The Effect of Size, Book-to-Market Ratio, and Prior Distress Information on the Excess Returns to Debt Restructuring Firms

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Abstract:
The paper examines the intertemporal and cross-sectional excess return patterns in financially distressed firms that attempt to restructure their debt privately. As suggested by the the economics of the troubled debt restructuring (TDR) transaction, the equityholders' call and put options on the firms' assets, and the findings of prior financial distress research, significantly positive announcement and post-announcement excess returns accrue to the shareholders as their firms renegotiate.

However, an analyis of the financial profiles of the 86 TDR firms and a matching sample of 86 non-TDR, non-bankrupt firms reveals that the TDR sample is composed of small-to-medium sized, high leveraged firms with high or negative book-to-market equity (BTM) and acute liquidity and profitability problems, establishing these ex-ante characteristics as confounding factors likely to explain the positive market reaction results. Accordingly, size and BTM are used to control for the negative size and the positive BTM effects on returns, regardless of what the explanation for these anomalies might be, while the net benefits to shareholders and the effect of prior distress information availability on the excess returns to TDR firms are tested.

The findings support the basic hypotheses of the study. First several proxies to measure the exit values of assets are not found to be higher in the TDR sample than in the matched sample, indicating that higher abandonment option values could not have been the reason for the abnormal returns observed only in the TDR sample. Second, market reaction tests performed on sample partitions reveal that the excess returns are greater for larger, low book-to-market firms and firms that have larger pre-announcement stock price declines and other distress signals such as deratings, covenant violations, and qualified opinions. The finding of this anomalous-signed positive size and negative BTM effect, also confirmed by cross-sectional regressions of the excess returns on these control variables, a TDR dummy variable and their interactions, corroborates that the abnormal returns are not merely a compensation for higher risk or due to market mispricing of these value stocks. Instead, the announcement seems to provide an unexpected, favorable signal for larger firms whose financial distress has already been disseminated.

Keywords: Troubled debt restructuring, financial distress, abandonment option, size, book-to-market