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The value implications of target debt issuance in withdrawn takeovers: What role do country-specific M&A regulations play?

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ABSTRACT

Under the implicit assumption of well-developed capital markets and strong investor protection, finance theory predicts that managers of target firms will respond to a takeover threat by increasing firm leverage. Leverage increases target management's negotiating position with the bidder, potentially thwarting the acquisition altogether. Target management should therefore have less incentive to increase leverage where investor protections are weak and financial regulations favor incumbents. Examining changes in firm leverage in an international sample of target firms, we find that targets significantly increase leverage around takeover attempts, but only in countries with well-developed capital markets and strong investor protections. These target firms realize negative abnormal returns around debt issuance announcements, especially those between takeover announcement and withdrawal. Further, target shareholders suffer significantly negative long-term returns after the takeover bid is withdrawn. Negative returns are significantly mitigated, but not eliminated, with high performance target managers in place.

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1. Introduction

A voluminous literature exists addressing mergers and acquisitions in corporate finance, typically focusing on completed deals.[1] A smaller literature addresses changes in the capital structure of target firms. Erel et al., 2015 document that acquisitions ease financial constraints for target firms, especially for smaller targets. Capital structure, target leverage, and changes in target leverage have been found to influence the price, means of acquisition, and the likelihood of deal completion (Palepu, 1986; Billett and Xue, 2007; Harford et al., 2009; Morellec and Zhdanov, 2008; Povel and Singh, 2010). Povel and Singh (2010) argue that loan commitments negotiated by target firms subsidize weaker bidders and raise the acquisition price for the presumably stronger eventual acquirer, and that drawn commitments are likely to underperform other loans on bank balance sheets.

Theoretical models by Stulz (1988); Harris and Raviv (1988), and Israel (1992) predict that in response to a potential takeover threat, managers will increase leverage and use proceeds from debt issuance to repurchase equity. While other

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[1] See Betton et al., 2008 for a thorough survey of the literature on corporate takeovers.

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measures, such as antitakeover provisions, are used to thwart takeover attempts, these must typically be in place ex-ante (Bebchuk et al., 2008), whereas leverage adjustments by managers occur more rapidly in response to an unanticipated takeover threat.[2] There is a growing literature examining changes in target capital structure and firm performance after a failed acquisition.[3] According to practitioners, approximately 10–20% of proposed acquisitions and 3% of announced acquisitions are not completed, though the actual number may be significantly higher.[4] Studying the effects of incremental leverage adjustments of target firms around acquisition attempts, Jandik and Lallemand (2014) find that 16.6% of announced acquisitions are ultimately withdrawn. More importantly, the authors document the defensive nature of debt issuance, finding negative abnormal returns to target shareholders overall around both debt issuance and withdrawal announcement, with high performance firms realizing less-negative returns.

Regulatory and legal literature well documents that when firm ownership is concentrated, performance suffers, and markets are less efficient in less developed markets where creditor rights, shareholder protections, and regulatory enforcement are weaker. These same generalities hold for the market for corporate control. With regard to mergers and acquisitions, Ferreira et al. (2010) find that foreign institutional shareholders lower information asymmetries between bidders and targets in cross-border transactions, making both a bid and a completed acquisition more likely. Further, the authors find that these effects are more pronounced in countries with less developed legal institutions. If takeovers are less likely and managers more entrenched in countries with weaker institutions, it is a reasonable conjecture that target managers are less inclined to issue value-destroying debt in countries where such actions do not further mitigate the threat of takeover and dismissal.

Previous studies on the effects of target debt issuance on acquisitions and subsequent firm performance primarily focus on U.S. firms. This paper bridges the international regulatory and target capital structure literatures. Specifically, we study the likelihood and results of target debt issuance around withdrawn takeovers in relation to the efficiency of the market for corporate control.

In a sample of 1400 non-U.S. and non-Canadian target firms and matched, non-target firms, we find that target firms issue debt more than twice as often as non-target firms. Target firms increase book leverage, defined as total debt to total assets, from 19.1% to 22.3% at the mean, from two years prior to a takeover announcement to one year following the withdrawal of the acquisition. Importantly, this effect is limited to those countries with developed, and therefore relatively more efficient, markets for corporate control, strongly suggesting that the cost of defensive debt issuance outweighs the benefit to target managers who are already shielded from disciplinary takeovers due to institutional weakness and financial market inefficiencies. In markets that are more efficient, however, we find in support of Jandik and Lallemand (2014), that targets suffer negative abnormal returns around announcements of debt issuance. These negative returns are most severe for debt issued after takeover announcement but prior to withdrawal. Target abnormal returns around debt issuance are also more negative when the takeover is likely to be disciplinary in nature (e.g. when firm managerial performance is poor relative to industry peers). Long term, post-withdrawal buy and hold abnormal returns are found to be negative, especially for poorly managed firms headquartered in countries with well-developed financial markets.

The rest of the paper is organized as follows: hypotheses developed in Section 2. Section 3 describes data and empirical results while Section 4 concludes.

2. Hypotheses

2.1. Changes in leverage levels

Theoretical models predict that in response to takeover threats, managers of target firms increase leverage through both the issuance of debt and the use of debt capital to repurchase outstanding equity (e.g. Stulz, 1988; Harris and Raviv, 1988; Israel, 1992). Share repurchases have the added effect of concentrating voting rights in the hands of remaining shareholders, with managers often holding substantial equity stakes in their own firms. Along with the mechanical increase in bargaining power that accompanies concentrated voting rights, share repurchases also increase the overall reservation price of remaining shareholders (Bagwell, 1991) as existing shareholders with the lowest internal valuation of the firm will sell their holdings first, leaving shareholders with higher average internal valuations of the firm. Further, higher leverage maintained by target firms also has the potential to exhaust an acquirer's overall leverage capacity, as posited by Stulz (1988), thereby reducing the pool of potential acquirers.

A model of optimal managerial leverage decisions described by Zwiebel (1996) also predicts that leverage will be increased when firms are faced with external control threats. The model further suggests that fewer poor projects will be undertaken, reducing agency costs associated with free cash flow (Jensen, 1986). Grossman and Hart (1982) yield similar predictions about new debt as a signaling mechanism relaying managerial commitment to enhancing firm value.

The aforementioned theoretical models predict that in response to a takeover threat, target management will utilize additional leverage in an attempt to capture a greater share of anticipated merger synergy gains, or alternatively, to thwart

[2] This rapid response is possible in cases where a target has had a long-standing relationship with debt providers.

[3] See, for example, Berger et al. (1997); Safieddine and Titman (1999), and Jandik and Makhija (2005).

[4] http://www.economist.com/news/business/21611161-when-giant-deals-fail-life-rarely-goes-back-normal-coming-unstuck, http://www.cnbc.com/2014/06/04/why-are-so-many-ma-deals-being-pulled.html

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