



The value of cash holdings in hotel firms



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ABSTRACT

Extant research in finance suggests asymmetric information increases the cost of external financing substantially and creates underinvestment problems. While franchising might reduce underinvestment problems, it might exacerbate overinvestment problems in poorly-governed firms. Using combined postulations from both the pecking order theory and the free cash flow theory, this study examines the value of cash holdings in hotel firms and the extent to which franchising, financial constraints, and corporate governance affect this value. The findings suggest that cash can be a curse and a blessing; cash is more valuable for financially constrained firms than for unconstrained firms and less valuable for poorly-governed firms than for well-governed firms. Also, financial constraints have a greater effect on the value of cash holdings than weak corporate governance. Although franchising could solve underinvestment problems, it makes poorly-governed firms more vulnerable to overinvestment. Practical and theoretical implications are discussed within realms of corporate finance and franchising.

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1. Introduction

Hotel firms need external funds to develop and/or acquire additional hotel properties because a substantial capital investment is required to build a new hotel property or renovate existing hotel properties (Houthakker, 1979; Tsai and Gu, 2012). However, the high cost of external funds could turn the positive net present value (NPV) of an investment negative due to asymmetric information problems between the company and outside investors. Firms that face asymmetric information problems may forgo positive NPV investments that require financing beyond the available internal funds. These firms encounter underinvestment problems because they are financially constrained to their internal funds. One solution to the underinvestment problem is to retain more cash because the cost of internal funds is lower than the cost of external funds (Myers and Majluf, 1984). The extant literature provides empirical evidence that financially constrained firms keep more cash compared to unconstrained firms (Almeida et al., 2004). Financially constrained firms have profitable investment opportunities; nevertheless, they have limited access to external funds. Cash management becomes of extreme importance for financially constrained firms because cash holdings allow these firms to safe-

guard against possible value-increasing investment opportunities (Denis and Sibilkov, 2009; Mun and Jang, 2015). Therefore, shareholders of financially constrained firms place more value on cash holdings relative to those of unconstrained firms (Chen and Wang, 2012).

While cash holdings can be more valuable in financially constrained hotel firms because retained cash can help to reduce underinvestment problems, cash holdings could also increase overinvestment problems in poorly-governed firms (Harford et al., 2008). Jensen (1986) argues that managers of firms with free cash flows and unused borrowing powers are more likely to complete negative NPV projects and create overinvestment problems. One solution to mitigate overinvestment problems is to distribute the excess cash to shareholders (Harford et al., 2012; Starks and Wei, 2013). However, retaining excess cash in the company might be crucial for well-governed hotel firms to execute positive NPV projects. Another solution to overinvestment problems is to establish well corporate governance mechanisms (Gompers et al., 2003; Masulis et al., 2007). Well-governed firms' CEOs are more likely to be aligned with shareholders compared to poorly-governed firms' CEOs, and they are more likely to make value-increasing investments (Bebchuk et al., 2006; Dogru and Sirakaya-Turk, 2017; McCahery et al., 2016). Corporate governance mechanisms further affect hotel firms' cash management policies because powerful CEOs can fund a potentially value-decreasing projects with the excess cash to increase their power. Simply put, poorly-governed firms' CEOs are likely to waste the firms' resources in projects that

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benefit their personal wealth. Therefore, shareholders of poorly-governed firms put lower value on cash holdings relative to those of well-governed firms (Franzoni, 2009).

Although financially constrained hotel firms can retain internally generated funds in order to eliminate underinvestment problems, internal funds may not be sufficient to undertake all value-increasing projects. Another solution to underinvestment problems is the expansion via franchising, which is a widely adapted investment model in the hotel industry (Dogru, 2017a). The capital scarcity theory of franchising suggests that firms utilize franchising when they lack the necessary capital to fund their growth, as franchisor firms do not need substantial capital expenditures for expanding through franchising (Hunt, 1973; Oxenfeldt and Thompson (1968–1969)). The franchising strategy enables hotel companies to grow quickly in both domestic and foreign markets by eliminating the time required for individually developing a new hotel project from the ground up. Furthermore, franchisor hotel firms will generate additional cash from franchising and royalty fees, which can be used to develop new hotel properties or acquire existing ones for further expansion. Indeed, acquisitions are a very common *modus operandi* in the hotel industry with over \$440 million average target value and \$41 billion (including new development) in total capital investment in 2015 (Alon et al., 2012; CBRE, 2016; Kim and Canina, 2013). Thus, franchising could be a practical tool for expansion when hotel firms lack the necessary internal resources to make value-increasing investments.

While franchising might help solve underinvestment problems in financially constrained firms, it could make overinvestment easier for empire-building CEOs especially in the context of mixed investment models, where hotel firms expand via both franchising and corporate-owned outlets. Franchising could create overinvestment problems in poorly-governed hotel firms because managers that desire to build empires are likely to waste resources generated via franchising on investments that serve their interests. In other words, CEOs of a poorly governed hotel firms may consolidate their powers using the excess cash generated through franchising and royalty fees in value-decreasing investments. Indeed, in their recent study, Madanoglu and Karadag (2016) showed that expanding via franchising beyond the optimal level further deteriorates the relationship between corporate governance and firm value. Therefore, the implications of cash holdings and cash management can be even more complicated in hotel firms due to the complex nature of investment models in the hotel industry. Cash holdings might be more valuable for franchising firms if franchising is viewed as a solution to underinvestment problem because excess cash generated from franchising and royalty fees allows these firms to undertake company-owned hotel investments. However, shareholders of franchising firms will place a lower value on cash if franchising is perceived as a path to managerial overinvestment. Although Guillet and Mattila (2010) showed that well-governed hospitality firms have better financial performance compared to poorly-governed hospitality firms in regards to equity, leverage, size, and return on assets, the extent to which the quality of corporate governance affects the value of cash holdings in hotel firms is not clear. Moreover, little is known about the extent to which financial constraints affect the value of cash holdings in hotel firms. Many hotel chains start business with few wholly owned establishments, instead they expand rapidly via franchising. Why hotel firms choose the franchising investment model is yet to be explored.

The purpose of this study is to examine the extent to which franchising, financial constraints, and corporate governance affect the value of cash holdings in hotel firms using the pecking order theory of capital structure and free cash flow theory. First, the relation between cash holdings and firm value is investigated in order to determine the value of cash holdings in hotel firms. Second, the effects of financial constraints and corporate governance on the

relation between cash holdings and firm value are examined in order to effects of financial constraints and the quality of corporate governance on the value of cash holdings. Lastly, the effect of franchising on the relation between cash holdings and firm value is analyzed in order to explain why firms expand through franchising investment.

The findings of this study will provide guidance to hotel firms' CEOs, board of directors, institutional investors, and minority shareholders. Cash management is crucial to hotel firms as the decision of retaining or distributing the excess cash might affect the perceived value cash. Firms determine the level of cash holdings based on their degrees of financial constraints and the quality of corporate governance mechanisms (Franzoni, 2009). The adopted business model can further affect the perceived value of cash holdings. Hotel firms can better devise cash management and cash holding strategies depending on their investment models. The results can potentially guide hotel firms' decision either via expansion through franchising or corporate-owned divisions. Institutional investors can use their voting power to institute better corporate governance mechanisms. Shareholders can then plan an investment strategy based on hotel firms' degree of financial constraints, the quality of corporate governance, and investment models.

2. Literature review and hypotheses development

An extensive body of research suggests that external and internal finances are not perfect substitutes. Myers and Majluf (1984) developed the pecking order theory that suggests entrepreneurs experience difficulties conveying true information about their firm to the capital markets, which creates asymmetric information problems and makes external funds more costly than internal funds. Asymmetric information makes firms financially constrained to their internal funds for investments. Financially constrained firms may forgo valuable investment opportunities that requires external funds and face underinvestment problems. Therefore, financially constrained firms are expected to use internal funds to make value-increasing investments and maximize firm value. Fazzari et al., 1988 argued that firms are financially constrained if their investments are highly sensitive to internal funds, suggesting that high investment-internal funds sensitivity is an indication of financial constraints. However, Kaplan and Zingales (1997) argued that investment-internal funds sensitivity alone cannot be a good measure of financial constraints, proposing that further methods are needed to measure financial constraints in firms. A number of studies have developed indices that measure firms' degrees of financial constraints based on the information that firms disclose on their financial reports (see e.g., Almeida et al., 2004; Hadlock and Pierce, 2010; Hennessy and Whited, 2007; Lamont et al., 2001; Whited and Wu, 2006). According to these financial constraint indices, a higher index value indicates greater degrees of financial constraints and vice versa.

Consistent with the pecking order theory and recently developed financial constraint indices, a number of studies have shown that financially constrained firms hold more cash and depend more on cash flows than unconstrained firms to overcome underinvestment problems (Almeida et al., 2004; Denis and Sibilkov, 2009; Hadlock and Pierce, 2010; Hennessy and Whited, 2007; Kim and Jang, 2012; Whited and Wu, 2006). Studies of Franzoni (2009) and Khatami et al., 2014 show that financially constrained firms use the retained cash to reduce the underinvestment problems that arise due to the difference between the costs of external and internal funds. Furthermore, Edwards et al. (2015) showed that financially constrained firms devise cash tax saving strategies to retain more cash in the company to finance value-increasing investments when

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