



CEO overconfidence and corporate debt maturity☆



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ABSTRACT

This paper extends our knowledge of corporate debt maturity structure by examining whether and to what extent overconfident CEOs affect maturity decisions. Consistent with a demand side story, we find that firms with overconfident CEOs tend to adopt a shorter debt maturity structure by using a higher proportion of short-term debt (due within 12 months). This behavior of overconfident CEOs is not deterred by the high liquidity risk associated with such a financing strategy. Our demand side explanation remains robust even after considering six possible alternative drivers including a competing supply side explanation (in which creditors are reluctant to extend long-term debt to overconfident CEOs).

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1. Introduction

Our understanding of the industry- and firm-level determinants of debt maturity structure is well established in terms of traditional finance theory (e.g., Flannery, 1986; Johnson, 2003; Myers, 1977; Stohs and Mauer, 1996). More recently, researchers have focused attention on the agency problem between stockholders and managers by examining how CEOs affect the corporate debt maturity decision at a personal level.¹ While these studies typically maintain the broad framework of “neoclassical” executive rationality, a behavioral finance perspective embracing the concept of overconfidence suggests alternative considerations that potentially offer important new insights.² Accordingly, the primary objective of our study is to examine whether and to what extent the overconfidence of CEOs affects a firm’s debt maturity decisions.

The overconfidence concept examined in this study primarily stems from the notion of a “better-than-average” effect. That is, when individuals self-assess their relative skills or personal traits, most overestimate their own abilities and consider themselves to be above the average at a particular skill or consider themselves more likely to be described by desirable attributes (Alicke,

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¹ Datta, Iskandar-Datta, and Raman (2005) and Brockman, Martin, and Unlu (2010) examine how CEOs’ stock and option ownership affect debt maturity structure.

² A large body of psychology literature documents that people are ‘biased’ in their beliefs. See, for example, Svenson (1981) and Alicke (1985). As rightly cautioned by the anonymous referee, the reader is counseled against interpreting this view to be one of “irrationality”. Executives may well be very confident and in some sense even “overconfident”, but the fact that they tend to be quite successful and that the evidence suggests they do not systematically destroy firm value (e.g., Hirshleifer, Low and Teoh, 2012), implies that they should not be labeled irrational. Arguably, a superior view is to see this behavioral perspective as meaningfully broadening our conception of rational behavior/decision making.

1985; Svenson, 1981). This “better-than-average” effect also applies to future events for which people express unrealistic optimism (Weinstein, 1980). As shown by Camerer and Lovallo (1999), the better-than-average effect also appears in experiments focused on economic decision-making, where participants overestimate their chances of relative success if the payoffs are based solely on their own abilities. Similarly, in the behavioral corporate finance literature, overconfident CEOs are often modeled to overestimate future firm performance (i.e., see Malmendier and Tate, 2005). This is because they generally expect good outcomes or because they overestimate their own efficacy in bringing about success (Hirshleifer, Low, and Teoh, 2012).³

Theoretically and empirically, overconfidence has been shown to have a substantial impact on corporate decision-making. For example, Roll (1986) first uses the overconfidence approach to explain the often observed phenomenon of value-destroying mergers and acquisitions. Although the term “overconfidence” is not explicitly mentioned in his work, Roll’s managerial hubris is closely allied to the concept of overconfidence that we examine in our study. His “hubris” theory suggests that managers are too confident about the expected benefits emanating from mergers and acquisitions and, thus, they bid excessively for target firms, thereby leading to ex post losses on “successful” deals.

More recently, Malmendier and Tate (2008) find that overconfident CEOs undertake value-destroying mergers due to overestimating firms’ ability to generate returns, especially when they have access to internal funding.⁴ Similarly, Heaton (2002) uses a simple model to demonstrate the underinvestment and overinvestment problems for overconfident managers, even in the absence of information asymmetry. Empirically, Malmendier and Tate (2005) use CEOs’ propensity to hold deep in-the-money stock options as a proxy for CEO overconfidence and find that such CEOs’ investments are more sensitive to cash flow, especially for those in equity-dependent firms.

In terms of the financing decision, Hackbarth (2008) suggests that managers’ growth and risk perception biases are important factors in explaining capital structure decisions such as firm leverage and debt issuance. Hackbarth (2008) argues that, compared to “unbiased” managers, “biased” managers tend to use more debt financing as they believe that the firm is more profitable and/or less risky. Malmendier, Tate, and Yan (2011) empirically find that overconfident CEOs are less likely to issue equity than debt when accessing external financing as they believe equity is more undervalued than debt, which (other things being equal) leads to higher leverage observations.⁵ Moreover, in a mini-boom of recent research effort, the effect of managerial overconfidence is more widely explored in the context of other areas of corporate decision-making and activity, such as compensation contracts and capital budgeting (Gervais, Heaton, and Odean, 2011), financial misreporting (Schrand and Zechman, 2012); earnings forecasts (Hribar and Yang, 2015), CEO turnover (Campbell, Gallmeyer, Johnson, Rutherford, and Stanley, 2011), and innovation (Hirshleifer et al., 2012).

Despite the large amount of research investigating the concept and impact of overconfidence in financial decision-making, its influence on debt maturity structure remains largely unexplored. The standout exception is Landier and Thesmar (2009). However, they only focus on a sample of small French start-up firms.⁶ Our study differs from (and improves upon) theirs in the following three aspects. First, we examine the effect of managerial overconfidence on a representative sample of large US listed firms, whose financing decisions are generally quite different from and economically more important than small start-up firms. Second, our study measures overconfidence based on executive option exercise behavior and includes a comprehensive set of control variables – thereby addressing some of the omitted variables concerns associated with their study.⁷ Third, we expand the scope of their study by considering the influence of liquidity risk and explore the channel overconfident CEOs manage their preferred debt maturity.

We argue that overconfident CEOs believe that they can enhance stockholder value by taking on more short-term debt. This is because overconfident CEOs overestimate the probability that they can refinance short-term debt with lower costs when favorable news arrives in the future. Empirically, we follow Malmendier and Tate (2005, 2008) by using revealed beliefs from executives’ option exercise behavior to identify overconfident CEOs. We conduct our empirical analysis in the US market with a sample of 4309 firm-year observations from 2006 to 2012. Consistent with our hypothesis, we provide strong evidence that firms with overconfident CEOs tend to have a higher proportion of debt due within a short horizon – namely, one, two or three years.

To further explore the main channel of short-term debt used by overconfident CEOs, we more finely partition our measurement of debt maturity into two components; namely: (1) newly-contracted short-term debt (ST, i.e. debt due in less than 12 months) and (2) the maturing of previously-contracted longer-term debt (excluding ST). This analysis shows that the main driver for the documented overconfidence-short-term debt linkage is ST.

³ The anonymous referee raises the distinction between personal overconfidence regarding the executive’s own abilities versus overconfidence regarding their firm’s prospects. We acknowledge that this is a legitimate concern, not only for our paper, but more generally for this pocket of behavioral finance literature. One means of connecting personal overconfidence with overconfidence in firm performance is to invoke an assumption of “illusion of control”, in which overconfident CEOs believe that their abilities can determine firm outcomes. From such a perspective, our analysis is in effect a test of a joint hypothesis.

⁴ In more recent work, Kolasinski and Li (2013) and Ferris, Jayaraman, and Sabherwal (2013) confirm that overconfident CEOs are more acquisitive.

⁵ Malmendier et al. (2011) argue that the net impact of overconfidence on leverage is an empirical question as it depends on the relation between overestimated investment returns, cash holdings and perceived financing costs. Empirically, they find support for a positive relation between overconfident CEOs and financial leverage.

⁶ The sample of Landier and Thesmar (2009) is typified by very small operations. Specifically, the average number of employees is generally less than 10 and the total annual sales only a few hundred thousand Euros.

⁷ Landier and Thesmar (2009) use the difference between forecasted and realized sales and employment figures as a measure of overconfidence. This measure raises the concern that the correlation between overconfidence and short-term debt could just come from omitted variables that affect both firm performance and the use of short-term debt. For example, if risky firms tend to borrow more short-term debt, a negative shock will have a greater impact on the performance of those risky firms which makes the entrepreneurs appear optimistic (when they might not be).

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