Deviation from the Target Capital Structure and Acquisition Choices: Evidence from Pakistan

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Abstract

This study investigates the influence of leverage deviations from their target capital structures on the mergers and acquisitions decision. To explore the impact of leverage deviation on acquisition decision we used panel data of Pakistani firms over a period of 21 years (2000 to 2020). We used panel regression to understand the relationship of leverage deviation and acquisition. Specifically, the research reveals that firms that find themselves over-leveraged compared to their target debt ratios exhibit a decreased likelihood of engaging in acquisitions. This research enhances the existing body of knowledge and specifically in the context of Pakistani firms' behavior by empirically expanding the comprehension of how deviation from capital structure impacts the investment decision i.e. mergers and acquisition.

Key Words: Target Capital Structure, Acquisition, Mergers, Leverage Deviation, Pakistan.

Introduction

History reveals that business activities have been an integral part of mankind on this earth, with the passage of time and evolution of technology the business strategies streamlined, industry rules and regulations made, economies developed. The sole purpose of business remains the maximization of shareholder's wealth and value creation. Investors are always in search of opportunities where they can invest their wealth and gain maximum (Denis, 2016). Business can grow themselves either by organic growth or inorganic growth. Organic growth means increase in market share by using internal resources like operation's expansion, broadening the product offering, increase in sales. Mergers and acquisitions are taking place since ages and they are increasing in volume and value with the passage of time. The type of mergers may vary across the globe and time. Every merger and acquisition deal is unique and may have a particular motive behind it. There are so many motives identified by theory behind mergers. Managerial motivations idiosyncratic motives, corporate control, tax considerations, synergistic gains, and inefficient financial markets, market structure valuation gaps are the most cite in the literature (Weidenbaum & Chilton, 1988).

One of the reasons for mergers and acquisitions is capital restructuring. Businesses may engage in mergers and acquisitions in order to maximize value creation and improve their debt-to-equity ratio. In this approach, companies can restructure their capital (Gaughan, 2010). The capital structure of the company and investment choices are closely related. Following the development of the modern capital theory, this field has seen extensive investigation. According to the capital structure theory, a company should choose the best possible capital mix since it will gain more from tax benefits than interest payments (Modigliani & Miller, 1958).Firms often have specific leverage targets, and evidence from acquisitions suggests that these targets play a significant role in shaping the financial structure and decision-making of acquiring companies. One of the most important aspects of corporate finance is leverage, or the use of debt to finance operations and investments. This is particularly valid throughout M&A transactions. The following factors may be taken into account when interpreting an organization's leverage aims in the context of acquisitions: risk management, integration costs, market circumstances, shareholder value optimization, and regulatory concerns.

Leverage objectives in the context of mergers and acquisitions (M&A) provide insight into the financial approaches' companies use during times of change, which are fundamental to understanding the world of finance. Academics and practitioners need to have a deep grasp of the precise leverage goals that are sought throughout these financial transactions in order to properly comprehend the underlying motivations, risks, and repercussions involved with M&A transactions. Pakistan is an attractive and understudied market for leverage targets in M&A research. As a result of economic reforms, sector consolidation, and globalization, M&A agreements in Pakistan have increased in recent years. The motivation of this study is to analyze the relationship of leverage deviation and mergers decision in the context of Pakistan. To the best of our knowledge, the mergers and acquisition is least studied area in Pakistan literature. In this paper we have used the three-stage approach, in first step we will estimate the target leverage of the sample firms, in second stage the deviation from target leverage will be calculated and in final step the impact of target leverage on merger decision will be observed.

Literature Review

During an M&A, a company's financial decision-making process heavily relies on its leverage objectives. They take into account which mix of loans and equity will best finance the deal. These objectives are typically stated as certain ratios, such as the debt-to-equity ratio, which shows how much of a company's capital structure is made up of debt as opposed to equity. A company's leverage goals in the context of acquisitions can be viewed from the following angles: regulatory issues, market conditions, risk management, integration expenses, and strategic finance. Firms purpose of existence lies in maximization of shareholder wealth. In the business world firms are bound to compete, there are always someone who leads the share in the market while others lag them. Every business wants to grow and compete in the market in order to grab the maximum

market share and maximize the shareholder's wealth. Firms can expand their business activities or acquire the existing entities in order to improve its operating efficiency. There are so many motives involved behind mergers and acquisitions. Devos, Kadapakkam, and Krishnamurthy (2009) categorized the motives of mergers and acquisition. The first motive identified is the productive synergy, the second listed is diversification in order to gain benefit from the tax savings and the third most observed motive behind mergers is high market dominance.

After late 1980s the research in the area of Mergers and acquisition accelerated. Resti (1998) identified that companies profitability increases after merger and acquisition as they have bigger pool of resources available to increase the synergy. The free cash flow theory (Jensen, 1986) supports the agency cost theory in explaining firm's behaviors toward mergers and acquisitions. The both theories supports that fact that firms having high liquidity are more inclined towards acquisitions. Firms laying with free cash flow show more interest towards low-benefit takeovers (Hanson, 1992). Harford (1999) studied cash richness and takeovers. The study reveals a positive relation between free cash flow and takeover. And he observed conflict of interest among managers and shareholders. Due to poor future anticipation in such scenario a negative market reaction has been observed for acquiring firms.

What should be the optimal capital structure of the firm? How firms choose the combination of debt to equity? The debate on these questions is still open and never ending. The finance literature has identified several theories relating capital structure decisions to the act of merger, among them (1) the latent debt capacity incentive, (2) the increased debt capacity incentive, and (3) coinsurance wealth transfer effects. Harford et al. (2009) studied firm target capital structure of large acquisitions in US. They examined the target capital deviations during mergers and acquisitions and how these deviations affect the financing decisions. The results showed a positive relationship among merger induced changes in target and actual capital mix. 75% of the merger firms reverse back to their target leverage within five years of mergers. Uysal (2011) stated that managers take in account the capital structure deviations while planning and structuring for mergers and acquisitions the study highlighted the interdependence of capital structure and investment decisions. Firms that are over leveraged are less inclined towards mergers and are hesitant to pay cash in their offer. Such firms go towards smaller targets. The findings say that overleveraged firms rebalance their capital structure after acquiring.

Martynova and Renneboog (2009) tested financial leverage during mergers and acquisitions. A cross sectional study is being conducted on US mergers over the span of 1978 and 1987. Findings state that leverage ratio significantly increased after mergers. The reason behind increase of debt is considered as an outcome of an increase in debt capacity. Ghosh and Jain (2000) analyzed the financing decisions involved in takeover. The findings show that ratio of external sources of financing is high as compared to internal funds. Internally financed acquisitions underperform than financed with debt. The financing decisions involved in mergers and acquisitions influenced by bidder's its corporate governance and cost of capital.   Dudley (2012) gave insights on capital structure adjustments in large investment projects. The findings of the

research say that firms readjust their debt ratios during the investment projects and firms prefer equity over the debt for financing of projects. Dudley endorses the tradeoff theory and infer that firms move closer to their target leverage when they invest.

Mergers and acquisitions play a crucial role in facilitating corporate growth, efficiency enhancement, market share expansion, and overall financial performance improvement for businesses across the globe. However, the effectiveness of these strategies and their impact on financial performance may vary depending on various factors, including leverage targets (Andrašić, Milenković, Mijić, Mirović, & Kalaš, 2018).

A company's leverage target is the maximum level of debt or leverage that it hopes to maintain. For academic researchers as well as practitioners, it is essential to comprehend the significance of leverage targets in mergers and acquisitions, as it may offer insightful information about the decision-making processes and results of significant deals Previous research often considers low leverage to be a favorable characteristic in the context of mergers and acquisitions. The acquirer may utilize its available financing capacity to take advantage of expansion opportunities after acquiring the target firm. According to Jensen (1986), Low debt benefits acquirers since it allows them to use their borrowing capacity post-acquisition, improving their financial position and allowing them to explore further growth opportunities. Deng (2023) also concluded in his research that firms leverage deficit plays an important role in mergers decision and firms who are over levered behaves differently than the under levered firms.

Rafaqat and Rafaqat (2020) indicate that a company's chance of being acquired is increased by low leverage in order to strengthen this argument. When conducting mergers and acquisitions, leverage deficit is an important consideration since it allows the acquirer to use its available borrowing capacity after purchasing the target firm. Potential improvements in the financial situation and the ability to investigate future development opportunities are made possible by this increased flexibility. Eichholtz and Kok's (2008) analysis lends support to the concept that leverage objectives are significant in merger and acquisition transactions. With a focus on the years 1999–2004, their study looks at data from 122 mergers and acquisitions across a five-year period. According to Eichholtz and Kok's investigation, there is a connection between leverage goals and the outcomes of mergers and acquisitions. Specifically, their findings indicate that acquisition targets are more likely to be low-leverage enterprises.

Mugoša and Popović (2021) argues that companies with lower levels of debt are more likely to make acquisitions, although the market usually reacts negatively to these transactions. On the other hand, companies with high levels of leverage are less likely to make acquisitions, but when they do, the deals are worth more. Uysal (2011) supports this by showing that businesses with high levels of debt are more likely to realign their capital structures in anticipation of acquisitions than to pursue acquisitions themselves. These findings have applications for corporate finance practitioners as well as researchers. Deng (2023) also highlighted leverage deviation a great motive for acquiring new business. He conducted research on USA companies and find out that achieving the targeted capital structure can be done through mergers and

acquisitions. over levered firms tend to acquire firms having low levered level so that it can compensate them. Bae and Chung (2022) also suggested that firms investment decision are heavily influenced with their leverage level, firms with zero leverage are considered as conservative and let go of many investment opportunities while firms who are under levered takes risk and go for diversion and expansion by mergers or acquisition.

Various studies have examined the variables influencing Pakistan's capital structure. Tangibility and profitability are significant variables, as found by Nasimi (2018); the latter has a positive association with leverage, while the former has a negative correlation. As per Mazhar (2010), enterprises that are controlled by the government often utilize more leverage than those that are not. Riaz (2011) identified profitability and asset growth as key determinants, while Sheikh (2011) found that the debt ratio has an adverse correlation with business size and a positive relationship with other characteristics like profitability, liquidity, earnings volatility, and asset structure. The aforementioned studies emphasize the significance of a company's asset mix, ownership structure, and financial performance in defining its capital structure.

This article addresses a gap in the literature by examining the relationship between acquisition decisions and deviations from the target capital structure in emerging nations such as Pakistan. Although the factors influencing the target debt ratio have been studied in the past, little is known about how the leverage deficit really affects mergers choices in Pakistan. By presenting empirical data on the connection between acquisition decisions made in developing markets and deviations from the desired capital structure, the research seeks to close this gap. This study contributes to the existing literature on capital structure and investment decisions by providing empirical evidence on the interdependence between target capital structure and acquisition choices in developing countries. The study uses a three-step process to estimate the target capital structure and deviations from it, and tests the probability of making an acquisition depending on the from the deviations target debt ratio. The findings of this study could be valuable for managers engaged in evidence-based decision-making regarding capital structure. It can assist in determining the key factors that contribute to an optimal capital structure and how this structure can subsequently influence future investment decisions.

Research Methodology

The study is conducted to analyze the relationship of leverage deviation and acquisition decision using the sample of public traded companies in Pakistan. The data is taken from Karachi stock exchange website, Competition Commission of Pakistan and from the respective companies' websites. There was total 586 deals listed on the Competition Commission of Pakistan website. The time frame taken for the analysis of Mergers and acquisitions is 2002-2020. A few checks were applied to refine the data, firstly only those companies were selected who acquired the 50% shares of the other company. Secondly Acquirer company should be registered Pakistani Firm. Thirdly only completed merger and acquisition deals are taken into analysis. Financial and non-financial sectors are included in sample. However, modaraba and insurance firms are excluded

from the sample due to uniqueness in their balance sheets as compared to other firms included in the sample.

Our estimation of the hypothesized relationships requires identification of over and under levered firms. Every firm has its own characteristics and optimal level of debt varies from company to company. So, estimation of target capital structure needs to be measured for every firm. I followed the three-step procedure for this purpose as adopted in (Fama & French, 2002; Mugoša & Popović, 2021; Uysal, 2011). The first step involves estimation of the target capital structures for each of the sample firms. The second step involves deviations of actual leverage ratios of each firm from the estimated targets, while the third step would finally conclude on classifying the firms into over and underleverage categories. The details of these steps are given below. In first step target market leverage is estimated by regressing the market leverage over the determinants of capital structure. The fitted value of this regression is defined as target leverage ratio (Harford, Klasa, & Walcott, 2009; Kayhan & Titman, 2007; Mugoša & Popović, 2021; Titman & Wessels, 1988; Uysal, 2011). The general equation is mentioned below:

$$\text{Market leverge}_{i,t} = \alpha + \beta X_{i,t-1} + \epsilon_{i,t}, \qquad \text{.........(1)}$$

Every firm is unique in terms of its operations and practices and it's very difficult to actually calculate the target capital structure of the firms, but previous researches has helped us in determining the factors who critically impact the capital structure of a firm. The variables we have used in degerming the target leverage is firm size, profitability, tangibility, market to book ratio and sales as shown in equation 2. As per the existing literature on the leverage targets the leverage ratio increases with the increase in firm size , level of fixed assets and non-debt-tax shield whereas the leverage targets decreases with the increase in firms profit ,growth opportunities, product uniqueness , level of bankruptcy, R& D costs (Fama & French, 2002; Harford et al., 2009; Harris & Raviv, 1991; Kayhan & Titman, 2007; Titman & Wessels, 1988; Uysal, 2011).

$$Lev_{i,t} = \alpha + \beta_1 Size_{i,t-1} + \beta_2 Profit_{i,t-1} + \beta_3 Tang_{i,t-1} 1 + \beta_4 M/B_{i,t-1} + \beta_5 \text{Sales}_{i,t-1} + \varepsilon_{i,t} .... \quad (2)$$

In the second step the leverage deviation is calculated by subtracting the predicted leverage level from the actual leverage of firm as shown in equation 3

$$\text{LevDeviation} = \text{TLev}_{i,t} - \text{Lev}_{i,t} \qquad \text{.....(3)}$$

After calculation of leverage deviation of firms, the firms are categorized as under leveraged, over leveraged and at the target leverage. This grouping is used in further analysis. In the next step, dummies based on leverage deviation categories (under or over levered) used in an estimation of the likelihood of acquisition decision in the following model

$$\text{M\&A Decision} = \acute{\alpha} + \beta X_{i,t\ t} + \beta_2 \text{overlevered} + \beta_3 \text{underlevered} + e_{i,t} \qquad ...(4)$$

The explanatory variables as suggested by the literature are used in equation in 4 are Market-to-Book ratio of assets, EBITDA/TA, Net sales, net debt (Deng, 2023; Harford et al., 2009; Uysal, 2011).

Results And Discussions

Table 1 below presents the descriptive statistics of the main variables used in our study

Table 1: Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
Size	308	16.9	2.3	7.0	21.5
StockReturn	277	2.5	42.4	-140.1	139.8
MTB	306	55.1	62.8	0.0	298.1
Sales	308	16.2	2.0	7.1	19.0
Selling Exp	228	22.0	28.7	0.5	98.7
Profitability	305	11.1	15.4	-42.4	75.3
Tangibility	307	35.0	25.8	0.0047	95.6

As per the Table 1 the size of companies has the average value of 16.93 by following the minimum value of 7.02 and maximum value of 21.46 stock return has the average value of 2.50 with having minimum value of -140.11 and maximum value of 139.82. The profitability ratio has average profitability of 11.14 with a range of 0.50 to 3.07. Leverage proxy equity to liabilities has average value of 0.09 with minimum value of -42.4 and maximum value of 75.31. The MTB is 55.13 averages with a range of 0.02 and 298.12. The tangibility has the mean value of 34.97 by following the maximum 95.62 and minimum with 0.004.

Table 2: Regression Model Result

	Market Leverage
Tangibility$_{t-1}$	0.02826**
	(-0.12047)
Profitability$_{t-1}$	0.215
	(-0.0304)
SellingExpSales $_{t-1}$	0.00***
	(-0.14599)
MTB$_{t-1}$	0.00***
	(-1.0221)
Sales$_{t-1}$	0.04**
	(0.0898)
Return$_{t-1}$	0. 0799
	(-0.0493)
R-sq: 0.7659	

*** indicates 1 %, ** indicates 5 % and * indicates 10% level of significance

Table 2 suggests that 76.59% change in target leverage is due to the independent variables. Each determinant is statistically significant in terms of sign and correlation to target debt ratio. The results are consistent with the previous studies(Kayhan & Titman, 2007; Mugoša & Popović, 2021; Uysal, 2011; Zhou, Tan, Faff, & Zhu, 2016). The targeted leverage increases with sales (0.089844). Larger businesses presumably have more debt capacity and easier access to funding sources due to less volatile revenue and diverse company. The target leverage is negatively linked with Market to book (-1.022089) and total return (-0.049267). It is more common for highly valued businesses to issue stock. It is logical to decrease debt when the market is favorable. The results are also consistent with market timing theory (Baker & Wurgler, 2002). Growth parameter (total return) is also significantly impacting the leverage ratio (-0.049267). This also confirms the market timing theory assumption managers are hesitant to issue shares at a discount. Profitability and target leverage ratio are significantly negatively associated (-.0304782) which explains the fact that cash rich firms rely more on internal resources then funding outside.

The second stage analysis

The second phase involves estimating the probability of making an acquisition using the leverage deficit variable. Leverage deficit is calculated by estimated the fitted values of target leverage as calculated in the step one analysis and subtracted from the firm actual leverage. The firms have been divided into quartiles according to the leverage deficit, Firms in the first quartile have the smallest deficit, hence named as underleverage while Firms in the last quartile have the largest deficit, hence named as overleverage. The logit model has been used to examine the marginal effects of variables in order to get more accurate results (Mugoša & Popović, 2021; Uysal, 2011). The likelihood of acquisition is correlated with the completed acquisitions' success. The dependent variable takes on value 1 in the event of a successful transaction and value 0 in the event of a failed transaction. The model incorporates size, growth, profitability, and leverage deficit as explanatory factors. Prior research (Datta, Iskandar-Datta, & Raman, 2001) (Officer, 2003) (Moeller, Schlingemann, & Stulz, 2004; Mugoša & Popović, 2021; Uysal, 2011) demonstrated that large corporations possess a well- a varied range of businesses, consistent cash flows, and simple access to funding sources. Moreover, the growth perspectives of the target and acquirer determine the purchase value (Smith & Kim, 1994).

Table 3: Regression Model Result

	M&A
Tangibility	0.016**
	(0.009)
Profitability	0.045**
	(-0.015)
Size	0.005
	(-0.158)

MTB	0.00***
	(-0.021)
Sales	0.039**
	-0.09
Return	0.037**
	(-0.049)
Underlevered	0.002***
	(3.753)
Overlevered	0.08*
	(-1.196)
	R-sq: 0.7022

The findings in table 3 demonstrate the increased acquisition likelihood for the underleveraged company grouping. The chance of acquisition rises by 3.75% with an increase in variable underleveraged enterprises. Size, profitability, and MTB are shown to be positively correlated and statistically significant.

Conclusion and Implications

For academics as well as practitioners, it is imperative to comprehend the function leverage targets play in mergers and acquisitions since it may offer important insights into the decision-making processes and results of these deals. Low leverage is frequently seen as a desirable quality in the context of mergers and acquisitions, according to earlier research. This is so that, following the acquisition of the target firm, the acquirer may make use of its existing borrowing capacity due to low leverage (Andrašić et al., 2018). According to Jensen (1986), acquirers benefit from low leverage because it gives them the freedom to use their borrowing capacity after the acquisition is completed, potentially strengthening their financial position and enabling them to pursue future growth opportunities. Harrison et al. (2018) concludes that low debt raises the possibility of a company being an acquisition target, which lends more credence to this idea.

In conclusion, leverage targets do matter in mergers and acquisitions. This paper enhances the existing research on the connection between capital structure and investment decisions by demonstrating the correlation between a company's leverage deficit and its choices about acquisitions. The firm's likelihood of undertaking acquisition decreases with its leverage deficit. They can influence the likelihood of a firm becoming an acquisition target and impact the financial position and flexibility of both the acquirer and the target company. In conclusion, leverage targets do matter in mergers and acquisitions. The study finds that overleveraged firms are less likely to make acquisition decisions. Managers of overleveraged firms also actively rebalance their capital structures when they anticipate a high likelihood of making an acquisition. However, the under levered firms has a significant impact on mergers decision and have higher probability to indulge in merger and acquisition activities.

The study's findings offer managers valuable insights to facilitate data-driven decision-making regarding capital structure, particularly in relation to investment decisions and the potential impact of capital structure on future acquisitions. This work addresses a notable gap in the existing literature by conducting an empirical analysis of the cause-and-effect relationship between acquisition decisions made in Pakistani markets and deviations from the ideal capital structure. A more complete approach to evaluating the intended capital structure and deviations from it has improved our understanding of the relationship between capital structure and investment decisions.

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