defined as operating expense scaled by annual sales. Additionally, independent variables as proxied by the determinants of capital structure such as size, profitability, and tangibility will be adopted from previous studies (Titman & Wessels, 1988; Fama & French, 2002; Frank & Goyal, 2004). The following cross-sectional time-series model will be used to analyze the relationships among variables.

Keywords: hubris theory, managerial overconfidence, behavioral finance, financing decisions, capital structure.

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