Anticipating binding constraints: 
an analysis of financial covenants

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September 30, 2022

Abstract

This paper documents evidence that the anticipation of future covenant violations affects firm investment and borrowing decisions. Applying textual analysis to earnings call transcripts, I construct a novel measure of anticipated covenant violations by distinguishing between discussions of covenants that relate to the future as opposed to the past or present. Firms that anticipate covenant violations reduce their investment and debt issuance prior to an actual violation. To disentangle the response due to the constraint from unobserved changes in productivity, I calibrate a theoretical model to firm-level data and study the dynamics of investment and debt issuance around violations relative to an unconstrained firm facing an identical path of productivity shocks. Results from model simulations confirm a sizeable reduction in investments and net debt issuance in anticipation of covenant violations.

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