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The role of credit lines in funding takeovers

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Abstract

I provide new evidence on the role of credit lines in M&A, using a hand-collected sample of the sources of funds in 1,400 US takeover bids from 1994–2020. I show that credit lines are the most frequently used source, financing partially 57% and entirely 23% of the cash bids. Deals financed with new or amended credit lines tend to have higher bidder returns and lower premiums than deals financed with existing credit lines or other sources. This suggests that creditor screening in negotiating credit lines positively influences firms to make value-creating acquisitions.

Theoretical Motivation and Predictions

Possible channels for the valuation impact of the use of credit lines in M&A

1. **Creditor control**: The negotiation of credit lines allows banks to screen firms' takeover decisions (Diamond, 1991).
   - Empirical evidence: Creditors use their bargaining power to influence firm policies through covenant restrictions (Becher et al., 2022).
   - Prediction 1: Bidder announcement returns are higher in deals financed with new or amended credit lines that require creditor consent.
2. **Financial flexibility**: Undrawn credit lines offer firms the flexibility to act fast on new valuable acquisition opportunities (Martin and Santomero, 1997).
   - Survey evidence: CFOs use credit lines to fund investment projects available in good times (Lins, Servaes, and Tufano, 2010).
   - Prediction 2: Deals financed with existing credit lines close faster and have higher bidder returns.
3. **Agency problem**: Access to undrawn credit lines allows empire-building managers to make lower-quality M&A (Jensen, 1986).
   - Empirical evidence: Cash-rich firms are more likely to make value-destroying acquisitions (Harford, 1999).
   - Prediction 3: Bidder returns are lower in deals financed with existing credit lines.

Data

- Publicly listed firms from CRSP, Compustat.
- Mergers from SDC.
- I manually retrieve bid funding data from 8,000 company filings (10K, 10Q, 8K) on EDGAR.

⇒ **Final sample** of 3,199 takeover bids (1994-2020), with detailed data on the funding sources and credit line contracts in cash bids.

Main Takeaways

- The traditional view is that credit lines are used primarily to fund short-term liquidity needs. A surprising finding of this paper is the extensive use of credit lines to fund the cash component in takeover bids.
- Bidder announcement returns and the combined dollar returns are higher for deals funded with credit lines, but only in the subsample where the credit line is negotiated with the bank.
- Deals financed with existing credit lines tend to close faster, consistent with undrawn credit lines offering firms the flexibility to quickly act on new takeover opportunities.
- Firms often refinance their credit lines shortly after the takeover, implying that the credit lines effectively serve as bridge loans.

Funding of the cash portion in 1,400 takeover bids

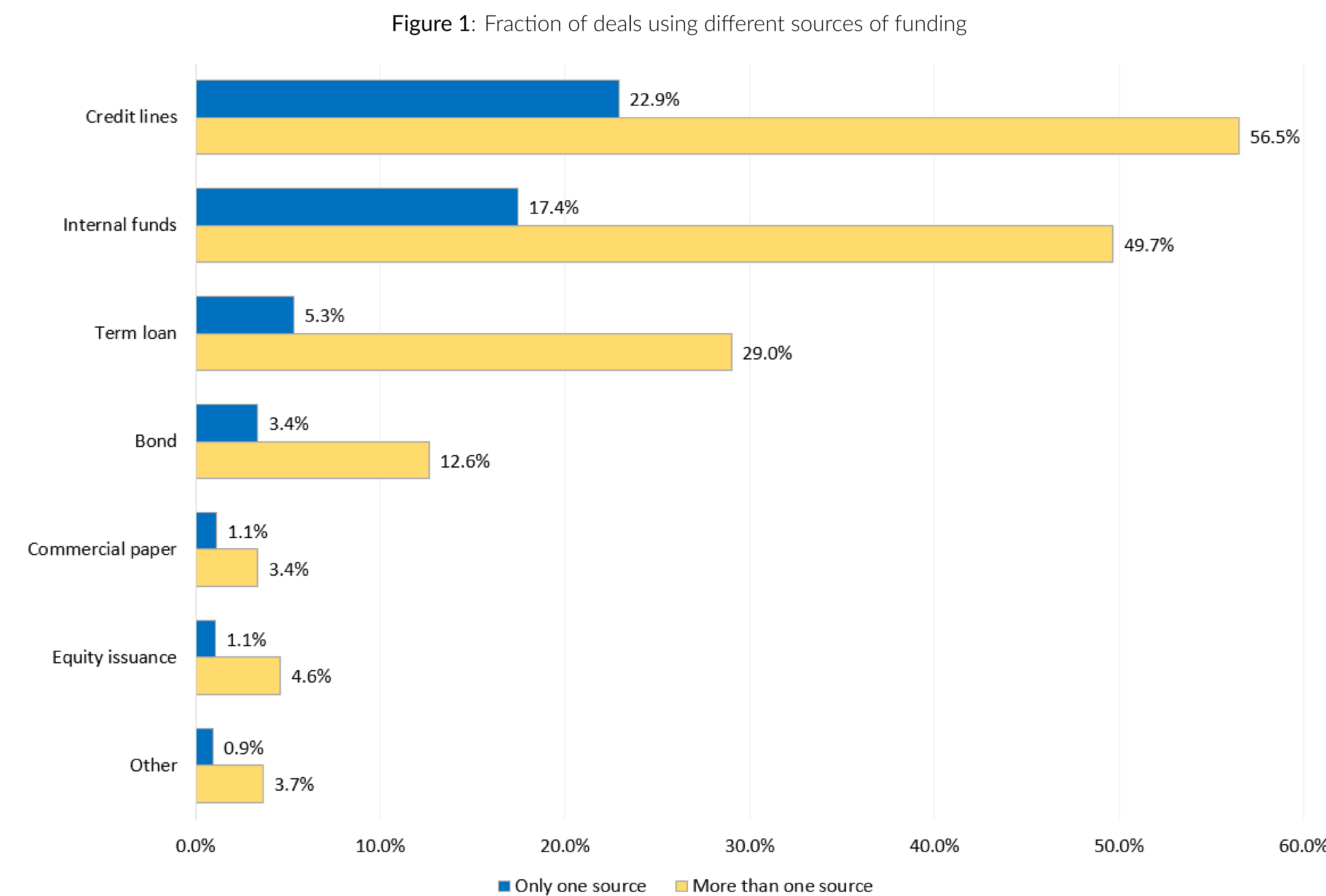
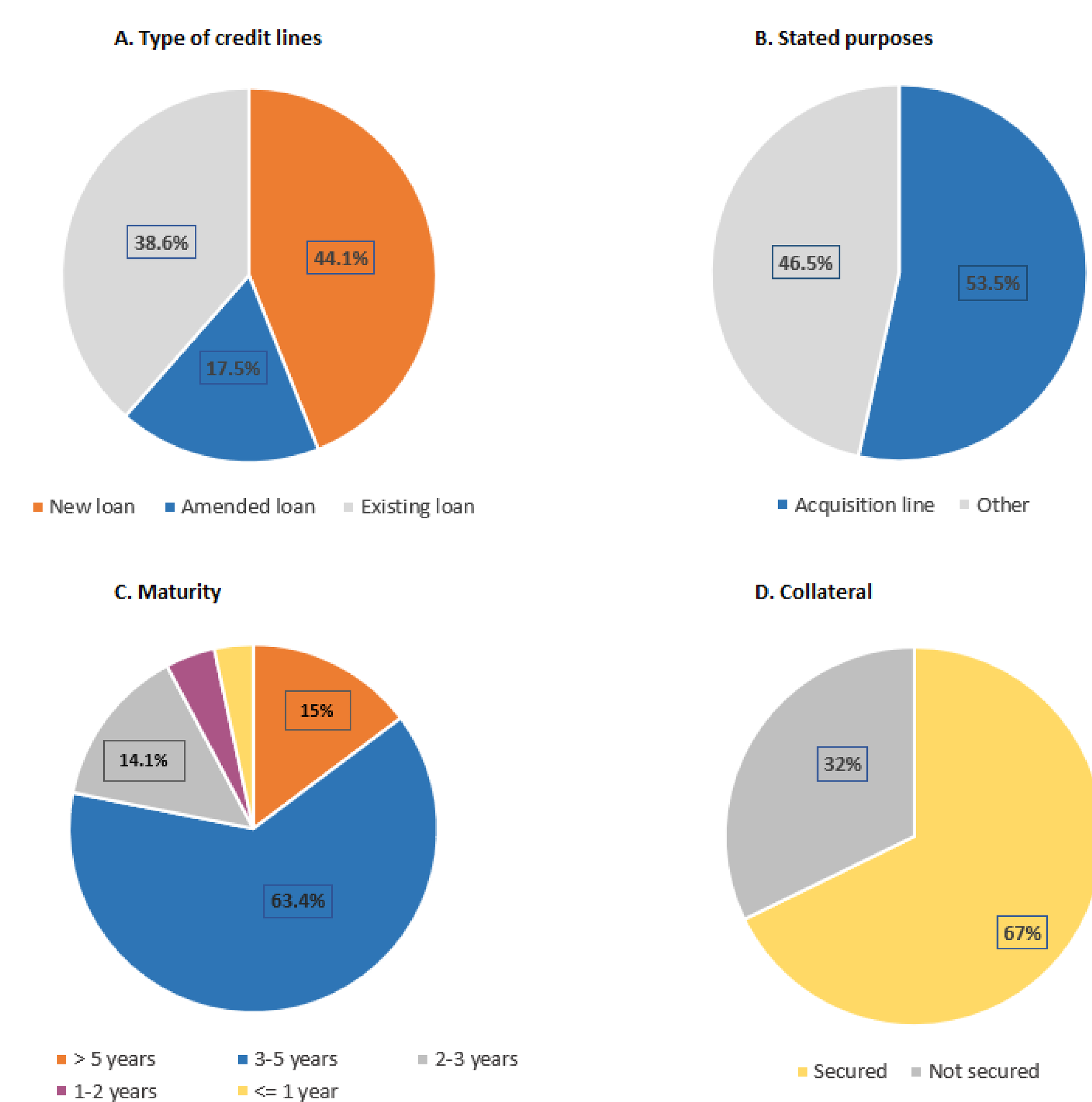


Figure 1: Fraction of deals using different sources of funding

Credit lines in M&A: Loan characteristics

Figure 2: Credit line financing (N=787)



Main Results: Cross-sectional Regressions of Bidder CAR

Models	(1)	(2)	(3)	(4)	(5)	(6)
CL	0.006*	0.004			-0.006	-0.009
	(1.77)	(1.08)			(1.06)	(1.53)
OLDCL			-0.005	-0.008		
			(0.97)	(1.46)		
REVISECL			0.014***	0.012***	0.019***	0.021***
			(3.18)	(2.71)	(2.94)	(3.30)
Firm Controls	Y	Y	Y	Y	Y	Y
Deal Controls	Y	Y	Y	Y	Y	Y
Year FE	Y	Y	Y	Y	Y	Y
Industry FE		Y		Y		Y
Observations	3,053	3,052	3,053	3,052	3,053	3,052

(*) Dependent variable: bidder CAR from two days before and two days after the announcement date (event-study methodology).
(*) Deal controls: Large relative size, public target, all cash, all stock, tender offer, within-industry merger, hostile.

- Bidder CAR are higher in deals funded with new/amended credit lines (*REVISECL*) → consistent w/ **Prediction 1**.
- No relationship between existing credit line financing (*OLDCL*) and bidder CAR → fails to support **Prediction 2** and **Prediction 3**.
- Economically significant (large): 1.2-1.4 percentage points (pp) higher average bidder gains.

Endogeneity concern and identification

- **Omitted variable bias**: Possible that firms' choice of financing with credit lines is correlated with certain observed or unobserved bidder- and/or deal-specific characteristics.
  - Use Heckman's (1979) two-stage procedure to correct selection bias.
  - Instrumental Variables (IV)
    - Z (Instrument for *OLDCL*): Unused credit line capacity in the year prior to the takeover.
    - **Relevance**: firms with greater unused credit lines are more likely to finance their bids with existing credit lines: confirmed in the first stage (F-stat = 75).
    - **Exclusion**: Unused credit lines (Z) can only influence bidder CAR (Y) via its effect on the use of existing credit lines in acquisitions, conditional on other channels being controlled.
  - Additional robustness: different measures of bidder gains, the sample of all-cash bids only, and inclusion of firm FEs.

  ⇒ Results are consistent with the main results.

Additional tests and interpretation

The evidence suggests that creditor screening creates value for acquirers

1. If creditor screening impacts bidder returns, the effects of new/amended credit line usage should be more pronounced in subsamples where screening is more valuable.
   - Supporting evidence: Higher bidder CARs in deals funded with new/amended credit lines when (i) the loan is provided by top-tier banks and (2) the acquirer is relatively small, for which outside advice is more beneficial.
2. Acquirers using new/amended credit lines bid less aggressively due to creditor screening.
   - Supporting evidence: The combination of higher bidder CAR and lower premium suggests that bidders extract a greater portion of the takeover gains.

References

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