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Cross-border acquisitions and financial leverage of UK acquirers

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ABSTRACT

Based on a sample of 782 acquisitions by UK firms during 1982–2009, this paper examines the impact of cross-border acquisitions on financial leverage. The paper shows that cross-border acquisitions have a negative impact on the financial leverage of acquiring firms. However, the negative impact of cross-border acquisitions disappears when acquirers choose targets from developed countries, and also when the acquisitions are undertaken by multinational firms. Collectively, the findings imply that exposure to foreign markets reduces the borrowing ability of acquiring firms especially when they choose targets from developing countries, and when they have no previous experience in foreign markets.

1. Introduction

Recent years have witnessed a tremendous growth in cross-border mergers and acquisitions (M&As). Erel, Liao, and Weisbach (2012) report that the share of cross-border acquisitions in the total volume of M&As increased from around 23% in 1998 to about 45% in 2007, and UK corporations have played a prominent role in this global trend. The UK alone accounted for 31% of worldwide cross-border M&As by the end of year 2000, making her the largest acquiring country globally (UNCTAD, 2000). Agyei-Boapeah (2014) shows that a salient feature of recent M&As in the UK is the growing importance of cross-border acquisitions. He reports that during the period 2002–2011, while the value of domestic acquisitions by UK firms declined by about 70% (i.e. from £25.2 billion in 2002 to £7.6 billion in 2011), there was a surge in the value of cross-border acquisitions from £26.6 billion in 2002 to £50.8 billion in 2011, representing an increase of over 90%.

These developments perhaps explain why cross-border acquisitions, particularly those undertaken by UK acquiring firms have received more attention in the finance literature over recent years (e.g. Conn, Cosh, Guest, & Hughes, 2005; Stiebale & Trax, 2011). These studies, however, often focus on the performance impact of cross-border acquisitions without considering how these international deals may impact the acquirers' financial structures. This is an important gap in the existing literature because Nurnberg (2006) notes that business acquisitions (including cross-border acquisitions) may directly impact firms' financing activities shown on the Statement of Cash Flows. This paper bridges this gap by empirically examining the impact of cross-border acquisitions on acquiring firms' financial leverage (i.e. gearing ratio), as well as analysing the moderating impact of two variables (i.e. the status of the target country and the foreign market experience of the acquiring firm) on the link between cross-border acquisitions and leverage. Fig. 1 presents the conceptual framework for this study.

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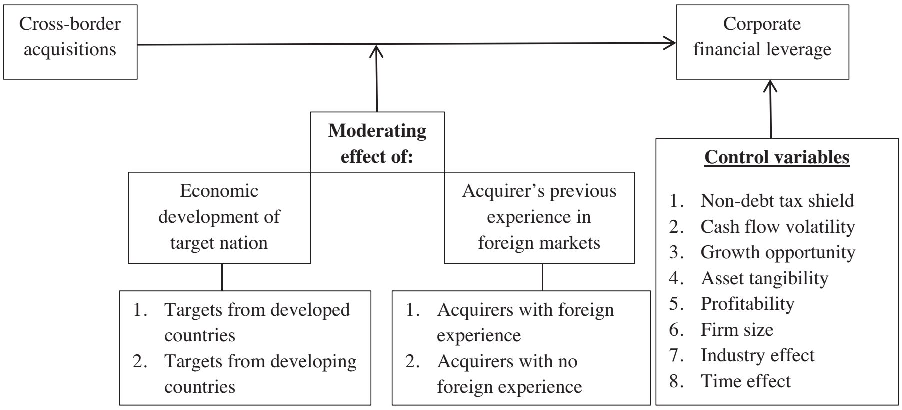

Fig. 1. Conceptual framework.

Based on the literature about foreign direct investment and international business, this paper establishes a link between cross-border acquisitions and corporate financial leverage. Specifically, the paper argues that since cross-border acquisitions represent an important mode of foreign market entry, they may expose the acquiring firm to some opportunities/costs that could either enhance or impede the acquiring firms' borrowing ability. For example, cross-border acquisitions may enable acquiring firms to expand into new geographic locations and to obtain strategic assets, advanced technologies, and new skills that could ultimately result in competitive advantages to the firm (see Nocke & Yeaple, 2007; Rossi & Volpin, 2004; Seth, Song, & Pettit, 2002; Shimizu, Hitt, Vaidyanath, & Pisano, 2004). Such competitive advantages could reduce the acquiring firm's bankruptcy risk, which could, in turn, enhance their borrowing ability and debt usage. However, when firms expand into new foreign markets, they may face additional risks/costs such as political and exchange rate risks and higher agency costs which could make it difficult for them to obtain debt capital (see Burgman, 1996; Kwok & Reeb, 2000; Mittoo & Zhang, 2008; Reeb, Kwok, & Baek, 1998). Ultimately, the issue of the impact of cross-border acquisitions on the debt levels of acquiring firms becomes an empirical matter to be settled by empirical research.

The present study relates to, but also differs in a number of ways from existing empirical studies on the link between internationalisation and leverage (e.g. Burgman, 1996; Kwok & Reeb, 2000; Mansi & Reeb, 2002). First, the empirical design utilised in prior studies has been primarily based on the analysis of existing multinational corporations (MNCs) and domestic corporations (DCs). This approach relies on segmental data in databases to construct proxy variables for firms' degree of internationalisation. However, some concerns have been raised about the validity of the internationalisation proxies that are constructed from segmental data (see Chen, Cheng, He, & Kim, 2007; Ramaswamy, Kroeck, & Renforth, 1996; Sullivan, 1994). For instance, the definition of a geographic segment adopted by both previous and current accounting standards on segment reporting (see IAS 14, paragraph 35 and IFRS 8, paragraph 13) could imply that international firms with foreign assets or sales of less than 10% may be classified as domestic firms. Unlike prior studies, the present article investigates the relationship between internationalisation and leverage without reference to segmental data. Specifically, the internationalisation-leverage link is examined by directly modelling the change in financial leverage following a corporate action (cross-border acquisitions) that increases the firms' international activities. Using such an approach, this paper circumvents the issue of which internationalisation proxies to use and their associated limitations.

Second, the present investigation differs from the previous studies by focusing on how a *specific mode of entry into foreign markets* (i.e. cross-border acquisitions) may impact firms' leverage. This distinction is important because Shimizu et al. (2004) argue that while internationalisation can be achieved in a variety of ways (e.g. cross-border acquisitions, exports, formation of alliances and joint ventures), the risks/costs associated with the equity entry modes (cross-border acquisitions, and greenfield investments) far outweigh those of the non-equity entry modes (e.g. exports, formation of alliances, etc.). Specifically, it is likely that political risks (and thus, bankruptcy risks) and the agency costs of debt (e.g. monitoring cost by lenders) will be greater for firms that become international through the purchase of existing assets/firms in other countries, compared to those international firms that merely export to foreign countries. This is because while exporting firms may have little or no tangible assets in host countries, cross-border acquiring firms do establish a physical presence in host countries, which make their foreign tangible assets easy targets for expropriation by host governments (Burgman, 1996). In addition, the potential for fraud is greater among foreign subsidiaries because of the large distance between them and their parents, thus, increasing the risk associated with cross-border acquisitions.[1] Within this context, it is plausible for the link between internationalisation and leverage to vary for the various modes of entering foreign markets, since corporate risks and agency costs are important determinants of financial leverage (Castanias, 1983; Jensen & Meckling, 1976).

[1] I am grateful to an anonymous reviewer for suggesting this argument.