Banks' Screening of Startups: The Role of Initial Leverage

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Speaker:
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Abstract:

Banks provide substantial financing to startups despite severe asymmetric information. As a result, we find that banks' credit allocation among startups is mechanically related to startups' ex-post performance. Startups with a lower first leverage ratio (initial leverage) perform better ex post, even controlling for observables available to banks at the time of origination, such as startups' credit score, entrepreneurial wealth and education, and startup size. This effect is larger when banks have a higher incentive to screen - in more concentrated lending markets and for corporate loans, in which startups enjoy limited liability. To interpret these facts, we propose a model in which initial leverage captures information about startups' future growth prospects in equilibrium.

The initial leverage of startups also predicts their duration and subsequent leverage, and such predictability is stronger in more concentrated lending markets.