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The Use of Equity Financing in Debt Renegotiation

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Abstract

Debt renegotiation is often modeled as pure debt for equity or debt for debt swaps in the theoretical literature. However, the empirical evidence in the debt repurchase literature shows that a combination of debt and equity, along with asset sales is used in renegotiation. In this paper we analyze the use of equity financing in addition to debt financing and asset sales in debt repurchases. Firms with larger volatility, lower cash flow growth rates, or higher recovery rates are more likely to use equity financing in debt renegotiation. Flotation and renegotiation costs, the bargaining power of the creditors, and macroeconomic variables also influence this choice. When equity issuance is a possible source of financing in renegotiation, firms optimally choose smoother coupons and welfare increases as compared to pure debt for debt swaps. We provide closed-form solutions for the optimal use of funding and we derive novel testable empirical implications regarding the use of equity financing in debt repurchases.

Keywords: Debt renegotiation, Debt repurchase, Strategic contingent claim analysis, Equity issuance
JEL: G30, G32, G33

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