Manager Characteristics and Capital Structure: Theory and Evidence

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Big picture

• Continuous time *trade-off* model of financing and payout decisions with manager-shareholder conflicts

• **Managers**

- are *risk averse*
- can exert *costly* effort to improve cash flows
- *appropriate* the rents associated with their effort choice
- *own* part of the firms' equity
- *make* payout, financing, and default *decisions*

• **Shareholders**: Well diversified (risk-neutral) investors

Big picture

- Relation to litterature

  - **Incomplete contracting**: Zwiebel (AER 1996), Morellec (RFS 2004), Benmelech (2006), Lambrecht and Myers (JFE 2008), Khuenen and Zwiebel (2008)

  - **Optimal contracting**: DeMarzo and Sannikov (JF 2006), Biais, Mariotti, Plantin and Rochet (RES, 2007), He (2009), Biais, Mariotti, Rochet and Villeneuve (Econometrica 2010)

  - **Entrepreneurial firm**: Ju, Parrino, Poteshman, and Weisbach (2006), Chen, Miao, and Wang (2009)

- Empirical litterature:

  - **II** and **SMM**: Hennessy and Whited (2005, 2007)

  - **SML**: Morellec, Nikolov and Schuerhoff (2008)

Details of the model

• **Payout policy**

- Manager choses payout s.t. the participation constraint of shareholders ⇒ No sharing of the surplus

- Nash and subgame perfect

• **Financing**: The manager maximizes an objective function that balances two terms

- Equity stake: Provides incentives to issue debt (tax benefits)

- Rents: Reduce incentives to issue debt

• **Predictions**: Maturity of corporate debt and leverage are related to a number of firm- and manager-specific characteristics

Comments on the paper

- **Game** between manager and shareholders

  - Drives most of the results. Nash bargaining over the surplus created by the manager should generate different results

  - Example: *systematic* (industry-specific) and *idiosyncratic* components of managerial human capital.

  ⇒ May change results on the effects of effort, ability, … since the equity component would now depend on managerial characteristics

Comments on the paper

- **Maturity**: Very important topic; very few results

  - Short-term debt is not really short term (Manso, Strulovici and Tchistyi (RFS 2010), Morellec and Smith (RF 2007))

$$\textit{Cash flow} = (1-\tau)\lambda P_t\,dt - a(t)dt \quad \textit{with an infinite horizon}$$

  so that all the action comes from the manager's (performance invariant) compensation *a(t)*

  - Not a choice variable for the manager

  - Short-term debt does not give tax benefits

  - No relation to the existing litterature (theoretical and empirical)

Comments on the paper

- **Leverage**

  - Shall one bind the participation constraint of shareholers with θ or with θ^* (chosen by replacement manager) ?

  - Aggregate the predictions on short- and long-term debt

  - Should go back to the litterature and compare predictions. What is unique to your model?

  - Empirical predictions are based on a model that is not the one presented in the paper

Comments on the paper

- **Utility function** of the manager

  - Quadratic utility function

- **Contracting space**

- **Empirical strategy** :

  - Not clear that the paper needs some empirics.

  - Why do the authors use a reduced-form specification ?

Conclusion

- **Ambitious** and **interesting** paper

  - New set of empirical predictions

  - Empirical evidence supporting most of the results

  - Analysis can be deepened along some dimensions

  - Empirical testing