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journal homepage: www.elsevier.com/locate/jfecDeviation from the target capital structure and acquisition choices[☆]Vahap B. Uysal^{*}

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ABSTRACT

This study finds that managers take deviations from their target capital structures into account when planning and structuring acquisitions. Specifically, firms that are over-leveraged relative to their target debt ratios are less likely to make acquisitions and are less likely to use cash in their offers. Furthermore, they acquire smaller targets and pay lower premiums. Managers of overleveraged firms also actively rebalance their capital structures when they anticipate a high likelihood of making an acquisition. Finally, they pursue the most value-enhancing acquisitions. Collectively, these findings improve understanding of how firms choose their capital structures and shed light on the interdependence of capital structure and investment decisions in the presence of financial frictions.

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1. Introduction

Traditional theories of capital structure suggest that firms have target capital structures that are determined by

balancing the costs and benefits of debt financing.¹ However, firms often deviate from their target capital structures (Leary and Roberts, 2005; Frank and Goyal, 2007), and these deviations could influence the ability to issue further debt.² Therefore, the deviation from the target debt ratio (henceforth, leverage deficit) could affect subsequent corporate decisions.³ Although the effect of leverage deficit on security issuance decisions is well-documented in previous studies (Hovakimian, Opler, and Titman, 2001; Fama and French, 2002; Flannery and Rangan, 2006),

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¹ See, e.g., Bradley, Jarrell, and Kim (1984), Stulz (1990), Rajan and Zingales (1995), Hovakimian, Opler, and Titman (2001), and DeAngelo, DeAngelo, and Whited (2011) for the existence of the target capital structure. Consistent with this strand of literature, Graham and Harvey (2001) also report that 81% of chief financial officers claim to have target debt ratios.

² Hovakimian, Opler, and Titman (2001), Fama and French (2002), and Flannery and Rangan (2006) show that firms that are overleveraged relative to their target capital structures are less likely to issue debt.

³ Leverage deficit is defined as actual minus target debt ratio. Based on this definition, overleveraged firms have excessively positive leverage deficit (largest leverage deficit quartile), and underleveraged firms fall in the lowest leverage deficit quartile.

understanding of how leverage deficit influences corporate acquisitions is still limited.

In the presence of financing frictions, the leverage deficit could play an important role in acquisition decisions. Although firms in frictionless capital markets can finance all positive net present value (NPV) projects with no restrictions on the form (i.e., payment method) and level (i.e., transaction value) of financing (Modigliani and Miller, 1958), financing frictions limit the ability of overleveraged firms to raise capital on short notice, in general, and constrain them from issuing further debt, in particular. While the inability to raise capital on short notice impedes a firm from bidding aggressively for acquisition targets, the constraints on issuing further debt reduce the cash component of acquisition offers.⁴ Collectively, these imply that a firm's leverage deficit is likely to influence its ability to undertake an acquisition, and, conditional on making an acquisition, it affects the form and level of financing.

In this paper, I explore the effects of a firm's leverage deficit on its acquisition choices. In particular, I examine the extent to which a firm's leverage deficit affects the likelihood of the firm making an acquisition as well as the effect of its leverage deficit on the payment method and on the premiums paid for the target firm. Because managers are likely to anticipate the constraints of overleverage on acquisition choices, I also analyze managerial decisions on capital structure in the light of potential acquisitions. Specifically, I test whether managers of overleveraged firms reduce their leverage deficits when they foresee a high likelihood of making acquisitions. Finally, I close my inquiry by studying how capital markets react to the acquisition announcements of firms that deviate from their capital structures. Managers of overleveraged firms face constraints on the form and level of financing and are more likely to be selective in their acquisition choices if they fail to decrease their leverage deficits substantially. Therefore, I hypothesize that managers of overleveraged firms will pursue only the most value-enhancing acquisitions, which, in turn, will foster favorable market reactions to the news of their acquisitions.

To examine the role of leverage deficit on acquisition choices, I utilize a two-step estimation procedure that is similar to that used by Hovakimian, Opler, and Titman (2001). In the first step, I estimate the target leverage ratio by running annual regressions of leverage ratios on the main determinants of capital structure considered in prior studies (e.g., Rajan and Zingales, 1995; Frank and Goyal, 2003; Lemmon, Roberts, and Zender, 2008). In the second step, I perform regressions that examine whether the deviation from the predicted target capital structure affects a firm's acquisition decisions.

The results presented in this paper indicate that the estimated leverage deficit is strongly related to acquisitions choices. Leverage deficit decreases both the likelihood of making an acquisition and the size of that

acquisition. However, the effect of leverage deficit on the likelihood of a firm making an acquisition is not symmetric for underleveraged and overleveraged firms. While the effect of overleverage is negative and significant, underleverage has an insignificant effect on the acquisition probability. There are also significant effects of leverage deficit, which are driven by overleveraged firms, in payment choices and premiums paid to targets: overleveraged acquirers pay lower premiums and are less likely to use cash in their offers. Collectively, these findings are consistent with the view that overleverage constrains the ability to acquire and the terms of acquisitions.

The fact that leverage deficit has a significant impact on acquisition behavior suggests that managers could attempt to mitigate the negative effect of overleverage. I find that overleveraged firms reduce their leverage deficits and issue equity in an effort to move toward their target capital structures. Furthermore, the tendency to rebalance capital structure is stronger for overleveraged firms when they are more likely to acquire target companies. These findings suggest that managers of overleveraged firms reduce their leverage deficits when they anticipate the possibility of making future acquisitions.

Finally, I examine how capital markets react to the announcements of corporate acquisitions. Acquisition announcement returns increase with leverage deficit and are significantly positive for overleveraged acquirers, whereas the effect of underleverage on announcement returns is insignificant. Furthermore, these effects do not prompt price reversals in the long run. These findings lend support to the notion that managers of overleveraged firms undertake the most value-enhancing acquisitions.

This paper is related to studies on the interdependence of financing and investment decisions. Specifically, Harford, Klasa, and Walcott (2009) examine how deviations from a firm's target capital structure affect financing choices around acquisition events. This study goes beyond Harford, Klasa, and Walcott (2009) by examining the role of leverage deficit in a firm's ability to make acquisitions and in its acquisition choices. In particular, by showing a lower likelihood of making acquisitions for firms that are overleveraged relative to their target capital structures, this study suggests that overleverage is an impediment to pursuing acquisition opportunities. Furthermore, by showing that overleveraged acquirers undertake more value-enhancing acquisitions than underleveraged firms do, this study indicates differences in acquisition choices of overleveraged and underleveraged firms. Collectively, these findings provide novel evidence on the interdependence of financing and investment decisions: a firm's leverage deficit affects both its ability to make acquisitions and the quality of its acquisitions.

The findings in this paper also improve our understanding of how firms choose their capital structures. For example, Harford, Klasa, and Walcott (2009) show that adjustment costs are important determinants of rebalancing decisions in the post-acquisition period. In contrast, I examine the capital structure decisions in the pre-acquisition period and find that overleveraged firms that have a high likelihood of undertaking an acquisition are more likely to issue equity and to reduce leverage deficit relative to

⁴ The latter influence occurs because cash components of offers are predominantly financed by debt issuance (Bharadwaj and Shivdasani, 2003).

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