Chapter 3

M&A Activity, Financial Distress, and Trade Credit: Evidence from Turkey

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ABSTRACT

This paper investigates the effects of firm constraints on the likelihood of M&A involvement and explores if mergers mitigate financing constraints. The results display that young and small firms facing financial constraints, corporations that have low R&D expenditures and capital investments have higher likelihood of M&A activity. Firms that compete in technology-driven industries are more likely to merge. Equity-constrained firms have high likelihood of M&A involvement while cash insolvency and leverage are not significantly related with mergers. The results support the positive relation between the use of trade credit and financial distress displayed in previous studies, but reveal that distressed firms involved in mergers reduce trade credit significantly. Results indicate that mergers mitigate the positive relation between distress and trade credit. Distressed firms involved in mergers avoid payables which rank lower in pecking order finance. M&As seem to alleviate financing constraints for cash-constrained corporations in an emerging market.

INTRODUCTION

The extensive literature on M&As start with motives for M&As (Lubatkin and O’Neill, 1987; Kim and McConnell, 1977, Higgins and Schall, 1975, Lee, 1977; Shrieves and Pashley, 1984; Lewellen, 1971), post M&A performance, and gains to acquirer and target shareholders (Elgers and Clark, 1980; Healy et.al, 1992; Franks et.al, 1991; Bradley et.al, 1988). Recent research on M&As focuses on how and when mergers can be value creating or destroying (Borochin, 2014; Moeller et.al, 2005; Clooet et.al, 2006; Sevilir and Tian, 2011). Moreover, discussions prevail on the role of M&As in alleviating constraints for firms. The effects of parent-subsidiary relation on financial flexibility of corporations are investigated (Vijh, 2006). A firm with few investment opportunities may seek to be acquired by a firm with a larger capacity for debt thereby reducing free cash flows and agency costs.

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Frictions in financial markets that arise primarily from the information asymmetry between a firm and a lender can make the external financing costly and these financing constraints can be mitigated if a firm is a subsidiary of a conglomerate having access to the internal capital market of the entire organization or has a parent-subsidiary relation following an acquisition (Stiglitz and Weiss, 1981; Myers and Majluf, 1984; Greenwald et al., 1984). Size, age, growth, R&D intensity are alternative measures that affect the information asymmetry surrounding the corporations, and encourage sale through a merger since the value of such organizations will be difficult to assess by the market participants (Poulsen and Stegemoller, 2008). Financial distress, and its close relation with the capability to innovate in technology competitive environments (Eisdorfer and Hsu, 2011) lead to mergers that tend to reduce distress and increase innovation performance of firms. (Gantumur and Stephan, 2011)

The need for financial flexibility is inversely related to the size of the capital markets and the quality of the legal system of the country (Bancel and Mittoo, 2004). The authors reveal that financial flexibility is valued more in French civil-law countries and firms have higher concerns for maintaining target debt-to-equity ratios and matching maturity than do firms in the common law countries. The study by La Porta et al (1998) rests on 49 countries, including Turkey, and find that highest ownership concentration is found in French civil law countries and report that the three largest shareholders hold 59% of shares in Turkey. Furthermore, La Porta et al. (1997) report that countries with poor investor protection have smaller debt and equity markets which bring financial constraints for the firms. Consequently, the study has important implications for the equity-constrained firms that have limited access to financial markets in emerging markets such as Turkey.

The first part of the paper attempts to disclose the impact of information asymmetry measures like R&D expenditures, growth, distress, and ownership concentration on the likelihood of M&A involvement of the constrained firms operating in an emerging market, controlling for size, age and industry of the firms. The evidence rests on 212 nonfinancial firms listed in Borsa Istanbul over 2006-2010 period. The second part of the paper investigates whether M&A involvement mitigates the constraints of the firms involved in mergers. Resting on the literature that distressed and financially constrained firms rely more on trade credit because of unavailability of other resources (Molina and Preve, 2012; Atanasova, 2012; Petersen and Rajan, 1997), we investigate if the constrained firms which are involved in M&A activity reduce the use of trade credit which ranks lower in pecking order finance than debt. M&A involvement is expected to increase financial flexibility of the constrained or distressed subsidiaries by enabling access to the resources of the merged entity.

Results reveal that firms that have low R&D expenditures and capital investments have higher likelihood of M&A involvement to reach economies of scale in operations. Distressed firms that have low equity to asset ratios, small and young firms that are more constrained in their access to financial resources, are more likely to be involved in M&A activity. Firms in highly competitive, technology-driven industries have higher likelihood of M&A activity involvement. The results display that equity-constrained firms tend to be involved in acquisitions while there is no significant relation between distress and M&A activity in firms facing cash insolvency. The positive relation between liquidity and M&A activity reveals that the likelihood of being involved in an M&A rises as cash holdings of a firm rise. This evidence documents that M&A activity is a means of distress resolution only for firms that have equity erosion.

The results also reveal that cash-constrained firms involved in M&As reduce use of trade credit, indicating that M&A activity mitigates the constraints of the distressed firms enabling them to access to alternative resources. There is no significant relation between equity to assets ratio measure of distress
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