“Debt Covenants and Capital Structure: Evidence from an Exogenous Shock to Debt Capacity”

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Abstract

We utilize an exogenous accounting-based shock to the distance to covenant violation to explore the relation between debt capacity, capital structure, and investment. We find that the shock to debt capacity led to an increase in leverage. The increase was highest for firms that were close to violating the affected covenants, and that were otherwise financially unconstrained. We also examine how the additional debt affected firms’ financial behavior and find that it did not result in an increase in investments or cash holdings, but rather was associated with lower profitability and lower likelihood to enter default or bankruptcy. Some firms even maintained or increased their dividend payouts.