

RESEARCH BRIEFS

CEO MANAGERIAL SKILLS AND COST OF EQUITY CAPITAL: IS THERE A “DARK SIDE?”

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RESEARCH QUESTIONS

Consider the career trajectories of two well-known CEOs. Hubert Joly, CEO of Best Buy, started his career in 1985 and then moved through various roles at McKinsey, EDS, Vivendi, and Carlson Wagonlit Travel before joining Best Buy in 2012. In contrast, Doug Oberhelman of Caterpillar joined the firm immediately after graduation in 1975 and moved up the ranks to become CEO in 2010. Today, CEOs of large corporations are more likely to have a career path like Joly's (Gupta & Gupta, 2015). Indeed, corporations seem to prefer career variety in their top executives and choose CEOs who already have held top positions elsewhere (Murphy & Zbojnik, 2004).

The preference for career variety among top executives leads one to ask whether there are potential downsides to CEOs with diverse, as opposed to specialized, work experience. This question is explored by Dev Mishra (University of Saskatchewan) in a recent study examining the relationship between CEOs' managerial skills and investors' expected rate of returns. The study assesses whether managerial skills—in the form of diversity of CEOs' work experiences—is associated with meaningful differences in investors' expected returns. Mishra argues that if generalist CEOs generate higher expected rates of return than specialist CEOs, this difference may be attributed to CEOs' general lifetime work experience. Generalist CEOs have broad knowledge and experience, which is readily transferrable across firms. Since firms may fear losing this key talent, they will want to provide superior returns and meet investors' higher expectations.

Mishra also argues the relationship between managerial skills and cost of equity capital will be stronger when firms face industry shocks, agency problems, governance issues, higher organizational capital, and merger and acquisition activity. Generalist CEOs may take greater risks than specialist

CEOs since they have better job prospects elsewhere, even if their risky bets don't pan out. Such risk-taking may be in conflict with shareholders' interests, which creates an agency problem. Yet firms in industries with high levels of merger and acquisition activities, product market changes, external shocks, and distress may rely on generalist CEOs to deal with these challenges. Consequently, the relationship between managerial skills and cost of equity capital will be more pronounced in such industries.

Mishra's research is a significant departure from the general tendency to focus only on the positive impact of CEOs' managerial skills for their firms. Song (1982) showed that diversified prior experience of CEOs leads to a broader range of strategic initiatives. Previous research also suggests that generalist CEOs can overcome functionally driven stereotypes (Bunderson & Sutcliffe, 2002), stimulate information sharing (Balkundi & Harrison, 2006; Buyl, Boone, Hendriks, & Matthyssens, 2011), and enhance communication among top management team members (Arendt, Priem, & Ndofor, 2005). Although the prior academic literature emphasized the “bright side” view of general managerial skills, Mishra attends to its “dark side.”

STUDY DESIGN AND METHOD

Mishra collected data for S&P 1500 firms spanning the years 1993 to 2006. The final sample consisted of a panel of 12,431 firm-year observations for firms included in Institutional Brokers Earnings Service historical earnings file and the Compustat North America annual file.

CEOs' lifetime work experience was operationalized as a gestalt construct comprising five factors: number of positions held, number of firms worked for, positions held in the past, number of industries worked in, and prior work experience in multidivisional firms (see

Custodio, Ferreira, & Matos, 2013). When the index value for a particular firm for a particular year was greater than the annual median, it was classified as a generalist CEO firm-year. Conversely, when the index value for a particular firm-year was lower than the annual median for that year, it was classified as a specialist CEO firm-year.

The dependent variable of implied cost of equity capital was calculated using three different indicators from prior research (see Claus & Thomas, 2001; Easton, 2004; Gebhardt, Lee, & Swaminathan, 2001). The three indicators were averaged to calculate an overall measure of expected returns. To test the robustness of the findings, alternative models of the cost of equity were also used, including capital asset pricing models (Fama & French, 1997; Lintner, 1965), dividend growth model/price-earnings-growth (Easton, 2004), earnings price ratio (Francis, LaFond, Olsson, & Schipper, 2005), and the abnormal growth model (Ohlson & Juttner-Nauroth, 2005).

To analyze contingencies, information on mergers and acquisitions was collected from the SDC platinum database, and firms were divided into industry groups. Industry sales growth and industry market value growth served as measures to estimate industry shock, and high or low agency costs were calculated using free cash flow.

Control variables included in the regression analyses were: firm size, market beta, book value of equity, book-to-market ratio, leverage, and short- and long-term growth in forecasted earnings.

KEY FINDINGS

The results were interesting and revealing, underscoring the importance of CEOs' prior lifetime work experience on the cost of equity capital. In particular, investors expected higher return from the firms with generalist CEOs as compared to firms with specialist CEOs. The magnitude of the effect is such that one standard deviation increase in the general managerial index was associated with 0.08% increase in investors' expected rate of return. The main finding was also robust under the above-mentioned alternative models of cost of equity capital.

Mishra also attempted to address whether the effect of CEOs' general managerial skills on cost of equity capital is stronger for firms facing agency problems, frequent mergers and acquisitions activities, high organizational capital, industry shocks, and weak corporate governance. Past research shows that CEOs' managerial skill is valuable for these types of firms since executives with diverse professional

careers are exposed to different and complex business environments, have less incentive to reduce risk-taking, and are more likely to implement strategic decisions which may be contrary to the shareholders' interests. The increase in agency problems between shareholders and managers leads to a high demand of return by investors. Mishra found greater variability in cost of equity capital for firms undergoing restructuring, such as during merger and acquisition, poor governance, high organizational capital, and high agency issues.

CONCLUSION AND IMPLICATIONS

A wealth of research exists on the upper echelon perspective (Hambrick & Mason, 1984), which highlights top executives' characteristics, personality, experiences, values, and dispositions as key determinants of organizational processes and outcomes (Priem, Lyon, & Dess, 1999). Mishra, rather than examining performance consequences for the firm, looked at performance outcomes for investors. More specifically, Mishra delved into the association between the nature of CEOs' managerial skills (generalized or specialized) and investors' cost of equity, thereby contributing to the academic literature in both management and finance.

Mishra draws three main conclusions from this research. First, executives' general managerial skills affect investors' expected rate of return. In short, increases in managerial skills leads to increases in the return demanded by investors. Second, consistent with agency theory, CEOs with diverse managerial ability have fewer incentives to reduce risks over specialist CEOs. Finally, Mishra suggests that the increase in expected rates of return due to general managerial skills is more salient in firms facing mergers and acquisitions.

Mishra's research does have some critical limitations. First, measuring cost of equity using indicators of returns raises a question unanswered in his study. Specifically, do the results reflect that investors are demanding higher payback for their investment (as Mishra suggests) or is the firm actually performing better? Second, several regression coefficients presented in support of the findings of this paper are significant at the 0.1 level, which is much higher than the conventional significant level of .05. Finally, the conceptual arguments underlying this research assume that the market for CEOs is quite liquid. It is unclear whether the results found here would generalize to countries where CEO talent is less mobile and executives change companies infrequently.

In terms of practical implications, by linking executives' prior work experience to the cost of equity capital, Mishra casts light on the economic incentives behind choosing a particular type of CEO. This seems useful for boards tasked with hiring and recruiting CEOs. Further, CEOs' lifetime work experience may also be considered by firms assessing investors' additional risk premium.

SOURCE

Mishra, D. R. (2014). The dark side of CEO ability: CEO general managerial skills and cost of equity capital. *Journal of Corporate Finance*, 29, 390–409.

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