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The effect of sovereign wealth funds on the credit risk of their portfolio companies☆

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ABSTRACT

We study how sovereign wealth fund (SWF) investments affect the credit risk of target companies as measured by the change in their credit default swap (CDS) spreads around the investment announcement. We find that the CDS spread of target companies decreases, on average, following an SWF investment. The reduction in the CDS spread is higher when the SWF is established by a politically stable non-democratic country that has a neutral political relationship with the host country of the target company. Our results suggest that creditors expect SWFs to protect target companies from bankruptcy when it is in the interest of their home country to build political goodwill in the host country of the company.

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1. Introduction

In this work, we analyze the impact of sovereign wealth fund (SWF) investments on the credit risk of target companies. SWFs are government-owned investment vehicles that manage portfolios including foreign financial assets (IWG, 2008). Since the second half of the 2000s, SWFs have significantly increased in number and size and have been involved in a growing number of high-profile deals (SWF Institute, 2011; UNCTAD, 2008). The debate about the extent to which SWFs are beneficial or detrimental to their target companies has grown together with the importance of SWFs. The empirical evidence on the subject is, however, still underdeveloped.

One of the most interesting phenomena associated with SWFs, and the one that raises the greatest concerns, is that some of the political objectives of the governments behind SWFs may be transmitted to their funds (Keller, 2008). Concerns about the potential negative impact of SWFs have led several countries to introduce new regulatory proposals specifically targeting this

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class of investors (Monk, 2008). The academic literature has highlighted that the political dimension of SWFs is important in explaining their investment patterns (Dyck and Morse, 2011; Knill et al., 2012a) and their impact on the stock value of their portfolio companies (Dewenter et al., 2010). However, no study has yet analyzed how the political dimension of SWFs may affect the credit risk of their portfolio companies. Our study aims to fill this gap.

The literature shows that a government may have a political interest in preventing the bankruptcy of companies it owns, thus providing an implicit guarantee to creditors (Borisova and Megginson, 2011). Although SWFs may be more sheltered from political influence than other government-owned investment vehicles (Borisova et al., 2012), the protection against governmental influence is not perfect, and the empirical evidence shows that governments may use SWF investments as part of a broader political strategy to improve their political relations with other countries (Knill et al., 2012a). Political objectives may induce foreign governments, much like domestic governments, to prevent the bankruptcy of a portfolio company, thus creating political goodwill (Drezner, 2008).

The strength of the implicit guarantee to the creditors of SWF portfolio companies will depend on a number of factors that reflect the distinctive characteristics of the political objectives a SWF may serve. First, supporting a foreign distressed company may result in short-term losses for the SWF, which might raise political discontent at home. Accordingly, the implicit guarantee should be more credible when the SWF government is stable (i.e., when the threat posed by social protest is low) and when the SWF country is authoritarian (Cowhey, 1993; Drezner, 2008; Leeds, 1999).

Second, the implicit guarantee should be proportional to the expected gain from the political goodwill. The potential political gain is at its greatest when the relationship between the two countries is neither too strong nor too weak. On the one hand, when the two countries maintain a close bilateral relationship there is limited additional gain from using SWF investments to further improve the relationship. On the other hand, when the political distance between two countries is substantial the cooperative equilibrium that makes political goodwill valuable in the first place becomes unstable (Crescenzi, 2003).

We conduct our study on a sample of 391 SWF investments conducted between 2003 and 2010 in 198 companies. We gauge the impact of SWF investments on credit risk by measuring the change in the CDS spread of a target company in a window around the investment announcement, adjusted by the change in the CDS spread of companies in the same rating category (Hull et al., 2004; Jorion and Zhang, 2007; Norden and Weber, 2004). Our findings indicate that the CDS spread of target companies decreases, on average, when an SWF investment is announced. In a $[-1, +1]$ window around the investment announcement, the mean CDS abnormal decrease is 1.608 bps (p-value < 5%) for the 1-year maturity, 1.424 bps (p-value < 5%) for the 3-year maturity and 1.135 bps (p-value < 10%) for the 5-year maturity.

This evidence is robust when we use a different event window, an alternative benchmark to compute the abnormal decrease in the CDS spread (in which all companies are included, rather than only those with the same credit rating), and a matching procedure along the lines of Tykvová and Borell (2012) – using the main firm level determinants of SWF investments identified by Kotter and Lel (2011) – to control for endogeneity. Our findings show that the size of the reduction in the CDS spread is higher when the implicit guarantee provided by the SWF is stronger (i.e., when the originating country is stable and authoritarian and the relationship with the host country is neutral). Our results also suggest that the reduction in CDS spread is higher when the SWF is more transparent. These results hold across different subsamples and choices of the dependent variable.

The rest of the paper is organized as follows. Section 2 illustrates the theoretical background of the study. Section 3 describes the data and methodology. Section 4 reports the empirical results of the study. Finally, Section 5, concludes the paper.

2. SWFs and the credit risk of portfolio companies

2.1. SWFs as a new form of state capitalism

SWFs are a relatively new form of state capitalism (Lyons, 2007). While the first funds were established in the early 1950s, most SWFs are relatively new to the market (29 of the 51 SWFs in the (SWF Institute, 2011) were created in the 2000s), and the term SWF was only introduced in 2005 by (Rozanov, 2005). The most interesting novelty of SWFs as government-owned investment vehicles lies in their mandate to pursue (at least part of) their investments outside their national borders. This mandate represents a fundamental difference between SWFs and other government-linked investment vehicles and has important implications for the impact of SWFs on the credit risk of their portfolio companies.

There are four channels through which government ownership may affect creditors (Borisova and Megginson, 2011). First, government ownership may affect profitability. Second, a transition between state and private owners may cause organizational instability, leading to higher credit risk. Third, after acquiring a stake the state may cater to shareholder interests at the expense of creditors. Fourth, government ownership may provide an implicit guarantee to creditors. In this section, we will argue that the first three dimensions are likely to be of marginal significance to creditors when government ownership is acquired through an SWF.

The empirical literature finds that the operating performance of SWF target firms in the years following the investment is not significantly different from those of similar, non-invested companies (Kotter and Lel, 2011; Sojli and Tham, 2011). The impact of SWF ownership on creditors through organizational risk is also unlikely to be significant because SWFs are typically passive shareholders (Rose, 2008). Normally, SWFs acquire minority stakes in their target companies, especially when they invest abroad. In their analysis of a large sample of SWF investments, Dyck and Morse (2011) show that the median stake acquired by SWFs is 0.08% and investments above 5% of equity represent only 14.1% of cases for public equity in North America and 15.9% of the cases in Europe. Moreover, SWFs rarely request a seat on the board of directors (Bortolotti et al., 2013), and companies in which SWFs have invested do not exhibit higher-than-average management turnover (Kotter and Lel, 2011). Ultimately, SWFs are typically

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