“Debt covenants and the value of commitment”

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Chair: Prof. Roberto Savona

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We analyze the value of shareholders’ commitment created by empirically observed debt covenants. We show that the renegotiation following covenant violation improves the ex post firm value at an ex ante cost and can lead to value losses similar to those under no commitment. Therefore, renegotiation frictions are key for covenants to increase the ex ante firm value. In an dynamic model, the main driver of the value loss is the no-commitment issue and the rigid debt policy ensuing from it. Hence, covenants that discipline the leverage improve firm value the most because they restore the flexibility of the debt policy. Instead, debt and asset sweeps, which are designed as ex post debt protections, are less efficient because they do not discipline the leverage policy. An efficient covenant has positive effects also on firm investment, and alleviate the agency conflicts between existing claim holders.