



Value creation from asset sales: New evidence from bond and stock markets[☆]



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ABSTRACT

This paper examines the influence of capital structure change on the value creation from asset sales. We find significant positive equity and debt excess returns are concentrated in the subsample of highly leveraged firms that use the proceeds to retire debt. Low leverage firms display no consistent significant excess equity or bond returns. The existent literature has focused on efficiency redistribution, increase in focus, and access to capital for investment as the primary drivers of value creation from asset sales and agency costs as a major factor that mitigates this value creation. The evidence presented in this paper suggests that the primary driver of value creation is from capital structure change for highly leveraged firms.

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1. Introduction

A sale of assets is a frequent and important form of corporate reorganization. Empirical research has documented that asset sales create value for equityholders by consistently demonstrating positive mean excess equity returns on the announcement of voluntary asset sales (Alexander et al., 1984; Bates, 2005; Jain, 1985; John and Ofek, 1995; Lang et al., 1995 (hence forth LPS); Hite et al., 1987). The mechanism of the value creation from asset sales, however, is not fully understood. The literature has focused on three channels through which asset sales create value for equityholders: 1) the financing hypothesis and investment opportunities from LPS (1995) and Bates (2005); 2) the increase in focus from John and Ofek (1995); and 3) the efficient redistribution of assets from Alexander et al. (1984). In addition, these papers suggest that capital structure changes may contribute to the gains from asset sales; however, capital structure change is generally dismissed as a primary contributor to equityholder gains.

This paper performs a comprehensive analysis of a sample of voluntary asset sales to determine if capital structure change is a primary factor in value creation. Both debt and equity excess returns are examined to document value creation in both of these important parties and determine if any of the value created for either party is due to wealth transfer. To direct the empirical analysis, we rely on a simple model based on established capital structure theories that shows how asset sales can mitigate costs

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associated with excess leverage. The key insights of the capital structure theory of asset sales are 1) value creation from asset sales should be concentrated in firms that are highly leveraged and use proceeds from asset sales to pay-off debt, and 2) the value will be created for both debtholders and equityholders.

The full sample of asset sales that is examined has a 0.99% monthly excess equity return, which is similar in magnitude to existing evidence. The capital structure hypothesis suggests asset sales only create value for firms that have high leverage. To test this theory, the sample is partitioned based on investment grade or non-investment grade debt; the sample with investment grade debt shows no significant excess equity or debt returns¹ and, in contrast, the sample with non-investment grade debt has significantly positive excess equity returns and excess bond portfolio returns of 4.00% and 0.99%, respectively.

The capital structure hypothesis further requires that firms use the proceeds from the asset sale to retire debt. When the non-investment grade debt sample is delineated by use of proceeds, firms that have non-investment grade debt and use the proceeds to retire debt have a 9.54% excess equity return and 2.21% excess bond portfolio return. However, firms that retain the proceeds have insignificant mean excess equity and debt returns. These results are consistent with the capital structure theory of asset sales. The results are robust to an alternative approach of identifying highly leveraged firms and the notion that the use of proceeds is unlikely to be assigned randomly across firms, but rather is endogenously determined as a function of firm characteristics.

2. Relation to existing evidence

Further, the implications of the alternative theories are examined in the sample to better understand the relative importance of capital structure change. The main result is that the capital structure change (decreasing leverage for highly leveraged firms) is the primary determinate of value creation from asset sales. This provides support for the capital structure theory of asset sales since the alternative theories do not suggest a significant difference in value creation based on leverage.

2.1. Asset sales as financing

LPS (1995) propose a financing hypothesis to explain value creation from asset sales. Under this financing hypothesis, a firm undertakes an asset sale when it is the cheapest source of funds. This occurs when the asset can be sold for a higher than expected price and thus an asset sale announcement is positive news for the valuation of the firm. Managers are self-interested, so, if the proceeds are retained, the value created from the asset sale can be destroyed due to agency costs. The main implication of the financing hypothesis is that shareholders will only capture the value created from the asset sale when the proceeds are distributed (to equity or debt) and not retained by the firm. Consistent with the financing hypothesis, LPS (1995) find that firms which payout the proceeds (to equity or debt) have a 3-day mean abnormal equity return of 3.92% (*t*-stat 5.93) whereas firms that retain the proceeds show no significant mean abnormal equity return.

In the financing hypotheses, asset sales in general create value and this value is destroyed by managerial agency costs if the proceeds are retained. This suggests any sample of asset sales where the proceeds are distributed should show positive excess equity returns. When the use of proceeds is examined in the investment grade sample, we find there are no significant mean excess equity returns for the firms that distribute the proceeds. We find that the value creation from asset sales is restricted to highly leveraged firms that use the proceeds to retire debt. Taken together these results are consistent with the capital structure theory and suggest that the financing theory alone cannot explain value creation from asset sales.

LPS (1995) also examine the extent to which capital structure change could be driving their results and dismiss this as a primary factor. To examine this question, they use measures of past performance, e.g. interest coverage. The authors generally conclude that “it is unlikely that the relationship between abnormal returns and the use of proceeds depends on the selling firm’s financial condition.” We use debt rating to proxy for high leverage as opposed to using measures of past performance and find that poor financial condition (as measured by debt rating) is significantly related to value creation from asset sales. We believe debt rating is a better proxy than, for example, interest coverage to identify firms that are over-leveraged due to the effect of current earnings and accounting method on the interest coverage calculation.²

2.2. Asset sales and investment opportunities

Bates (2005) conducts a comprehensive investigation into asset sales using growth opportunities and capital expenditures to examine what determines the use of proceeds and the cross sectional variation in value creation. Overall, Bates (2005) finds investment decisions can account for the empirical finding that “retention decisions, on average, reduce an otherwise positive shareholder reaction to an asset sale.” He does acknowledge that capital structure change, in addition, can have some impact on value creation from asset sales, however the above statements makes clear this is considered only as marginal impact and not the primary driver of value creation. In contrast, our results suggest that the capital structure change is the primary driver of the value creation from asset sales.

¹ The result is not due to the lack of power. See Section 4 for details.

² A poor earnings year will cause a low interest coverage calculation even if the firm has plenty of cash and other assets so that it does not suffer from agency costs of debt (i.e., is not over-leveraged). In addition, interest coverage is calculated using accounting earnings per share. This number can change significantly due to one-time write-offs or from other accounting regulations that have little to do with the long term prospects of the firm.

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