Journal of Corporate Finance 29 (2014) 390–409

Contents lists available at ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

The dark side of CEO ability: CEO general managerial skills and cost of equity capital☆

Dev R. Mishra *

Edwards School of Business, University of Saskatchewan, 25 Campus Drive, Saskatoon, SK S7N5A7, Canada

ARTICLE INFO

Article history:
Received 27 September 2013
Received in revised form 27 September 2014
Accepted 1 October 2014
Available online 13 October 2014

JEL classification:
G3
M1
Z

Keywords:
Implied cost of equity
CEO generality
Organization capital
Agency costs

ABSTRACT

CEOs with substantial general managerial ability (generalist CEOs) possess a substantial share of organization (human) capital and have different risk-taking incentives than do their counterpart specialist CEOs. Using an index increasing in CEO general managerial skills as a proxy for general managerial ability, we find that investors require higher returns from firms featuring CEOs who have profuse general managerial ability. Furthermore, expected returns are significantly increasing with CEO general managerial ability in firms with high organization capital, that belong to M&A-intensive industries and that have complex operations, high agency problems and high anti-takeover provisions. These findings are consistent with arguments that organization (human) capital has significant expected return implications and that CEOs with higher general managerial skills may lead to higher agency problems, feature different risk-taking incentives and be more costly to retain in times of need.

© 2014 Published by Elsevier B.V.

1. Introduction

Organization capital (investment in key talent) – similar to physical capital – is a highly valuable asset of the firm, at the nucleus of which resides the firm's chief executive officer (CEO). Modern corporations appear to have a growing appetite for hiring outside CEOs, particularly those who already have held CEO positions elsewhere (Murphy and Zabojnik, 2007) and those high in general managerial skills, as opposed to those with skills specific to a particular firm or industry. For example, firms are often willing to provide substantially fatter pay packages to CEOs richer in general managerial skills acquired over a lifetime of work experience (henceforth referred to as generalist CEOs) compared with those who have skills specific to a firm or industry (henceforth referred to as specialist CEOs) (Custódio et al., 2013). The market perceives such CEOs as precious organization capital who may be more valuable during times of shock and restructuring (Eisfeldt and Papanikolaou, 2013) and may have incentives to take more risk (May, 1995). This perception may factor into pricing firms' equity securities such that investors may require higher returns for investing in firms with generalist CEOs. Therefore, this study asks whether there is heterogeneity in investors' expected returns from securities of firms featuring generalist CEOs compared with firms featuring specialist CEOs. We attempt to uncover an answer to this key question primarily by using firms' implied cost of equity capital and the Custódio et al. (2013) index of CEO general managerial ability.

☆ I acknowledge financial support from the Social Sciences and Humanities Research Council of Canada (SSHRC) and N. Murray Edwards through the Centre for Strategic Financial Management. I thank the participants at the Edwards Research Seminar at the University of Saskatchewan, 17th SGF Conferences (2014), the Midwest Finance Association annual meeting (2014), the Financial Management Association European meeting (2014), Stuart Gillan, Shantaram Hegde, Vahe Lskavyan, Thomas O'Brien, Markus Schmid, Jianhua Zhang, and the anonymous referees for their comments and Liwen Zhang for the excellent research support.

* Tel.: +1 306 966 8457.
E-mail address: Mishra@edwards.usask.ca.

http://dx.doi.org/10.1016/j.jcorpfin.2014.10.003
0929-1199/© 2014 Published by Elsevier B.V.

We employ a sample of 12,431 firm-years of S&P 1500 firms from 1993 to 2006, the CEO generality index (*GEN-INDEX*) is based on lifetime work experience as used in Custódio et al. (2013) and the required rates of return are determined primarily based on the implied cost of equity capital supported by discount rates estimated using several models that we discuss below. The *GEN-INDEX* is the first principal component of the following five aspects of a CEO's lifetime work experience: the number of CEO positions held, the number of firms worked for, the number of industries worked in, CEO positions at other companies and prior work experience in a conglomerate firm. A higher value of *GEN-INDEX* refers to a higher level of "general managerial ability." As discussed in greater detail in Section 2 below, we argue that a higher value of *GEN-INDEX* implies higher CEO human (organization) capital, a lack of incentives to reduce risk (compared with specialist CEOs) and increased agency issues in the firm. Both the analytical and empirical literature suggest that organizational capital has a non-diversifiable component of risk that factors into higher expected returns (Eisfeldt and Papanikolaou, 2013), that generalist CEOs have less incentive to reduce risk compared with specialist CEOs (May, 1995) – because the latter's future cash flows are more contingent on the firm itself – and that increased agency problems factor into higher risk premiums (Chen et al., 2009, 2011; Easley and O'Hara, 2004; Hail and Luez, 2006). Therefore, we argue that firms' required rates of return are positively associated with CEO general managerial ability.

Our key dependent variable is the implied cost of equity (investors' expected returns ex-ante) estimated using accounting-based valuation models. We follow Dhaliwal et al. (2006, 2011) to estimate firms' implied cost of equity capital. The beauty of these models is that, unlike the traditional approaches for estimating required rates of return, these models do not rely on historical pricing data. Therefore, estimates of implied cost of equity reflect the investor's expected rate of return at the point of estimation. Apart from this, these models imply discount rates by simultaneously controlling for the effects of cash flows and growth in firm valuation. Using ordinary least-squared regressions on pooled time-series data and cluster-corrected standard errors, we find that the *GEN-INDEX* is positively associated with a firm's implied cost of equity after controlling for the standard determinants of the cost of equity capital with and without year and industry effects. Our evidence is robust to using alternative measures of the ex-ante cost of equity, such as estimates based on Ohlson and Juettner-Narouth (2005) and the price–earnings–growth (PEG) model. It is also robust to comparisons with traditional models for estimating expected returns, such as the dividend growth model (see Harris et al., 2003), the earnings to price ratio (Francis et al., 2005), the Sharpe (1964)–Litner (1965) single factor capital assets pricing model (CAPM) and the Fama–French three-factor model (see, e.g., Fama and French, 1997).

The literature suggests that CEO general managerial ability (or CEO human capital) is more important for firms experiencing industry M&A activity surge, industry shocks, or operational distress, because such generalist CEOs may be hired to perform difficult tasks such as restructuring, acquisitions, recovery from operational distress and/or managing shocks. Such CEOs are also preferred in conglomerate firms that are expected to have more complex operations. In our additional tests, we find that investors' expected returns increase as the *GEN-INDEX* increases with respect to firms in industries with high M&A activity and multi-segment (conglomerate/complex) firms. However, we find that the sensitivity of the cost of equity to CEO generality is homogeneous across firms categorized based on industry shock or operating distress. Another possibility is that managerial ability may have heterogeneous cost of equity implications for firms with different levels of organization capital because firms with high organization capital are characterized by a higher degree of intangible assets, such as human capital. Indeed, we find evidence the cost of equity effect of the *GEN-INDEX* significant only in the sub-sample of firms with high stock of organization capital.

Similarly, we also argue that CEOs with high general managerial skills are characterized by incentives that may not be aligned with those of the firm and its shareholders. The effects of such incentives may be more exacerbated in firms featuring high levels of agency problems and poor governance quality. To this end, we find that investors' expected returns increase significantly with the *GEN-INDEX* in firms with high levels of agency costs of free cash flows and with weak corporate governance.

Our tests are likely subject to two forms of specification and endogeneity concerns: i) selection bias and the omission of certain variables that may affect both the cost of equity and CEO generality and ii) direction of causality (in particular, the possibility that firm performance and the discount rate may affect CEO choice and availability). We address these endogeneity issues in several ways. First, we use a propensity score matching technique to find the nearest matching specialist CEO for each generalist CEO. This technique helps alleviate significant misspecification, endogeneity and selection bias (Armstrong et al., 2010; Roberts and Whited, 2012; Rosenbaum and Rubin, 1983) by ensuring that there is little difference in the observable characteristics between the treatment (with generalist CEO) and control (with specialist CEO) group of firms. Second, we include several potential suspects of omitted variables, such as forecast bias, stock of organization capital, momentum, financially distressed firm dummy, CEO ownership, governance proxies and proxies of the agency costs of free cash flow. Third, to control for the unknown firm and CEO characteristics that may affect both the cost of equity and CEO generality, we separately control for firm and CEO fixed effects. Fourth, we perform change tests and use the difference-in-difference of the cost of equity capital with respect to the direction of change in CEO generality surrounding the appointment of a new CEO and the difference-in-difference of CEO generality with respect to the past change in the implied cost of equity. We find that the change in CEO generality is significantly positively associated with future change in the cost of equity and that the past change in the cost of equity is not associated with the current change in CEO generality. After implementing all these endogeneity corrections, we continue to find that the cost of equity is a significantly positive function of CEO generality. We believe that these corrections largely mitigate potential concerns for identification, misspecification and/or omitted variables.

To our knowledge, this is the first study to directly examine the effect of CEO general managerial ability on the cost of equity capital. The previous literature has found that generalist CEOs receive higher pay for their perceived ability to manage organizations. Additionally, it is anticipated that such CEOs may positively affect firm performance, although the empirical evidence does not appear to support this expectation. We dispute neither the abilities of such CEOs nor their eventual (perhaps positive) effect on a firm's strategies and expected operating performance. However, our findings overwhelmingly suggest that generalist CEOs are not only expensive but also likely to induce investors to require higher rates of return, prompting them to discount a firm's cash flows at a higher rate.

Download English Version:

https://daneshyari.com/en/article/5093507

Download Persian Version:

https://daneshyari.com/article/5093507

Daneshyari.com