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Mandatory Convertibles and Shareholders Incentives

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1 Introduction

A relative large proportion of the academic literature about the agency dilemma studies corporate governance or the instruments that can balance the incentives of shareholders and debt holders. This article studies a balance sheet instrument, the mandatory convertible bond (MCB), as a means to increase the value for shareholders, without reducing the bondholders claim. Following the options valuations theories, one way to increase the value for shareholders is to increase the risk of the firm that in turn reduces the value for bondholders. MCB are equity instruments, therefore the increase in shareholders' value comes at the expense of MCB holders, not of bondholders.

2 Objectives

This research intends to study the influence of the issuance MCB in company credit perception and risk shifting. The theoretical framework predicts that companies that include MCBs as a balance sheet instrument can increase the shareholders' value by increasing the company risk, without deteriorating credit metrics.

3 Methods

Multinomial logit regression and standard multinomial regression models analysis of data from 81 MCB issued between 2010 and 2018. For the regression analyses we have used the following ratios: Senior Credit Spread, Dividend Yield, Equity Volatility, Debt to Market Cap, Cash Ratio, and Net Debt to EBITDA.

4 Results

Despite the limited number of modern convertible bonds issued since 2010, the empirical results seem to partially confirm the hypothesis. As predicted by the model, risk shift increased in more than 1% after the issuance of MCB. The logistic regression model shows a 62% predictive power. The multivariable regression shows that volatility is, as in the hypothesis, positively correlated with the existence of a MCB in the company balance sheet.

5 Conclusion

The scientific literature about the influence of capital instruments in the agency dilemma is scarce. This research shows how on average the companies that issued MCB reduced its credit spread increasing at the same time its leverage ratios, increasing volatility, probably implying the investment in risky projects that can add value to shareholders without reducing debtholders' claims.

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