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Catering to investors through capital expenditures: Testing assets substitution problem around financing[☆]

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ABSTRACT

We test the catering theory, which describes how investor preferences might influence individual firms' investment financing decisions. To the best of our knowledge, our study may well be the first that directly connects catering with asset substitution to contrast the magnitude of catering by bondholders and shareholders. And indeed, it is interesting to find that although catering behavior is found to exist among both corporate bond and seasoned equity offering (SEO) managers, the coexistence of both appears to offset the abnormal investment phenomena of either underinvestment or overinvestment. The study results further reveal that firms engage in overinvestment when catering to conversion holders of existing convertible bonds. Taken together, we find that support for the asset substitution and abnormal investment argument is strong from a stockholder–bondholder conflict.

1. Introduction

The essence of catering theory is that managers give investors what they want. Extant literature proposes different explanations for how firms cater to investors; for example, [Baker and Wurgler \(2004\)](#) indicated that decisions to pay cash dividends are driven by prevailing investor demand for dividend payers. Additionally, [Rajgopal, Shivakumar, and Simpson \(2007\)](#) proposed that earnings

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