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Does corporate governance influence convertible bond issuance?

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ABSTRACT

We examine the influence of corporate governance quality on firms' choice between convertible debt, straight debt, and equity using a Western European sample of security offerings made between 2000 and 2010. We find that weaker firm-specific and country-specific corporate governance quality increases firms' likelihood of issuing convertible debt instead of straight debt and common equity. We also find that stockholder reactions to convertible debt announcements are more favorable for firms with weaker corporate governance. Our results suggest that corporate governance quality is a significant security choice determinant, with firms using convertible debt as a substitute for high quality governance mechanisms.

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1. Introduction

In recent decades convertible debt has become a major financing source for companies around the world. However, despite a large body of empirical literature (Billingsley and Smith, 1996; Dong et al., 2012; Dorion et al., (2014–this issue); Dutordoir and Van de Gucht, 2009; Graham and Harvey, 2001; Lewis et al., 1999), firms' motives for issuing convertible debt remain unclear.

Our goal is to examine the impact of firms' corporate governance quality on their likelihood to issue convertible debt instead of straight debt or seasoned equity. The literature on convertible debt issuance motives predicts that convertibles can mitigate agency costs (Green, 1984; Isagawa, 2000; Lyandres and Zhdanov, (2014–this issue); Mayers, 1998) and adverse selection costs resulting from asymmetric information about firm value or risk (Brennan and Kraus, 1987; Brennan and Schwartz, 1988; Stein, 1992). The corporate governance literature, in turn, documents that governance mechanisms can reduce agency and adverse selection costs (Anderson et al., 2004; Becker-Blease and Irani, 2008; Bhojraj and Sengupta, 2003; Masulis et al., 2007).

We combine these two strands of literature to develop predictions on the relation between corporate governance quality and firms' likelihood to issue convertible debt. The Substitution hypothesis predicts that, since convertibles and high quality governance mechanisms are both able to reduce agency and adverse selection costs, firms with lower quality governance in place are more likely to issue convertible bonds instead of straight bonds or equity. In contrast, the Complementarity hypothesis assumes that firms with high quality governance are more likely to adopt financing strategies that further improve shareholder value. Given convertibles' potential to reduce agency and adverse selection costs, this yields the prediction that well governed firms are more inclined to issue convertibles instead of standard non-hybrid financing instruments.

While the Substitution and Complementarity hypotheses rely on the assumption that managers act in shareholders' interests, the Entrenchment hypothesis predicts that entrenched managers use convertibles to further insulate themselves from market discipline. We derive this hypothesis from Isagawa's (2002) rationale for convertible bond issuance. Isagawa (2002) argues that, like straight debt, convertible debt reduces the probability of a hostile takeover. However, unlike with straight debt, managers can

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avoid bankruptcy by forcing conversion of the bonds into equity by calling them. Convertibles may therefore help entrenched managers preserve their control benefits, even if this is not in shareholders' interests. Since managerial entrenchment is likely to be higher in firms with weaker corporate governance (Bebchuk et al., 2009; Berger et al., 1997), the Entrenchment hypothesis predicts a higher likelihood of convertible bond issuance by firms with weaker corporate governance.

Ultimately, therefore, the impact of corporate governance on a company's likelihood to choose convertible debt over standard financing instruments is an empirical question. To examine this question, we use a pan-Western European dataset of 176 convertible issues, 350 straight debt issues, and 141 seasoned equity issues made between 2000 and 2010. The European convertible debt market has experienced dramatic growth in recent decades (Bancel and Mittoo, 2004; Dutordoir and Van de Gucht, 2009) and the diversity of European regulatory environments creates a variety of corporate governance systems (Aggarwal et al., 2009; Shleifer and Vishny, 1997), enabling us to consider both internal (company-specific) and external (country-specific) corporate governance features (Doidge et al., 2007).

We hand collect data for seven internal and four external corporate governance characteristics. We analyze firms' security choices with multinomial logistic regressions including corporate governance measures and a range of firm-specific and macroeconomic control variables. Our focus on incremental security issues allows us to conduct the analysis with independent variables measured prior to security offering announcement dates, which has the advantage of mitigating endogeneity problems inherent to many corporate governance studies.

Our main results are as follows. Companies with weaker internal and external corporate governance quality are more likely to issue convertible debt than straight debt or seasoned equity. Among corporate governance quality proxies, the impact of the presence of large shareholders is particularly strong. Companies with large shareholders are significantly less likely to issue convertible debt than straight debt and seasoned equity. We also find a significant negative impact of a number of country-specific proxies for corporate governance quality on firms' likelihood of issuing convertible bonds.

The finding that firms with weaker corporate governance are more likely to issue convertible bonds instead of straight debt or equity is consistent with both the Substitution and Entrenchment hypotheses. To discriminate between these two hypotheses, we analyze the impact of corporate governance on stock returns around convertible bond announcements. Consistent with the Substitution hypothesis, we find that stockholders perceive convertibles as more valuable for firms with weaker corporate governance. Overall, our results indicate that corporate governance characteristics have a statistically and economically significant impact on firms' security choices, and security choice models should therefore incorporate these characteristics.

Our paper contributes to the literature on securities issuance by providing new insights into the so far unresolved question of why firms choose convertible bonds instead of straight bonds or equity.[1] Our key finding that firms with lower quality corporate governance mechanisms in place are more likely to issue convertibles instead of straight bonds or equity is consistent with theories predicting a role for convertibles in reducing the agency and adverse selection costs associated with non-hybrid financing instruments. In addition, to our knowledge, we are the first to empirically test Isagawa's (2002) rationale for convertible debt issuance.

Our paper also contributes to the corporate governance literature. While early studies examine individual corporate governance mechanisms in isolation, a more recent stream of articles documents that firms tend to use governance mechanisms as substitutes (e.g., Agrawal and Knoeber, 1996; Rediker and Seth, 1995; Rutherford et al., 2007; Singh and Davidson, 2003; Westphal and Zajac, 1994) or as complements (Cremers and Nair, 2005; Danielson and Karpoff, 2006; Schepker and Oh, forthcoming). A common feature of these studies is that they focus on traditional corporate governance measures such as board and ownership structure. Our findings suggest that researchers should consider convertible bond issuance as part of a bundle of corporate governance measures that serve to protect shareholder interests (Ward et al., 2009).

The remainder of the paper continues as follows. The next section reviews the relevant literature and develops the hypotheses. Section 3 describes the dataset and discusses the research methodology. Section 4 reports and discusses the empirical results. Section 5 concludes the paper.

2. Literature review and hypothesis development

Our hypotheses draw from three strands of literature: studies of the relation between convertible bond issuance and firms' financing costs, studies of the relation between corporate governance and firms' financing costs, and studies of the interdependency between corporate governance mechanisms. In this section, we first briefly review these relevant studies, and then formulate our testable predictions.

2.1. Convertible bond issuance as a tool to reduce agency and adverse selection costs

Theories of convertible bond issuance broadly subdivide into two groups. The first, largest group considers convertible debt as a solution to agency conflicts. Jensen (1986), Stulz (1990), and Hart and Moore (1995) argue that straight bonds can mitigate managerial overinvestment by reducing free cash flows and imposing the threat of bankruptcy. Consistent with these rationales, Berger et al. (1997), Morellec (2004), and Harvey et al. (2004) obtain empirical evidence suggesting that straight debt acts to reduce management's empire building tendencies. However, as Jensen et al. (1992) and Isagawa (2000) point out, straight debt

[1] Dutordoir et al. (2014–this issue) provide an extensive overview of empirical evidence on firms' motives to issue convertibles. Their overall conclusion is that this evidence is mixed and inconclusive.

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