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The mitigating effect of bank financing on shareholder value and firm policies following rating downgrades

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Abstract

We document that shareholders of high-yield firms are less sensitive to credit rating downgrades the higher the proportion of bank financing in the firm. This positive effect is linked to firm behavior. In the year after the downgrade, high-yield firms with large bank debt ratios i) need to reduce their leverage less, and ii) display higher capital expenditures, compared to peers that rely relatively more on other sources of debt. Bank financing thus helps alleviate the adverse effects of rating downgrades on shareholders and firms in the high-yield segment. As such, one may view our findings as new evidence of the “specialness” and flexibility of bank debt.

Keywords: Credit ratings, Bank financing, Shareholder value, Firm leverage, Firm investments

JEL Codes: G14, G24, G32

1. Introduction

The importance of credit ratings for firms is a well-established fact. Whether ratings represent a valuable source of information on the creditworthiness of the issuer or merely an indicator to

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