THE JOURNAL OF FINANCE • VOL. LIX, NO. 1 • FEBRUARY 2004

Convertible Bond Design and Capital Investment: The Role of Call Provisions

TIMO P. KORKEAMAKI and WILLIAM T. MOORE*

ABSTRACT

If firms issue convertible securities to facilitate sequential investment, the securities should be engineered to give sufficient flexibility to accommodate timing of follow-on investment. We examine call provisions in convertible bonds and argue that firms with investment options expected to expire sooner (later) will offer weaker (stronger) call protection. We find that issues with weak or no call protection are offered by firms that invest greater amounts soon after issuance than those issuing convertibles with strong protection. Moreover, capital expenditure levels during the 5-year period following issuance are inversely related to the length of call-protection periods.

MOST CONVERTIBLE BONDS AND NOTES have call provisions, and most provisions have important qualifications or protection. Broadly speaking, convertibles may have absolute protection (not callable), hard call protection (noncallable for a specified period), provisional or soft call protection (callable if certain conditions on stock price are met), or no protection (callable anytime). In this study, we investigate the relations between the strength and length of call protection and firms' subsequent investment behavior.

Our hypothesis is a natural implication of the sequential financing motive for convertible debt financing. For example, in Mayers (1998), firms finance their planned multistage investment programs with convertibles. Besides Mayers' sequential financing motive, other explanations for convertible financing include theories based on post-issuance risk shifting (Jensen and Meckling (1976), Green (1984)), heterogeneous risk assessment (Brennan and Schwartz (1988)), and asymmetric information (Stein (1992)). In a recent study, Lewis, Rogalski, and Seward (2001) offer an explanation based on equity market rationing.

Stein's (1992) model has at least an implicit role for callability, but we believe Mayers' explanation has direct implications for the nature of call provisions that we examine here. He argues that convertible financing is well suited to

*Korkeamaki is with Gonzaga University and Moore is with the University of South Carolina. We thank an anonymous reviewer for careful guidance from which the study has benefited greatly. We also wish to express our sincere gratitude to Mary Bange, Jan Breuer, John Finnerty, Scott Harrington, Eric Johnson, Chuck Kwok, Steve Mann, Greg Niehaus, Eric Powers, David Shrider, Jeremy Stein, Solomon Tadesse, Sergey Tsyplakov, and Jeff Woolridge for helpful comments and guidance, and to Ellen Roueche for help in preparation of this manuscript. Special thanks to the editor, Rick Green, for his comments and guidance. We gratefully acknowledge valuable comments from participants at a 2002 joint seminar of the Swedish School of Economics and Business Administration and the Helsinki School of Economics.