Managerial Overconfidence, Equity Pledge and Interest Transfer ——A Case of LETV

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Abstract. CEO is the direction of an enterprise, and his psychology is an important factor affecting the financing of the enterprise. Overconfidence is the most typical and stable psychological performance of the CEOs. The paper uses a single case study to explore the impact of Managerial Overconfidence on financing decision-making. Taking the expansion pace and financing situation since the listing of LETV as the research object, the paper tries to explore the influence of managers' overconfidence on financing decision-making by using event study and draws two conclusions. Firstly, over-confident managers prefer diversified investments, especially in riskier new industries. Secondly, when managers are controlling shareholders, they will invest in other industries in order to create their own imperial group to pledge the equity of listed companies. In view of the above problems, the paper puts forward two suggestions. On the one hand, the state should establish a sound supervision mechanism of major shareholders and management to prevent the transfer of enterprise interests. On the other hand, establish a professional independent director institution to enhance the status of independent directors in company management.

1. Introduction

MM theory is a conclusion drawn under a series of strict hypotheses. The most basic hypothesis in the decision-making subject is the "rational person hypothesis", that is, the decision-making for the decision-maker is basically independent of their own emotions, and the decision-maker is making decisions under the condition of complete rationality. However, since the emergence of behavioral economics, the psychological factors of decision-makers lead to irrational behavior has become a hot topic, in which overconfidence is the most typical and stable performance of the characteristics of decision-makers favored by everyone. Overconfidence is called psychological cognitive bias by medical circles, which makes decision makers believe too much in their own intuition, ability and knowledge level to listen to other people's opinions and suggestions and lead to wrong decisions. Weinstein proposed that managers always overestimate their abilities and intuitions in economic decision-making.

When overconfident company managers deal with complex business activities in very uncertain environment to predict future cash flow and probability of occurrence, always show overconfident psychological characteristics. In decision-making, Malmendier and Tate (2005) study found that overconfident decision makers underestimate market risk, overestimate returns, overestimate the impact of mergers and acquisitions and investment, make wrong analysis of projects, invest in high-risk projects, and make decisions that deplete corporate value. In the capital market, overconfident people choose bond financing rather than stock financing because they believe that the market undervalues their company. In addition, overconfident people overestimate their own projects in order to make more profits, and are more inclined to seek low-cost debt financing in the capital market when they lack free capital. There are a lot of empirical studies on overconfidence in financing decision-making, but few case studies directly examine the role of overconfidence in corporate financing. In order to make up for the vacancy of case study overconfidence in corporate financing, the paper adopts a single case study method to study the expansion pace and financing situation since the listing of LETV. The paper got the information from information disclosure and CEO voice of the company's annual report. The results not only contribute to the academic research

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on the role of overconfidence in corporate financing, but also have practical significance.

2. Review

2.1 CEOs overconfidence and corporate governance

Overconfidence is the most common psychological bias of CEOs, which is closely related to corporate governance by affecting managers' intuition. Literature on the relationship between the two is more extensive, mainly focused on the overconfident managers in the pay management and merger and acquisition behavior. Hayward and Hambrick (1997) proposed that the pay gap should be used as a measure of managers' overconfidence in the study of overconfident managers. Later, Paredes (2004) empirical study proved that overconfident managers can reflect themselves by widening the pay gap between themselves and other managers. In the study of Managerial Overconfidence and M&A behavior, Roll proposed that the root of irrational behavior in M&A is the psychological bias of managerial overconfidence. Brown and Sarma (2007) found that managing overconfident people is more likely to diversify mergers and acquisitions.

2.2 CEOs overconfidence and corporate investment

As for the impact of Managerial Overconfidence on corporate investment, the current research conclusions mainly include the following two aspects. On the one hand, Heaton (1997) and LiCalzi (2003) proved that overconfident CEOs subjectively reduce the risk of investment projects when the company has a large amount of cash flow, and investment decisions tend to blindly expand and overinvest. On the other hand, Malmendier and Tate (2005) argued that overconfident CEOs always think the outside is underestimating the profits of the investment.

2.3 CEOs overconfidence and corporate finance

The financing strategy should be matched with the risk and future cash flow of the investment plan. However, an overconfident CEO has made wrong judgments about his own investment projects, and will inevitably make decisions that deviate from reality. In terms of financing sequence, Shefrin (2001), Huang Lianqin and Fu Yuanluo (2010) found that overconfident CEOs preferred internal funds to get money regardless of the project they invested in. In terms of long-term and short-term debt, Hackbarth (2009) argues that overconfident CEOs overestimate future cash flows and choose short-term borrowing.

3. Research methods and case introduction

3.1 Research methods

The case studied in the paper belongs to media field, and the paper studies it by using single case study method. Elsbach (2010) proposed that, compared with large sample studies, case studies focus more on telling the story well, so as to make a deeper understanding of phenomena and theories. Therefore, the paper combs the crazy layout and a large number of all-round financing processes since the listing of LETV, using theoretical knowledge to explore those things. In the paper, the main sources of the data disclosed in the company's annual report and LETV announcement, CSMAR database, LETV executives said in a speech and news media reports related to LETV financial problems.

3.2 Case Introduction

A large number of scholars like to take the speed of mergers and acquisitions as a measure of whether an entrepreneur is overconfident. However, according to Jiang Fuxiu's 2009 article "Managerial Overconfidence, Corporate Expansion and Financial Dilemma", the paper uses the data of Listed Companies in China to find that managerial overconfidence is positively correlated with the level of investment and internal expansion of enterprises. Therefore, the view of Jiang Fuxiu is more applicable as the overconfidence evaluation criteria in China. Table1 summarizes the process of investment expansion disclosed by LETV. It can be seen that LETV's investment covers a wide range of fields, ranging from television and film industry to information technology, to television and mobile phones, and smart cars. In addition, today we know that he lost so much money in those fields especially in car. Besides, the CEO of LETV is a traditional Chinese who has no experience of learning and living abroad. Therefore, according to Jiang Fuxiu's view we can draw a conclusion that the CEO is a typical overconfident Chinese entrepreneur.

Table1. The investment expansion process of LETV

Time	Investment	Field
2010/12/16	Set up subsidiaries in Tianjin and Beijing	integrated field
2011	Purchase a large number of film and television copyright	films and TV
2011/5/30	Set up subsidiaries in Hong Kong and Taiwan	integrated field
2012/9/19	Invest in smart TV industry	smart TV
2012	Invest in Set-Top Box industry	Set-Top Box
2012	Invest a wine business platform	wine
2013/9/30	Invest in new media market	new media
2014/1/29	Set up a sport company	sports
2014/1/29	Set up a cloud computing company	cloud computing
2014/7/14	Set up subsidiaries in Los Angeles and Silicon Valley	integrated field
2014/12/9	Research and development of Internet smart car	smart car
2015/4/14	Release a mobile phone	mobile phone
2015/4/2	Invest in bicycle market	bicycle
2015/7/8	Invest in technology company	GPS
2015/6/30	Buy 17.9% shares of Coolpad	mobile phone
2015/7/15	Invest Beiqing media	media
2016/1/20	Invest a property insurance company	property insurance
2016/5/11	Invest TCL	smart TV
2016/6/8	Invest a technology company	technology
2016/6/17	Buy 11% shares of Coolpad	smart TV

3.3 CEOs' financing preference and profit transfer

Since its launch in 2010, LETV has had a high financial risk, with no financial problems in the year from 2011 to 2015, largely because of a story-telling CEO, Jia Yueting, who invented a bright future with his stories and introduced more capital and technology to his corporate empire, relying on what he described as new. No one in the market can see clearly that the era of intelligence is coming to win money, but with the advent of the era of intelligence, everyone has a clear definition of the future, Jia Yueting's story is not enough to impress investors, when the money is not available, Jia Yueting's dream of Empire will be shattered. Even though Jia Yueting has been reluctant to admit it, the financial crisis of LETV has been unprecedented since 2016, and LETV has no funds to expand its business. In order to solve the funding gap, LETV had to introduce a large number of equity financing in 2016, only in the second half of 2016 reached 11.9 billion yuan, but 11.9 billion failed to fill the funding gap. However, in its financial statements, 11.9 billion is 92% of its 2015 revenue, which is more than enough to fill the fund gap, so the huge gap can only be found in other investment companies in the industry.

3.3.1 LETV's interest transmission

The following table2 shows the pledge of senior Executives' shares from 2011 to 2015. The total pledged shares are 49% of the company's shares. According to the total assets of 17 billion in 2015, the pledged funds are 8.33 billion yuan. The senior Executives' financing in pledge is personal capital demand, while the CEO Jia Yueting and Jia Yueting's sister, Jia Yuefang, are involved in the pledge of equity. Therefore, there is no suspense for capital to expand the media industry. According to the above research, we can find that there are a lot of undisclosed debts among the top executives and affiliated companies. The top executives are going to play a big game, especially when they invest up to 60 billion yuan in cars, while the top executives in the US media blasted that the automobile factories invested by LETV could not produce on time because of lack of funds. The Empire built by him collapsed instantly, and the share price plunged downward. In 2017, Jia Yueting announced that he would reduce operating costs and resolve the group crisis by reducing equity and scope of business.

table2. The executives equity pledge of LETV

Time	Name	Pledged Shares	Closing price	Pledge amount	Share of executives（%）	Share of company（%）
2011/7/6	Jia Yuefang	11,000,000	22.78	250,580,000	79.4	6.3
2011/11/26	Jia Yueting	22,000,000	31	682,000,000	42.73	20
2013/2/8	Jia Yueting	12,000,000	21.48	257,760,000	6.13	2.87
2013/4/2	Jia Yueting	12,000,000	26.37	316,440,000	6.13	2.87
2013/4/9	Jia Yueting	10,800,000	27.6	298,080,000	5.52	2.58
2013/5/16	Jia Yueting	19,900,000	42.82	852,120,000	10.17	4.76
2013/8/7	Jia Yuefang	10,000,000	28.14	281,400,000	19.99	1.26
2013/9/12	Jia Yuefang	35,000,000	31.84	1,114,400,000	89.94	5.64
2014/5/30	Jia Yueting	9,400,000	40.9	384,460,000	2.53	1.12
2014/9/29	Jia Yueting	13,000,000	37.65	489,450,000	3.5	1.55
2015/1/13	Jia Yueting	26,000,000	42.31	1,100,060,000	6.99	3.09
2015/10/26	Jia Yueting	50,730,000	50.32	2,552,900,000	64.81	27.34
Total	——	11,000,000	——	8,579,650,000	——	48.95

3.3.2 Interest transmission market reflects

As shown in Table2, there is a high potential risk that the shares pledged on October 26, 2015 will be the largest and the Pledged Shares will reach 75% of the CEO's equity on that day. So the paper chooses the announcement day as the event occurrence day, and uses the event study to study the market reaction to the use of senior managers' equity pledge for personal investment. The stock trading data comes from CSMAR database. In the paper, 150 trading days before the announcement is defined as the estimated period, and 5 trading days before the announcement to 5 trading days after the announcement is defined as the event period. Because LETV is the A-share of Shenzhen Stock Exchange, the paper uses the data of Shenzhen A-share market as an independent variable, and both market and stock data adopt the daily return data considering the steep dividend reinvestment. The cumulative excess return rate is shown in Table3. The regression equation is dretwd=-0.041dretwdeq-0.002 and the cumulative excess return is 0.008. The market reacted positively to the 75% equity pledge by the CEO and the largest shareholder, suggesting that investors did not see a wrong expectation of the stock pledge by the senior executives of LETV. In other words, market investors were not aware of the risk impact of equity pledge financing when they judged LETV. Investors saw a significantly lower risk than LETV. International risk also indicates a bigger crisis after 2016 when the capital chain rupture of LETV is exposed.

Table3. Results of event study on equity pledge

Event day	Time	Excess return rate	Cumulative Abnormal Return
-5	2015/10/19	-0.01	0.008
-4	2015/10/20	0.0035	0.008
-3	2015/10/21	0.0157	0.008
-2	2015/10/24	-0.0225	0.008
-1	2015/10/25	0.0003	0.008
0	2015/10/26	-0.0097	0.008
1	2015/10/27	-0.0096	0.008
2	2015/10/28	0.0123	0.008
3	2015/10/31	0.0289	0.008
4	2015/11/1	0.0095	0.008
5	2015/11/2	-0.0106	0.008

4. Conclusions and Implication

The paper studies the expansion investment process and financing situation of LETV, and gets the following two conclusions. Firstly, overconfident CEOs are eager to build their own empire group, investing in a diversified way. The main direction of investment expansion is not external investment (M&A), but internal investment in new industries, looking for partners to enter new areas. Secondly, when the manager is a major shareholder of the company, will be in order to fight it is undoubtedly to use the interests of listed companies to purchase the commercial empire of managers, which greatly infringes the interests of minority shareholders and creditors.

In view of the above conclusions, the paper puts forward the following two suggestions on the separation of ownership and management rights of enterprises, providing reference for the decision-making and supervision of stakeholders.

On the one hand, the state should establish a sound supervision mechanism for large shareholders and management to prevent profit transfer. When large shareholders are CEOs, it is obvious that controlling shareholders will invest in high-risk industries for their own ambitions. In addition, the controlling shareholder will transfer the benefits of the listed company to other industrial companies under his name without the knowledge of the minority shareholders and creditors. The state should establish a perfect system in the information disclosure of controlling shareholders, closely monitor the direction of capital and equity pledge, and prevent the transfer of controlling shareholders' interests.

On the other hand, establish a professional independent board of directors to enhance the right of independent directors to speak in the company. Independent director system was originally set up to be very good, but independent directors and controlling shareholders are employed. Independent directors often do not express their true opinions in order to keep the job. China should establish a professional independent director institution, establish a list of candidates for independent directors for independent directors to establish a record of benefits, let independent directors take responsibility for their own position, has a follow-up impact.

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