Corporate financing decisions and their implications: Evidence from takeovers and rights offerings by firms in India

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Abstract

Financing decisions by managers of firms occupy the central position in corporate finance. Despite the voluminous body of research on corporate financing decisions, several intriguing questions remain unanswered. Some of these research questions cannot be answered using contexts, such as those of the US and other developed markets, in which the bulk of the literature has been set. This dissertation exploits the Indian context to examine some novel questions related to corporate financing decisions and their implications. In this dissertation, which has been divided into three essays, we examine two different kinds of financing decisions by managers of firms in India – financing of acquisitions and raising of capital using rights offerings.

In the first essay, we exploit an interesting setting of overlapping insiders at the acquiring and target firms in acquisitions and answer how the presence of overlapping insiders influences the financing of these large investments. All prior studies on takeovers have either been set in a context where the insiders of an acquirer and those of a target are almost always different sets of individuals, or they do not consider the possibility of having common insiders at the acquirer, as well as the target, when financing acquisitions. In markets with business groups, both in developing and developed countries, there is a distinct possibility that both the acquirer and the target belong to the same business group in case of corporate acquisitions, and thus, they share the same set of insiders. When the insiders are overlapping on both sides of an acquisition deal, the considerations of control are likely to become unimportant in financing of the deal. The first essay

of the dissertation proposes a new order of financing investments based on the considerations of control and financial constraints in a market with the presence of business groups. Basing our analysis on a sample of acquisitions, we test the relative propensity of group-affiliated firms, as well as that of standalone (non-affiliated) firms, to finance their investments with stock on the one hand, and either cash or debt on the other. We find that group-affiliated bidders have the greatest propensity to finance their investments with stock when taking over firms affiliated with the same business group (within-group acquisitions), followed by standalone firms making acquisitions (standalone acquisitions). Finally, group-affiliated bidders acquiring either standalone firms or firms not affiliated with their group (outside-group acquisitions) have the lowest propensity to finance their investments with stock. The evidence of higher stock-financing of within-group acquisitions is robust to alternative explanations of tunneling and propping up in business groups.

In the second essay, we again exploit the setting of overlapping insider ownership in acquiring and target firms in India to conduct direct tests of adverse selection in stock-financed acquisitions. We find that when the insiders are non-overlapping on both sides of the deal, cash-financed deals generate greater value for acquiring firms' shareholders relative to stock-financed deals. The underperformance of stock-financed deals relative to cash-financed deals in the case of non-overlapping insiders is consistent with the adverse selection effects of stock issues. The presence of overlapping insiders at the acquiring and target firms, on the other hand, is likely to mitigate adverse selection in stock-financed acquisitions due to symmetric information between the transacting parties. Consistent with this explanation, we show that stock-financed deals with overlapping insiders outperform those without them. Finally, we do not find a significant difference between the performance of stock-financed and that of cash-financed deals, when there is an insider overlap on both sides of the deal. This result suggests that difference in performance between cash-financed and stock-financed deals stems primarily from the adverse selection effects associated with equity issues.

The third and final essay of the dissertation is based on another important corporate financing decision – capital raising through rights offerings. Rights offerings, as well as follow-on or further public offerings (FPOs), are two different forms of seasoned equity offerings (SEOs). Unlike some of the developed markets such as the US, rights offerings have been a popular means of raising finance in India, and rights offerings often outnumber the FPOs year after year. Even though both rights offerings and FPOs involve the issue of new shares to investors, there is a striking difference between the issue of rights offerings and that of FPOs. In an FPO issue, the new shares are almost always issued to the new investors, while in a rights issue, the new shares are issued primarily to the existing shareholders of a firm. Further, unlike an FPO, a rights offering can potentially transfer wealth from non-participating (minority) shareholders to participating shareholders (insiders) of the rights-issuing firm, and the extent of wealth transfer increases with the degree to which earnings are managed downward. Exploiting these notable differences between the two types of SEOs, we hypothesize as well as document income-decreasing accrual-based earnings management as well as real-activities based earnings management immediately prior to the issue of rights offerings. Further, the incidence of accrual-based earnings management is limited to the period of weak corporate governance enforcement. Our results, which are in stark contrast to the conventional wisdom of income-inflating earnings management around SEOs, also provide evidence of another form of tunneling of wealth from minority shareholders to insiders.

Overall, this dissertation attempts to exploit the uniqueness of the Indian context to answer some questions hitherto little explored on corporate financing decisions of firms and which are otherwise difficult to answer in many other contexts.