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# Financing decisions and bidder gains

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## Abstract

This paper analyzes the relation between bidder gains and the source of *financing* funds available. We document that after controlling for the form of payment, financing decisions during the year before a takeover play an important role in explaining the cross section of bidder gains. Bidder announcement period abnormal returns are positively and significantly related to the amount of ex ante equity financing. This relation is particularly strong for high *q* firms. We further report a negative and significant relation between bidder gains and free cash flow. This relation is particularly strong for firms classified as having poor investment opportunities. The amount of debt financing before a takeover announcement is not significantly related to bidder gains. Together, we take these findings as supportive of the pecking-order theory of financing and the free cash flow hypothesis.

## Introduction

In a world with agency costs and asymmetric information, among other market imperfections, it is well established that the strict Miller and Modigliani (1958) separation of corporate investment and financing decisions no longer holds. In the vast literature on mergers and acquisitions, a number of studies focus specifically on the interaction between financing and investment decisions.[1] In many instances, however, the form of *payment* has been used as a proxy or substitute for the source of *financing*. Yet, even if the takeover is paid for with cash, the actual source of this cash, i.e., the actual financing decision, has largely been ignored as an explanatory variable in valuing managerial takeover decisions and establishing the link between financing and investment decisions.

Unfortunately, there is no way to establish a precise correspondence between a dollar raised in time $t$ and a dollar spent on a takeover in time $t+\tau$.[2] However, rather than establishing this exact correspondence, we consider the source of the cash that is available at the time the takeover is announced. In other words, can the source of the firm's cash determine whether the cash used to pay for the takeover can be categorized as costly free cash flow or as valuable financial slack? We specifically analyze the relation between the bidder's financing decisions in the period before the takeover and its subsequent acquisition gains. It is shown that, holding the form of payment constant, knowing the firm's financing decisions before the takeover is a significant factor in explaining the cross section of bidder returns.

According to the pecking-order theory, a firm's financing choice is determined by its relative costs of raising funds. Generally, equity financing is the most expensive form, both in direct issuance related and adverse selection costs. When a firm raises external financing in the equity market, investors are uncertain about the motive behind the firm's financing decision. For example, an equity issue could be interpreted by the market as a sign of overvaluation (e.g., Myers and Majluf, 1984) or —alternatively—as a sign of a profitable investment opportunity (e.g., Cooney and Kalay, 1993). Consequently, the investment decision helps in resolving the uncertainty associated with motivation behind the firm's prior financing decision. This potentially links bidder gains and prior financing decisions irrespective of the firm's investment opportunities.

Alternatively, following Stulz (1990), given a poor investment opportunity set, the likelihood for management to invest in negative NPV projects increases in the level of managerial discretion over investment funds. In contrast, firms with a good investment opportunity set are more likely to forego a project for lower levels of managerial discretion. Since the level of managerial discretion depends on the source of financing, a link between financing decisions and bidder gains in cash acquisitions is expected to exist. The qualitative nature of this link depends on the perceived value of the firm's investment opportunities.

The main findings of this study are as follows. We find bidder gains to be positively and significantly related to the amount of cash raised through equity issuance during the fiscal year preceding the takeover announcement. We interpret this as evidence that the takeover announcement serves as a resolution of uncertainty associated with the firm's decision to issue equity. Consistent with the free cash flow hypothesis and the findings of Lang et al. (1991) we do find a negative and significant relation between internally generated free cash flows and bidder gains. We do not find a significant relation between the amount of cash raised from debt financing and bidder gains. This is consistent with the notion that debt could serve a monitoring role as well as a restricting role in managerial discretion depending on the firm's investment opportunities.

When we consider the impact of the firm's growth and investment opportunities, we find the following. Using a measure of Tobin's $q$ to measure investment opportunities, we find that the positive relation between equity flows and bidder gains is particularly pronounced for high $q$ firms. To the extent that our measure of growth opportunities could also proxy for performance and valuation, an equity issue for a high $q$ firm is likely to be perceived as a sign of market timing or overvaluation rather than as a sign of profitable future investment opportunities. The takeover announcement in this scenario serves an even larger role as a resolution of uncertainty for firms, which could explain the strong positive relation between equity financing and bidder gains for high $q$ bidders.

The negative relation between internally generated funds and bidder gains is particularly pronounced for firm with below median investment opportunities. This last result is again consistent with the findings in Lang et al. (1991) and supports the free cash flow hypothesis.

We report little or no support for debt financing playing either a monitoring role or reducing managerial discretion. While the link between debt financing and bidder gains is generally more positive for firms with poor investment opportunities, we do not find a significant difference when we compare this relation to that of firms with good investment opportunities.

The remainder of the paper is organized as follows. Section 2 develops the two main hypotheses that are tested and discusses the related literature. Section 3 presents the sample design, selection criteria, and research methodology. Section 4 presents the results for the univariate and multivariate analysis. Section 5 concludes the paper.

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## Section snippets

### The pecking order of financing choices and bidder gains

Following Myers and Majluf (1984), external financing is generally considered to be more costly, in terms of adverse selection costs and transaction costs, than internal financing. Furthermore, issuing equity is assumed to be more costly than issuing debt. Myers and Majluf (1984) focus on asymmetric information between managers and investors to derive a model, which predicts that firms will never finance their investments with equity and would rather reject a positive NPV project in order to…

### Sample and data definitions

The sample is constructed from Securities Data Corporation (SDC) International Merger and Acquisition Database (SDC-IMAD) and contains acquiring firms for the period 1984–1998. The acquiring firms in the sample satisfy the following set of conditions. The transaction is completed and categorized by SDC as a majority takeover transaction, i.e., a merger, acquisition of majority interest, or acquisition of all assets. The successful bidder is the bidder making the first bid for the target. The…

### Multivariate regression analysis

We use the abnormal announcement period return to proxy for the net present value of the takeover bid from the acquirer's shareholders perspective. The reported regression specifications use the market-model residuals cumulated over the [−1,+1] as the dependent variable, but the results are robust to using the market-adjusted abnormal returns. The main variables of interest in this study are the various definitions of internal, equity, and debt financing. Each specification includes as number…

### Conclusion

Prior literature has theorized and documented a relation between the form of *payment* and a bidder's abnormal announcement return. When considering pure cash transactions, however, the actual source of the cash available for an investment—the *financing* decision—has largely been ignored as an explanatory variable in valuing managerial takeover decisions. This paper analyzes the relation between the source of the firm's funds available for the acquisition to bidder gains. It is shown that, holding …

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