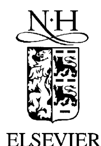

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Predation due to adverse selection in financial markets

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Abstract

An entrant can alleviate adverse selection problems in financial contracting by conditioning its own survival on future assessments made by financial markets. However, an incumbent may then engage in predatory behavior to try to adversely affect these markets' assessments and make exit more likely. We examine optimal financial contracting in the presence of this predatory threat, both when renegotiation is feasible, and when it is not. In contrast to previous literature, a contract that would be suboptimal in the absence of a predatory threat may optimally deter predation, even under competitive capital-markets and renegotiation.
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1. Introduction

In a well-known theory of predation (the "long-purse" theory), firms with ample financial resources drive financially constrained entrants out of the market by preying on them until these constraints are violated. In early versions (McGee, 1958; Telser, 1966), this theory lacked an explanation for a simple, yet fundamental question: Why do rational investors fail to do something in light of the predatory threat? Why do they not—for instance—simply lift the financial restrictions that render the entrant a vulnerable prey—and the incumbent a willing predator?

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Some imperfection in the capital-market is needed as a basis for answering these questions. In a seminal paper, Bolton and Scharfstein (1990) considered one such imperfection: they showed that the assumption that a firm's ex-post returns are imperfectly observable by outsiders can provide a rigorous rationale for the long-purse theory of predation. Yet, this assumption is sometimes difficult to justify in practice. Alternative assumptions on capital-market imperfections exist, which are widely used in the finance literature and which have yielded predictions supported by numerous empirical studies. A careful examination of the implications of such alternatives is needed, particularly when the importance of predation as a policy issue is considered. This paper is a contribution in this direction.

We examine the consequences on predation of outsiders having difficulty in assessing the ex-ante prospects of a project, rather than in monitoring its ex-post results. Models in which investors are ex-ante less informed about a firm than the firm itself have a long tradition in financial economics and have been used to explain a wide variety of corporate behavior, including capital-structure decisions (Myers and Majluf, 1984; Ross, 1977) and dividend policy (Bhattacharya, 1979; Miller and Rock, 1985). In our paper, this capital-market imperfection is at the core of predatory behavior: to mitigate the ex-ante informational asymmetry, an entrant may optimally condition its own survival—through the design of its financial liabilities—on future assessments by financial markets. A rival's predatory action aimed at adversely affecting these financial markets' assessments—and making exit more likely—may follow.

Bolton and Scharfstein (1990) showed—in a framework with ex-post hidden information—that investors may rationally commit to stop financing a firm if it performs poorly, and that this commitment may induce established rivals to engage in predatory behavior. They showed that when this predatory threat is taken into account, the equilibrium financial contract may, or may not, induce predation. Further work on this model (Faure-Grimaud, 1997; Snyder, 1996) analyzed the consequences of the potential renegotiation of financial contracts. Renegotiation weakens the ability of financial contracts to deter predation, which is then more likely to occur. Snyder (1996) showed that, with competitive capital-markets, predation is not deterred in equilibrium unless it is trivial to do so (i.e. the optimal financial contract in the absence of predation trivially deters predation).[1] In this class of models, therefore, financial contracts are strategically distorted to deter predation only if renegotiation is not feasible (Bolton and Scharfstein, 1990) or capital-markets are imperfectly competitive (Snyder, 1996).

In this paper we consider ex-ante asymmetric information as an alternative imperfection causing the firm's survival to depend on its performance. Assuming competitive capital-markets, we examine both cases: with renegotiation and without it.

[1] To gain some insight on why this is so, notice that the benefits of predation for the incumbent firm depend on the sensitivity of the entrant's refinancing decision to the entrant's performance. To dissuade the incumbent from preying, this sensitivity needs to be reduced. But, even in the absence of a predatory threat, this sensitivity is already as small as it can credibly be. Since the project has a positive NPV—and under competitive capital-markets the entrepreneur receives this value—the optimal date-zero contract maximizes the probability of refinancing. This probability is 1 if performance is good, and as high as is compatible with the provision of proper incentives, if the performance is bad. One cannot credibly contract a less likely refinancing decision after a good performance because such a contract would not be renegotiation-proof. One cannot raise the likelihood of refinancing after a bad performance either: it is already as high as the incentive problem allows.

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