Article

Corporate Investment and Hotel Firm Value: Does Corporate Governance Matter in Financially Constrained Firms?

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Abstract

Corporate investments are expected to create value for firms. Although some studies report evidence supporting such expectations, many studies document contradictory findings. However, it is not clear why corporate investments create value in some firms but reduce value in others. The purpose of this study is to examine the extent to which the quality of corporate governance and the degrees of financial constraints affect the relationship between corporate investments and hotel firm value in a unified model where both weak corporate governance and financial constraint problems are concurrently observed. Shareholders of poorly governed firms place a lower value on corporate investments compared with those of well-governed firms, whereas shareholders of financially constrained firms perceive corporate investments to be of greater value compared with those of unconstrained firms. The results further showed that CEOs of financially constrained firms make value-increasing investments despite poor corporate governance mechanisms. Theoretical and practical implications are discussed within the realm of corporate finance theories.

Keywords

corporate governance; financial constraints; investment; hotels; firm value

Introduction

A natural conflict of interests exists between shareholders and CEOs within firms, because shareholders' wealth maximization goals do not necessarily maximize CEOs' personal wealth. Jensen (1986) proposed the free cash flow theory, arguing that CEOs may invest beyond the optimal investment level by undertaking investment projects with negative net present value (NPV), overpaying in acquisitions, or investing in unrelated businesses that do not increase firm value but rather increase their own wealth and/or power. That is, CEOs may not act in the best interests of shareholders and thereby increase agency costs. Although shareholders strive to reduce the agency cost, CEOs could, in the extension of their power, make subordinate investment decisions that purposefully serve to increase their compensations and/or power. Harford, Humphery-Jenner, and Powell (2012) argued that CEOs of firms with poor corporate governance policies could particularly exploit personal benefits from corporate investments.

Corporate governance mechanisms establish rights for shareholders who seek to increase their wealth, safeguard their equity investments in the firm, and reduce agency cost. While well corporate governance standards enhance shareholders' rights and increase their power, poor corporate governance policies (or the absence thereof) expand CEOs' power and protect them from being replaced (Gompers, Ishii, & Metrick, 2003). That is, poor corporate governance mechanisms increase agency costs. Establishing high-quality corporate governance mechanisms could alleviate the agency costs and help to align CEOs' incentives with those of shareholders (Bebchuk, Cohen, & Ferrell, 2006). In a recent study, Aggarwal, Schloetzer, and Williamson (2016) reported that poorly governed firms have lower firm value compared with their well-governed counterparts, suggesting that CEOs of firms with fewer shareholders' rights are likely to make corporate investments to attain personal gains. Examining the cash holding and investment policies, the studies of Dittmar and Mahrt-Smith (2007) and Masulis, Wang, and Xie (2007) showed that cash is less valuable in poorly governed firms compared with well-governed firms, as CEOs of poorly governed firms are more likely to invest in projects that increase their personal wealth even though such investments might reduce overall firm value. Therefore, shareholders perceive the value of corporate investments differently depending on the firm's quality of corporate

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governance policies (Officer, 2011; Starks & Wei, 2013). In this study, we examine the extent to which the quality of corporate governance mechanisms affects the relationship between corporate investments and hotel firm value.

The value of corporate investments might also be perceived differently depending on firms' degrees of financial constraints (Baños-Caballero, García-Teruel, & Martínez-Solano, 2014; Edwards, Schwab, & Shevlin, 2015; Franzoni, 2009). It should be noted that financial constraints and financial distress are two distinct measures. A firm is considered to be *financially constrained* if the cost of external funds is higher than the cost of internal funds, and the degree of financial constraints increases as the difference between the internal and external cost of funds increases (Kaplan & Zingales, 1997). However, financial distress results from leverage in a firm's capital structure (Asquith, Gertner, & Scharfstein, 1994). In particular, firms are considered to be financially distressed when they cannot meet their obligations, such as interest payments (Wruck, 1990). In this study, we are primarily concerned with financially constrained firms.

The pecking order theory developed by Myers and Majluf (1984) suggests that firms should retain all internal funds in the company because the relatively higher cost of external funds could make a positive NPV investment negative. Investigating the role of financial constraints on the interrelations between the cash holdings, investment, and firm value studies of Denis and Sibilkov (2009) and Khatami, Marchica, and Mura (2015) showed that financially constrained firms retain more cash, their investments are more sensitive to internal funds, and they gain higher returns from acquisitions compared with unconstrained firms. These results collectively suggest that shareholders of financially constrained firms place a higher value on corporate investments because they believe that CEOs will use the cash holdings to invest in projects that increase shareholders' wealth. Thus, we analyze the extent to which the degree of financial constraints affects the relationship between corporate investment and hotel firm value.

The free cash flow and pecking order theories' postulations are extensively (albeit independently) examined in the context of cash holding policies, investment–cash flow sensitivities, and acquisitions. However, the effects of corporate governance and financial constraints on the relationships between corporate investments and firm value have not been widely examined. While the value of corporate investments in firms with weak corporate governance is expected to be decreasing, financially constrained firms are expected to make value-increasing investments. Furthermore, a firm could be both poorly governed and financially constrained (Dogru, 2017; Franzoni, 2009). While financially constrained firms are expected to make value-increasing investments, CEOs of poorly governed firms are likely to make suboptimal investment choices. However, the relationship between corporate investment and firm value has not been analyzed in an integrated model where both financial constraints and corporate governance problems have been concurrently observed. Therefore, we further examine the extent to which weak corporate governance mechanisms affects the relationship between corporate investment and hotel firm value in financially constrained firms. Specifically, this study seeks to answer the following research questions:

Research Question 1: To what extent does the quality of corporate governance affect the relationship between corporate investment and hotel firm value?

Research Question 2: To what extent does the degree of financial constraints affect the relationship between corporate investment and hotel firm value?

Research Question 3: To what extent does the quality of corporate governance affect the relationship between corporate investment and firm value in financially constrained hotel firms?

Contribution and Significance of the Study

Publicly listed hotel firms make investments to expand their operations and increase their market share through acquisitions and the development of new hotel properties, which further necessitate recurring maintenance, refurbishment, and renewal. Thus, hotel investments require periodic capital investments to maintain operations and conventional service quality. According to a recent report by CBRE, hotel investment reached US$41 billion in the United States in 2015 (CBRE, 2016). However, corporate investments can be value-increasing or -decreasing depending on the quality of corporate governance mechanisms, degrees of financial constraints, or both.

Although extensive research has been conducted analyzing hotel firms' value around acquisitions, findings from these studies remain inconclusive. Also, previous studies did not answer the perplexing questions of why investments create value for some firms yet reduce value for other firms (Canina, Kim, & Ma, 2010). For example, Hsu and Jang (2007) reported that acquiring hotel firms gain negative returns from acquisitions, whereas the studies of Canina (2001) and Yang, Qu, and Kim (2009) showed that acquisitions increase hotel firms' value. Corporate finance literature suggests that the quality of corporate governance and the degree of financial constraint affect the value of corporate investments (Jensen, 1986; Myers & Majluf, 1984). However, the implications of corporate governance and financial constraints received limited attention in hospitality literature despite the substantial theoretical background and empirical applications in the mainstream corporate finance field (see, for example, Bebchuk et al., 2006; Denis & Sibilkov, 2009; Masulis et al., 2007).

Comparing the investment–cash flow sensitivities of lodging firms, Kim and Jang (2012) found that hotel Real Estate Investment Trusts (REITs) are more financially constrained than C-corporation hotels. Guillet and Mattila (2010) showed that hospitality firms on average have weaker shareholders' rights, suggesting that the majority of hospitality firms are poorly governed. In a recent study, Altin, Kizildag, and Ozdemir (2016) showed that hospitality firms with weaker shareholders' rights receive higher credit ratings, indicating that CEOs of poorly governed hotel firms can easily raise funds to make investments that possibly increase their personal wealth. Nevertheless, the role of corporate governance in the relationship between corporate investment and firm value has not been previously investigated in hospitality literature. Also, little is known as to whether the quality of corporate governance affects the value of corporate investments in financially constrained firms, where CEOs are expected to make value-increasing investments. This study intends to fill these gaps in the literature by investigating the effects of corporate governance and financial constraints on the relationship between capital investment and hotel firm value.

Analyzing the relationship between corporate investments and hotel firm value within the realms of corporate governance and financial constraints can help to explain why corporate investments can be value-increasing or -decreasing for hotel firms. The findings of this study will provide managerial and practical guidance for hotel firm CEOs, boards of directors, shareholders, and lenders. Hotel firms' CEOs and boards of directors may be able to put more emphasis on corporate governance and financial constraints, depending on their effects on the value of corporate investments. Boards of directors and shareholders may institute better corporate governance mechanisms and initiate alternative dividend and financing policies to control CEOs. Lenders may take the quality of corporate governance policies and the degree of financial constraints into consideration prior to making loan decisions. The findings may also provide valuable information to existing and prospective shareholders on making investment decisions based on hotel firms' quality of corporate governance and degrees of financial constraints.

Literature Review and Hypotheses Development

Modigliani and Miller (1958) proposed the irrelevance theorem, suggesting that external and internal funds are perfect substitutes and thus firm value will not be affected by the financing decision to make an investment as long as the investment has a positive NPV. That is, corporate investments are expected to increase firm value according to the irrelevance theorem. However, since Modigliani and Miller (1958) proposed their seminal work, contradictory theoretical arguments have been proposed and extensive empirical research has documented corroborative evidence against their theory.

Jensen (1986) argued that CEOs have incentives to invest firms' resources in projects that increase their compensations. The conflict of interests between CEOs and shareholders creates agency problems, which can be very costly. According to Jensen (1986) free cash flow theory, CEOs tend to invest more when the firms have more internal funds, even if an investment has a negative NPV. To reduce the agency costs, therefore, firms should distribute internal funds to shareholders and raise external funds for financing positive NPV investments. However, forcing CEOs to distribute internal funds to shareholders might be a difficult task to accomplish. There are alternative strategies that can be implemented to alleviate the agency costs. Firms, for example, might improve the quality of corporate governance mechanisms to align CEOs' incentives with those of shareholders. In general, the number of antitakeover provisions (ATPs) determines the quality of corporate governance mechanisms in a firm. ATPs consist of provisions that protect managers from being replaced, such as the presence of a staggered board of directors, limit to shareholders' bylaw amendments, and limit to shareholders' charter amendments. Increased numbers of ATPs decrease the disciplinary role of the market for corporate control and deliver weaker shareholders' rights. Gompers et al. (2003) showed that CEOs of poorly governed firms (i.e., firms with an increased number of ATPs) are likely to waste firms' resources on subpar investment projects that possibly increase their personal fortune and certainly solidify their power at the expense of shareholders' wealth. The studies of Bebchuk et al. (2006) and Masulis et al. (2007) found evidence supporting the free cash flow theory and the findings in Gompers et al. (2003) that CEOs of firms that are protected with more ATPs destroy value in acquisitions. Harford et al. (2012) also showed that CEOs of poorly governed firms waste firms' resources in acquisitions by overpaying their targets.

In the context of hospitality literature, Guillet and Mattila (2010) showed that hotel firms have a high number of ATPs, which suggests that hotel firms, in general, are poorly governed and hence offer weak shareholders' rights. Analyzing whether acquisitions do indeed create value for both acquirers and targets in the hotel industry, Canina and Kim (2013) found contrary evidence suggesting that hotel firms overpay in acquisitions for reasons other than the potential synergy effects. Recently, Altin et al. (2016) showed that CEOs of hospitality firms with weaker shareholders' rights can use their power to make corporate investments that essentially benefit them but not necessarily the shareholders. Overall, managers of hotel firms protected with more ATPs may waste firms' resources by investing in subpar NPV projects, and hence, corporate investments are expected to

be of lower value in poorly governed hotel firms. We offer the following hypothesis based on the free cash flow theory and related empirical work.

Hypothesis 1 (H1): The value of corporate investments is lower in poorly governed firms compared with well-governed firms.

In addition to the quality of corporate governance mechanisms, the degree of financial constraints can also affect the value of corporate investments. Myers and Majluf (1984) argued that there is a wedge between external and internal funds due to asymmetric information that exists between firms and outside investors, and for some firms, the wedge might be so high that it could make firms abandon their projects. The difference between the cost of external and internal funds could turn a positive NPV project negative, which makes firms financially constrained to their internal funds. Fazzari, Hubbard, Petersen, Blinder, and Poterba (1988) showed that financially constrained firms' investments are more sensitive to cash flows and they pay lower dividends compared with those of unconstrained firms.

In the context of hospitality literature, extant studies showed evidence supporting both the free cash flow and pecking order theory propositions. Prior studies, however, utilized Tobin's *Q* to identify firms' degree of financial constraints and agency problems. Firms with a Tobin's *Q* higher than average are considered to be financially constrained, while firms with a Tobin's *Q* lower than average are considered to have agency problems. Kim and Jang (2012), for example, compared the investment–cash flow sensitivities of hotel firms and found that hotel REITs are more financially constrained than C-corporation hotels. However, Tobin's *Q* has been criticized on the grounds that it is generally imprecise in capturing financial constraints and agency problems and could therefore be misleading (Kaplan & Zingales, 1997; Whited & Wu, 2006). To avoid the mismeasurement of the Tobin's *Q*, Lamont, Polk, and Saa-Requejo (2001) developed the KZ index of financial constraints following the methodology used in Kaplan and Zingales (1997). Similarly, Whited and Wu (2006) and Hadlock and Pierce (2010) constructed financial constraint indices based on the information that firms disclose on their financial reports.

Utilizing these financial constraints indices, Almeida, Campello, and Weisbach (2004) showed that financially constrained firms retain more of their cash out of cash flows and distribute lower dividends compared with unconstrained firms to make value-increasing investments with retained cash. Along the same line, Denis and Sibilkov (2009) found that shareholders of financially constrained firms put more value on cash because investments in these firms are expected to create more value relative to unconstrained firms' investments. More recently, Khatami et al. (2015) showed that financially constrained firms gain higher returns from acquisitions compared with unconstrained firms because investments are expected to create value in financially constrained firms and maximize shareholders' wealth. In other words, both shareholders of financially constrained firms and the stock market place a higher value on financially constrained firms' investments because they have limited resources and are therefore less likely to waste their limited funds on unprofitable projects. The following hypothesis is developed based on the pecking order theory's propositions and former empirical research.

Hypothesis 2 (H2): The value of corporate investments is greater in financially constrained firms compared with unconstrained firms.

While pecking order theory suggests that corporate investments increase firm value in financially constrained firms, the free cash flow theory postulates that corporate investments reduce firm value in poorly governed firms. Both financial constraints and poor corporate governance can be detrimental for a firm. On one hand, financially constrained firms face costly external finances, which could make CEOs abandon value-increasing projects. On the other hand, misaligned CEOs (i.e., CEOs of poorly governed firms) might invest in suboptimal investment projects and hence increase the agency costs (Dogru & Sirakaya-Turk, 2017). Although the implications of costly external finance and agency costs have been extensively examined, it is not clear whether the quality of corporate governance affects firm value in financially constrained firms when such firms are also poorly governed. In this case, shareholders of financially constrained firms might place less emphasis on the quality of corporate governance mechanisms and perceive corporate investments to be value-maximizing despite a weak corporate governance mechanism. This intuition is ultimately an empirical question that needs to be investigated. However, previous studies did not examine the simultaneous effects of financial constraints and corporate governance mechanisms on firm value. Analyzing the effects of financial constraints and the quality of corporate governance mechanisms in a unified model, where both financial constraints and poor corporate governance mechanisms are concurrently observed, could help to explain why corporate investments create value for some firms yet reduce value for other firms. The following hypothesis is developed based on the postulations of the pecking order and free cash flow theories.

Hypothesis 3 (H3): The value of corporate investments is greater in financially constrained firms that are poorly governed compared with unconstrained firms that are poorly governed.

Method

Multivariate analyses are employed to examine the effect of corporate investments on firm value and the extent to which the degrees of financial constraints and the quality of corporate governance mechanisms affect the value of corporate investments. Panel ordinary least squares (OLS) analysis may yield biased estimates if the Gauss–Markov assumptions are violated. Standard errors are clustered by firm and year to cope with the autocorrelation problem. Variance inflation factors are further assessed for multicollinearity, and all the values in the models yield acceptable results. Therefore, the estimated parameters of the models are best, linear, and unbiased estimates (BLUE) (Gujarati, 2003).

The following models are applied to examine the relationship between investments and firm value for financially constrained and empire-building firms:

$$SR_{it} = a_0 + \beta_1 I_{it} + e_{it} \tag{1}$$

$$SR_{it} = a_0 + \beta_2 I_{it} + \sum_{k=1}^{n} \beta_k X_{kt} + e_{it} \tag{2}$$

$$SR_{it} = a_0 + \beta_6 I_{it} + \beta_7 I_{it} CG + \beta_8 CG + \sum_{k=1}^{n} \beta_k X_{kt} + e_{it} \tag{3}$$

$$SR_{it} = a_0 + \beta_3 I_{it} + \beta_4 I_{it} FC + \beta_5 FC + \sum_{k=1}^{n} \beta_k X_{kt} + e_{it} \tag{4}$$

where SR is the firm i's excess stock returns at time t, I is the firm i's capital expenditures at time t, CG is a corporate governance index variable, FC is a financial constraints index variable, and X represents a set of control variables of the firm i at time t that includes the Tobin's Q, net financing, and leverage. e is the error term, and a_0 and β_{1-k} are the models' parameters.

Data and Variable Construction

The sample of this study consists of publicly traded hotel companies with the Standard Industrial Classification (SIC) code 7011 in the United States during the period 1993-2013. As the Securities and Exchange Commission's (SEC) EDGAR database's records only reach back to 1993, the sample period begins in 1993. The dependent, independent, and control variables and the data for constructing the financial constraint indices are obtained from the Compustat annual database. It should be noted that similar to previous studies that investigated publicly traded hotel firms' acquisitions (see, for example, Hsu & Jang, 2007) and financing (see, for example, Dalbor & Upneja, 2004), the primary focus of this study is capital expenditure decisions in publicly traded hotel firms rather than capital expenditure decisions on the hotel unit level (see, for example, Turner & Guilding, 2010).

The Investor Responsibility Research Center (IRRC) publishes 24 ATPs for about 2,000 large corporations. However, the publications do not cover most of the firms in the hotel industry. Therefore, the data for constructing exposure to empire-building proxies are hand-collected from firms' 14-A, S-1, S-4, S-11, F-1, F-4, and 10-K statements, certificate of incorporation, and the shareholders' rights plan that are available on the SEC EDGAR. The final sample consists of 343 firm-year observations with 41 unique firms.

Following the studies of Denis and Sibilkov (2009) and Franzoni (2009), we use the *stock return* (or *excess stock return*), which is the stock return over a fiscal year minus the return on a beta-matching portfolio, as the dependent variable. The benchmark portfolio is adapted from the 48 Fama-French value-weighted portfolios. Essentially, the benchmark portfolio is the average returns of the hotel industry at year t. The stock return is calculated as follows:

$$SR_{it} = R_{it} - BR_{it} \tag{5}$$

where R_{it} is the Center for Research in Security Prices (CRSP) stock return during year t, BR is the return of stock i's benchmark portfolio during year t, and SR is the stock i's excess return during year t. Two alternative stock return measures (i.e., value weighted [VW] and equal weighted [EW]) are used to provide robust results. The EW stock return measures the firm value without taking firm size into account, whereas the VW stock return is calculated based on the relative market capitalization of the firm to adjust firm value based on firm sizes. The use of VW and EW stock returns as the dependent variable yields similar results, and hence, the analyses are conducted using VW stock returns as the dependent variable.

The independent variable is the capital expenditures (or investments), which is measured by capital expenditures (Item 128) in year t. Analyzing the effects of Tobin's Q on acquisition returns, Lang, Stulz, and Walking (1991) showed that Tobin's Q has a positive effect on firm value. Jensen (1986) argued that managers of firms with low leverage are likely to destroy shareholders' wealth through corporate investments. Also, studies of Almeida et al. (2004) and Denis and Sibilkov (2009) showed that net financing might affect firm value. Based on the literature, the following variables are included in the models to control for the changes in the firm's profitability and the firm's leverage and net financing. Tobin's Q, which is measured by total assets (Item 6) plus CRSP December Market Equity [the firm's December closing price on CRSP (Item 199) times common shares outstanding (Item 25)], minus common equity (Item 60) minus balance sheet deferred taxes (Item

74) divided by total assets (Item 6); net financing, which is measured by the sale of common and preferred stock (Item 108) minus the purchase of common and preferred stock (Item 115) plus long-term debt issuance (Item 111) minus long-term debt redemption (Item 114); and leverage, which is defined as the ratio of total debt (Item 9 + Item 34) to total assets (Item 6) in year *t*. Independent and control variables are adjusted by lagged market equity, which is defined as the number of common shares (Item 54) times the fiscal year closing price for stock *i* on year *t* (Item 199). Therefore, the coefficient of investments indicates the marginal dollar value of investments.

Three financial constraint indices are utilized to measure firms' financial constraint levels. Specifically, the Kaplan and Zingales (1997) (KZ) index, the Cleary index (Hennessy & Whited, 2007), and the SA index (Hadlock & Pierce, 2010) are utilized to classify firms as constrained and unconstrained. The KZ and Cleary financial constraint indices are constructed following the methodologies used in Lamont et al. (2001) and Hennessy and Whited (2007), respectively, as follows.

$$KZ = -1.00019 \times CF - 39.36 \times TDIV - 1.3 \times Cash + 0.282 \times Q + 3.139 \times TLTD \quad (6)$$

$$Cleary = -0.12 \times CURAT - 1.90 \times TLTD + 0.001 \times COVER + 1.46 \times IMARG + 2.03 \times SG - 0.05 \times SLACK \quad (7)$$

$$SA\ Index = -0.737 \times Size + 0.043 \times Size^2 - 0.040 \times Age \quad (8)$$

where *CF* is the cash flow, which is the income before extraordinary items (Item 18) plus depreciation and amortization (Item 14) divided by total assets (Item 6); *TDIV* is the total dividends (Item 21 + Item 19) divided by total assets (Item 6); *Cash* is the cash and short-term investments (Item 1) divided by total assets (Item 6); *Q* is the Tobin's *Q; TLTD* is the total long-term debt (Item 9) divided by total assets (Item 6); *SG* is the firm's real sales growth; *CURAT* is the current assets (Item 4) divided by current liabilities (Item 5); *COVER* is the interest coverage and measured as earnings before interest and taxes (Item 3 minus Item 14) over interest expense (Item 15) plus preferred dividend payments (Item 19) divided by one minus tax rate, where tax rate equals to income taxes (Item 16) divided by operating income before depreciation (Item 13) minus depreciation and amortization (Item 14) minus interest expense (Item 15); *IMARG* is the net income (Item 18) divided by sales (Item 12); *SLACK* is the financial slack measured as cash and short-term investments (Item 1) plus 0.5 times inventory (Item 3) plus 0.7 times accounts receivable (Item 2) minus short-term loans (Item 196) divided by net fixed assets (Item 8); *Size* is natural logarithm of total assets; and *Age* is the number of years the firm has been on Compustat with nonmissing financial data information. Items are Compustat annual items. A higher value of an index indicates greater financial constraints.

Gompers et al. (2003) analyzed the effects of the external governance mechanism on the firm value using an external governance index that consists of 24 ATPs (six of which are included in this study) and found that managers protected by more ATPs make poorer investments. Bebchuk et al. (2006) investigated the extent to which these 24 ATPs affect firm value and found that only six out of 24 ATPs negatively affect firm value. The six ATPs are limit to shareholders' bylaw amendments, limit to shareholders' charter amendments, presence of a staggered board, supermajority requirement to approve a merger, golden parachutes, and poison pills. Masulis et al. (2007) showed the effect of the six ATPs on firm value was stronger compared with those of Gompers et al. (2003), corroborating the findings in Bebchuk et al. (2006). Therefore, the external corporate governance index (BCF index), which consists of six ATPs, is constructed following the criteria used in Bebchuk et al. (2006). Basically, the BCF index is the total number of firms' ATPs that ranges from one to six, where higher values indicate high exposure to empire-building and hence higher overinvestment problems. Firms are also sorted into dictatorship and democracy portfolios based on the firms' number of ATPs, where firms with three or more ATPs are included in the dictatorship (high exposure to empire-building) portfolio and firms with two or fewer ATPs are included in the democracy portfolio (no exposure to empire-building) (Bebchuk et al., 2006). The internal corporate governance index, which is constructed as the sum of the percentage of shares held by firms' institutional investors that have greater than 5% ownership of the firm's outstanding shares, is used following Cremers and Nair (2005) and Dittmar and Mahrt-Smith (2007). The data on institutional shareholdings are obtained from the Thomson Financial Institutional Holdings (13F) Database, which collects information on institutional shareholdings from the SEC 13-F filings.

Summary Statistics

The summary statistics of dependent and independent variables and financial constraints and corporate governance variables are presented in Table 1. The mean and median hotel firm values in this sample are negative based on both VW and EW stock return measures.

The summary statistics of financial constraint indices suggest that the majority of hotel firms have relatively lower degrees of financial constraints. However, the median values of corporate governance variables indicate that the majority of hotel firms also have poor corporate governance mechanisms and hence weaker shareholders' rights.

Table 1.
Summary Statistics.

Variables	*M*	Median	*SD*
Stock returns (VW)	−11.19	−12.03	17.34
Stock returns (EW)	−8.56	−4.06	26.43
Investments	0.54	0.003	5.43
Tobin's *Q*	2.46	1.54	4.57
Net financing	0.06	0.001	0.26
Leverage	0.44	0.45	0.23
Market capitalization	17.10	4.98	32.78
KZ index	1.37	1.23	6.76
Cleary index	0.38	0.90	4.11
SA index	−1.83	−3.25	4.08
BCF index	3.58	4.00	1.82
BCF dummy	0.62	1.00	0.48
Block holdings	0.08	0.00	0.15

Note. VW = value weighted; EW = equal weighted.

Empirical Results

This section presents the results of the regression analyses that investigate the relationship between corporate investments and firm value, and the effects of financial constraints and corporate governance on the relationship between corporate investments and stock returns. The relationships are estimated utilizing panel OLS and panel fixed-effects techniques. Table 2 presents the preliminary results of the multivariate analyses for the entire sample.

Irrespective of the chosen firm value proxy (VW and EW stock returns) and the analysis technique, the effect of corporate investments on stock returns is statistically significant ($p < .01$). A one-dollar investment increases stock returns between 53 and 65 cents, suggesting that corporate investments overall have positive effects on hotel firms' stock returns. However, the effect of investments on stock returns might be different based on firms' degrees of financial constraints and the quality of corporate governance mechanisms. To further ensure that the effect of corporate investments on stock returns is not spurious, analyses are conducted by controlling for Tobin's *Q*, net financing, and leverage. Table 3 shows the results from these analyses.

The results support the preliminary findings that the effect of corporate investments on stock returns is positive and statistically significant ($p < .01$) even after controlling for Tobin's *Q*, net financing, and leverage variables. The results do not change based on the empirical technique (i.e., panel OLS and panel fixed effects), and hence, the rest of the analyses are conducted utilizing the panel OLS technique because this empirical technique is generally applied in the corporate finance literature (see, for example, Bebchuk et al., 2006; Franzoni, 2009).

Table 4 presents the results from the regression analysis of the effects of corporate governance on the relationship between corporate investments and stock returns controlling for firms' financial characteristics.

The coefficients of the corporate investments are positive and statistically significant ($p < .01$) in the BCF dummy, BCF index, and Block holdings columns of Table 4. The coefficients of the interaction terms that capture the effect of corporate governance on the relationship between corporate investments and stock returns are negative and statistically significant. Specifically, the value of corporate investments is 47 cents lower in poorly governed hotel firms compared with well-governed hotel firms based on the BCF dummy variable. Also, the value of corporate investments decreases by seven cents with an increased number of ATPs. Similarly, the value of corporate investments decreases by US$13.24 with a one-unit decrease in the percentage of institutional ownership in hotel firms. These results suggest that corporate investments are less valuable in poorly governed hotel firms, supporting the free cash flow theory's propositions and our research hypothesis (H1).

CEOs of well-governed firms are more likely to be replaced if they waste firm resources on poor investment choices, and hence, their interests are aligned with those of shareholders. However, CEOs of firms protected by more ATPs, which make it difficult to replace them, make self-serving corporate investments and intensify agency problems (see, for example, Aggarwal et al., 2016; Franzoni, 2009; Madanoglu & Karadag, 2016; Officer, 2011). Put differently, dismissing CEOs of poorly governed firms is more difficult, and these CEOs take advantage of their power by investing in projects that increase their own compensation and power, which in turn increases agency costs. Specifically, CEOs of poorly governed firms tend to overdiversify to enhance their power and control in the company, as the more complicated the firm becomes, the less likely it becomes that the CEO can be replaced (Gompers et al., 2003).

Table 5 illustrates the results from the regression analysis of the effects of financial constraints on the relationship between corporate investments and stock returns controlling for firms' financial characteristics.

The coefficients of the corporate investments in all columns (i.e., KZ index, Cleary index, and SA index) of Table 5 show that the value of corporate investment is positive and statistically significant ($p < .01$), which is in agreement with the preliminary results. Also, the coefficients of the interaction terms that capture the effect of financial constraints on the relationship between change in investments and firm value are positive and statistically significant. In particular, the value of corporate investments is 25, 10, and 74 cents higher in financially constrained hotel firms compared with unconstrained hotel firms based on the KZ, Cleary, and SA financial constraints indices. The results provide support for the hypothesis drawn from the pecking order theory (H2), postulating that corporate investments are more valuable in financially constrained firms compared with unconstrained firms.

Table 2.
The Effect of Corporate Investments on Firm Value.

	Firm Value (VW)		Firm Value (EW)	
Independent Variables	Panel OLS	Panel Fixed Effect	Panel OLS	Panel Fixed Effect
Investments	0.63[a] (10.13)	0.53[a] (6.76)	0.65[a] (9.78)	0.53[a] (6.30)
Constant	−17.22[a] (–12.92)	−17.25[a] (–11.59)	−33.96[a] (–23.65)	−33.91[a] (–21.17)
R^2	.88		.94	
Adjusted R^2	.87		.93	
Within R^2		.88		.94
Between R^2		.83		.89
F	111.97[a]	100.78[a]	228.43[a]	203.30[a]

Note. The dependent variable is stock returns. All regressions control for firm and year effects. *t* statistics are in parentheses. VW = value weighted; EW = equal weighted; OLS = ordinary least squares.
a, b, and c indicate 1%, 5%, and 10% statistical significance levels, respectively.

Table 3.
The Effect of Corporate Investments on Firm Value (With Control Variables).

	Firm Value (VW)		Firm Value (EW)	
Independent Variables	Panel OLS	Panel Fixed Effect	Panel OLS	Panel Fixed Effect
Investments	0.59[a] (8.93)	0.48[a] (6.02)	0.61[a] (8.65)	0.48[a] (5.65)
Tobin's *Q*	0.21[a] (2.81)	0.23[a] (2.78)	0.19[b] (2.41)	0.22[b] (2.48)
Net financing	0.001 (0.88)	0.001 (0.02)	0.004 (0.75)	−0.001 (–0.16)
Leverage	0.001 (0.93)	0.001 (1.39	0.001 (0.73)	0.001 (1.25)
Constant	−18.11[a] (–12.42)	−17.54[a] (–10.67)	−34.78[a] (–22.05)	−34.05[a] (–19.20)
R^2	.88		.94	
Adjusted R^2	.87		.93	
Within R^2		.88		.94
Between R^2		.78		.87
F	100.51[a]	90.71[a]	202.79[a]	181.26[a]

Note. The dependent variable is stock returns. All regressions control for firm and year effects. *t* statistics are in parentheses. VW = value weighted; EW = equal weighted; OLS = ordinary least squares.
a, b, and c indicate 1%, 5%, and 10% statistical significance levels, respectively.

Table 4.
The Effect of Corporate Investments on Firm Value: Corporate Governance.

Independent Variables	BCF Dummy	BCF Index	Block Holdings
Investments	0.96[a] (7.22)	0.95[a] (3.35)	0.52[a] (6.40)
Investments × CG	−0.47[a] (–3.06)	−0.07[c] (1.78)	−13.24[a] (–5.61)
CG	0.28 (0.72)	0.17 (0.83)	1.64 (1.44)
Tobin's *Q*	0.13[a] (1.57)	0.16[c] (1.78)	0.21[b] (2.54)
Net financing	0.003 (0.66)	0.003 (0.60)	0.004 (0.64)
Leverage	0.001 (0.55)	0.001 (0.63)	0.001 (1.51)
Constant	−34.78[a] (–22.08)	−35.10[a] (–21.36)	−35.82[a] (–12.11)
R^2	.94	.94	.94
Adjusted R^2	.93	.93	.93
F	191.91[a]	188.30[a]	197.98[a]

Note. The dependent variable is stock returns. CG is a measure of corporate governance. All regressions are conducted utilizing panel OLS and control for firm and year effects. *t* statistics are in parentheses. OLS = ordinary least squares.
a, b, and c indicate 1%, 5%, and 10% statistical significance levels, respectively.

Table 5.
The Effect of Corporate Investments on Firm Value: Financial Constraints.

Independent Variables	KZ Index	Cleary Index	SA Index
Investments	0.49[a] (5.08)	0.37[a] (3.35)	4.17[a] (4.80)
Investments × FC	0.25[c] (1.96)	0.10[a] (2.99)	0.74[a] (4.13)
FC	0.04 (0.36)	−0.03 (–0.31)	−0.21[c] (–1.75)
Tobin's *Q*	0.18[a] (1.27)	0.13 (1.62)	0.12 (1.43)
Net financing	0.004 (0.76)	0.004 (0.69)	0.003 (0.63)
Leverage	0.001 (0.60)	0.001 (0.66)	0.001 (1.14)
Constant	−34.78[a] (–22.08)	−34.65[a] (–22.20)	−35.53[a] (–22.06)
R^2	.94	.94	.94
Adjusted R^2	.93	.93	.93
F	188.46[a]	191.63[a]	197.98[a]

Note. The dependent variable is stock returns. FC is a financial constraints index. All regressions are conducted utilizing panel OLS and control for firm and year effects. *t* statistics are in parentheses.
a, b, and c indicate 1%, 5%, and 10% statistical significance levels, respectively.

Table 6.
The Effect of Corporate Investments on Firm Value.

	Financial Constraints		Corporate Governance	
Independent Variables	Constrained	Unconstrained	Poorly Governed	Well Governed
Investments	0.98[a] (34.89)	0.69[a] (6.77)	0.48[a] (4.57)	0.96[a] (64.56)
Tobin's *Q*	0.11[a] (6.71)	1.23[c] (1.69)	0.09 (0.38)	0.15[a] (14.29)
Net financing	0.002 (0.76)	0.01 (1.05)	0.004 (0.53)	0.001 (0.87)
Leverage	−0.001 (–0.93)	0.001 (1.52)	0.001 (0.37)	0.001 (0.57)
Constant	−29.20[a] (–30.06)	−36.13[a] (–15.99)	−34.06[a] (–10.85)	−34.77[a] (–154.28)
R^2	.99	.95	.92	.99
Adjusted R^2	.99	.94	.90	.99
F	994.83[a]	89.69[a]	82.39[a]	651.10[a]

Note. The dependent variable is stock returns. All regressions control for firm and year effects. *t* statistics are in parentheses.
a, b, and c indicate 1%, 5%, and 10% statistical significance levels, respectively.

Financially constrained firms have unexploited investment opportunities, but they also have limited resources with which to undertake value-increasing investment projects (see, for example, Almeida et al., 2004; Denis & Sibilkov, 2009; Khatami et al., 2015; Whited & Wu, 2006). Thus, shareholders of financially constrained firms place a higher value on corporate investments than do shareholders of unconstrained firms, on the grounds that financially constrained firms are able to generate sufficient internal funds from their operations to make value-increasing investments and reduce financial constraint problems.

In addition to the main empirical tests presented above, further analyses are conducted to corroborate our findings following the methodologies used in Almeida et al. (2004) and Denis and Sibilkov (2009). Accordingly, the sample is divided into financially constrained and unconstrained and poorly and well governed hotel firm categories. Table 6 presents these results.

The results show that the value of corporate investments is positive and statistically significant ($p < .01$) in all hotel firm categories. However, the coefficient of corporate investments is greater in financially constrained hotel firms compared with unconstrained hotel firms. Specifically, the value of corporate investments is 29 cents higher (i.e., the difference between the coefficients of the corporate investments in financially constrained and unconstrained columns) in financially constrained hotel firms. Also, the coefficient of corporate investments is lower in poorly governed hotel firms compared with well-governed hotel firms. Specifically, the value of corporate investments is 48 cents lower (i.e., the difference between the coefficients of the corporate investments in poorly and well-governed columns) in poorly governed hotel firms. These results are in alignment with the findings from our previous analyses and hence corroborate the free cash flow and pecking order theories' hypotheses (H1 and H2).

Table 7.
The Effect of Corporate Investments on Firm Value: Corporate Governance in Financial Constrained Firms.

	KZ Index		Cleary Index	
Independent Variables	Poorly Governed Constrained	Poorly Governed Unconstrained	Poorly Governed Constrained	Poorly Governed Unconstrained
Investments	0.64[a] (4.21)	−0.61 (–0.32)	0.68[a] (4.57)	−10.18[a] (–3.67)
Tobin's *Q*	2.90 (1.42)	0.06 (0.24)	0.06 (0.15)	0.32 (1.12)
Net financing	0.02 (0.70)	−0.004 (–0.35)	−0.002 (–0.15)	0.01 (0.81)
Leverage	0.001 (0.93)	−0.001 (–0.90)	0.001 (1.90)	0.001 (1.03)
Constant	−29.20[a] (–37.12)	−31.42[a] (–7.48)	−34.95[a] (–7.38)	−34.77[a] (–34.87)
R^2	.95	.90	.94	.92
Adjusted R^2	.92	.88	.92	.90
F	32.32[a]	43.33[a]	42.47[a]	46.84[a]

Note. The dependent variable is stock returns. All regressions control for firm and year effects. *t* statistics are in parentheses.
a, b, and c indicate 1, 5, and 10% statistical significance levels, respectively.

Although these findings suggest that shareholders of hotel firms put a higher (lower) value on corporate investments in financially constrained (poorly governed) firms, it is not clear whether the quality of corporate governance affects the value of corporate investments in financially constrained firms. To determine the answer to this question, poorly governed hotel firms were further classified into financially constrained and unconstrained hotel firm categories. Table 7 presents the results from the analyses that examine the extent to which the quality of corporate governance mechanisms affects the relationship between corporate investment and stock returns in financially constrained hotel firms compared with unconstrained hotel firms.

The sample is divided into financially constrained and unconstrained portfolios based on the KZ and Cleary indices to determine whether capital market investors show more tolerance for financially constrained firms that are also poorly governed. The coefficients of the investments in all columns of Table 7 are statistically significant with one exception. The results show that the value of corporate investments is lower in unconstrained hotel firms with poor corporate governance mechanisms compared with financially constrained hotel firms with a similar quality of corporate governance. Specifically, one-dollar investments in financially constrained hotel firms with poor corporate governance mechanisms increase firm value between 64 and 68 cents. However, one-dollar investments in unconstrained hotel firms that are poorly governed decrease firm value between 61 cents and US$10.18 based on the Cleary financial constraints index. These results suggest that the quality of corporate governance is not considered to be a major concern in financially constrained firms. Simply put, the findings show that the value of corporate investments is greater in financially constrained firms that are poorly governed compared with unconstrained firms with similar corporate governance mechanisms, thus supporting our hypothesis (H3).

Corporate governance mechanisms do not affect the value of corporate investments in financially constrained firms. That is, shareholders of financially constrained firms place a higher value on corporate investments compared with unconstrained firms, despite having weak shareholders' rights. More strikingly, the value of investments is negative in unconstrained firms with poor corporate governance mechanisms. It is important to note that the value of corporate investments was greater in financially constrained firms without taking the quality of corporate governance into consideration. Thus, shareholders of financially constrained firms perceive corporate investments to be value-increasing regardless of the quality of corporate governance mechanisms.

Conclusion

In this study, we examined the effects of corporate governance and financial constraints on the value of hotel firms' investments. The hotel industry is uniquely positioned for studying the implications of costly external finance and agency problems, as hotel firms' investments consist of developing, building, and acquiring real estate properties that require substantial initial and ongoing capital investments. These investments, however, can be value-increasing or decreasing depending on firms' quality of corporate governance mechanisms and degrees of financial constraints. The findings of this study contribute to the explanation of why shareholders place greater or lesser value on corporate investments.

Although shareholders place a lower value on poorly governed firms' investments, they tolerate the poor corporate governance mechanisms in financially constrained firms. In other words, although investors place a lower value on investments in firms with poor corporate governance mechanisms, they place less emphasis on the quality

of corporate governance in financially constrained firms. It is also worth noting that the value of corporate investment was positive in unconstrained firms, albeit lower compared with financially constrained firms, when the quality of corporate mechanisms was ignored. However, the value of corporate investments was negative when the quality of corporate governance mechanisms was simultaneously examined. Also, the value of corporate investments was positive when only the quality of corporate governance mechanisms was examined. However, the value of corporate investments turns negative when the degrees of financial constraint and the quality of corporate governance mechanisms are concurrently investigated.

Overall, the empirical evidence presented in this study shows that the value of corporate investments is higher in financially constrained hotel firms and well-governed hotel firms compared with unconstrained hotel firms and poorly governed hotel firms, respectively. The difference between the values of investment in poorly and well-governed firms is due to the likely cost of agency problems and the fact that unconstrained firms that are poorly governed face higher agency costs. Also, the difference between the value of corporate investments in financially constrained and unconstrained firms reflects the cost difference between internal and external funds (Franzoni, 2009). However, weak corporate governance mechanisms are not considered to be increasing agency problems in financially constrained firms as they are in unconstrained firms.

Managerial Implications

ATPs cause higher agency costs because they protect CEOs from being replaced. Boards of directors and shareholders of firms with weak shareholders' rights should institute better corporate governance mechanisms by eliminating ATPs to prevent misaligned CEOs from destroying firm value and control CEOs. Well-established corporate governance mechanisms create control over CEOs, help to align their interests with those of shareholders, and strengthen shareholders' rights. Therefore, implementing resilient corporate governance mechanisms can be a practical solution for reducing agency problems. Firms with little or no ATPs will also attract institutional investors such as public pension funds, which in turn improve firms' internal corporate governance mechanisms and lower agency costs. Offering dynamic and innovative compensation plans might better align CEOs' interests with those of shareholders and hence reduce agency problems. Furthermore, these firms should force CEOs to distribute excess cash to shareholders and raise external funds from capital markets to make additional investments. Capital markets will only finance projects with a positive NPV, which will establish an additional external control mechanism on CEOs of poorly governed firms.

Financially constrained hotel firms should retain their cash to make additional value-increasing investments and reach the optimal investment level, where firm value is maximized.

Keeping excess cash, however, may create agency problems (Dogru & Sirakaya-Turk, 2017). Thus, an optimal payout policy in financially constrained firms is recommended. Financially constrained firms should use their cash when undertaking investment projects from the ground up. Another investment strategy for financially constrained firms to expand their businesses and increase market share is to expand through acquisitions, where the target company is paid with stocks rather than cash. Although the market tolerates poor corporate governance mechanisms in financially constrained firms, these firms should increase the quality of their corporate governance mechanisms to gain maximum benefits from corporate investments and increase firm value. Financially constrained firms with poor corporate governance mechanisms might merge with unconstrained firms that are well-governed. Stock market investors seeking high-income yields in the short run should focus on unconstrained firms with strong corporate governance mechanisms. These firms are more likely to pay dividends or buy back stocks than financially constrained firms. However, unconstrained firms with weak shareholders' rights should be avoided, as CEOs of these firms are likely to make self-serving corporate investments.

Limitations and Recommendations for Future Research

Despite its significant contribution to the corporate finance and hospitality literature, this study has limitations. An inherent delimitation in corporate finance studies is that corporate culture and its effect on firms' decisions cannot be observed. Although we found evidence that the value of corporate investments is lower in firms with poor corporate governance mechanisms, the inferior performances in poorly governed firms could also be due to the unobserved firm characteristics. While the findings of this study provide significant empirical evidence that the relationship between corporate investments and firm value depends on the quality of corporate governance mechanisms and the degrees of financial constraints, corporate investments are limited to changes in capital expenditures. Therefore, future research may investigate the effects of corporate governance and financial constraints on shareholders' reactions to acquisition announcements. Future studies may also examine the role of corporate governance and financial constraints on the marginal value of cash and the sensitivity of investments to internal funds. Studies that examine the roles of dividend policies and growth opportunities on the value of corporate investments can shed more light on why investments can be value-increasing in some firms and value-decreasing in others. Although the results might be

generalizable to hospitality firms, the analyses are limited to hotel firms. The effects of corporate governance and financial constraints on the relationship between investments and firm value could be examined in other sectors of the hospitality industry. Testing the free cash flow theory and pecking order theory propositions in different sectors of the hospitality industry may substantiate the findings of this study.

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