International Review of Financial Analysis 60 (2018) 87–97

Contents lists available at ScienceDirect

International Review of Financial Analysis

journal homepage: www.elsevier.com/locate/irfa

Asset sales and subsequent acquisitions☆

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ARTICLE INFO

JEL:
G34

Keywords:
Asset sale
Acquisition
Retention
Payout
Announcement return

ABSTRACT

In this paper, we find that the decisions to retain asset sale proceeds are positively related to the likelihood of subsequent acquisitions. We demonstrate that retention decisions destroy the wealth of shareholders. First, we document negative market reactions towards a retention decision, and the effect is more pronounced when the decision is followed by an unexpected acquisition. Second, we show that subsequent acquisitions reduce the wealth of shareholders, especially when the acquisitions are unexpected by the market. Third, retention sellers' long-run performance declines when they pursue an acquisition following the sale of their assets. Altogether, we provide novel evidence suggesting that retention sellers tend to reallocate proceeds to specific acquisitions that are detrimental to shareholders' wealth.

1. Introduction

From 1990 to 2014, more than 17,000 inter-corporate asset transactions, whose value placed over $2.5 trillion, were completed in the U.S. alone.[1] Firms often reap a large amount of cash following asset sales (Eckbo & Kisser, 2014; Edmans & Mann, 2018). In 2014, asset sales generated $74.3 billion in cash, which equals an average increase of $305 million in cash per transaction. Cash proceeds are often used by managers to fund subsequent acquisitions (John & Ofek, 1995; Kaplan & Weisbach, 1992; Mavis, McNamee, Petmezas, & Travlos, 2016). For example, in 1999, Ackerley Group Inc. divested its Miami Billboard Bus segment and obtained $300 million cash. Denis Curley, the company's CEO, stated that the proceeds from its asset sale were to fuel future acquisitions consistent with the company's cluster strategies including the broadcast, outdoor, and sports and entertainment markets.[2] In a similar fashion, Boston Scientific Corporation sold its stroke-treating neurovascular business in 2010 and received $1.2 billion proceeds after tax to finance subsequent acquisitions. Shortly after the asset sale, the corporation bided Sadra Medical, Inc., which was based in Los Gatos for $193 million and acquired Cameron Health, Inc. for $1.3 billion in 2011 and 2012, respectively. Although the existing literature has acknowledged that asset sale proceeds are one of the important financial sources to fund corporate acquisitions (e.g., John & Ofek, 1995; Kaplan & Weisbach, 1992; Mavis et al., 2016),[3] there is little understanding about the decision of a firm to divest its assets and finance following acquisitions, and how it affects the wealth of shareholders and the firm's long-term performance.

In this paper, we aim to fill in the gaps in the existing literature and tackle two questions, specifically whether: firstly, asset sale proceeds can be the sources to finance a firm acquisition; and secondly, retention sellers destroy the wealth of their shareholders through subsequent acquisitions. We collect a sample of 2431 inter-corporate asset sales which are announced between 1990 and 2014, from the SDC Platinum database. After identifying the asset sales' announcement date, we search Factiva and Lexis-Nexis around those events to determine sellers' intended use of cash proceeds.[4] We classify sellers into payout and retention sellers. Payout sellers are firms that use of asset

☆ We thank the Editor, three anonymous referees, and conference participants at International Finance and Banking Society (IFABS) Asia 2017 for their many constructive comments and suggestions.

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[1] SDC database.
[2] Factiva.
[3] Managers may use cash proceeds to payout, particularly reduce debts, repurchase shares or pay dividends (Clayton & Reisel, 2013). Alternatively, managers may use proceeds to fund investment (e.g., Arnold, Hackbarth, & Xenia Puhan, 2018; Edmans & Mann, 2018) or R&D (Borisova & Brown, 2013).
[4] We require the acquisition announcement to follow the announcement of asset sales from Day 1 to next one year.

https://doi.org/10.1016/j.irfa.2018.09.005
Received 14 March 2018; Received in revised form 16 August 2018; Accepted 10 September 2018
Available online 11 September 2018

sale proceeds for retiring debts, repurchasing stocks, or issuing dividends, while retention sellers keep sale proceeds for general corporate activities.[5]

We identify whether asset sellers become a bidder following the sales by first collecting a sample of acquisitions including the bidder details from the SDC Platinum database. Second, we match the details of sellers and bidders, i.e., *permno*, to check whether the sellers become a bidder in one year from the time they sell assets. In our sample, 14% of sellers decide to pay out proceeds, while 24% of them announce an acquisition after selling assets. The difference of acquisition ratios between retention and payout sellers is large and significant at 11%.

We find that retention sellers are more likely to pursue subsequent acquisitions by showing that the average likelihood of announcing an acquisition increases 8% when the sellers retain proceeds. We also document that the likelihood of announcing a diversifying acquisition is 9% higher, on average, when the seller decides to keep sale proceeds, thus emphasizing that a retention seller is more likely to diversify through acquisitions than a payout seller.

Following the decision to pursue an acquisition, we reveal that a retention seller destroys the wealth of shareholders using three different tests. First, we examine the market reactions to a retention decision, and how the decision is associated with an unexpected acquisition. We follow Harford (1999) and define an expected bidder as a seller who has the probability of announcing an acquisition larger than its 75th percentile.[6] We show that the wealth of shareholders measured as three-day cumulative abnormal returns (*DispCAR3*) decrease 2% when the seller decides to retain proceeds. The effect of the retention decision on *DispCAR3* remains negative and statistically significant when the retention decision is associated with an unexpected acquisition. However, it becomes insignificant when the subsequent acquisition is expected. We also document that the market reacts positively to a payout decision associated with an unexpected acquisition.

Second, we measure the announcement returns of post-sale acquisitions as three-day cumulative abnormal returns (*AcqCAR3*) around the announcement date. We then compare *AcqCAR3* between retention and payout sellers. The results show that *AcqCAR3* are lower when the seller divests assets and retains the sale proceeds. Specifically, after controlling for the deal and acquirer characteristics, the acquisition's announcement returns are 5% lower when it is announced by a retention seller. Our findings are particularly more pronounced in the sample of unexpected bidders.

Third, we analyze the change in ROA of retention sellers following the announcement of asset sales and subsequent acquisitions. Specifically, we measure the change in the seller's ROA between year $t + 2$ and $t - 1$, given that t is the fiscal announcement year. We find that retention sellers have 5% less change in ROA when they engage in an acquisition compared to those that do not announce an acquisition. In addition, we measure the change in adjusted ROA, where adjusted ROA is the difference between the seller's ROA and the median ROA of controlling firms operated in the same industry. The regression of the change in adjusted ROA also shows that retention sellers who subsequently become a bidder have less change in ROA. Altogether, our findings demonstrate retention decisions reduce the wealth of shareholders, suggesting that sale proceeds might be reinvested in value-destroying acquisitions which reduce the seller's long-term performance.

We contribute to the literature in three important ways. First, we contribute to the literature investigating the financial decision following asset sales. Hovakimian and Titman (2006) document that firms use cash proceeds from asset sales for capital expenditure purposes. Borisova and Brown (2013) on the other hand show that firms finance their research and development using the proceeds from selling assets. We extend this line of research by revealing that retention sellers are more likely to invest sale proceeds in subsequent acquisitions. Our paper is consistent with the early findings of Mavis et al. (2016) who show that asset sales' proceeds are positively related to the likelihood of an acquisition. We add to Mavis's study by providing more insights into the decision to retain or pay out sale proceeds and the effect of those decisions on the wealth of shareholders.

Second, we add to the literature on factors that motivate corporate acquisitions (e.g., Cornett, Tanyeri, & Tehranian, 2011; Harford, 1999; Kempf, Manconi, & Spalt, 2016). Cornett et al. (2011) show that the firm's life cycle is positively related to the likelihood of becoming a bidder. Harford (1999) proposes that excess corporate cash reserves will lead to inefficient investments, such as diversifying acquisitions. Kempf et al. (2016) find that firms tend to make value-destroying acquisitions when their shareholders are distracted, suggesting that the attention of investors affects corporate actions. We extend this line of research by showing that a retention seller is more likely to acquire following the sales of its assets, i.e., we analyze the effect of a sudden cash increase from asset sales on the seller's announcement returns.

Third, we provide direct evidence indicating how post-sale acquisitions explain the negative (positive) market reaction towards the decision to retain or pay out proceeds. Lang, Stulz, and Walkling (1989), Bates (2005) and Clayton and Reisel (2013) find that the average stock-price reaction to assets sales is negative only when the proceeds are retained, supporting the agency problem of managerial discretion. We add to their study by showing that the market discounts more for a retention decision associated with an unexpected acquisition, and the subsequent acquisitions reduce the wealth of the seller's shareholders.

Our study is also related to the literature on the agency problem in inter-corporate asset transactions. Berger and Ofek (1999) and Gillan, Kensinger, and Martin (2000) show that managers may have postponed sales until they experience pressure from institutional investor activists or other corporate control or incentive-altering events. Other studies indicate that the announcement returns of divestitures are related to monitoring incentives, such as board independence and managerial ownership (Hanson & Song, 2000), private lenders' monitoring (Datta, Iskandar-Datta, & Raman, 2003), or seller listing status (Nguyen & Nguyen, 2017). We provide supporting evidence for this line of research by revealing that retention sellers tend to waste sale proceeds on value-destroying acquisitions which negatively influence their long-term performance.

The remainder of the paper is organized as follows: Section 2 reviews the related literature and proposes hypotheses. Section 3 shows the data collection and descriptive statistics. Section 4 presents empirical results. Section 5 concludes the paper.

2. Literature review and hypothesis development

Hite, Owers, and Rogers (1987) and Brown, James, and Mooradian (1994) propose that retaining the proceeds from selling assets increases the wealth of seller shareholders if the proceeds are reallocated to unfunded, but positive net present value (NPV) projects. According to Bates (2005), sale proceeds are retained based on the optimal level of cash holdings where the expected benefit of holding cash is simply offset by the expected cost. In addition, raising cash through selling assets could enhance the provision of internal capital for subsequent investments (Harford, 1999). It is also less expensive than other sources of financing raised through external capital markets because of asymmetric information (Myers & Majluf, 1984).

However, the existing literature also shows that the stock market reacts negatively when the seller decides to retain proceeds (e.g., Ataullah, Davidson, & Le, 2010; Kaiser & Stouraitis, 2001; Lang,

[5] If we cannot determine the intended use of cash proceeds shortly after the asset sales, we widen our search into a year after the asset sales. We consider that firms retain asset sale proceeds if no payout information is released within the course of one year.

[6] Unexpected bidder as a seller who has the probability lower than its 75th percentile.