M&A Activity and the Capital Structure of Target Firms

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Abstract

Using a large sample of European acquisitions, we find that acquired firms substantially close the gap between their actual and optimal leverage ratios. The bulk of this adjustment occurs quite rapidly – within a year of the acquisition. The typical over-levered firm adjusts its debt-to-assets ratio from 34.4% in the year before acquisition to 20% in the year after. (The adjustment is smaller, but still quite rapid, for targets that had been under-leveraged.) These adjustments occur primarily through debt issuances or retirements. We also investigate whether target firms' pre-merger leverage contributes to the probability of them being acquired. We find that firms further away from their optimal leverage are more likely to be acquired: for an average firm, an increase in the absolute leverage deviation from 1% to 10% of total assets increases the probability of being acquired by 4.1% to 5.6% (The larger effect applies to over-leveraged firms.) Overall, our results provide support for the trade-off theory of capital structure and suggest that financial synergies have a significant role in the typical European acquisition decision.

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