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Why Takeover Vulnerability Matters to Debtholders

by Joan Farre-Mensa

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About the Author



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Abstract

Recent work documents that firms that are more vulnerable to takeover have higher borrowing costs. This paper investigates the reasons behind this stylized fact. My results show that firms with few antitakeover defenses face a higher cost of debt because lenders are concerned that takeovers may result in leverage increases. Specifically, I find that takeover vulnerability does not increase loan spreads when the loan deal contains covenants restricting leverage. In order to identify the effect of covenants on spreads, I use two instruments to control for the endogeneity of covenants, which arises from the fact that lenders are more likely to include covenants when lending to riskier firms. My first instrument exploits exogenous supply-side variation in the contracting strictness of the lead-arranger lender, induced by lender-specific factors such as the rate of past defaults suffered by the bank in unrelated loans. My second instrument makes use of the relation between syndicate size and the likelihood that a given loan includes covenants. This instrument exploits exogenous variation in the contribution of the deal to the idiosyncratic risk of the lead bank's loan portfolio. The identifying assumption is that lead banks tend to include covenants in those loans whose risk has a higher correlation with the risk of their existing portfolio, so that they can syndicate a larger share of such loans. Overall, my findings show how debt covenants can successfully resolve agency conflicts between shareholders and debtholders. In the absence of covenants, takeover defenses have opposite effects on the cost of equity and debt capital. Yet this difference disappears when debt deals contain leverage-limiting covenants.

Keywords: [Acquisition](#); [Borrowing and Debt](#); [Cost](#); [Equity](#); [Banks and Banking](#); [Investment Portfolio](#); [Risk Management](#); [Agreements and Arrangements](#); [Business and Shareholder Relations](#); [Conflict and Resolution](#);

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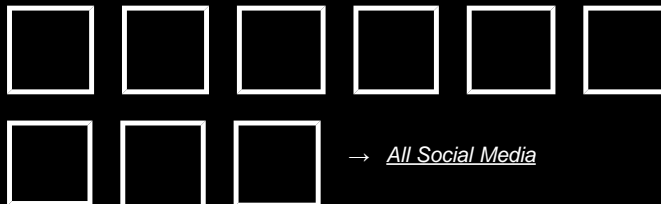
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