

Cash Windfalls and Acquisitions

Bastian von Beschwitz

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Bastian von Beschwitz*

Federal Reserve Board

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Abstract

This article studies the effect of cash windfalls on the acquisition policy of companies. As identification, I use a German tax reform that permitted firms to sell their equity stakes tax free. Companies that could realize a cash windfall by selling equity stakes see an increase in the probability of acquiring another company by 14%. I find that these additional acquisitions destroy firm value. Following the tax reform, affected firms experience a decrease of 1.2 percentage points in acquisition announcement returns. These effects are stronger for larger cash windfalls. My findings are consistent with the free cash flow theory.

JEL classification: G31, G34

Keywords: Acquisitions, Free Cash Flow Theory, Overinvestment

* Bastian von Beschwitz, Federal Reserve Board, International Finance Division, 20th Street and Constitution Avenue N.W., Washington, D.C. 20551, tel. +1 202 475 6330, fax. +1 202 452 2235, e-mail: bastian.vonbeschwitz@gmail.com

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