



Does meeting analysts' forecasts matter in the private loan market?

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ABSTRACT

Prior studies find that firms meeting or beating analysts' earnings expectations (MBE) have higher equity valuation and lower bond yield spread. In contrast to those studies which focus on public financial markets, this paper explores a firm's MBE effect on its private loan terms, including price and non-price terms. We find that, despite the fact that banks possess superior information access and processing abilities that reduce information asymmetry costs for borrowers, they still impose more favorable price (i.e., lower loan spread) and non-price (longer loan maturity) terms for firms meeting expectations than for firms missing expectations. In addition, we find that the benefits of meeting expectations (i.e. lower loan spread and longer maturity) are more pronounced for financially distressed firms (habitual beaters) than financially sound firms (sporadic beaters). Further analyses document whether and how prospect theory can be used to explain differential loan terms.

1. Introduction

It is well-documented that firms meeting or beating analysts' earnings expectations (hereafter MBE firms) have higher equity valuation (Bartov et al., 2002; Kasznik and McNichols, 2002) and lower bond yield spread (Jiang, 2008). However, in addition to public financial markets (e.g., equity and public debt), the private loan market becomes a significant source of corporate financing (Altunbas et al., 2006; Ball et al., 2008).¹ The extant studies document significant institutional differences between the two types of markets. For example, lenders across private and public debt markets differ with respect to their access to information, ability to monitor the borrowers and flexibility in resetting contract terms (Bharath et al., 2008). When private lenders possess superior information access and processing abilities that reduce information asymmetries between lenders and borrowers, whether the extant inferences on MBE can be generalized to private debt market is an interesting but unsolved question. To fill the gap, we examine whether the presence of MBE affects price (i.e., loan spread) and non-price (i.e., maturity) terms of bank contracts.²

Prior studies indicate that firms have incentive to avoid earnings decreases and losses, and to meet or beat analysts' earnings forecasts (Burgstahler and Dichev, 1997; Degeorge et al., 1999). The market rewards firms meeting or beating their earnings benchmarks (Barth et al., 1999; Bartov et al., 2002; Brown and Caylor, 2005; Kasznik and McNichols, 2002; Skinner and Sloan, 2002). In the context of public bond market, Jiang (2008) finds that a firm's MBE leads to lower bond spread. On the other hand, Burgstahler

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¹ For example, over the past decade, there have been \$780 billion in net debt security issuances and bank loans play a significant role (about 54% of total debt since 1980) (Graham et al., 2008).

² Wittenberg-Moerman (2010) explores the syndicated loan market to investigate the impact of information asymmetry on loan spread and maturity; Gottesman and Roberts (2004) examine the association between loan spread and maturity to test whether lenders are compensated for longer maturity loans, or limit their exposure by forcing riskier borrowers to take short-term loans. Following Wittenberg-Moerman (2010) and Gottesman and Roberts (2004), our focus is on bank loan terms on interest rate and loan maturity.

and Dichev (1997) and Degeorge et al. (1999) present two theories to explain why firms have incentives to meet these targets: transaction cost theory and prospect theory. The former posits that to reduce information-processing costs, some firm stakeholders, such as stockholders and creditors, use earnings benchmarks as heuristics or reference points to evaluate firms' performance and determine terms of transaction with firms; the latter argues that decision makers are more sensitive to losses but less sensitive to gains relative to some natural reference points (Kahneman and Tversky, 1979). However, the extant literature provides no direct evidence regarding which theory accounts primarily for the incentive for firms to meet or beat earnings benchmarks. In this paper, we further address this issue.

Our motivation for the examination of loan contracting consequences of MBE stems from a variety of reasons. First, debt financing, in particular bank loans, is a major source of external financing in the U.S. and most other countries around the world (Bharath et al., 2008; Graham et al., 2008). For example, in 2005, the total new capital raised in the syndicated loan market was \$1500 billion, and firm bond issuance amounted to about \$700 billion (Bharath et al., 2008). As a result, the issue of whether MBE affects loan terms of bank contracts is of economic importance.

Second, multi-faceted features of private debt contracts enable us to assess not only direct cost of firm's MBE (e.g., loan spread), but also the related indirect cost (i.e., tighter non-price terms such as shorter maturity). For example, Bharath et al. (2008) find that higher risk is entirely reflected in the interest spread in the case of public debt. However, in the case of private debt, there is substantial variation in loan contract terms. Therefore, in the context of private debt, focusing on the interest cost *alone* potentially misestimates the total cost borne by borrowers.³

Third, prior research documents significant institutional differences between the private and public financial markets. Relative to investors in public markets (equity and bond), banks possess superior information-processing abilities and have better access to private information used to both design the loan terms of the contract (Diamond, 1991) and monitor the loan *ex post*. In addition, borrowers are relatively more willing to share their proprietary information with a small group of lenders than with dispersed bondholders (Bhattacharya and Chiesa, 1995).⁴ Prior studies argue that in the public financial markets, MBE reduces the costs imposed in transactions with stakeholders (e.g., lenders), assuming that stakeholders' decisions are often based on heuristic cutoffs at earnings thresholds.⁵ However, due to their better access to information from borrowers and ability to process information, whether the extant inferences on MBE can be generalized to private debt market is an interesting but unsolved question. In addition, MBE in a loan market, *if any*, should also be able to be explained by another prospect theory. Thus, a private loan market provides a setting to empirically examine whether and how transaction cost theory and prospect theory can account for MBE.

The first question to be addressed in this paper is whether and how a borrower's MBE has an impact on price and non-price terms of bank loan contracts. To analyze the impact of MBE on price terms, we examine the effect on the loan spread. In this paper, loan spread is measured as the amount the borrower pays in basis points over LIBOR or LIBOR equivalent. Next, in addition to price terms, we further investigate whether MBE has an impact on non-price terms. In this paper, we use bank loan maturity as proxy for non-price terms of loan contracts.

Using a sample of listed loan firms in Dealscan database during 1996–2011, we find that, as predicted, the loan spread is lower for firms meeting analysts' earnings expectations (MEET firms) than those falling short of expectations (MISS firms). In addition, we also find that a borrower's MBE is translated into a longer loan maturity, i.e., firms meeting or beating expectations have significantly longer loan maturity than those missing expectations. The results are in line with the argument that a longer maturity due to MBE induces less frequent refinancing of bank loans to firms meeting or beating expectations, which allows the borrowers to less frequently renegotiate the loan contract terms. As a result, the economic effect of a borrower's MBE on the cost of loan contracts is likely to be even higher than that implied by the loan spread decrease *alone*.

The second question to be addressed in this paper is whether favorable contract terms due to a borrower's MBE are more pronounced for firms in financial distress than for financially sound firms. When a firm in financial distress beats its earnings expectation, this conveys information about its ability to survive, and thus the premium to MBE of financially distressed firms is larger than the premium to MBE of financially sound firms (Bartov et al., 2002). Since lenders bear the borrower's downside risk, but do not share in the upside growth potential, we thus hypothesize that in the loan context, more favorable contract terms due to a borrower's MBE are offered to firms in financial distress than to financially sound firms. The empirical results provide evidence supporting our predictions. Specifically, we find that the decrease in loan spread and increase in loan maturity due to MBE are more pronounced for firms in financial distress than for financially sound firms. Further analyses indicate that the differential loan spread and maturity due to a borrower's MBE are more pronounced for "habitual beaters" than "sporadic beaters".

In addition, we find that reporting positive earnings or earnings increases is positively associated with more favorable loan terms, and such an association is much more pronounced when borrowers are in financial distress.

The extant literature presents two theories, based on the stakeholder use of information-processing heuristics (transaction cost theory) and prospect theory, regarding the motivation for meeting or beating earnings benchmarks. However, little work to date provides empirical evidence on these arguments. In this paper, we use private debt setting to provide more direct evidence on these

³ Private loans tend to have more concentrated lenders relative to public debt. In addition, information access and re-contracting flexibility allow private lenders to customize the price and non-price terms of the debt contract.

⁴ Private debt contracts typically depend on the flow of confidential information between borrowers and lenders. For example, the origination and ongoing maintenance of syndicated loans rely crucially on borrowers providing lenders with confidential information. This confidential information tends to include timely financial disclosures (e.g., quarterly or monthly financial disclosures), covenant compliance information, amendment and waiver requests, financial projections, and plans for acquisitions or dispositions (Bushman et al., 2010; Wittenberg-Moerman, 2010).

⁵ Transaction cost theory argues that information-processing costs are sufficiently high that stakeholders determine the terms of transaction with the firm based on the heuristic or reference point, such as earnings.

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