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CEO turnover and bondholder wealth ☆

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ABSTRACT

We examine the impact of CEO turnover announcements on bondholder wealth, stockholder wealth, and overall firm value. Using publicly traded data for the period from 1973 to 2000, we find evidence consistent with both the wealth transfer and signaling hypotheses. Specifically, we find that CEO turnover events are associated with lower bondholder values, higher stockholder values, and that net changes in firm value are a function of turnover type (forced vs voluntary and outside vs inside firm replacements) and the riskiness of the firm's debt (investment vs non-investment grade). Overall, the results contribute to the understanding of the effects of corporate governance mechanisms, of which CEO turnover is an extreme form, on bondholders.

1. Introduction

In this paper, we examine the impact of CEO turnover on the values of two primary classes of traded securities, debt and equity, and on overall firm value. In doing so, we also discuss how evidence from a range of other studies documenting changes in expected operating performance, investment policies, shareholder wealth, and equity return volatilities fit with our evidence on bondholder wealth and overall firm value.[1] While the literature provides ample evidence on the relation between CEO turnover and accounting return and stock prices, there is little if any evidence on the impact of CEO turnover on bond prices. Examining the impact of CEO turnover on bond prices is of interest because the changes in value around CEO turnover, reported in earlier studies, mainly reflect changes in equity prices.[2] They do not tell us how much of the changes are due to wealth transfers from bondholders to stockholders or due to signaling effects. Overall, our results suggest that certain CEO turnover events while value enhancing to stockholders are value decreasing to bondholders, and that the magnitude and direction of changes in overall firm value are a function of the relative size of the signaling and wealth transfer effects.

When CEO turnover occurs due to poor performance, the new CEO typically take actions that include a combination of operating, investing, and financing policy changes (John et al., 1992; Ofek, 1993). Signaling theory suggests that changes in wealth associated with CEO turnover can be attributed to an information effect, a real effect, or some combination of the two (Bonnier and Bruner, 1989). If the event was unexpected, then the turnover announcement may convey information that firm performance was worse than previously thought. In this case, investors react negatively to the informational component of the announcement. There could also be a positive real effect on the announcement if investors anticipate future firm performance to improve. The consequence of each of these effects on security prices could be different depending on which effect dominates which event. In either case, however, the reaction from both bondholders and stockholders should be in the same direction, and overall firm value should either increase or decrease as a result.

Prior research suggests that turnover events benefit shareholders and are associated with an increase in future operating performance. Weisbach (1988) and Furtado and Rozeff (1987) report positive and significant stock price reactions to CEO turnover announcements, while Borokhovich et al. (1996) report similar

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[1] See Huson et al. (2004) for issues related to operating performance, Weisbach (1995) for issues related to asset restructuring, Huson et al. (2001) for issues related to shareholder wealth, and Clayton et al. (2005) for issues related to equity volatility.

[2] Other advantages to using corporate debt is that bonds have well-defined payouts and shorter durations, and their valuations are well specified and less subject to the criticism that the results might be driven by misspecification of the equilibrium asset pricing model when compared to equity.

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findings around forced turnover announcements when successor CEOs are selected from outside the firm. Fee and Hadlock (2003) find that outsider CEOs are selected from firms with above normal stock returns, suggesting equity holders anticipate better performance. Denis and Denis (1995) report that average and industry adjusted operating returns on assets (OROA) improve following CEO turnover, especially for forced turnovers. Overall, the evidence suggests that real wealth effects dominate information effects. The signaling hypothesis predicts a positive correlation between stock price reactions and changes in bondholder value on the announcement of a turnover since improved operating performance lowers the firm's default probabilities and its debt costs.

A turnover announcement may also be associated with a wealth transfer from one security claimant to another. Stock and bond values may diverge around CEO turnover events even though performance is expected to increase due to conflicts of interests between the two claimants. Corporate policies, events, and governance mechanisms instituted by CEOs that are beneficial to shareholders but nonetheless increase default risk should be reflected in lower bond prices and higher yields. This increased agency cost of debt represents a wealth transfer from bondholders to stockholders. Empirical research has documented that CEO turnover events which are beneficial to stockholders may have indirect negative consequences for bondholders. For example, Clayton et al. (2005) suggest that CEO turnover events are associated with increased future equity volatility as a result of uncertainty in future operating performance as well as changes in investing and financing policies. Campbell and Taksler (2003) and Landschoot (2008) find that firm specific volatility can explain variations in bond yields; evidence that equity volatility is an important element in the pricing of corporate bonds.

The literature also provides evidence that turnover activity is related to changes in firm investing and financing policies. Weisbach (1995) and Denis and Denis (1995) report that turnover is associated with increased asset restructuring.[3] As such, CEO turnover may decrease bondholder wealth via loss of coinsurance if cash flows between business segments become more correlated due to changes in investment policies. Denis et al. (1999) find that firms become less diversified following top management turnover.[4] In addition, a decrease in firm size may result in a loss of collateral and an increase in the cost of debt. Berger et al. (1997) argue that CEO turnover is associated with subsequent increases in firm leverage; evidence consistent with operating and stock performance improvements (Safieddine and Titman, 1999). This suggests that existing bondholders incur losses (wealth expropriations) when the values of their claims fall because of the increased debt costs. Overall, we expect pure wealth transfer events to be such that any gains to stockholders must be at the expense of bondholders, with no net change in firm value.

Using data from the Lehman Brothers Fixed Income database and an extension of the Huson et al. (2001) CEO turnover sample of over 670 turnover events for the period from 1973 to 2000, we find evidence in support of both the wealth transfer and signaling hypotheses. Specifically, we find that CEO turnover events are associated with lower bondholder values, higher stockholder values, and that net changes in firm value are a function of turnover type and the riskiness of the firm's debt. Segmenting the full sample based on the nature of the turnover event, whether the incumbent CEO voluntarily resigns or is forcibly removed, we find increased abnormal yield spreads of about 28 basis points for the forced turnover sample, which represents an approximate loss to bondholders of about 0.73%. For the same sample and consistent with prior research (e.g., Furtado and Rozeff, 1987; Denis and Denis, 1995), we find a positive gain to stockholders of about 2.43%. The results are not only statistically significant but also economically meaningful. For example, in the forced turnover sample, the firm's average tradable and total liabilities are about $2.8 billion and $4 billion, respectively. This represents an average loss to the bondholders of about $20 million and $28 million, respectively. Segmentations based on the origin of successor (inside, outside, inside industry, and outside industry replacements) yield similar results.

We further partition the data based on debt types (investment and non-investment grade debt) and examine the impact of CEO turnover on the cost of debt financing. Because firms with non-investment grade debt have a higher probability of incurring financial distress, we expect CEO turnover events for these firms to have a larger impact on bond prices and yields. Consistent with this prediction, we find that firms with non-investment grade debt exhibit a statistically significant mean abnormal yield spread of about 40 basis points, while firms with investment grade debt have a mean abnormal yield spread of about 2 basis points. Similar results are found for the forced, inside, and outside turnover categories. On the equity side, we document positive abnormal stock returns for forced and outside CEO turnover events in both the investment and non-investment grade samples. We also document an insignificant change in firm value for forced turnovers in both debt grade samples and a positive and significant change in firm value for outside turnover events in the investment grade sample.

Our research contributes to the literature in several ways. First, this is the only study that examines the relation between CEO turnover and overall firm value incorporating both publicly traded debt and equity. This issue is of importance because the firms in our sample have larger asset bases than the average firm with significant liabilities. Second, this study helps reconcile previous research by considering the implications of operating performance changes, asset restructuring, capital structure choices, information asymmetry, and stock volatility around CEO turnover events. Third, this study examines and attempts to isolate the changes in firm value observed around CEO turnover announcements in the context of signaling and wealth transfer hypotheses. Finally, this research further contributes to the understanding of the effects of corporate governance measures, of which CEO turnover is an extreme form, on bondholders.

The remainder of this study is organized as follows: Section 2 provides the sample, variable measures, and descriptive statistics for the data employed in the analysis. Section 3 highlights the event study methodology for bond yield spreads, stock returns, and change in total value of the firm. Section 4 provides the empirical results and robustness evidence. Section 5 concludes.

2. Sample selection

2.1. Data

We utilize five databases in our analysis: Lehman Brothers Fixed Income database (LBFI), Huson et al. (2001) database for those CEOs listed in the Forbes Annual Compensation Survey who have held their position for one year or less, Compustat database for financial and firm specific information, Center of Research in Security Prices database (CRSP) for stock pricing data, and Bloomberg financial database for recent bond pricing data that

[3] Additionally, Huson et al. (2004) find that firm size, measured by the book value of total assets, decreases following forced turnover, while Clayton et al. (2005) report similar evidence following outsider replacement.

[4] Mansi and Reeb (2002) provide evidence of a positive relation between corporate diversification and bondholder wealth (i.e., increased corporate diversification is associated with a lower cost of debt financing).