

Corporate Investment Decision Practices And the Hurdle Rate Premium Puzzle

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ABSTRACT

We survey a cross-section of 127 companies to gain insight on various dimensions of firms' investment decisions. The questions posed by our survey examine the hurdle rates firms use, calculations of project related cashflows, the interaction of cashflows and hurdle rates, and the determinants of firms' capital structure and financing policies. Unlike previous studies which examine investment decisions by either using survey data or data obtained from financial tapes, we use both sets of data. This approach produced one of our primary findings that there is a hurdle rate premium puzzle, in that hurdle rates used by our sample of firms exceed their cost of capital that we calculate using Compustat data by 5%. We investigate the determinants of the hurdle premium in question. Additionally, we find that both systematic and to a lesser extent unsystematic risk play a role in the determination of both the self-reported and computed-WACC. Furthermore, our findings show that while firms use discounted cashflow methods in evaluating projects, they do not always appear to handle the cashflow dimension of their investment decisions in a consistent manner. Finally, we uncover evidence that firms use the various financing alternatives available to them in the order predicted by the pecking-order hypothesis. We also find that formulation of capital structure policies in practice confirm the predictions of the trade-off model.