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Do hotel REIT companies face investment constraints? A comparison with C-corporation hotel companies

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ABSTRACT

This study investigates whether corporate investment by REIT hotel companies (hotel REITs hereafter) is more constrained than investment by C-corporation hotel companies (hotel C-corps hereafter). The investments of hotel REITs and hotel C-corps are examined by comparing the sensitivities of investment to cash flow and investment opportunities between the two groups. Results show that the sensitivity of investment to cash flow is positive and significantly higher for hotel REITs than for hotel C-corps, suggesting that hotel REITs are likely to experience more constraints on their corporate investment. This finding suggests that hotel firms and owners should be more cautious about electing to be a REIT if they are planning large investments in the future. In addition, this finding has policy implications; even a small reduction in the rate of mandatory dividend payouts could significantly increase hotel REITs' corporate investments.

1. Introduction

Do hotel real estate investment trusts (i.e., REITs hereafter) tend to experience constraints on their investments in comparison with hotel C-corporations (i.e., C-corps hereafter)? The profits of hotel C-corps are taxed separately from its shareholders, based on subchapter C of the Internal Revenue Code. However, as a pool of real estate properties traded on stock exchanges, REITs must distribute at least 90 percent of their taxable income as dividends. Although the dividends distributed to shareholders are deductible from the taxable income of REITs, the mandatory dividend payout requirement also limits their ability to retain earnings. Consequently, this forces REITs to rely more heavily on external financing sources to fund their investment opportunities. There are two contrasting predictions regarding the effects of this constraint on REITs' investments. According to the pecking order theory of financing (Myers, 1984; Myers and Majluf, 1984), the constraint may impede REITs' investments because external funding sources are more costly than internally generated funds. Contrary to this expectation, some REIT studies have documented that REITs generally pay out substantially greater dividends than are legally required (Hardin III and Hill, 2008; Wang et al., 1993). The existence of these "excess" dividends implies that the mandatory dividend payout requirement does not necessarily impede investments.

Unfortunately, little is known about how (or even whether) hotel REITs differ from hotel C-corps in terms of corporate investment. Understanding the effects, if any, of the mandatory dividend payout requirement on hotel REITs' investments is especially important for hotel firms and management wavering between REIT and C-corp structures (Tang and Jang, 2008). Once they decide to invest in the hotel business through public stock exchanges, they have two distinctively different options: REITs and C-corporations. If the dividend requirement indeed tends to impede REITs' investments, the REIT structure may not be the right organizational form for hotel firms that want to pursue rapid growth through large capital expenditures. At first glance it may seem feasible for a firm to switch back and forth between the REIT and C-corp structures. However, as Gyourko and Sinai (1999) point out, de-REITing (switching back from a REIT to a C-corp) would disappoint a clientele of shareholders who prefer the high payouts of REITs because they are tax-exempt or in a low tax bracket. Therefore, electing to be a REIT is a hard-to-reverse, long-term decision and should be made based on a thorough examination of its comparative impact on expected returns and corporate investments.

The purpose of this study is to investigate whether hotel REITs experience more investment constraints relative to hotel C-corps. Two hypotheses are developed based on the financial constraints literature to test whether REIT hotels experience more investment constraints than C-corp hotels. The first hypothesis predicts that the sensitivity of investment to cash flow is positive and higher

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for hotel REITs than for hotel C-corps. The second hypothesis predicts that the sensitivity of investment to investment opportunities (measured by Tobin's Q) is positive and higher for hotel REITs than for hotel C-corps.

2. Literature review

2.1. REIT dividend requirement and its impacts on financing and investment decisions

To maintain federal tax-exempt status, a REIT must distribute at least 90 percent of its taxable income (excluding capital gains) to its shareholders as dividends (Tang and Jang, 2008). While this restriction was initially designed to ensure that REITs function as a passive investment vehicle and reduce agency problems that arise from widely dispersed ownership, it may also have unintended effects on various firm decisions.

The most direct effect of the mandatory dividend payout, which also constrains income retention, may be that it leads REITs to rely more heavily on external sources of capital to finance growth. Indeed, during the 1980s and 1990s REITs financed more than 80 percent of their investments with equity and long-term debt (Ott et al., 2005). By contrast, as Tirole (2006) documents a number of studies have found that non-REIT industrial firms in major Organization for Economic Cooperation and Development (OECD) countries generally finance their investments with internal funds. Nichols and Boutell (2005) point out that this heavy reliance on external funds may be especially relevant to hotel REITs as compared with other REIT subsectors. Typically, hotel REITs' funds for replacing existing properties and acquiring new properties well exceed the sum of depreciation and the available 10 percent of internally generated income.

Dependence on external funds may, in turn, affect the investment behavior of REITs. Finance theories and conventional knowledge suggest that heavy reliance on external funds impedes a firm's investments because external financing is generally more costly than internal financing (Jang et al., 2008). As Schiantarelli (1996) points out, these increased expenses are due to information asymmetries and agency problems between managers and outsiders (i.e., potential equity and debt holders). These increased expenses lead outsiders to demand a premium on the debt or equity they purchase. If this argument is true, REITs may not be able to fund all desired investment opportunities due to a lack of retained earnings and the high costs of external capital. The REIT literature generally accepts, at least in part, that the dividend payout requirement impedes REITs' investments (e.g., Chan et al., 2003).

In reality, however, whether the mandatory dividend payouts hamper REITs' investments is not as clear as the aforementioned theories suggest. Several phenomena exist that appear to contradict these theories' claims. First, REITs tend to distribute significantly more dividends than required by tax regulations (Bradley et al., 1998; Chan et al., 2003; Wang et al., 1993). If REITs truly lack funds for growth, paying out significantly more dividends than legally required appears illogical and requires an explanation. For example, Hardin III and Hill (2008) investigate why REITs pay out excess dividends above mandatory requirements. Their findings suggest that REITs recognize their need to access capital markets for growth and either pay out excess dividends or repurchase stocks to facilitate future access to the capital markets. Second, REITs' investments (as a percent of assets) were generally equal to or even exceeded the investments of C-corps during the period 1990–2003 (Riddiough and Wu, 2009). Third, a theoretical criticism exists as well. The notion that the mandatory payout requirement impedes investment rests on the crucial assumption that external financing is more costly than internal financing. If REITs can alleviate the information or agency problems in the capital markets, and thereby obtain external funds at moderate prices, dividend payout requirements would not impede investment as severely as finance theories and conventional wisdom predict. In fact, several studies have shown that some factors can reduce information problems and/or agency problems in capital markets. For example, Almeida and Campello (2007) find that asset tangibility (a proxy for debt capacity) increases the sensitivity of investments to cash flow for financially constrained firms. This finding suggests that while financial constraints affect investment decisions, other factors such as debt capacity may alleviate the degree of such constraints. In sum, all of these phenomena, as well as the theoretical criticism, cast doubt on the idea that REITs face more severe constraints in funding their investment opportunities than comparable C-corps.

2.2. The financial constraints literature

The question of whether the dividend payout requirement impedes REITs' investments may translate into whether REITs have more severe financial constraints than comparable C-corps. Financial constraints are generally defined as "frictions that prevent firms from funding all desired investments" (Lamont et al., 2001, p. 529). Financially constrained firms are defined as "firms whose investments are below the first-best level" (Hahn and Lee, 2009, p. 892). Therefore, the dividend payout requirement and costly external funds may translate into such a friction, leading one to hypothesize that REITs are likely to be more constrained than comparable C-corps.

To determine whether REITs are more constrained than C-corps, it is essential to measure and compare the financial constraint levels of both groups. Fortunately, a large body of literature has developed various methods for measuring degree of financial constraint and has employed them to investigate how firms' financial constraints affect corporate decisions. These methods include various a priori measures of financial constraints, such as the investment–cash flow sensitivities criterion (Fazzari et al., 1988), the Kaplan and Zingales (KZ) index as adapted by Lamont et al. (2001), the Whited and Wu (WW) index (Whited and Wu, 2006), and the size-age (SA) index of financial constraints (Hadlock and Pierce, 2010).

2.3. The investment–cash flow sensitivity criterion

Beginning with Fazzari et al. (1988), a large body of literature has investigated the relationship between corporative investment and cash flow to test for the presence and degree of financial constraints. The essential argument of this approach is that the sensitivity of investments to internal funds increases with the degree of financial constraint. The test begins by dividing a sample of firms into multiple subsamples according to an a priori measure of financial constraint, such as dividend payout ratio (Fazzari et al., 1988), and industrial group with close banking ties (Hoshi et al., 1991). Then, the sensitivities of investment to cash flow are estimated and compared across the subsamples to check whether firms that are, a priori, considered more financially constrained actually exhibit higher sensitivities. Employing this methodology, a number of studies have found that corporate investment responds positively to internal cash flow. More importantly, the sensitivity is generally higher for more constrained firms than for less constrained firms (e.g., Fazzari et al., 1988; Hoshi et al., 1991; Schiantarelli, 1996).

The general model for testing the effects of internal finance on investment is

$$\frac{I_t}{K_{t-1}} = \beta_0 + \beta_1 \frac{\mathrm{CF}_t}{K_{t-1}} + \beta_2 Q_{t-1} + \varepsilon,$$

where I_t represents investment in plant and equipment during period t; K_{t-1} is the beginning-of-period capital stock (i.e., book