Credit Market Driven Acquisitions

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Discussion – SFS Cavalcades – May 2022

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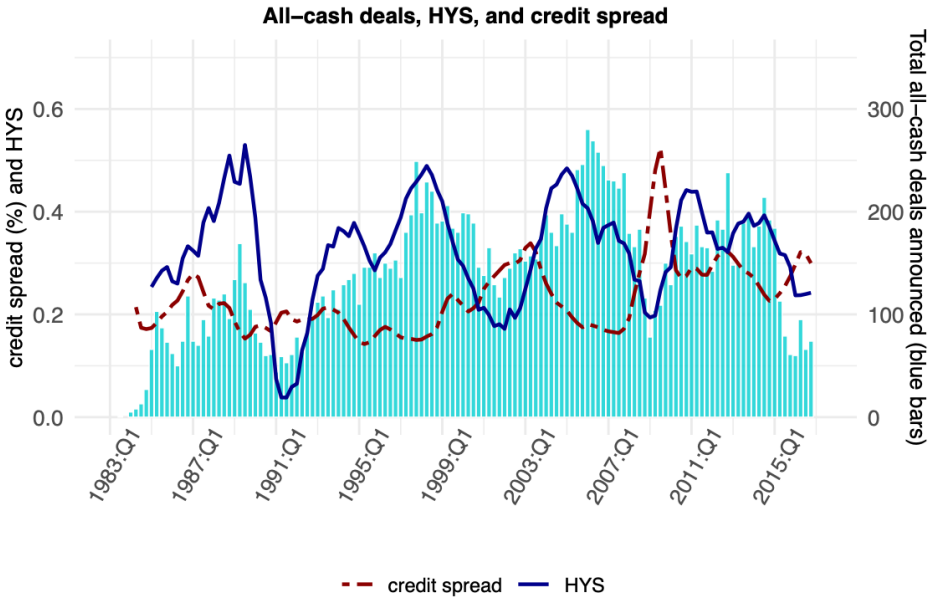
This Paper


All−cash deals, HYS, and credit spread
credit spread (%) and HYS
Total all−cash deals announced (blue bars)
0.0
0.2
0.4
0.6
0
100
200
300
1983:Q1
1987:Q1
1991:Q1
1995:Q1
1999:Q1
2003:Q1
2007:Q1
2011:Q1
2015:Q1
credit spread
HYS

This Paper

Understanding the dynamics of takeover activity

- Credit market conditions drive takeover activity
  - More for cash deals (debt financed?) than for stock deals
  - Signs of manager overconfidence?

This Discussion

- Quick summary
- What is the benchmark?
- Identifying the channel in another context (buyouts)

Plan

Summary

Why do firms engage in takeovers?

- Synergies ($V_{A+T} > V_A + V_T$)
- Cheap financing
  - Stock price is high: opportunity for a stock deal
  - Credit is cheap: raise cash for a cash deal

Testing the credit hypothesis

- Cash deals respond strongly to credit conditions
  -  *you could also raise cash with equity*
- Stock deals respond less to credit conditions

What are the fundamental differences between raising cash or equity?

Plan

Modigliani-Miller

Benchmark

- The cost of capital through equity or debt financing is the same
- General discount rates drive the value of corporate transactions:

$$PV(\text{Synergies}) = \sum_{t \geq 0} \frac{\text{CF}_t^{(A+T)} - \text{CF}_t^{(A)} - \text{CF}_t^{(T)}}{(1+r)^t}$$

  - Low discount rates: PV of deal is high $\rightarrow$ more deals and deals can be less profitable
  - High discount rates: PV of deal is low $\rightarrow$ fewer deals and deals have to be more valuable

Why should credit market matter more (or differently) than equity markets?

- What frictions determine corporate transations

Moving away from M&M Benchmark

Why do firms use debt to finance M&A?

General mispricing of debt and equity (in the aggregate)

- Test in the cross-section firms: Khwaja-Mian type variation on sources of debt financing
- Test in the time series: times where credit is tight relative to equity (health of banking sector)

Empire building

- Managers incentives to manage a large firm (compensation is tied to size)
- Debt financing alleviates some of the frictions (disciplining nature of debt)
- Tests in the cross-section of firms
  - Gompers, Ishii, and Metrick (2003); Free cash-flow (Jensen, 1986)

Moving away from M&M Benchmark

Other frictions

- Managerial quiet life
- M&A decrease industry market competition: free cash-flow problem (Giroud and Mueller, 2010)
- Internal capital market (socialism within the firm)
- Diversification channel

Plan

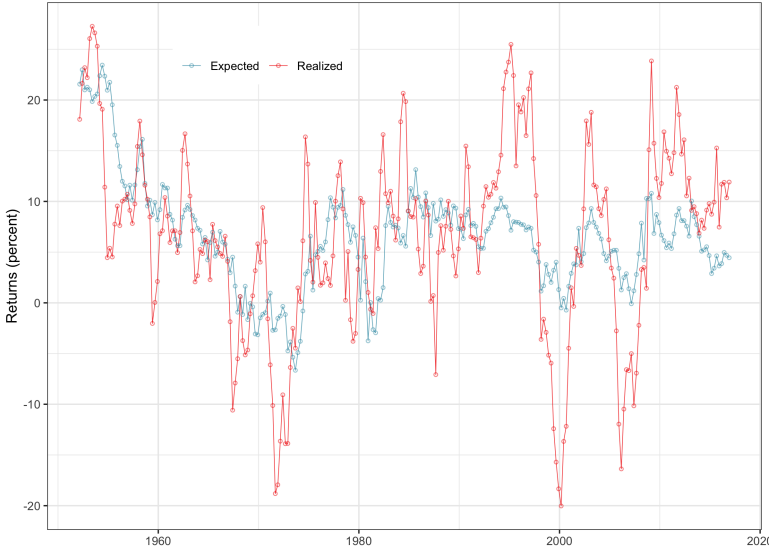
Do we want to move away from the benchmark?

Equity markets are great!

- Equity markets provide liquid and high frequency quotes
- High quality information about the cost of capital
  - in the time-series (predictability) ...
  - ... and in the cross-section (link between characteristics and returns)

Do we want to move away from the benchmark?

Measure of equity risk premium from Haddad, Loualiche, Plosser, JF 2017



Do we want to move away from the benchmark?

	Cash				Stock			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
HY Share	1.34**			1.40***	0.50			0.32
	(0.52)			(0.47)	(0.65)			(0.58)
Credit Spread		−0.01		0.06		−0.46***		−0.42**
		(0.08)		(0.07)		(0.16)		(0.16)
Risk Premium			−7.91***	−8.27***			−7.60**	−5.96
			(1.41)	(1.35)			(3.67)	(3.71)
R^2	0.07	0.00	0.09	0.17	0.01	0.11	0.04	0.13
Num. obs.	133	133	133	133	133	133	133	133

$^{***}p < 0.01$; $^{**}p < 0.05$; $^{*}p < 0.1$

Table: Takeover deals: Cash and Stock by Count

Do we want to move away from the benchmark?

	Cash				Stock			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
HY Share	1.59***			1.63***	0.26			0.03
	(0.49)			(0.45)	(0.70)			(0.60)
Credit Spread		−0.04		0.03		−0.57***		−0.53***
		(0.09)		(0.07)		(0.16)		(0.16)
Risk Premium			−7.02***	−7.27***			−8.80**	−6.72
			(1.66)	(1.51)			(4.37)	(4.27)
R^2	0.11	0.00	0.08	0.19	0.00	0.13	0.05	0.16
Num. obs.	133	133	133	133	133	133	133	133

$^{***}p < 0.01$; $^{**}p < 0.05$; $^{*}p < 0.1$

Table: Takeover deals: Cash and Stock by Value

Other example: the case buyouts, from public to private

Buyout transactions (Haddad, Loualiche, and Plosser, JF 2017)

- Performance channel: buyouts increase cash-flow growth
- Diversification channel: buyouts decrease diversification of GP's portfolio
- Both costs/benefits vary with aggregate discount rates (not credit specific activity)

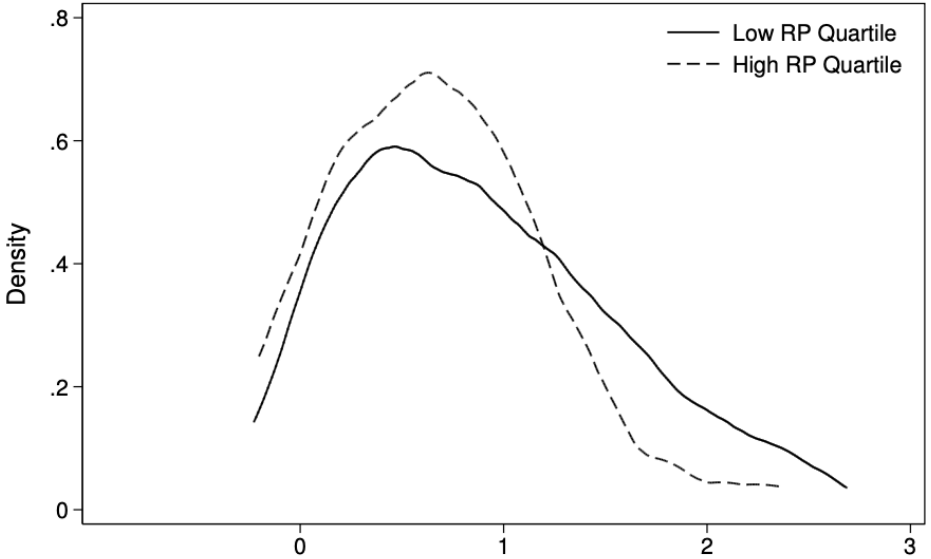
Other example: the case buyouts, from public to private

Buyout volume goes down with discount rates

Panel A: Volume of Activity									
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
$\hat{rp}$	−1.17***		−1.14***		−1.26***		−1.22***		−1.50***
	(0.25)		(0.25)		(0.24)		(0.25)		(0.24)
EBITDA Spread		1.50*	0.27					1.01	2.10*
		(0.81)	(0.48)					(0.99)	(1.09)
HY Spread				−1.07*	0.34			−0.59	1.92**
				(0.63)	(0.42)			(0.93)	(0.97)
GZ Spread						1.21	−0.76	1.82*	−1.17
						(1.34)	(0.72)	(1.08)	(0.95)
Observations	117	117	117	117	117	117	117	117	117
R^2	0.317	0.074	0.319	0.077	0.322	0.031	0.322	0.107	0.360

Other example: the case buyouts, from public to private

More risky buyouts with low discount rates



Other example: the case buyouts, from public to private

More risky buyouts with low discount rates

Panel A: Performance Proxies

	(1)	(2)	(3)	(4)
Characteristic (X):	β	GIM	FCF/Assets	Industry HHI
$(X)\hat{rp}$	−0.026*	−0.058**	−0.0085	−0.044***
	(0.014)	(0.025)	(0.017)	(0.015)
Time FE	X	X	X	X
Observations	234	174	234	234
R^2	0.015	0.030	0.001	0.028

Panel B: Illiquidity Proxies

	(1)	(2)	(3)	(4)
Characteristic (X):	M&A Vol.	M&A Val.	IPO Vol.	IPO Val.
$(X)\hat{rp}$	0.060***	0.015	0.021*	0.024*
	(0.014)	(0.013)	(0.013)	(0.013)
Time FE	X	X	X	X
Observations	234	234	234	234
R^2	0.085	0.006	0.012	0.015

Other example: the case buyouts, from public to private

Horse race of credit and equity on M&A Activity

Panel A: Volume

	M&A					LBO/M&A		IPO
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
$\hat{rp}_{OLS}$	−0.054***	−0.052***	−0.054***	−0.054***	−0.052***	−0.032**	−0.054***	0.0087
	(0.0062)	(0.0065)	(0.0061)	(0.0078)	(0.0071)	(0.015)	(0.018)	(0.026)
EBITDA Spread		0.058*			0.033		0.14**	
		(0.033)			(0.038)		(0.070)	
HY Spread		0.027*			0.0040		0.15**	
		(0.015)			(0.025)		(0.061)	
GZ Spread		0.00024			−0.015		0.13	
		(0.047)			(0.040)		(0.082)	
GDP Growth			−0.55		−0.82		13.9***	
			(2.44)		(2.75)		(3.96)	
CE Fund Discount				0.015*	0.014		0.010	
				(0.0083)	(0.0100)		(0.020)	
Sentiment				0.059	0.064		−0.12	
				(0.081)	(0.073)		(0.097)	
Observations	123	123	123	120	120	116	113	164
R^2	0.456	0.488	0.457	0.475	0.491	0.079	0.242	0.007

Final Thoughts

Interesting Paper! Go read it.

Take away

- How do credit conditions drive takeover activity
- Separation between cash and stock deals highlight the role of credit
- ... but equity markets are still useful?