Accepted Manuscript

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PII: S0378-4266(17)30149-8
DOI: 10.1016/j.jbankfin.2017.06.016
Reference: JBF 5205

To appear in: *Journal of Banking and Finance*

Received date: 31 January 2017
Revised date: 22 May 2017
Accepted date: 25 June 2017

Please cite this article as: Matthew T. Billett , Burcu Esmer , Miaomiao Yu , Creditor Control and Product-Market Competition, *Journal of Banking and Finance* (2017), doi: 10.1016/j.jbankfin.2017.06.016

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May 2017

Abstract

We explore how rival firms respond when firms in their industry violate debt covenants. We find that rival firms increase advertising expense, and that this increase is proportional to the size of industry violators' pre-existing market share. Rival firm product-market share also increases in the industry market share of violators, and this relation is more pronounced when products are more substitutable. Rival firm operating performance also increases in proportion to the industry market share of violators. Overall, these findings suggest that the increased creditor control associated with covenant violations has a significant influence on rival firms and product-market competition.

Keywords: Debt covenants, Covenant violations, Creditor control, Product market competition JEL Classification: G21, G30, M30

We thank Redouane Elkamhi, Jon Garfinkel, Dave Mauer, Phuong-Anh Nguyen, Raunaq Pungaliya, David Smith, Xuan Tian, and seminar participants at Bilkent University, the University of Saskatchewan, and participants at the 2015 Northern Finance Association, 2014 Turkey Finance Workshop and 2013 Financial Management Association meetings for helpful comments and discussions. All errors remain our own. *Richard E. Jacobs Chair in Finance, Kelley School of Business, Indiana University, 1309 E 10th Street HH6100, Bloomington, IN 47405-1701. 812-855-3366 (Office). Email: mbillett@indiana.edu ; ** The Wharton School, University of Pennsylvania, 3620 Locust Walk, 2455 SHDH, Philadelphia, PA 19104. 215-898-1587 (Office). Email: besmer@wharton.upenn.edu ; *** E.J. Ourso College of Business, Louisiana State University, Baton Rouge, LA 70803. 225-578-7676 (Office). Email: miaomiaoyu@lsu.edu.