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Entering the public bond market during the financial crisis: Underinvestment and asymmetric information costs



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ABSTRACT

This paper investigates the impact of underinvestment and asymmetric information cost on the determinants and timing of a firm's decision to issue its first-time public bond. Using a sample of non-convertible public bonds made by UK public and private companies between 2007 and 2011, the results show that the choice of capital source is strongly affected by the agency conflict. In particular, the agency cost in the form of underinvestment problems delays a firm's entry to the public bond market. However, the results show that, unlike previous studies, private companies are more likely to enter the public bond market before undertaking their equity IPOs, supporting the pecking order theory under asymmetric information argument. The results also suggest that firms with less information asymmetry and those that establish a track record are more likely to undertake bond IPOs during the crisis, but private companies enter the public bond market earlier than the equity market. These results hold even after controlling for bank relationships and demands for external funds.

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1. Introduction

An article by the Bank of England in 2011 shows that there has been a large increase in first-time bond issuance by UK companies during the recent crisis.¹ While first-time non-convertible issuers decreased in number with the financial crisis in 2007, the number of first-time non-convertible bond issuers rose in 2008 and 2009.² The reasons and consequences of such a financing decision remain an open question. This paper assesses how private and public companies trade off the costs and benefits of entering the public bond market when they decide to issue public bonds for the first time. Unlike previous studies (e.g., Denis and Mihov, 2003; Hale and Santos, 2008), I test the impact of asymmetric information and underinvestment costs on firms' decision to enter the public bond market. To test my hypotheses, the hand-collected data from prospectuses is also used to assess whether such a decision can be predicted at the IPO date, and to identify the firms that came to the market specifically to raise debt and equity capital, which is considered to be one of the major motivations for public capital market listings (e.g., Pagano et al., 1998).

This paper contributes to the existing literature in several ways. Firstly, the empirical literature on firms' choices of external funding predominantly investigates the decision to go public through equity IPOs. Studies on going public have devoted little attention to the alternative source of going public, which is the decision to tap the public bond market. In particular, unlike previous studies, this paper includes private companies in order to investigate the different decision of

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¹ 2011, Going public: UK companies' use of capital markets.

² See Fig. 1.

entering the public market, the choice between bond- and equity-IPOs, and uses public companies to analyse the decision between bond-IPOs and issuance of further equity financing during their quotation life, which have not been investigated in the literature. However, my results are related to previous studies that analyse the choice of bank, non-bank, or public debt (Blackwell and Kidwell, 1988; Denis and Mihov, 2003; Hale and Santos, 2008). The recent study by Hale and Santos (2008) investigates new public bond financing in the US. They find that firms with developed bank relationships and established track records enter the public bond market earlier than their counterparts. Denis and Mihov (2003) find the significant impact of credit quality on external borrowing, suggesting that firms with the highest credit quality borrow from public sources while those with the lowest credit quality borrow privately. These studies do not distinguish in depth between the choice of new debt and equity. Unlike previous studies, this paper tests the impact of asymmetric information and agency conflicts between shareholders and debt-holders on firms' decisions to enter the public bond market.

Secondly, in contrast to existing studies which are US-based, this paper analyses the UK market. It is of particular interest to examine corporate external financing in a country with a market-oriented environment similar to that of the US, but with different institutional settings with stronger creditor rights (see La Porta et al., 1997; Djankov et al., 2007).³ Finally, this paper attempts to control for market conditions, and is thus one of the first studies to investigate the decision to go to the public bond market during the financial crisis, which is highly important for firms' decisions to enter the public market.

This paper documents several new findings. Unlike previous studies (e.g. Hale and Santos, 2008), I find that the agency cost in the form of underinvestment problems delays a firm's entry to the public bond market, suggesting that high-growth firms wait longer to issue their first public bonds. The results for private companies show that, although high-growth companies are less likely to issue their first public bonds, they tend to follow the pecking order theory, and hence have higher incentives to issue their first public bonds before going to the equity market, supporting the asymmetric information hypothesis. However, high-growth public companies prefer to raise equity capital, delaying their decision to enter the public bond market to resolve the underinvestment problem.

Moreover, the results show that larger firms with higher tangible assets undertake their bond IPOs earlier than smaller firms with lower tangible assets, supporting the asymmetric information hypothesis, as larger companies with lower intangible assets have better market reputations, and hence suffer less adversity from bond IPOs. Controlling for the firm's debt-equity decision, I find that larger firms with higher tangible assets delay entering the public bond market, while, in contrast to private firms, public firms are those that I find issue further new equity prior to public bond. Consistent with previous studies (e.g., Berlin and Loyes, 1988; Datta et al., 2000; Denis and Mihov, 2003), I find that both public and private firms with higher credit risk, measured by interest coverage and/or solvency ratio, are more likely to time their entry into the public bond market. But, unlike previous studies, the results show that creditworthy firms rely more on public debt than on equity.

Firms delay their entry to the public bond market when they have higher internal funds, as measured by return on assets. The results are consistent with the pecking order theory, suggesting that firms prefer internal funds to external financing (Myers, 1977), and are in line with those empirical studies (e.g. Frank and Goyal, 2009 and Rajan and Zingales, 1995) which find that firms with higher profitability (return on assets) are less likely to use external financing in order to mitigate the asymmetric information. Finally, the impact of leverage and bank relationships on the timing of bond IPOs is mixed for public and private companies. For public companies, leverage delays firms' entry to the public bond market while prior bank relationships accelerate firms' decisions to undertake their bond IPOs. These results are consistent with those of Hale and Santos (2008), who investigate the timing of a firm's decision to issue for the first time in the US public bond market. By contrast, for private companies, the firm's timing of their bond IPOs is positively affected by leverage.

The remainder of the paper is organised as follows. Section 2 discusses the literature review and research hypotheses. Section 3 presents the data and methodology. Section 4 discusses the results, and the conclusions are presented in Section 5.

2. Theories and research hypothesis

Myers (1977) argues that the conflict between shareholders and debt-holders in the form of underinvestment problems arises in high-growth firms in which shareholders are disincentivised to invest in positive-NPV projects due to the partial payoff that debt-holders receive from these positive projects. The more valuable growth options the firms has, the greater the degree of the underinvestment problem. This problem can be mitigated by lowering leverage or shortening the debt maturity, which will allow valuable growth opportunities to be taken (Myers, 1977). Barclay and Smith (1995) suggest that a firms' future investment is considered as options that its value depends on the likelihood of exercising the options optimally. Since firms with greater investment opportunities have higher conflicts between shareholders and debt-holders over the exercise of the options, riskier projects are more easily substituted for less risky ones. In addition, positive NPV projects are more susceptible to be forgone.

³ La Porta et al. (1997) argue that, in the UK, the level of creditors' rights is higher than in the US. Their findings are consistent with those of Franks and Torous (1993), who compare the UK bankruptcy code with that of the US, showing that the UK appears to have the highest creditor incentive while the US keeps firms as its main concern. The results are in line with Djankov et al. (2007), who show that, in contrast to the US, the UK has strong creditor rights protection.

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