



The impact of managerial ability on crisis-period corporate investment



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ABSTRACT

In this study, we document a strong positive relation between pre-crisis managerial ability and corporate investment during the crisis period, which remains robust in the presence of a large array of control variables capturing corporate governance attributes, executive compensation incentives and CEO characteristics. This relationship was prevalent only among firms with CEOs that had general managerial skills, rather than firm-specific skills. Our results also show that the positive relationship between managerial ability and corporate investment was supported by the capacity of such firms to secure greater financing and be less vulnerable to financial constraints during the crisis. Finally, we find that, on average, the stock market evaluates crisis-period investments positively, yet this effect is evident solely among firms characterized by high pre-crisis managerial ability. Overall, the results are consistent with the view that high managerial ability helps to mitigate underinvestment problems during a crisis which in turn increases firm value.

1. Introduction

The impact of managerial ability on firm policies has long been ignored under the assumption that managers are largely homogeneous entities, which implies a limited role for manager-specific influence on economic outcomes. Only recently have a handful of studies challenged this view by recognizing that managers play an economically significant role on their firms' choices and performance (Andreou, Philip, & Robejsek, 2016; Bamber, Jiang, & Wang, 2010; Chemmanur, Paeglis, & Simonyan, 2010; Choi, Han, Jung, & Kang, 2015; Demerjian, Lev, & McVay, 2013; Francis, Ren, Sun, & Qiang, 2016). We extend this literature by using the 2008 global financial crisis as a natural experiment setting to investigate the impact of managerial ability on corporate investment. In addition, we scrutinize the nature of managerial ability to acquire insights about the type of ability that has the greatest effect on investments. Finally, we explore the relationship of managerial ability with corporate financing and firm value respectively.

Although it could be argued that the relationship between firm managerial ability and corporate policy is straightforward, prior findings have often proved contradictory. For instance, a stream of literature suggests that more able managers with reputations at stake are expected to reject opportunistic rent-seeking actions that harm firm value, since such behavior could tarnish their ability and standing as perceived by shareholders

and investors (e.g., Falato, Li, & Milbourn, 2015; Fama, 1980; Graham, Harvey, & Puri, 2013; Kreps, Milgrom, Roberts, & Wilson, 1982). A different stream of literature, however, argues that more able managers may decide to pursue such as ill-advised investment- or earning- management to preserve their human capital and reputation, despite the fact that these actions usually reduce firm value (Malmendier & Tate, 2007; Francis 2008; Petrou & Procopiou, 2016). Such mixed evidence indicates that the relationship of managerial ability with firm policy and outcomes has not yet reached a consensus. Perhaps, this controversy is due to the confounding effects arising from endogeneity problems, whereby contemporaneous realizations of both the dependent variable and the explanatory variables in question affect each other (Abdallah, Goergen, & O'Sullivan, 2015).

In this paper, we circumvent such endogeneity concerns by focusing on the relationship between managerial ability and corporate policy during the financial crisis. This period is an ideal setting for such an investigation, not only for its recentness and severity, but primarily due to its broadly adverse impact on the availability of corporate finance, as well as consumers in general (Duchin, Ozbas, & Sensoy, 2010). Specifically, the extreme market conditions characterized by liquidity shortfalls (Ivashina & Scharfstein, 2010), along with the uncertainty and conservative approach of financial institutions dictating for more internal control, made it very difficult for corporations to obtain credit lines and access external capital. At the same time, firms faced various

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exogenously-driven bottlenecks, such as low demand for their products, resulting in losses that harmed their capacity to internally generate enough resources to finance attractive investments. Such weakened funding capacity created the conditions for firms to suffer from underinvestment problems (Balakrishnan, Watts, & Zuo, 2016; Campello, Graham, & Harvey, 2010; Duchin et al., 2010), which could be detrimental to firm value. Overall, the recent financial crisis abruptly changed firms' environment by causing an exogenous shock on their policies. The crisis therefore provides a natural experiment setting, suitable to alleviate endogeneity caveats that usually handicap empirical analyses in corporate finance research.

In this study, we hypothesize that the impact of managerial ability on firms' corporate investment were not only more easily identified during the crisis period, but were also more profound in the presence of an exogenous negative shock to the availability of financing resources that potentially undermines investments. Accordingly, we expect firms with higher pre-crisis managerial ability to have invested more during the crisis period because their managers' ability facilitated greater access to financing resources. In addition, such investments should also have been more highly valued by the market because they mitigated severe underinvestment problems that emerged during that period.

To investigate these hypotheses, we use a measure of managerial ability proposed by Demerjian, Lev, and McVay (2012). The measure is based on a comparison of managerial efficiency in transforming corporate resources to revenue, relative to their industry peers. Managerial ability is considered high when managers generate more significant revenue using a given level of resources or, conversely, when they minimize the resources used for a given level of revenue. Using this measure, we provide empirical evidence of a strong positive relation between pre-crisis managerial ability and crisis-period capital expenditure. The results remain robust even at the inclusion of additional control variables relating to corporate governance attributes, executive compensation incentives and CEO characteristics.

Despite the financial crisis being exogenous, capable of mitigating endogeneity, for robustness purposes, we also use a propensity score matching (PSM) approach to ensure that our results are not driven by different characteristics between firms with high or low managerial ability. This treatment controls for the possibility that certain firm attributes simultaneously affect managerial ability and crisis-period investments. The results of PSM lend further credence to our main finding regarding the positive relationship between pre-crisis managerial ability and crisis-period corporate investment.

Further, we examine the types of managerial ability that seem to withstand distressed times, shedding light on the growing importance of general versus firm-specific managerial skills (Brockman, Lee, & Salas, 2016; Custódio, Ferreira, & Matos, 2013). We find that the positive relationship between pre-crisis managerial ability and crisis-period investments is prevalent only among firms with CEOs who have general managerial skills (i.e. generalists) rather than firm-specific skills (i.e. specialists). Additionally, we find a positive relationship between pre-crisis managerial ability and crisis-period financing resources. Thus, an important channel through which managerial ability affects investments is by facilitating financing. Finally, we document that the stock market highly valued the crisis-period investments only when these were made by firms with high pre-crisis managerial ability.

This study contributes to the literature as follows. First, our results show positive valuation of capital expenditure during the crisis period for firms with high pre-crisis managerial ability, whereby firms with low pre-crisis managerial ability experienced negative valuation of investments. This finding contributes to the extant literature (e.g., Falato et al., 2015; Francis, Huang, Rajgopal, & Zang, 2008; Graham et al., 2013; Malmendier & Tate, 2007) by shedding light on the differential way that managerial ability impacts firm value and helps to settle the conflicting conjectures as debated in prior studies. Second, we contribute to recent studies that investigate how firms managed liquidity shortfalls in their effort to mitigate underinvestment problems

following the onset of the crisis (e.g., Campello, Giambona, Graham, & Harvey, 2011; Campello et al., 2010; Duchin et al., 2010). Our findings suggest that higher managerial ability contributed to the capacity of firms to secure more financing during the crisis, which in turn enabled them to pursue more investment opportunities. In this respect, high managerial ability appears to offset crisis-period underinvestment problems that in turn enhanced firm value. Finally, we contribute to the burgeoning literature that highlights the importance of general versus firm-specific skills with respect to CEO pay (e.g., Brockman et al., 2016; Custódio et al., 2013; Murphy & Zabochnik, 2004). Our results reveal that generalist, not specialist, CEOs mitigate underinvestment at times of constrained economic conditions. In this vein, our findings provide an economic explanation of why generalist CEOs earn significantly higher salaries compared to their specialist peers.

The remainder of this paper is organized as follows: Section 2 describes the literature review and the arguments of the study. Section 3 includes the sample and data measurement, Section 4, the statistical methodology and empirical results. Section 5 provides a conclusion.

2. Background on managerial ability, corporate policies and outcomes

Recent literature has investigated whether managerial characteristics and competencies such as ability, talent, quality or reputation influence corporate decision-making. Starting with Bertrand and Schoar (2003), a significant extent of the heterogeneity in investment, financial, and organizational practices of firms is shown to be explained by managers' fixed effects. Chang, Dasgupta, and Hilary (2010) link variations in management actions and styles to variations in firm performance, consistent with the view that differences in firm performance may also stem from managers' traits or experiences. This view is also supported by Chemmanur and Paeglis (2005), Chemmanur, Paeglis, and Simonyan (2009) and Switzer and Bourdon (2011) who document positive relations between firm management quality and IPO/SEO performance. In addition, Chemmanur et al. (2010) find value-enhancing anti-takeover provisions in the presence of higher quality firm management. In the banking industry, Andreou et al. (2016) demonstrate that more able bank managers have the capacity to handle higher risks and to facilitate greater intermediation. Finally, Francis et al. (2016) show that firms with higher ability managers obtain more favorable loan contract terms, such as lower loan spreads, less stringent covenants, and longer term maturity. Overall, the literature demonstrates the importance of managerial ability on firm policies and outcomes.

More able managers tend to be, inter alia, more knowledgeable about their business, leading to better judgments and estimates about product demand, a better understanding of technology and industry trends and a more efficient management of their employees (Demerjian et al., 2012, 2013). Therefore, firms with higher managerial ability are expected to align resources well with the environment in which they operate, resulting in greater internal profitability. This is particularly important in the presence of growth opportunities, since it can facilitate a continuum of investments, especially if these firms face difficulties in raising external finance.¹

Perhaps the most prominent channel through which managerial ability affects firm policy is through the reputational capital that managers accumulate over the course of their career. When financing

¹ Campello et al. (2010) report that during the financial crisis, 86% of US firms facing financial constraints bypassed attractive investments due to difficulties in raising external finance, compared to 44% of financially unconstrained firms that did the same. Also, they report that more than half of US firms rely on internally-generated cash flows to fund investment under financially constrained circumstances, and 56% of constrained firms are found to cancel investment projects when they are unable to obtain external funds, compared to 31% of unconstrained firms that may cancel investment.

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