Product Market Competition and Financing Costs*

Philip Valta†

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Abstract

I empirically investigate how the intensity of product market competition impacts the pricing of corporate debt. Using a large sample of loans to publicly traded US firms, I find evidence that the intensification of product market competition significantly increases the cost of bank debt. Further investigations reveal that this effect is strongest for firms in risky industries and in industries with low asset liquidation values. These results are consistent with the predictions of recent equilibrium models which show that a more intense product market competition affects loan spreads by increasing the firms’ cash flow risk and by decreasing the firms’ liquidation values. Moreover, I find that loans to firms that operate in more competitive environments contain more covenants restricting the firms’ financing and dividend policies. In sum, the results suggest that banks explicitly take into account the risk arising from product market competition when they price debt contracts.

Keywords: Product Market Competition, Bank Loans, Financing Costs, Financial Contracts

JEL Classification: G32, G34

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†Swiss Finance Institute and Ecole Polytechnique Fédéral de Lausanne, Extranef Building, 1015 Lausanne, Switzerland. Tel.: +41 21 693 0123; Fax.: +41 21 693 0020; E-mail: philip.valta@epfl.ch; Web: http://people.epfl.ch/philip.valta.