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Product market advertising and corporate bonds

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ABSTRACT

Research shows that by enhancing visibility, advertising improves stock liquidity and returns. Unlike stock holders, bond holders may view advertising skeptically. Without proven effectiveness in improving revenues, large pre-interest advertising expenditures can be seen as eroding a firm's ability to meet its debt service obligations. We find that although greater advertising by a firm improves liquidity of its bonds in the market, it does not lower the firm's cost of debt. However, firms with ineffective advertising experience reduced bond market liquidity and a higher cost of debt. Without a real positive economic impact, advertising has little or no value for bond investors.

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1. Introduction

In his influential work, Merton (1987) shows that incomplete information affects stock returns. Low-visibility firms carry large incomplete information premiums.[1] Indeed, a growing body of evidence supports the intuition that "familiarity breeds investments.[2]" Firms seem to benefit from visibility-enhancing activities such as advertising campaigns through more institutional investors, better stock trading liquidity (Grullon et al., 2004), greater trading volume, more analyst coverage, and improved stock returns (Chemmanur and Yan, 2008).[3]

The interesting question then is whether managers can utilize advertising and enhance their firms' visibility in an effort to reduce their overall cost of capital and hence add value. Of course, for such a strategy to be successful, bond holders have to value

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[1] A large body of evidence supports this notion. For instance, Grinblatt and Keloharju (2001) and Huberman and Regev (2001) find that investors tend to concentrate their portfolio strategies on local firms. Coval and Moskowitz (1999) find that portfolio managers tend to invest in locally headquartered firms.

[2] Huberman (2001) coins the phrase "familiarity breeds investments." He shows that Regional Bell Operating Companies' shareholders tend to live in the areas that these companies serve. They see this as "compelling evidence that people invest in the familiar." Odean (1999) proposes that investors manage the daunting task of choosing among thousands of possible stock purchases by narrowing their search to stocks that recently caught their attention. Barber and Odean (2008) indeed find evidence in support of this proposition.

[3] A growing body of literature in marketing (e.g., Chauvin and Hirschey, 1993; Cheng and Chen, 1997; Joshi and Hanssens, 2004; Rao et al., 2004, among others) also suggests that advertising positively relates to corporate value. Keller (2002) attributes brand equity related augmented cash flows to customer loyalty, increased marketing efficiency, brand extensions, and higher profit margins. Similarly, while Farquhar (1989) suggests that advertising-related cash flow augmentations may be traceable to price premiums, Boulding et al. (1994) relate increased cash flows to capturing greater market share.

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visibility in similar ways that stock holders do. Here, we examine how bond holders view product market advertising. More specifically, we test how the visibility-enhancing aspect of advertising (as measured by the scale of advertising) and the real effect of advertising or advertising effectiveness (as measured by sale-advertising sensitivity) affect corporate bonds' credit spreads and trading liquidity.

In contrast to equity holders, corporate bond investors are not residual claimants and tend to hold debt instruments for longer durations.[4] As a consequence, bond holders' return becomes highly sensitive to a firm's default risk.[5] Any cash outlay that could deteriorate the financial health and stability of a borrower's income would be detrimental to bond holders' interests. Since advertising expenditures may reduce a firm's resources that are available to meet debt service obligations — unless advertising strategies are effective in generating additional revenue over and above the advertising outlays — advertising may be viewed by debt holders as risky. Thus, ineffective advertising campaigns may actually increase default probability and corporate bond yields. Moreover, if bond holders perceive advertising campaigns as ineffective in improving future cash flows, they will fear advertising as a means of wealth transfer from bond holders to stock holders (Myers, 1977) and demand higher credit spreads.

If bond holders see advertising as an unproductive utilization of resources — unless a firm has a record of effective advertising campaigns — then advertising visibility will have minimal favorable impact on credit spread and liquidity. Effective advertising, however, is expected to have a meaningful positive impact in terms of lower cost of debt and increased liquidity of corporate bonds. Following Grullon et al. (2004), we assume that the size of the advertising budget serves as a reasonable proxy for the positive externality of advertising campaigns in terms of increased investor familiarity (exposure).[6] We measure effectiveness of advertising in terms of its historical average impact on future revenues. Our analysis shows that while increased visibility narrows credit spreads — albeit marginally — ineffective advertising significantly and pronouncedly widens the credit spreads. Interestingly, we find that much like equities, a larger scale of advertising increases liquidity of corporate bonds. However, advertising effectiveness remains a more significant determinant of corporate bond liquidity. Companies with a history of ineffective advertising experience significantly lower liquidity in their bonds.

Our analysis extends recent studies on the impact of familiarity on asset returns (Chemmanur and Yan, 2008; Coval and Moskowitz, 1999; Grinblatt and Keloharju, 2001; Grullon et al. 2004; Huberman, 2001). Building on a recent work by Grullon et al. (2004), we show that unlike equity, the impact for debt securities of advertising scale in improving liquidity is limited at best. Gains from greater advertising expenditures may not offset the negative impact of ineffective advertising manifested through both wider credit spread and lower liquidity. Firms cannot reduce their borrowing cost by ramping up their advertising without clear evidence of past success in utilizing advertising expenditures to improve sales. In the absence of such evidence, any increase in advertising expenditures will result in higher cost of debt.

These results support the notion that investors significantly consider salient attributes of attention-seeking strategies — in this case the borrower's ability to derive real value from advertising — in their investment decisions (Barber and Odean, 2008). Bond investors attracted to a firm through its consumer advertising need evidence of its real business and marketing prowess. This notion is in line with research that provides evidence of a positive relationship between advertising and corporate value. Several studies suggest that higher advertising associates with lower costs of capital and more stable cash flows through increased customer loyalty, brand extension, and price premiums (see Balasubramanian et al., 2005; Chauvin and Hirschey, 1993; Cheng and Chen, 1997; Farquhar, 1989; Joshi and Hanssens, 2004; Keller, 2002; Mathur and Mathur, 1996; Rao et al., 2004; Singh et al., 2005).

Our findings also shed additional light on the economics of advertising. Economic theorists contend that advertising provides valuable product market information that can help the firm to credibly signal quality and compete more effectively (Bagwell and Ramey, 1994; Chemmanur and Yan, 2009; Milgrom and Roberts, 1986; Stigler, 1961; Telser, 1964). While our results confirm that product market advertising can affect value through a capital market channel, they also highlight the fact that the inherent signaling facet of advertising must be credible for it to be a net value-adding proposition. With the absence of a verifiable positive product market effect, the impact of advertising on bond values through a capital market channel remains limited at best.

Our paper also extends recent research explaining credit spreads (Collin-Dufresne et al., 2001; Elton et al., 2001; Liu et al., 2006) in that we identify advertising as an additional management strategy that affects credit spreads. We also contribute to the growing literature on corporate bond liquidity by identifying advertising as a determinant (Chen et al., 2007; Longstaff et al., 2005). Our results suggest that advertising scale and effectiveness can affect a firm's cost of debt through two distinct channels: through their influence on a firm's financial fundamentals and their effect on market liquidity of its bonds.

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[4] Sarig and Warga (1989) show that after the initial offering phase, the corporate bond market becomes quite illiquid, mainly because the buyers tend to hold the instruments for a long time.

[5] Elton et al. (2001) state that corporate bonds' credit spreads reflect three important factors: expected default, personal taxes, and a systematic risk premium. For instance, for an A-rated, 10-year bond, they find that about 18% and 47% of the credit spreads is due to default risk and taxes, respectively. Of the remaining spread, as much as 85% is explained by Fama–French risk factors, leaving little room for all other factors, including liquidity. Interestingly, they also find that the proportional contribution of default risk to the credit spread grows exponentially with credit rating. For instance, for a 10-year, BBB-rated bond, the percentage contribution of the default risk rises to 41%.

[6] Grullon et al. (2004) use advertising expenditures as a proxy for the degree of visibility. Citing Bagwell's (2001, p. 440) survey of the economics of advertising, they argue that although "… advertising is presumably aimed at increasing the firm's market share in the product market, at the minimum it should make the firm's name and products better known to both consumers and investors…." Indeed, Grullon et al. (2004) find results consistent with the idea that more advertising can increase the advertising firm's stock market liquidity and institutional ownership.

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