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Credit watch and capital structure

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Abstract

We study the capital structure reactions of firms that have been added to Standard & Poor's (S&P's) CreditWatch list in order to test the role of credit ratings in firm financial decisions. Survey evidence by Graham and Harvey (2001) indicates that Chief Financial Officers (CFOs) consider credit ratings as the second most important determinant of financing policy. If credit ratings are indeed important, we should observe that firms facing a potential downgrade should react by reducing debt financing in an attempt to avert the potential rating downgrade. In the case of a potential upgrade, we should also observe a scaling back of debt financing to reinforce the rating upgrade. We find evidence for the latter but for potential downgrade firms, contrary to expectations; we find that these firms issue more debt relative to equity. Overall, we conclude that while credit ratings may be a consideration in determining corporate financing policy, it is probably a secondary determinant.

Keywords:

credit watch credit ratings capital structure

JEL Classification:

G14 G24 G32

Notes

[1] Michelsen and Klein (2012) also examine leverage changes following CreditWatch placements. However, we look at quarterly reactions to a credit watch addition – the quarters of the action and also around the action. Michelsen and Klein look at the financials in the year of a credit watch action. Credit watch actions by definition have a shelf life of 90 days and an examination of the quarters of and around an action may be more revealing.

[2] We also examine net debt issuance behaviour in the second quarter following the CreditWatch action but do not detect any differential financing behaviour for firms with either 'positive' or 'negative' placement.

[3] Though not reported, we also zero in on BBB firms with a 'minus' sub-rating, that is, the firms nearest to losing their investment grade status. For these firms, we find that the 'negative' Watch designation is not associated with any significant change in the marginal debt financing. We also examine other broad ratings (AA, A, BB, B, CCC). We find positive, significant coefficients for firms with a 'negative' CreditWatch dummy occur for ratings classes A and B. In the case of firms with 'positive' Watch placements, we observe significant declines in debt financing in A- and BBB-rating groups suggesting that these firms reduce debt financing at the margin with the prospect of an improved rating in the future. Overall, these results mirror those reported for the full sample and we therefore cannot conclude that firms are adjusting their capital structure to preserve their investment grade status.