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Does the decision to issue public debt affect firm valuation? Russian evidence

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ABSTRACT

This paper examines the association between firm valuation and the sources of debt financing. In particular, using a sample of 353 firms, we test whether the decision to issue bonds affects the firm's stock market performance in the emerging Russian markets. Our results indicate that public debt financing may have a negative effect on the firm's market valuation. After controlling for the differences in firm-specific characteristics and addressing potential endogeneity issues, we document that the firms which rely on public debt underperform relative to firms with other sources of debt financing in terms of stock market valuation.

1. Introduction

In this paper, we focus on the association between firm performance and the decision to issue public debt. Motivated by the different theories that provide arguments about both costs and benefits stemming from a reliance on either public or bank debt (see e.g. Diamond, 1991; Gertner and Scharfstein, 1991; Johnson, 1997; Rajan, 1992; Rajan and Winton, 1995), it is of interest to empirically examine the association between bond issuances and the firm's market valuation. For this purpose, we run several alternative panel regressions using a sample of large Russian firms to investigate whether the decision to issue bonds is reflected in the firms' Tobin's Q. To the best of our knowledge, this paper is the first attempt to address the implications of public debt issuances on firm performance in emerging markets.

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The existing theories suggest that bank debt may provide more efficient monitoring features than public debt financing by resolving potential adverse selection and moral hazard problems (Diamond, 1984, 1991), while it may also cause hold-up problems due to the information monopoly of banks (Rajan, 1992). Bank debt can also be considered beneficial in terms of easiness of renegotiation in case of financial distress (Chemmanur and Fulghieri, 1994; Rajan and Winton, 1995). Public debt in the form of bonds, on the other hand, seems to be able to resolve the hold-up problem but may not be as favorable as bank debt in terms of renegotiations (Gertner and Scharfstein, 1991) and in resolving information asymmetries (Johnson, 1997; Leland and Pyle, 1977).

The prior empirical literature suggests that different sources of external debt financing may be unequally valuable for a firm. Risk-averse banks may require higher interest on debt financing, and may maintain stricter monitoring conditions and thereby reduce managerial flexibility, while the high costs of bond issuances may create a considerable barrier for even entering the public debt market. Previous studies indicate that different debt source choices may exert a significant influence on firm performance. Lummer and McConnell (1989), Gilson et al. (1990) and Easterwood and Kadapakkam (1991), for instance, argue that private debt in the form of bank loans increases firm value. Several recent studies provide support for this argument (see e.g. Haan and Hinloopen (2003); Shirasu and Xu (2007)). On the other hand, Houston and James (1996) suggest that banks can create offsetting costs and cause hold-up problems, while Gilson and Warner (1998) and Arikawa (2008) document that public debt provides more financial flexibility and helps to increase growth rates, and consequently firm performance. Moreover, Weinstein and Yafeh (1998) find that bank debt may mitigate firms' growth rates by patronizing more conservative investment policies. Cantillo and Wright (2000) suggest that the main advantage of private debt is the possibility of less damaging interventions by banks in case of financial distress. Public debt, in turn, is more advantageous for firms that are less likely to default, have high and stable cash flows and profitability, and low level of real interest rates.

The existing literature also suggests that there are several primary determinants of the firm's choices between different sources of debt financing. Krishnaswami et al. (1999), Denis and Mihov (2003), Faulkender and Petersen (2006), Hale and Santos (2008), and Altunbaş et al. (2010) document that the main determinants of the choice between public and private debt are firm-specific characteristics such as size, profitability, leverage, age, and credit quality. Their findings indicate that firms with higher credit quality and greater levels of financial leverage are relying more on public debt, while larger, more profitable firms with higher liquidation values tend to rely on syndicated bank loans. Hadlock and James (2002), in turn, argue that the level of asymmetric information is the decisive factor in firm's decision to choose between bank and public debt. Zhang and Hou (forthcoming) show that the firm's financing choice may also be affected by productivity levels, the riskiness of investment projects, and the relative costs of public and bank debt. Finally, Hoshi et al. (1993) postulate that firms with good performance, valuable investment opportunities or valuable assets are more likely to rely on public debt. Using data from post-deregulated Japan, they document that reliance on bank debt financing is decreasing stock market valuations of keiretsu firms and increasing valuations of non-keiretsu firms.

In prior literature, the association between firm performance and the sources of debt financing has mostly been examined with event studies. In general, these studies provide considerable evidence of positive short-term stock price reactions to bank debt arrangements (see e.g. Aintablian and Roberts (2000); Kang and Liu (2008); Lummer and McConnell (1989); Mosebach (1999)). However, the evidence on the corresponding effects of bond issuances on stock prices is more mixed. While one strand of literature suggests that the effect of bond issue announcements on stock prices is negative (see e.g. Godlewski et al. (2011); Spiess and Affleck-Graves (1999)), other studies have documented that bond issuances are associated with insignificant or even positive changes in stock market valuation (Miller and Puthenpurackal, 2005).

In this paper, we aim to extend the existing literature by examining whether the decision to issue public debt affects firm valuation. In contrast to the prior literature, we utilize cross-sectional panel regressions to empirically analyze the association between firm performance and the decision to issue bonds. Furthermore, this paper contributes to the literature by focusing on emerging debt markets. Besides other differences, there are distinct differences in corporate governance norms and practices between emerging and developed markets. For instance, strong corporate governance practices make it easier for even relatively small U.S. firms to reach the bond market. As a result of legally regulated