The Spillover Effect of Debt Covenants: LBO loans

A company's shareholders own the company, so they have control over how the company operates. For creditors of the company, it might be less obvious they have an active role in firm's operating policy when the company is not *in default*. However, many researchers have found that through debt (of that company) covenant (contract), creditors can have such power as well! Note that the above relation is between borrower's (that company) operation and debt covenant.

This paper introduce a new dimension by analyzing whether and how industry incumbents' financing and operating policies can be changed in response to the *distance* between borrowers' debt covenant and *covenant threshold* permitted by the loan contract.

Specifically, the authors focus on *leveraged buyout (LBO) loan contracts*, and they will answer three questions. The questions, along with how they reach the conclusions by hypothesis testing, are presented below, respectively:
(Note that the hypothesis testing should be done orderly.)

(1) Can LBO borrowers' being capable or incapable to comply with financial covenant have *spillover effect* on industry incumbents?

Hypothesis 1 (There exists spillover effect): Existing firms' cost of issuing debt can be affected by LBO borrowers' being capable or incapable to comply with financial covenants.

Hypothesis 1b (It's a negative spillover effect) When the LBO borrowers' *covenant slack* increases, the (other) existing firms' net debt issuance and book leverage decrease.

Hypothesis 1a (The spillover effect is positive): ...

The LBO loans data, which contains the information including firm's cost of issuing debt and LBO borrowers' financial states, LBO borrowers' covenant slack and so on, is collected from DealScan database. We then run the regression model (the specification is not provided in this briefing) to test the hypothesis. Since this is exactly how we do in the rest of the article, we wouldn't repeat the method.

The authors find that there's negative spillover effect.

(2) Why the spillover effect can exist?

They find (through the regression model) that the spillover effect can exist because the creditors' (lenders) behavior change according to their LBO borrowers' ability to comply the debt contract. When the creditors have other borrowers in the industry, this fact will affects these borrowers' contract. That's why spillover effect can exist.

(3) What impact (if any) do LBO borrowers' being less restricted or more restricted to financial covenant have on industry incumbents?

When LBO borrowers have more covenant slack in one year after the loan contract, other firms in the same industry can experience significant decreases in operating income growth and sales growth. Incumbent firms can increase their cash holdings and have smaller firm size when LBO borrowers are not in technical default.

From (2), and (3), the implications is that for industry incumbents, they should understand the potential impact on their financing policies when there is a LBO loan made by *same loan lenders* in their industries and that they should realize that their operating performance can become worse when LBO borrowers with the same loan lenders have more covenant slack. Also, if you are a stock investor, you know you can pay attention on

the firms with the same loan lenders in the industry in order to have more insight for the firm's value.
leveraged: You borrow money to do something.
leveraged buyout (LBO) loan contracts: If you own a company, you borrow money (leveraged) to buyout (buy) the other company. Then LBO loan contracts is the contract you sign up when you borrow the money.
spillover effect (here): The spillover effect on the cost of issuing debt happens when a borrower violate the contract and other existing firms's cost of issuing debt changes.
covenant slack, covenant threshold: Covenant means contract. When you borrow money from some lender, for the lender to feel safe about your ability to make the repayment, you two need to make a deal on the limitation on how you will operate your company in case your operating policy exposes the creditors to unnecessary risk. Such a limitation includes, for example, "interests coverage rate, book leverage (will show up in your accounting book from seasons to seasons) are not allowed to be too large or too small". This kind of threshold limitation will be a specific number which is called covenant threshold. Combining with the real accounting result after you sign up the contract, we can calculate an index about how much quota you can troll on till your company will be in *technical default*. Roughly, this index calls covenant slack (it's a noun!).
technical default: If you borrow money from someone else, and you fail to repay, we say you are "in default". However, if you just breach some limitations in the contract, and you still may or may not be able to repay the borrowing, we say you are simply "in technical default". In practice, there will be renegotiation, and this is one of the moment creditors (lender,s rich people) can have control over how a company operates.
distance: How much you can troll before your company are in technical default.
"have same loan lenders": if me and you are firms in the same industry, and we both borrow (have a debt contract with) money from one (same) lender, we say me and you have same loan lenders. This lender could be a person, another company, and so on.