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Capital expenditure announcements and anti-takeover barriers

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Abstract

In this paper, we compare capital budget announcements by firms with anti-takeover mechanisms in place to announcements by firms without takeover barriers during the period 1980 to 1995. We find that anti-takeover provisions do not affect investors' average reactions to investment choices. Market responses are heterogeneous; however, and differ according to size, growth opportunity, the availability of free cash flow and exposure to the capital markets. We find evidence consistent with managerial entrenchment when firms are insulated from the threat of takeover and have enough free cash flow to avoid raising external capital. We also find that for small firms, the reaction to capital investment announcements are positively related to free cash flow when managers have high growth opportunities, but negatively related when investment opportunity is small. This result is consistent with Noe (1988), who shows that restricting managers' investment choices to positive NPV projects is necessary to obtain the pecking order results of Myers and Majluf (1984). © 2000 Bureau of Economic and Business Research, University of Illinois. All rights reserved.

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1. Introduction

Financial researchers [for example, Jensen (1986a)] argue that the constituency that bears the residual risk from the operation of an organization should be endowed with the power to

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direct the resources of the organization, and to do so in a manner that maximizes that constituency's welfare. In the case of publicly held corporations, firm resources should be deployed so as to maximize shareholder wealth. However, Berle and Means (1932), Manne (1965), and more recently, Jensen and Meckling (1976) among others, point out that there can be significant separation in ownership and control of the modern corporation. Each argues that this separation provides management with the opportunity to deploy resources in a manner that maximizes their personal welfare. Such a deployment scheme may be inconsistent with the goal of maximizing shareholder wealth.

Recognition of the principal-agent conflict has given rise to a substantial literature on mechanisms that can align the interests of management and shareholders. Jensen and Meckling (1976) demonstrate that the cost associated with "internal" attempts to minimize principal-agent conflicts is ultimately borne by shareholders. If the internal resolution is incomplete or accomplished through costly mechanisms, an "external" market solution may be economically justified. In a competitive market for the control of corporate resources, efficient management teams will ultimately dominate firms that have been managed inefficiently. External acquisition of underutilized assets has the potential to increase the wealth of the former owners (the target firm's shareholders) and enhance the overall efficiency of the economy.[1] Thus, Jensen (1986a, 1988) and others conclude that barriers in the market for corporate control should be eliminated or minimized.

In an ideal setting, managers acting in shareholders' best interests will invest in all positive net present value (NPV) projects. Absent sufficient disciplining and monitoring mechanisms, however, agency theory suggests that managers may deviate from the optimal investment policy to serve their own interests. The purpose of this paper is to compare the capital investment choices of managers with takeover mechanisms in place, both amendments and rights plans, to those of managers without anti-takeover devices. Specifically, we analyze the market reactions to their capital expenditure announcements. McConnell and Muscarella (1985) report that investors react positively to increases in spending and negatively to decreases; a result that is interpreted as evidence that managers follow the positive NPV rule on average.[2] If anti-takeover devices insulate managers from the disciplining mechanism of the market, one would expect that the market reaction to spending increases (decreases) by firms with barriers in place to be greater than (less than) the market reaction to announcements by firms subject to takeover discipline.

We examine 394 capital budget announcements from 1980 to 1995. We document a positive response to spending increases by firms without takeover barriers in place. This result, especially for non-oil announcements of spending increases, is consistent with McConnell and Muscarella (1985) and more recently Vogt (1997). Like Vogt, we do not document the significant negative response to capital budget decreases as documented by McConnell and Muscarella for the 1970s, nor do we find any systematic pattern of market responses to announcements related to oil and gas exploration.

Our results suggest that on average, anti-takeover provisions do not affect investors' perceptions of managerial behavior regarding investment policy. Market responses to budget announcements are heterogeneous; however and differ according to size, growth opportunity, the availability of free cash flow and raising capital in the financial markets. We find some evidence consistent with managerial entrenchment when firms are insulated from the threat

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