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Why do over-deviated firms from target leverage undertake foreign acquisitions?[☆]

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ABSTRACT

This paper examines how deviation from firms' target leverage influences their decisions on undertaking foreign acquisitions. Using a sample of 5746 completed bids by UK acquirers from 1987 to 2012, we observe that over-deviated firms are more likely to acquire foreign targets. Consistent with co-insurance theory, we find that over-deviated firms engage in foreign acquisition deals to relieve their financial constraints and to mitigate their financial distress risk. We also note that foreign acquisitions enhance over-deviated firms' value and performance, measured by Tobin's q and return on assets (ROA) respectively. These findings support the view that over-deviated firms pursue the most value-enhancing acquisitions. Overall, this paper suggests that co-insurance effects, value creation and performance improvements are the main incentives for over-deviated firms' involvement in foreign acquisitions.

1. Introduction

The connection between leverage deviation as a source of new finance and subsequent mergers and acquisitions (M & A) decisions is assumed, but few studies have investigated this link (e.g. Harford, Klasa, & Walcott, 2009). Uysal (2011) argues that leverage deviation-defined as the difference between actual and target leverage- is the main motive of undertaking an acquisition. Specifically, firms with a leverage level above their target (henceforth "over-deviated firms") are exposed to higher financial distress risk and greater financial constraints, which impede their ability to make a domestic acquisition (Kayhan & Titman, 2007; Dang, Kim, & Shin, 2012; Uysal, 2011). Harford et al. (2009) confirm that financial constraints of over-deviated firms reduce propensity of financing large acquisitions with cash. Morellec and Zhdanov (2008) find that high financial distress costs of issuing new debt by over-deviated firms impede their abilities to win takeover bidding contests. Accordingly, this paper extends the literature by examining whether a particular type of acquisition may help over-deviated firms to relief the drawbacks of holding debt higher than target, which would otherwise create both a higher risk of default and increased financial constraints.

According to co-insurance theory, global diversification through foreign acquisitions may induce uncorrelated cash-flow streams arising from operating in different countries (Lewellen, 1971). These stable cash flows may minimise firms' earnings volatility, which, in turn, reduce their financial distress risk and financial constraints (Higgins & Schall, 1975). Hann, Ogneva, and Ozbas (2013) confirm that the co-insurance effect of diversification mitigates firms both default and systematic risk. Baker, Foley, and Wurgler (2009) show that foreign acquisitions can ease the financial constraints of acquirers through the availability of cheap financial capital channels. Thus, motivated by co-insurance theory, this paper extends Uysal's (2011) paper by exploring whether over-deviated firms may undertake foreign acquisitions in order to reduce their default risk and ease their financial constraints. It also addresses the economic effect of foreign acquisitions on the value and performance of over-deviated firms.

This paper focuses exclusively on global diversification through foreign acquisitions rather than on industrial diversification for several

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reasons. First, Dos Santos, Errunza, and Miller (2008) suggest that it is hard to measure industrial diversification, whereas foreign acquisitions provide a clear channel for measuring global diversification.[1] Second, Heston and Rouwenhorst (1994) find that global diversification is a more efficient tool for risk reduction than industrial diversification. They argue that country-specific factors, such as monetary and fiscal policies, institutional regimes, legal regimes and regional economic shocks, reduce cash-flow volatility more effectively than industrial diversification within a single country. Previous studies (e.g. Baker et al., 2009; Francis, Hasan, & Sun, 2008) have confirmed the superior effect of global diversification in relaxing firms' financial constraints. Third, global diversification provides both financial and real benefits, while industrial diversification affords only real benefits (Barney, 1991; Errunza & Senbet, 1984; Morck & Yeung, 1992).[2] The financial benefits of global diversification enhance firms' value beyond value-destroying industrial diversification decisions (Gande, Schenzler, & Senbet, 2009; Dos Santos et al., 2008). Accordingly, consistent with Uysal (2011), we expect that over-deviated firms that already have high risk exposure will be more selective and choose value-enhancing global diversification.[3]

This paper also investigates what are the drivers and outcomes of foreign acquisitions by over-deviated firms in the UK context for the following reasons. First, The UK has become a leading player in foreign acquisitions markets.[4] By 2000, foreign acquisitions by UK firms constituted 31 per cent of the world's total volume of foreign acquisitions (UNCTAD, 2000). In 2012, the value of foreign acquisitions by UK firms was five times greater than the value of UK domestic acquisitions (see Office for National Statistics (ONS), 2013). Kollewe (2011) similarly reports that the UK has become the second largest buyer of foreign firms in the world. Second, the UK's bankruptcy codes are creditor-oriented, which usually results in prompt sales of bankrupt firms with no heed to the interests of other claimants (Davydenko & Franks, 2008). These strict codes provide a powerful setting in which to test the relationship between over-deviated firms and foreign acquisitions, since UK over-deviated firms might have greater incentives and pressure to diversify their default risk than peer firms in other contexts.

Using a sample of 5746 completed bids by UK firms from 1987 to 2012, we find that leverage deviation affects the likelihood of making foreign acquisitions as well as the size of these acquisitions. In particular, over-deviated firms are more likely to acquire foreign targets than domestic targets. We also observe that over-deviated firms reduce their precautionary demand for cash holdings, as evidence of relaxing their financial constraints, after making foreign acquisitions.[5] We show that over-deviated firms are exposed to lower risk of default after acquiring foreign targets. We complement our analysis by exploring the effect of foreign acquisitions on over-deviated firms' value and performance. We observe that foreign acquisitions enhance the actual value of over-deviated firms. We also find that over-deviated acquirers of foreign targets out-perform other acquirers. Finally, our results are robust to controlling for firm fixed effects and self-selection bias of foreign acquisitions, ensuring that drivers and economic consequences of these deals do not arise from either unobserved firm-specific characteristics or endogeneity effect.

Our findings contribute to the extant literature on the interdependence of capital structure and investment decisions. In particular, this paper extends the work of Morellec and Zhdanov (2008), Uysal (2011) and Harford et al. (2009) by addressing the effect of leverage deviation on firms' choices between foreign and domestic acquisitions. It provides strong evidence that UK firms take their target leverage level into account when they make foreign acquisition decisions. Specifically, it adds to the M & A literature by establishing empirically that over-deviation from target leverage influences the likelihood and the size of foreign acquisition investments.

Next, this paper extends the literature on the controversial issue of why UK foreign acquisitions are quite pervasive (Ozkan, 2012). It empirically investigates the main drivers of these foreign direct investments when carried out by over-deviated firms. A previous study by Erel, Jang, and Weisbach (2015) finds that M & A deals ease the financial constraints of target firms. However, this paper provides new evidence that over-deviated acquirers can exploit foreign acquisitions to relieve their financial constraints. It also introduces compelling evidence that over-deviated firms can globally diversify their risk of default when acquiring foreign targets. These findings support the premise of co-insurance theory that the main motive of foreign acquisitions can be to outweigh over-deviated firms' risk of default and financial constraints.

Further, to the best of our knowledge, no previous study has examined outcomes of foreign acquisitions when acquirers' leverage level is above its target. Contrary to Moeller & Schlingemann's (2005) view that foreign acquisitions may destroy shareholders value, our findings suggest that foreign acquisitions are a value-adding decision for over-deviated firms. This paper also provides novel evidence that over-deviated firms experience better performance following foreign acquisitions than domestic acquisitions. Accordingly, these findings support the view of previous literature (e.g. Gande et al., 2009; Dos Santos et al., 2008) that global diversification is a wealth-maximising decision and over-deviated firms pursue the most value-enhancing acquisitions (Uysal, 2011).

Overall, this paper documents that co-insurance effects (financial constraints and distress risk), enhancing firms' value and performance, are the main reasons for over-deviated firms to pursue foreign acquisitions.

This paper has potential implications for academics and practitioners. First, treating all acquisitions as a single homogeneous group without distinguishing between foreign and domestic acquisitions might be misleading, due to international nature of foreign acquisitions, which, can change drivers and ultimate outcomes of doing them relative to domestic acquisitions. Second, our findings shed light on the importance of addressing heterogeneity in firms' leverage deviation, whether they acquire debt above or under target. This paper documents that the two deviated groups exhibit different behaviours toward choosing an acquisition type. Third, this paper strongly advises firms to identify how far their level of leverage deviates from target before choosing a specific target type. Specifically, identification of the economic gains of deviated firms following foreign versus domestic acquisitions will enable managers to develop strategic plans for better acquisition decisions. This also can help policy makers to develop codes of best practice in order to assess whether management boards are compliant with their fiduciary responsibilities, as defined in company laws.

In the remainder of this paper, Section 2 introduces the main hypotheses, Section 3 outlines our sample and methodology, Section 4 reports our empirical findings, Section 5 introduces further robustness checks, and Section 6 provides some concluding remarks.

[1] Dos Santos et al. (2008) show that using industrial segment reporting or Standard Industrial Classification (SIC) to measure industrial diversification is subjective. For example, Graham et al. (2002) find that only 16 per cent of qualified firms change their business segment reporting subsequent to M & A deals.

[2] Financial benefits of foreign acquisitions may include offering shareholders international diversification opportunities that enhance their stock price compared to standalone counterparts (Errunza & Senbet, 1984). However, real benefits of foreign acquisition may include combining acquirers' and targets' information-based intangible assets (Barney, 1991; Morck & Yeung, 1992)

[3] In an unreported table, we find that over-deviated firms are unlikely to undertake domestic industrially diversifying acquisitions.

[4] In 1998, foreign acquisitions by UK firms accounted for 65 per cent of total UK acquisitions value (UNCTAD, 2000).

[5] Erel et al. (2015) observe that cash holdings reflect manager' assessments of their potential financial constraints. Accordingly, managers reduce their cash holdings when they believe that their financial constraints are relieved.