

Report Type

Mid Term Award Report

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Project Title

Why Do Firms Buy Back Their Debt?

Project Start Date

Sep 01, 2017

Project End Date

Sep 01, 2018

Project Abstract

Anecdotal evidence suggests that firms buy back debt to de-leverage, but recent studies of the leverage-ratchet effect show otherwise. Building a dynamic model a la Leland and Toft (1996), we study the incentives for equity holders to buy back the debt, and reconcile the theory with empirical observations. Buying back debt transfers value from bondholders to equity holders; the transfer incentivizes equity holders to choose a lower default boundary, which, in turn, reduces debt overhang and increases return to equity. As such, debt buybacks improve a firm's credit conditions. We also analyze the effect of market liquidity on debt buybacks.

Activities and Achievement

Anecdotal evidence suggests that firms buy back debt to de-leverage, but recent studies of the leverage-ratchet effect show otherwise. Building a dynamic model a la Leland and Toft (1996), we study the incentives for equity holders to buy back the debt, and reconcile the theory with empirical observations. Buying back debt transfers value from bondholders to equity holders; the transfer incentivizes equity holders to choose a lower default boundary, which, in turn, reduces debt overhang and increases return to equity. As such, debt buybacks improve a firm's credit conditions. We also analyze the effect of market liquidity on debt buybacks.

The paper has been presented during several conferences, including Midwest Finance Association Annual Conference, American Finance Association Annual Conference and Southwest Finance Association Annual Conference.

Dissemination

The paper has been submitted to a journal and is currently under review.

Outputs

Major Difficulties and Any Other Issues

Several feedback from the conference presentations suggests including empirical evidence. I am working on it to include it in the paper. Perhaps, the empirical evidence can be developed into a separate paper.

Web Links

<https://frankxu1987.weebly.com/uploads/6/2/5/8/62583677/earlyfin.pdf>