



Bond market access and investment[☆]

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ABSTRACT

Prior research has shown that differential access to debt markets significantly affects capital structure. In this paper, we examine the effect of access to debt markets on investment decisions by using debt ratings to indicate bond market access. We find that rated firms are more likely to undertake acquisitions than nonrated firms. This finding remains even after accounting for firm characteristics, for the probability of being rated, and in matched sample analysis as well as in subsamples based on leverage, firm size, age and information opacity. Rated firms also pay higher premiums for their targets and receive less favorable market reaction to their acquisition announcements relative to non-rated firms. However, the average announcement returns to rated acquirers are non-negative. Collectively, these findings suggest that the lack of debt market access has a real effect on the ability to make investments as well as on the quality of these investments by creating underinvestment, instead of simply constraining overinvestment.

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1. Introduction

Faulkender and Petersen (2006) hypothesize and show that having access to public debt markets affects a firm's capital structure such that firms having access to public debt markets have 50% higher leverage ratios relative to those not having access. In doing so, they draw attention to the differences in the cost of public and private debt. These credit supply-side differences matter such that firms with similar demand for credit hold different amounts of debt in their capital structures. In this paper, we build on their

findings by asking how differential access to capital affects firms' investment decisions. By affecting investment decisions, public debt market access would then have a real value effect on firms.

A priori, it is not clear that differential debt market access would affect firms' investments. Firms without public debt access could shift to use equity financing instead, such that the source of funding effect is limited to the capital structure and does not affect investment policy. Absent such a shift, access to debt markets can influence investment decisions. Specifically, firms that exclusively borrow from private (informed) lenders (e.g., banks) can be rationed by the debt capacity of their lenders (Stiglitz and Weiss, 1981; Faulkender and Petersen, 2006). Therefore, constrained access to debt markets could lead to constrained investment, which manifests itself in fewer investments, but with the investments being more value-increasing and less costly (the financial constraints hypothesis).

However, an increase in debt access could come at a cost. Specifically, higher volume of dispersed, less-informed

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investors could lead to less effective monitoring relative to concentrated informed lenders. Thus, firms that have access to public debt markets have larger borrowing capacity with more discretion on their investments. These collectively predict that firms with bond ratings are more likely to make investments that are likely to be value-decreasing (the free cash flow hypothesis). Overall, both the financing constraints and free cash flow hypotheses predict significant effects of access to debt markets on a firm's ability to undertake investment and on the quality of those investments.

In this study, we examine the effects of access to the public debt markets on real investment activity by examining large, visible investments: acquisitions. Specifically, we examine whether having a bond rating, which facilitates access to bond markets, influences the likelihood of undertaking an acquisition and the size of that acquisition. We also explore the effect of a bond rating on the premiums paid for the target firm. Finally, we study the extent to which debt market access has implications for value creation through acquisitions.

Following the [Faulkender and Petersen \(2006\)](#) finding that qualified firms without a bond rating are the exception, we assume that lack of a bond rating is a supply-side effect instead of indicating lack of demand for a rating. However, we also consider the endogeneity of becoming rated. Most notably, having a rating is related to a firm's size and leverage. In addition to controlling for these factors in our analyses, we take further steps to disentangle the effect on acquisition decisions of having a rating. First, we examine the subsample of firms that do not have a rating two years prior to the acquisition and study whether firms that obtain a rating subsequently have a higher likelihood of making an acquisition. Second, we replicate the acquisition decision analyses for the subsample of rated and nonrated firms matched by industry and size.² Third, we show that having a rating affects acquisition decisions even after controlling for the probability of being rated. Finally, we study the ability to make acquisitions across size, leverage, market-to-book, and age quartiles as well as for subsamples of information opacity. All of these analyses confirm bond market access' significant effects on acquisition decisions.

Specifically, we find that having a bond rating increases the likelihood of undertaking an acquisition by 4.6% (relative to a baseline of 11.2%) after controlling for market leverage and other determinants of making acquisitions. Thus, the source of funding does affect the ability to undertake investments. We also find that acquirers with bond ratings pay 5.5% higher premiums relative to non-rated acquirers. Consistent with the rated acquirers paying higher premiums, capital markets react more unfavorably to acquisition announcements by those acquirers. The announcement return is a sufficient statistic for the value implication as we find that there is also no long-run mean reversion in stock price for acquirers with a rating. On the contrary, in the long run, nonrated acquirers perform very similarly to those with a rating.

² We obtain similar results when we match rated firms and nonrated firms by industry and market leverage.

These results are consistent with optimal constraints, meaning that financial constraints due to capital access keep managers from overinvesting (the free cash flow hypothesis). However, they are also in line with suboptimal constraints, such that the constraints reduce a manager's ability to undertake all positive net present value investments (the financial constraints hypothesis). Under the latter hypothesis, financially constrained firms take only the highest NPV projects, so that their marginal project creates more value than the marginal project of unconstrained firms. In our final test, we attempt to disentangle the free cash flow and the financial constraints hypotheses. Although these two hypotheses both predict a difference in acquisition choices of rated firms relative to nonrated firms, the two hypotheses have different predictions for the sign of announcement returns. Specifically, the free cash flow hypothesis predicts that announcement returns to rated acquirers will be negative as these firms are more likely to make value-decreasing acquisitions that benefit managers personally. However, based on the full sample of public, private, and subsidiary targets, we do not find negative market reactions to rated acquirers on average either in the short or long run. Collectively, these findings suggest that the free cash flow hypothesis cannot explain the findings presented in this paper. We conclude that lack of public debt market access constrains firms to undertake only the best investments, rather than exhausting all positive NPV investments.

In additional robustness tests, we study whether the investment effect of a firm's access to debt markets is related to its degree of information opacity and life cycle. Specifically, firms that are informationally opaque are less likely to have a rating and are less likely to make an acquisition. Firms that are further into their life cycle are more likely to have a rating as they have a long track record. They are also more likely to make acquisitions due to low internal growth opportunities. We find a significant and positive effect of having a rating on the likelihood of making an acquisition for both subsamples of informationally opaque and nonopaque firms. The effect of having a rating persists for the subsample of older firms and most notably for the subsample of young firms. Collectively, these findings suggest that access to debt markets has a distinct effect on investment decisions.

Our paper fits into the broad literature examining the degree to which financial constraints cause underinvestment. Following the seminal work of [Fazzari, Hubbard, and Petersen \(1988\)](#), the majority of that literature examines differential access to internal cash flow, asking whether increased cash flows relax such constraints in an investment-cash flow sensitivity setting.³ We examine

³ For example, [Kaplan and Zingales \(1997, 2000\)](#) argue that investment-cash flow sensitivities are in fact higher for financially unconstrained firms. [Erickson and Whited \(2000\)](#) also argue that measurement error generates spuriously high sensitivities for financially constrained firms. Furthermore, [Gomes \(2001\)](#) and [Alti \(2003\)](#) generate investment-cash flow sensitivities in a setting where financing is frictionless. These sensitivities are similar to the ones observed in the data, thereby suggesting that cash flow sensitivities do not fully capture the financial constraints. However, [Moyen \(2005\)](#) shows that the results of [Fazzari et al. \(1988\)](#) can be replicated in the presence of financial

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