Pricing Strategy and Corporate Bond Value: Evidence from the Airline Industry

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ABSTRACT

Pricing strategy is expected to impose profound impacts on a firm’s cash flow and default risk. However, little research has been done to examine its direct impacts on financial markets. Applying event study methodology on the airline industry data, this paper aims to fill this gap by investigating whether and how corporate bond value is affected by pricing cut events in the airline industry in various time windows. The authors’ empirical results find significant positive abnormal bond returns in the announcement month. However, the price effect becomes insignificant and vanishes in the following months. By integrating financial market and marketing behavior analysis, this paper provides managerial insights for both marketing managers and corporate bond investors.

Keywords: Abnormal Bond Returns, Airline Industry, Corporate Bond Market, Event Study, Pricing Strategy

INTRODUCTION

Pricing strategy refers to how a firm employs the prices of its product and service to achieve its strategic goals, such as optimizing profits, maximizing revenues, increasing market shares, or merely surviving in the market. Probably the most effective profit level and revenue generator, pricing strategy is predicted to impose profound influence on the firm’s performance in financial markets. However, little research has been done in this important field. A notable exception is van Heerde, Gijsbrechts, and Pawwels’ (2008) study of a price war in Dutch retail industry, where a leading retail chain is found to outperform the stock market by initiating store-wide price promotions. However, to our best knowledge, there is no previous research on the relationship between pricing strategy and corporate bond market. Using data from the airline industry, this paper aims to fill this gap by examining the direct impact of pricing strategy on the corporate bond market. Specifically, this paper addresses two important exploratory issues: First, does abnormal bond return exist in the corporate bond market as a reaction to the announcement of pricing strategy? If so, second, how the magnitude of price effect changes in different time windows? Or,
is there any difference between short-term and long-term abnormal bond returns?

Evaluating the impact of pricing strategy on the corporate bond market will considerably extend our understanding of this important business tool beyond the stock market. First of all, the corporate bond market has grown to the most important source of external funds for many companies. According to the Security Industry and Financial Markets Association, U.S. corporate bond issuance increased about 40% from a year ago to a record-setting $1.05 trillion dollars in 2006 (http://archives1.sifma.org/story.asp?id=2793) outstripping the equity market by a wide margin. Comparing to the stock market, however, the corporate bond market received much less attention in the literature mainly due to lack of quality data (Warga & Welch, 1993). Second, the characteristic difference between the corporate bond market and the stock market is worthy of further investigation. Unlike stockholders who focus mainly on the firm’s projected profits, bondholders value their assets more on investment security, such as the firm’s default risk and stability of expected cash flows. Therefore, the corporate bond market should be sensitive to any announcement affecting the firm’s anticipated cash flow and total revenue. Unfavorable announcement will result in a broad sell-off in the market and decrease the bond value.

In this paper, the airline industry is selected for empirical study because of the following considerations. First, the airline industry historically is a debt-loaded business. To finance their aircraft purchases and business operations, airline companies rely heavily on the corporate bond market. For example, Emirates airline issued $413.7 million bond to finance a purchase of three new Boeing 777 aircrafts in October 2009. As Brain Jeffery, the senior vice president and the corporate treasury at Emirates, said in a news press, “we believe bond markets represent an important source of capital for the airline industry in general and for Emirates in particular” (“Emirates Airline issues US$413.7 million,” 2009). In addition, the corporate bond market sometimes is critical for airlines’ survival, especially considering their junk-level credit ratings. As one of the most recent examples, Japan Airlines filed for bankruptcy on January 19, 2010, when it defaulted on a $740 million corporate bond. Second, throat-cutting pricing strategy has become one of the most effective marketing tools in the airline industry since the U.S. Congress passed the Airline Deregulation Act of 1978 to remove regulator restrictions on ticket fare and market entry. Morrison and Winston (1996) estimate that the price competition has substantially reduced industry profits by $8 billion from 1979 to 1995 for the airline industry. Last but not least, pricing cut events in the airline industry are relatively easy to observe in business headlines, making it possible to construct a sizable dataset to perform meaningful statistical analysis.

The remainder of this paper is organized as follows. We first review relevant literature and develop research hypotheses in the context of the airline industry. Then we discuss the data sources and the research methodology. The empirical results are then presented and analyzed in the subsequent section. We conclude with a general discussion of the findings and suggest future research directions.

LITERATURE REVIEW

The inter-connection between product market and financial market has been of interests for both academic scholars and industrial practitioners for a long time. The main focus of this research field is to investigate whether and to what extent these two important markets influence each other. Naturally, academic literature can be classified into two research streams. The purpose of one research stream is to demonstrate the impact of a firm’s financial structure on its decision making in product market, especially product pricing and output choices. For example, Philips (1995) finds that, in three of the four industries he examined, product price and operating margins are positively associated with financial leverage levels, while product output and market share are negatively associated with
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