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Product market competition and the cost of bank loans: Evidence from state antitakeover laws

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ABSTRACT

The extant literature documents a positive relationship between a firm's takeover vulnerability and its agency cost of debt. Using state antitakeover laws as an exogenous measure of variation in takeover vulnerability, I investigate whether product market competition has a disciplinary effect that can lower a firm's cost of bank loans. After taking into account the industry composition of borrowers, I find that banks charge higher spreads to borrowers that are vulnerable to takeovers, but *only* in concentrated industries. In the absence of disciplinary competitive pressure, the effect of takeover vulnerability on the cost of bank loans is mitigated for larger firms, firms followed by analysts, firms with existing credit ratings, non-family firms, and for borrowers with shorter maturity loans or loans with covenants and collateral in place. Taken together, the results suggest that the effect of governance on the cost of financing is not homogenous across all industries, and that concentrated industry firms may need to use supplementary governance mechanisms to mitigate debt holder agency problems.

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1. Introduction

The ability to raise capital is vital for the existence of any business. Factors that influence the cost of capital are therefore of immense economic significance. A growing literature documents that shareholder rights are one such important factor. In a seminal article, Gompers et al. (2003, GIM) find that firms with stronger shareholder rights, as measured by fewer takeover defenses, earn higher equity returns. While the discipline imposed by the corporate control market is likely to benefit the equity holders of a firm by controlling managerial agency problems, lenders of such a firm might be concerned about future takeovers as well as any other actions taken by the shareholder-friendly manager that can exacerbate the shareholder-debt holder conflicts. Indeed, a growing body of empirical evidence documents that firms that are vulnerable to takeovers have on average a significantly higher cost of debt (see, e.g., Klock et al., 2005; Cremers et al., 2007; Qui and Yu, 2008; Francis et al., 2010; Chava et al., 2010).

Despite its intuitive appeal, however, empirical research in this literature estimates an *average* effect of governance on financing costs that is homogenous across all types of industries. This approach overlooks the possibility that corporate governance may affect different industries in a different manner. In fact, Kadyrzhanova and Rhodes-Kropf (2011) state that "empirical studies of the importance of corporate governance should allow for cross-industry heterogeneity since a failure to do so may lead to significantly understate the consequences of governance for firm value". In a similar vein, Giroud and Mueller (2011) conclude that the need to provide managers with incentives for good governance, and therefore the benefits of corporate governance are stronger in concentrated industries, where product markets impose less discipline on managers.

That product market competition is a powerful disciplinary mechanism is well established (see, e.g., Aggarwal and Samwick, 1999; Chhaochharia et al., 2009; Perez-Gonzales and Guadalupe, 2005; Bloom and van Reenen, 2007; Giroud and Mueller, 2010, 2011). The most common arguments in support of this idea are that competition puts pressure on managers to work harder because it drives inefficient firms out of the market (Alchian, 1950; Stigler, 1958; Shleifer and Vishny, 1997), and that it improves access to information and by that mitigates monitoring costs (Holmstrom, 1982; Nalebuff and Stiglitz, 1983; Hart, 1983).[1]

Motivated by the gap in the literature about the cross-industry variation in governance and its implications for financing costs, in this paper I examine the effect of corporate governance on the pricing of bank loans, conditional on a borrower's intensity of product

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[1] See also Section 2 for a review of the main product market competition literature and its implication for agency costs.

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market competition. Among debt holders, banks occupy a special place, as they represent an important source of funds even for large public companies (Houston and James, 1996; Bradley and Roberts, 2003). Roughly 80% of all public firms have private credit agreements in place, while only about 15% of those firms have public debt (Nini et al., 2009). It is therefore important to understand whether corporate governance and product market competition interact in their effect on the firm's cost of bank financing.

Using a large sample of bank loans extended to US public companies during 1990–2008, I test whether product market competition interacts with firm level governance as a mechanism to mitigate agency problems, and examine the combined effect of product markets and firm governance on the cost of bank loans. However, unlike most corporate governance studies that rely on the cross sectional variations in the Gompers et al. (2003) firm-level governance index (G-index) or its variants to infer the relation between the market for corporate control and credit spreads, I use the variation in state antitakeover laws as an exogenous measure of corporate governance.[2]

Representing a one-time change in the market for corporate control mandated by regulatory authorities, state antitakeover laws were passed by many states at different points in time from 1985 to 1991 to impose stringent restrictions on hostile takeovers. While viewed unfavorably by equity holders, these laws have been shown to benefit the firm's debt holders by lowering the variance of cash flows from operations that accompanies takeovers and/or takeover attempts. This increase in variance comes from several sources. One is the higher variability in earnings that results from the replacement of incumbent management that accompanies many takeovers. A second is the significant increase in leverage that often accompanies both takeover attempts and completed takeovers. The third is the likely increase in risk shifting incentives arising from the strengthening of mechanisms of equity-oriented corporate governance that can better align management to shareholders.[3]

Because state level antitakeover laws can protect debt holders from leverage increasing takeovers as well as any other actions taken by managers that can exacerbate the shareholder-debt holder conflict, they provide an important, exogenous source of variation in debt holder governance, and therefore a natural laboratory to examine the interaction between competition and governance. While several other papers study the implications of product markets for shareholder governance (see e.g., Giroud and Mueller, 2010, 2011; Guadalupe and Pérez-González, 2005; Karuna, 2010; Ammann et al., 2010), as far as I am aware, this is the first study that looks at this question from the perspective of banks.

Consistent with Chava et al. (2010), I find that firms that are more vulnerable to takeovers are charged significantly higher loan spreads than firms that are strongly protected from takeovers. Specifically, the cost of bank debt for firms with weak takeover protection is on average 18 basis points higher than that of firms incorporated in restrictive antitakeover law states. However, takeover vulnerability is associated with even higher loan spreads for firms in concentrated industries compared to their competitive industry counterparts. In particular, concentrated industry firms are charged up to 40 basis points more than competitive industry companies when takeover vulnerability is high. In contrast, the effect of takeover vulnerability on the firm's cost of bank loans is close to zero and statistically insignificant for the most competitive industries in the sample. Thus while the opportunity for lender expropriation increases equally across all industries when the firm is more exposed to takeovers, lenders appear to be more concerned (and therefore charge higher spreads) only in concentrated industries, but not in highly competitive industries, where competitive pressure enforces discipline on managers. This is consistent with the hypothesis that product market competition can enforce discipline on managers and alleviate debtholder agency concerns.

The strong mitigating effect of product market competition on the cost of bank lending in takeover friendly states is robust to a series of alternative specifications and tests of reverse causality and endogeneity. For example, the main competition measure in this paper is the 3-digit SIC HHI, computed from COMPUSTAT. However, I obtain similar results by using 2 and 4-digit SIC HHI, lagged or historical HHI, and the industry net profit margin (Lerner index) as an alternative measure for product market competition. The results are also robust to the inclusion of a mix between different firm and loan-specific governance mechanisms in the form of covenants and the Gompers et al. (2003) and Bebchuk et al. (2005) managerial entrenchment measures. I also obtain similar results by dropping Delaware firms or examining a subset of Business Combination laws, which are considered the most stringent state antitakeover laws, as a measure of exogenous variation in debt holder corporate governance.

I next investigate the mechanisms through which debt agency problems can be mitigated in the absence of product market competition as a disciplinary factor. The idea is that the effect of takeover vulnerability on the cost of bank debt in concentrated industries could be weakened by governance mechanisms that can reduce the credit risk and monitoring costs faced by lenders. I specifically focus on the following sets of factors: ownership identity, borrowing firm opacity, credit ratings and loan terms. I find that the effect of takeover vulnerability on firms in concentrated industries is mitigated if the borrowing firm is not owned by a controlling family. This is consistent with Villalonga and Amit (2009), who find that in the U.S., founding families are the only blockholders whose control rights exceed their cash flow rights, and with Lin et al. (2013) and Boubakri and Ghouma (2010), who report that this control and cash flow rights wedge is associated with higher agency costs of debt. In the absence of product market competition as a disciplinary force, the effect of takeover vulnerability on loan spreads is also mitigated for firms with lower degrees of informational opacity, large firms, firms with existing credit ratings, and firms with shorter maturity loans and collateral and loan covenants in place. These findings support the idea that firms in concentrated industries may need to use supplementary governance mechanisms to mitigate debt holder agency problems.

This paper is directly related to a growing literature that documents a link between product market competition and corporate governance. While most papers in this area focus on the impact of competition on managerial agency problems and the alignment of interests between shareholders and managers by examining, for example, managerial incentive schemes (Aggarwal and Samwick, 1999; Kedia, 2006; Cunat and Guadalupe, 2008), board structure (Karuna, 2010), firm-level takeover defenses (Cremers et al., 2006), and private benefits of control, there is little evidence on the impact of competition on the firm's debt holders. This is surprising given that debt holders, in general, and banks in particular are an important class of stakeholders, who supply a major source of external capital to most companies.

The findings in this study are most closely related with those of Qui and Yu (2008), who document an increase in the cost of

[2] Romano (1987) offers evidence that the passage of state antitakeover laws was often the result of political lobbying on behalf of a *single* firm. Bertrand and Mullainathan (2003), Giroud and Mueller (2010) and Francis et al. (2010) test and reject the idea that the state level antitakeover laws were the result of broad-based lobbying by a coalition of firms incorporated in the same state. Giroud and Mueller (2010) also argue that removing the small number of firms directly responsible for the passing of the Business Combination laws has no effect on their results. See also section 4 for tests of potential endogeneity between a firm's state of incorporation and its cost of bank loans.

[3] See Section 2 for a related literature review on the impact of antitakeover state laws on debt holders.

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