Private Equity and Debt Contract Enforcement: Evidence from Covenant Violations

Sharjil Haque **Anya Kleymenova**

Discussion by

Taha Ahsin
University of Pittsburgh

Financial Management Association Annual Meeting
October 2023

Summary

- Question
  - How does PE-sponsorship affect loan outcomes?

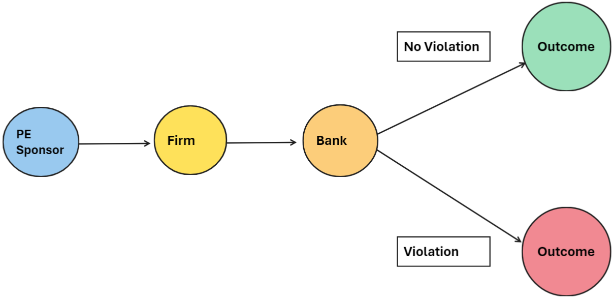
- Approach
  - Instrumental variables approach exploiting supervisor leniency
  - Compare outcomes across violation and PE-sponsorship

- Key Results
  - PE-sponsored firms violate covenants more often
  - PE backing leads to better outcomes following violation
  - Channels: Lender health and PE reputation

- Comments
  - Selection
  - Summary Statistics
  - Secondary Markets

Selection

- **Problem**: Endogenous selection of firms, violations, and outcomes



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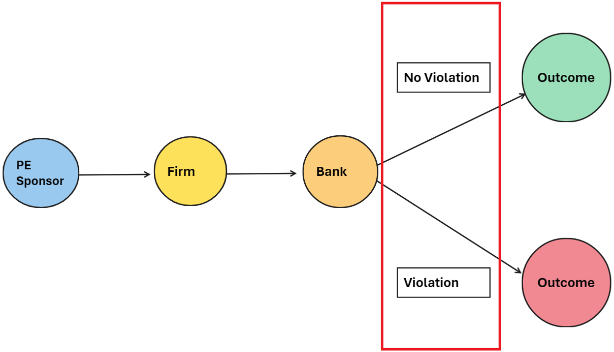

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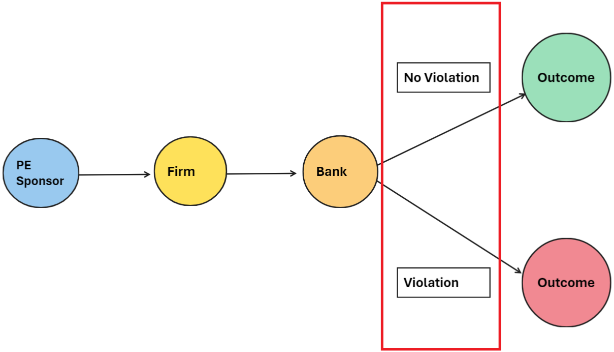

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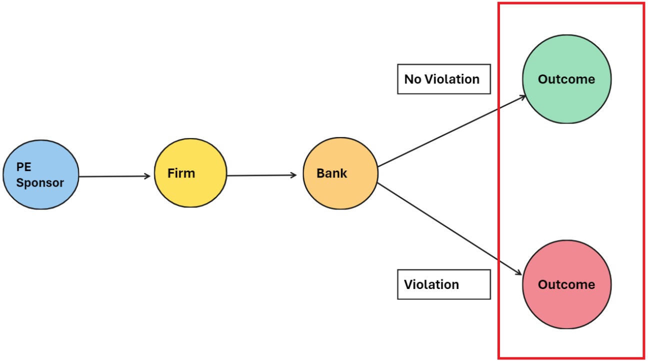

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    - PE-sponsored firms are chosen to survive violations better
    - Outcomes appear better for PE-sponsored firms due to selection

Alternative Narrative

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- Null Hypothesis: PE selects better firms
- Evidence appears consistent with the null
    - PE firms receive better terms due to ability to survive violations
    - PE firms with good lenders are better able to survive violations
    - High-rep sponsors find better firms to survive violations

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    - **Key**: Fails to reject the null despite exogenous violations

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  $\Rightarrow$ Test outcomes conditional on violation

  $\Rightarrow$ Measure response to change in PE-sponsor's reputation unrelated to violation

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Summary Statistics

- Testing the exclusion restriction
  - Should PE sponsors recognize when the terms appear more strict?
  - Can the bank communicate leniency to the PE sponsor or borrower?
  - Are the timing of deals and change in supervisor leniency correlated?
- Measuring sponsor reputation
  - Currently using outstanding LBO deals for High Exposure
  - More relevant to measure **past** history of Sponsor-Lender interaction

Secondary Market

- Rich literature on loan sales and distressed debt

  Hotchkiss and Mooradian (1997), Drucker and Puri (2008), Ivashina, Iverson, and Smith (2016), Irani and Meisenzahl (2017), Adelino et al. (2019), Irani et al. (2020), Kundu (2021), Elkamhi and Nozawa (2022), Giannetti and Meisenszahl (2021)

- Key questions regarding PE-sponsored firm debt:
  - How often do PE sponsors selling portfolio firms after a violation?
  - Do lenders account for ex-post violation by selling debt instead of renegotiating?

Conclusion

- Explores novel topic in the value of PE-sponsorship
- Rich data and clever research design
- Important to address lingering endogeneity concerns