ABSTRACT

This paper investigates the common stock price reaction at the announcement of the issuance of high-yield straight debt. The two-day announcement period abnormal returns are not different from zero for the 164 bond issues in the sample. No difference is found between announcement period abnormal returns of firms with bonds that default and firms with bonds that do not default. Results from statistical tests indicate that the announcement period abnormal returns are not explained by issuance year, bond-rate class, underwriter, issuance size, takeover activity or prior high-yield debt issuance experience. The findings are not consistent with the models by Miller and Rock (1985), Jensen (1986), Myers and Majluf (1984) and Krasker (1986). However, results indicate that existing stockholders are not harmed or helped by the issuance of the high-yield straight debt.

Introduction

The 1980s was a period of increased use of high-yield debt securities. The downturn in the economy in 1990 resulted in an increase in the default rate on corporate bonds. This study examines the impact of the issuance of high-yield debt on common-stock prices and the ability of the market to anticipate bond default. The Smith (1986) summary of the security-issuance literature reports that the stock-price reaction to straight debt issues is not statistically different from zero; however, abnormal returns of equity and convertible debt issues are consistently found to be negative. Most of the prior research on the impact of debt offerings on the value of the firm has involved firms which are able to offer investment-grade debt to the public. This research extends that analysis to common-stock shareholders of firms.
issuing high-yield debt and examines the relationship between stock-price reaction and a set of explanatory variables.

The primary goal of this study is to analyze the price reaction of a firm's common stock in the period around the announcement of the issuance of high-yield straight debt. Possible reasons for the observed insignificant announcement-period-price reaction to debt offerings are investigated. The stock market's ability to anticipate default is analyzed by comparing the common-stock-price reaction to the high-yield debt issues that default to the price reaction of issues that do not default within the period studied. Also examined is the difference in stock price reaction based on bond rating, underwriter, issuance size, takeover activity, prior issuances of high-yield debt, and issuance year. Specifically, the following research questions are addressed in this study:

1. What is the firm's common-stock-price reaction at the issuance announcement of high-yield straight debt?
2. Does the common-stock price react differently for high-yield bond issuances that default than to those that do not default?
3. Does the common-stock price react more to lower rated high-yield bonds than to higher rated (riskier) high-yield bond issuances?
4. Does the common-stock price react differently to high-yield bond issues when Drexel Burnham Lambert participates in the issuance?
5. Does the common-stock price react differently for large issues of high-yield bonds?
6. Does the common-stock price react differently if funds are used to finance a takeover?
7. Does the common-stock price react differently to firms with previously issued high-yield bonds outstanding?
8. Does the common-stock price react differently depending on the issuance year?

Because of the increased use of high-yield debt in the 1980s and the continuation of high-yield bond offerings in the 1990s, individual and institutional investors need a better understanding of the nature of high-yield bonds. Even if the investor does not hold the high-yield bond directly, but instead holds the common stock, the effect of issuing the high-yield bond may impact the firm. Further, corporate managers need to know the impact of issuing high-yield debt to make wealth-maximizing decisions. Finally, the issuance of high-yield debt is useful in making inferences about capital-structure models.

It is found that the two-day cumulative abnormal return at the issuance announcement for the sample of 164 high-yield bonds is not significantly different from zero. The common stock price reaction is similar for bonds that default eventually and those that do not default. Thus, the stock market is not able to anticipate default at the bond-issuance announcement. Results also indicate no