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Payment Methods in Mergers and Acquisitions: A Theoretical Framework

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Abstract

Purpose: This paper aims to review the prior literature on payment methods in Mergers and Acquisitions (M&As) and summarizing its effects on the performance of companies involved in M&As. This study also attempts to find out various determinants of the payment methods of M&As that affects the decision of payment methods in M&As.

Methodology: To carry out the analysis, this study focuses the past literature relating to payment methods in M&As and summarizes the positive and negative effects of different payment methods. The review is carried out by dividing into four parts (i) Literature studies on cash payment method (ii) Literature studies on stock payment method (iii) Literature studies on mixed payment and (iv) Determinants of payment methods. The paper investigates based on the findings of the major studies.

Research limitations: The scope of the study is confined to the contemporary review of M&As literature than the empirical survey. The study is focused more on giving suggestions for future work on M&As than providing conclusion.

Research Implications: The knowledge gained from this study will help managers from both acquirer and target companies for selection of appropriate payment methods and improve their investment mechanism and strengthen their finances by value creation in M&As.

Originality: To the authors' knowledge this paper is the first attempt to document for summarizing the impact of different payment methods and its determinants of performance of M&As deals.

Keywords: Merger and acquisition, Cash payment method, Mixed payment method, Stock payment methods

JEL Classification: G34

1. Introduction

Merger and Acquisition (M&A) is an important corporate strategy action which is vital for the corporate sector in order to survive in this competitive world. In recent times, M&A has turned into a vital component in the economic and business environment and playing an essential role to respond to the growing global competition and the rapid evolution of markets (Vyas et al., 2012). Both in terms of values and volumes in M&A have been increasing over the years throughout worldwide. As per Thomson Reuters, Merger and Acquisition review, the value of worldwide M&A reached 777.7 billion US dollar during the 1st quarter of 2017 which is an increase of 12% as compared to the 1st quarter of 2016. However, overall 10,433 number of worldwide deals were announced during the 1st quarter of 2017, which is a 9 % decrease compared to last year's first quarter. That shows that in spite of decrease in the number of deal the value of the deal is increased. A large number of research have been done in the field of M&A. Most of the studies were conducted on the motive of M&A deals during 1970 to 1980 and proved hubris hypothesis, market power hypothesis, synergy hypothesis, economy of scale and scope hypothesis, managerial hypothesis and method of payment hypothesis (Chevalier & Redor, 2008). The studies similar to Vyas et al. (2012), Erdogan (2012) and Ismail et al. (2011) focus on the determinants of M&A and identify that factors like company size, age of company, leverage, culture, profitability, deal value, management control, methods of payment, operating activities of company, tax implications and macro-economic conditions affect the M&A performance. But there are some of studies like Alshwer, Sibilkov and Zaiats (2011), Andre and Ben-Amar (2009), Dutta, Saadi, and Zhu (2013) and Boateng and Bi (2013) that focus on determinants of methods of payment and proclaim that the choice of methods of payment significantly influences M&A performance.

The choice of payment methods is an important risk management strategy. It is very critical situation that the seller would always want the highest possible price for the business, but in opposite side, the buyer would want to pay the lowest possible price. In such situation deal is finalized by satisfying both buyer and seller with appropriate purchase consideration and payment structure. Payment alternatives chosen in corporate acquisitions is a major decision making factor for both acquirer and target companies.

According to Ray (2010) the M&A deal value is discharged through various payment mode i.e. cash, share, debt, Leveraged Buyout (LBO) and earn-out plan. But as per Donald

Depamphilis, (2010) the payment methods of M&A are divided into two types: one is cash mode another one is non-cash mode. Cash payment mode is the simplest method of making the payment of M&A deal. In this method, the total deal value discharges through cash payment. The main advantage of cash payment mode is that the shareholders ownership and earnings per share are not diluted in the company (Sherman, 2011). In Equity Share financing method equity shares are given to shareholders of the target company by the acquiring company. It results in shareholders of target company become the shareholders of an acquiring company. In Debt and Preference Share payment methods, purchase consideration is released by contributing a fixed percentage interest and a fixed rate of dividend. The main aspect of this method is that there is no change in liquidity and ownership position of the company. In case of Leveraged Buyout (LBO), deal price borrowed funds are utilized to settle the whole or division of deal price for the acquisition of a company. The borrowed funds are collected through bank loans, junk bond, loans from Target Company management and private loans. When the management of the Target Company carries out a leveraged buyout of the company is called as management buyout or MBO (DePamphilis, 2010)

The pre and post M&A performance of both acquiring company and target company highly depends upon the method of payment used while making a M&A deal (Chevalier & Redor, 2008; Schlingemann, 2004). The payment method is one of the significant factors in achieving the success of the deal. The payment methods of deal value are affected by various factors like liquidity position, risk, leverage, ownership structure, cost of capital, capital structure, tax implication, dividend policy, premium value, market price of share, government rules and regulations, profit, free cash flow, equity flow, return on equity, market to book value, debt flow, transaction cost and target company willingness (Boateng & Bi, 2013; Kalinowska & Mielcarz, 2014; Barbopoulos & Sudarsanam, 2012).

In the light of past empirical and theoretical literature, this study summarizes both positive and negative outcomes of various payment methods used in M&A deal. This study also attempts to find out various determinants of the payment methods of M&A that affects decision for choice of payment methods of M&A.

The rest of the paper is structured as follows: Section-2 discusses literature review on methods of payments in M&A, Section-3 find out research gaps, Section-4 formulates the research questions, Section-5 describes the conceptual framework, Section-6 summarizes the results.

2. Literature Review

Over the last four decades, most of studies related to M&A were carried out by paying attention on the financing part of M&A which is driven by various factors of both acquirer and target companies (Amihud, Lev, & Travlos, 1990; Schlingemann, 2004). Choice of Payment method of M&A is a critical aspect of the successful M&A deal. A number of earlier studies have concentrated on M&A payment methods. Studies like Hansen (1987), Yook et al. (1999), Wansley et al. (1987) and Fishman (1989) developed theories and analyze the mode of payment in M&A based on asymmetric information. Some studies similar to Martin (1996), Barbopoulos and Sudarsanam (2012), Boateng and Bi (2013) and Kalinowska

& Mielcarz (2014) analyze the determinants of M&A payment methods. A few empirical and theoretical studies, like Travlos (1987), Alexandridis and Travlos (2010) and Ladkani and Banerjee (2012) concentrated on the shareholder wealth and stock returns due to announcement of different payment methods M&A deal and disclosed that acquirer returns are higher those choose cash payment method than those choose stock payment method. Huang and Walkling (1987) and Franks et al. (1988) proved that the payment method has a significant impact on the profitability of M&A deal. Faccio and Masulis (2005) focused on the M&As deals in Europe and reported that mode of payment in M&A are significantly affected by deal characteristics and target characteristics.

As per the past literature, the acquiring company financial variables affect the choice of payment methods of M&A. According to Jensen (1986) large amount of cash availability and sufficient debt raising capacity of acquiring companies prefer cash payment method in M&A deal rather than stock payment method. The financial factors of the acquiring companies like cash availability, leverage, collateral and profitability directly influence the decision of choice of payment methods in M&A transactions (Chaney, Lovata, & Philipich, 1991; Boateng & Bi, 2013).

According to Travlos (1987), when M&A deals are financed with stocks the abnormal returns are negative, but in cash payment method it shows positive returns. Similarly, Antoniou and Zhao (2004) supported that acquirer's abnormal returns are significantly lower in case of stock payment methods as compared to cash and mixed payment methods. In the same line of research, various empirical studies yield evidence of higher returns for the target company through cash offers M&As Deal. (Huang & Walkling, 1987; Eckbo & Langohr, 1989). Fuller and Glatzer (2003) focused on the cross border acquisition by U.S. acquirer's and their payment methods for acquisitions of foreign targets. They found that acquirer's returns are higher in cash payment method.

Studies like Amihud et al. (1990), Martin (1996), Yook et al. (1999) and Faccio and Masulis (2005) studied the link between managerial ownership of the acquiring company and the payment mode of M&A and noticed that, managers of the acquiring company prefer financing with cash payment method because of retaining ownership control with the company management. Stock financing dilutes the ownership control of acquiring the company. Amihud et al. (1990) verified that, stock payment method is negatively related to inside ownership. Martin (1996) analyzed the relationships between management ownership and investment opportunities with the payment method in corporate acquisitions and found stock payment method is used at the time of the higher acquirer's growth opportunities. In the banking sector, when the size of the target company is comparatively higher than acquiring company the more possibility of use stock or combine of cash and stock as payment method of M&A deal (Grullon et al. 1997). Boone et al. (2014) emphasized on mixed payment method and empirically proved that mixed payment method is more used method in most of the recent M&A deal.

The payment method of M&A affects the advertisement cost of the acquirer. Devos, Elliott and Karim (2013) examined the relationship between payment method of M&A and advertising cost of acquirer and conclude that advertising cost of an acquirer in the pre M&A period is relatively high in case of a stock based deal than cash based M&A deal. Similarly, Yung, Sun and Rahman (2013) explored the relationship between earnings quality of the acquirer and payment method of M&A and point out that the cash payment method of M&A deal is negatively related with the acquirer long-term earnings quality.

The empirical studies regarding taxation hypothesis such as Niden (1986), Eckbo and Langohr (1989) and Franks et al. (1988) suggested that cash payment method is more costly than stock payment method in the reason of immediate taxability whereas stock payment is taxable only when disposed-off. Ladkani and Banerjee (2012) studied on impact of payment methods on the shareholder's wealth of the acquiring companies in M&A in India and found that, method of payment have positive effects on shareholder wealth. The studies, like Doytch and Cakan (2011), Doytch & Uctum (2012) and (Ljungman, 2014) analysed the impact of M&A on economic growth or contribution to the gross domestic product (GDP) of the country.

Barbopoulos et al. (2017) focused on earnout payment method deals by US acquirers and found that earnout deal's performance are better as compare to non-earnout deals when earnout deal is combined with stocks payment or mixed (cash & stocks) payment. Adra and Barbopoulos (2018) detected that investor attention act as an important moderator in the connection between the payment method in M&A and the abnormal returns of acquirer's announcement period.

The literature review is made as follows by segregating the past studies based on different payment methods (cash, stock and mixed) and determinants affecting the choice of payment method.

2.1 Cash Payment Method

Cash is the most common and simplest form of payment for acquiring shares and assets of another company. Cash used in M&A transaction may be arranged by the acquiring Company from internal sources or through additional debt. The main advantage of cash payment method is a corporate identity and ownership structure remains unchanged. However the drawback of this method is that there is need of immediate tax payment to target shareholders.

Huang and Walkling (1987) proved that, the higher amount of cash used in M&A deal leads to higher abnormal returns to both acquirer and target companies shareholders. Travlos (1987), Hansen (1987) and Andrade et al. (2001) conformed the same result.

As per free cash flow hypothesis the acquiring company with excess free cash leads to cash payment in M&A deal. Jensen (1986), Martin (1996) and Chaney et al. (1991) supported to free cash flow hypothesis and found that there exists a direct relation between return on assets and cash offers. Similarly, higher managerial ownership leads to higher cash payment in M&A deal (Amihud et al., 1990).

Some empirical studied only concentrated on taxation hypothesis and observed that cash payment method is more costly due to immediate taxability (Auerbach & Reishus, 1988; Eckbo & Langohr, 1989).

Fuller and Glatzer (2003) focused on the cross border acquisition by U.S. acquirer and their payment method for acquisitions of foreign targets. They found that acquirer's returns are higher in cash payment method.

In the below Table 1 we summarized the both positive and negative results based on past empirical studies relating to cash payment method in M&A.

Table 1. Literature on Cash Payment Method

Results	Major Findings	Evidence
Positive Results	Abnormal return is higher in case of cash payment method than stock payment method in the initial days after the announcement period of M&A.	(Wansley, Lane, & Yang, 1987); (Huang & Walkling, 1987); (Hansen, 1987); (Fishman, 1989); (Antoniou & Zhao, 2004); (Andrade et al. 2001)
	Cash payment method takes less time to accomplish the deal than stock payment method.	(Wansley, Lane, & Yang, 1987) (Fishman, 1989)
	General performance is better for both acquirer and target in case of cash financing than a combination of cash and stocks financing in M&A.	(Travlos, 1987); (Linn & Switzer, 2001); (Tichy, 2001); (Andre et al., 2004); (Harris, Franks, & Mayer, 1987)
	Asset acquisitions are more possible to be financed through cash than stock issue.	(Swieringa & Schauten, 2007)
	In cash offer, return on assets in the post-transaction period is significantly higher than the shares payment method or mixed payments method.	(Kalinowska & Mielcarz, 2014) (Rahman, 2002)
Negative Results	Cash payment method in M&As deals does not have a positive impact on profitability.	(Dube& Glascock, 2006); (Heron & Lie, 2002)
	The instant taxability makes cash payment method is more costly than stock payment method which is taxable only when stock disposed-off.	(Niden, 1986); (Franks et al., 1988); (Eckbo & Langohr, 1989)
	Cash method of payment is negatively associated with financial constraints of acquirer.	

2.2 Stock Payment Method

Stock payment method is a non-cash payment method in which acquiring companies issue own equity share to target company as purchase consideration of the deal. Under this method, both acquirer and target company share post M&A deal outcome. The important part of this method is to determine of a rational exchange ratio. The exchange ratio and the price--earnings ratio of the companies are two important factors that significantly affect the actual benefits to the shareholders of acquiring companies those choose stock as payment method of M&As deals. Usually it is an ideal method of financing a M&A deal in case the price-earnings ratio of the acquiring company is comparatively higher than the target company.

Faccio and Masulis (2005) and Alshwer et al. (2011) developed a financial constraints hypothesis which is just opposite of free cash flow hypothesis. This hypothesis explained that financially constrained firms are more likely to use stock payment method. Similarly Industry relatedness hypothesis implies that the deals in related industries would attract stock payment (Swieringa & Schauten, 2007). Chang (1998) and Draper and Paudyal (2006) evidenced that in stock payment method the abnormal return is positive in the case of privately held target companies.

The main disadvantage of stock payment method is that it takes more time to complete the deal. It also involves more transaction cost and lots of legal procedures for the deal (Myers & Majluf, 1984).

Cho and Ahn (2017) studied on cross-border M&A by taking 4720 sample from 42 countries and found that the cross-border M&A deals through stock payment method normally has a negative impact on shareholder value. In takeovers deal acquirer's short-run and long-run performance is affected negatively when deal finance through stock (Fischer, 2017).

In the below Table 2 we summarized the both positive and negative results based on past empirical studies relating to stock payment method in M&A.

Table 2. Literature on Stock Payment Method

Results	Major Findings	Evidence
Positive Results	Higher investment opportunities of the acquiring company lead to an increased use of stock financing in corporate acquisitions.	(Martin, 1996); (Verter & Geo¤rey, 2002)
	Most overvalued companies normally use stock payment method for acquisitions than cash payment method.	(Savor & Lu, 2009); (Shleifer, & Vishny, 2003);
	Acquiring companies' gains have positively related to the amount of stock financing occurred during the financial year before the M&A announcement.	(Schlingemann, 2004)
Negative Results	In stock payment method for acquisitions the acquiring companies disappoint their investors.	(Heron & Lie, 2002)
	Stock payment method in M&A financing creates negative long-term abnormal returns for acquiring company.	(Loughran, & Vijh, 1997); (Mitchell & Stafford, 2000)
	Stock payment method is more costly than cash payment method in term of transaction cost.	(Myers & Majluf, 1984)

2.3 Mixed Payment Method

The mixed payment method is the combination of both cash and non-cash payment method. In this payment method, the purchase consideration is discharged through a mixture of cash, stock and debt. In mixed payment deals, the abnormal returns of both acquirer and target company is different from all cash and all stock deals (Scheuering, 2015). Eckbo et al. (1989) have empirically tested that the abnormal returns are positive and significantly higher in mixed payment method. Similarly, De et al. (1996) revealed in his study that mixed offers are more competitive in comparison to stock-only and cash-only offers. In contrary to this, Erickson and Wang (1999) have empirically tested that there is no differences in the use of different payment method (cash, stocks, and mixed method) used by the acquirer. In recent years, the use of mixed payment method has risen. The number of mixed-payment deals have increased three times since the end of the 1990s to 2008 (Boone, Lie, & Liu, 2014).

In the below Table 3 we summarized the both positive and negative results based on past empirical studies relating to mixed payment method in M&A.

Table 3. Literature on Mixed Payment Method

Results	Major Findings	Evidence
Positive Results	Mixed payments method is more used mode in M&A deal in the new century than previous.	(Boone, Lie, & Liu, 2014); (Scheuering, 2015)
	Mixed payment method is primarily different from both cash and stock payment methods in M&A.	(Heron & Lie, 2002) (Faccio & Masulis, 2005)
	Abnormal return is significantly higher for the acquiring company in case of a mixed payment method than cash and stock-only payment method.	(Eckbo & Langohr, 1989)
	Large M&A deal commonly finance with mixed payment method.	(Boone, Lie, & Liu, 2014)
Negative Results	In mixed payment method average return on assets (ROA) is lower than cash payment method in Eastern European markets M&A deal.	(Kalinowska & Mielcarz, 2014)
	Target company abnormal returns are lower in mixed offers than in pure cash offers	(Weitzel & Kling 2013),

2.4 Determinants of Payment Methods in M&A

The choice of the payment methods of M&A depends upon different factors. Various past empirical and theoretical studies focused on factors of the payment method in M&A and found that the factors like Ownership Structure, Financial Leverage, Free Cash Flow, Size of the Deal, Tax Considerations, Tobin’s Q, Asymmetric Information, Growth Opportunities, Business Cycle, Corporate Governance, Motives of Deal and Government Rule and

Regulation are significantly influence the decision for choice of payment method in M&A deal.

Table 4. Literature on Determinants of Payment Method in M&A and Its Effect on Abnormal Returns

Determinants	Effect on the payment method of M&A	Effect on acquirer abnormal returns	Evidence
Financial Leverage	1) High Financial leverage acquiring Companies use less cash financing and likely to finance with stock. 2) Moderate financial leveraged acquiring companies have no effect on choice of payment methods in M&A.	Highly leveraged firm uses stock financing lead to better abnormal returns.	(Uysal, 2011) ;(Trifts, 1991)
Free Cash Flow	More Cash availability with the acquiring company refers to making use of cash financing as a means of payment in M&A deal.	Large cash availability may attract management to go for expansion of business and that is expected to have a negative influence on abnormal returns.	(Jensen, 1986) (Martin, 1996)
Relatedness	Stock payment method is more likely to be used in the related M&A deal.	Related M&A deal shows positively effect on acquirer abnormal returns.	(Faccio & Masulis, 2005)
Size of the deal	Stock financing has a positive relation to M&A deal size.	Deal size is positively affects the abnormal return of acquiring company.	(Swieringa & Schauten, 2007); (Faccio & Masulis, 2005)
Tax considerations	Stock financing is used to take advantage of immediate tax payment than other payment methods. .	More tax payment leads to a negative impact on abnormal returns.	(Ayers, Lefanowicz, & Robinson, 2004); (Travlos, 1987) (Brown & D.Ryngaert, 1991)
Tobin's Q	There is a negative relationship between Tobin's Q and use of cash financing as a payment	Acquirer abnormal returns are significantly higher for greater Tobin's Q acquirer than lower Tobin's Q	(Boateng & Bi, 2013); (Martin, 1996); (Doukas, 1995)

Determinants	Effect on the payment method of M&A	Effect on acquirer abnormal returns	Evidence
	method.	acquirer	
Asymmetric information	Inside information of acquiring company affects choice of payment methods. Favorable information relating to acquirer performance lead to stock financing.	More information relating to target company near to more abnormal return.	(Hansen, 1987); (Myers & Majluf, 1984); (Travlos, 1987)
Ownership of managers	Acquiring company prefers to cash financing to prevent dilution of ownership of management.	Better managing of acquiring company management is expected from block holders, which positively impacts abnormal return.	(Amihud, Lev, & Travlos, 1990); (Martin, 1996); (Yook, Gangopadhyay, & McCabe, 1999);
Growth opportunities	Acquiring Company with highly growth opportunities chooses stock financing in M&A deal.	Growth opportunities lead to higher abnormal return.	(Alshwer, Sibilkov, & Zaiats, 2015); (Martin, 1996); (Faccio & Masulis, 2005)
The relative size of the acquirer and target companies	Acquiring company involve stock financing when the size of the target company is bigger than its company.	It is normally difficult to generate abnormal returns when the target is bigger than the acquirer	(Hansen, 1987); (Schlingemann, 2004); (Boateng & Bi, 2013)
Business Cycle	Stock financing is used in case of earlier stages of the business cycle, higher share price and expansionary phases of the business cycle.	Timing of acquisition comparative to the market cycle is negative correlated to performance	(Choe, Masulis, & Nanda, 1993); (Kusewitt, 1985)
Corporate Governance	The size board of directors in a company is performed a significant role in capital structure decisions.	There is a positive relationship between board size and acquisition announcement cumulative abnormal return.	(Butt & Hasan, 2009), (Andre & Ben-Amar, 2009), (Black, 1992)

The payment method in M&A has significant implication for both the acquiring and target companies, including post-takeover ownership structure, risk profile, capital structure and the allocation of synergy from the transaction (Faccio & Masulis, 2005). There are less studies given attention to the abnormal return of both acquirer and target due to announcement of different payment methods M&As deals. Still, there is no clear cut evidence that the effect of acquiring companies and target companies characteristics on choice of payment method in M&A deal.

3. Research Gaps

- The previous empirical and theoretical studies on payment methods of M&A have focused on specific developed economies countries like The United States of America (USA) and the United Kingdom (UK) which have scattered over ownership structures, long term performance, tax implication, bid premium, free cash flow, financial leverage, equity overvaluation, and the relative size, but there is limited number of study focus on developing and under- developed countries.
- The impact on the payment methods of M&A due to changes in rules and regulations relating to M&A not focused in earlier studies.
- There are insignificant studies deals with the relationship between different payment methods of M&A and macro- economic conditions of the country.

4. Research Questions

There are several research issued that can be pursued based on research gaps. Several key questions to be answered include:

- Is the payment method in M&A affecting the performance of acquiring Company and Target Company in M&A deal in emerging and developing countries?
- What is the recent trend of payment methods used by acquiring companies in emerging countries, whether they choose stock as a payment method or cash method of payment or hybrid method of payment?
- Which factors do influence the choice of payment method in M&A?
    - What is the impact of industry characteristics on the method of payment in Mergers and Acquisitions?
    - What is the impact of firm characteristics (acquiring company and target company) and deal characteristics on the method of payment in Mergers and Acquisitions?

5. Conceptual Framework

The conceptual framework of the choice of payment method in M&A can be built on a model based on the determinants of acquiring company characteristics, target company characteristics, deal characteristics and rule & regulation relating to M&A. Therefore, a complete measurement and understanding of the foundation is needed to develop a model. The conceptual model is developed on the basis of previous theoretical and empirical literature that will help both acquiring company and target company management for decision making on choice of payment method in M&A deal.

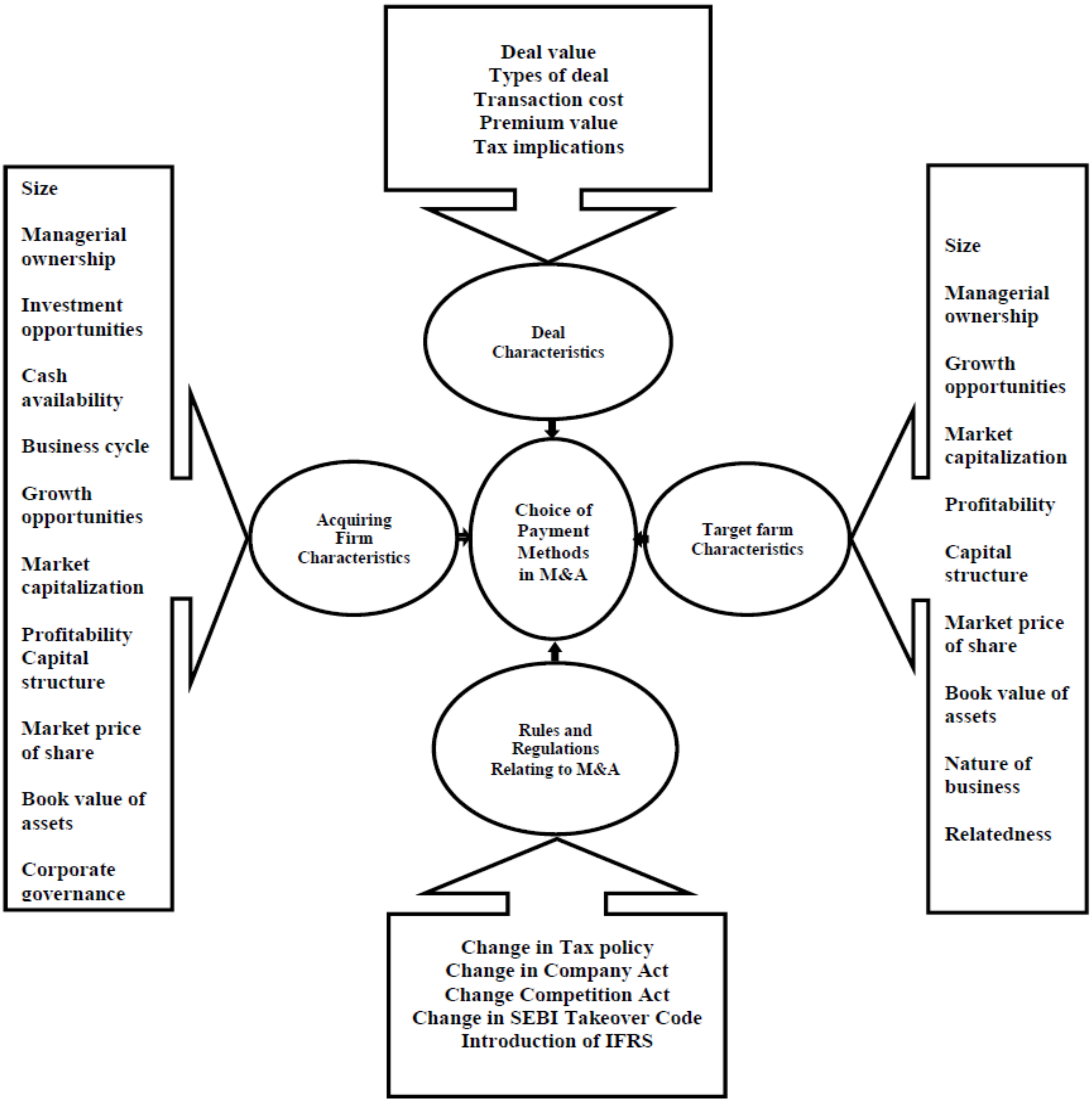

Figure 1. Conceptual Model

Source: Author's Own Compilation from literature review

6. Summary of Results & Concluding Remarks

In light of reviewing recent literature on payment methods of M&A, we have summarized the findings based on different payment methods and determinants. Some authors found positive as well as negative results in relation to company performance relating to cash, stock and mixed payment method.

Studies that focused only on cash payment method have shown inconsistent results. However, few studies reported positive abnormal return and higher Return on Assets in cash payment method. On the other side, some authors have endowed that Cash financing of M&A deal does not have a positive impact on profitability. In addition, tax liability in cash payment method is higher than the stock payment method. Some studies indicated that, there is a positive result in the company's performance after M&A as the level of stock financing is directly related to gains of the acquiring company. However, few researchers have found that, stock payment method creates negative long-term abnormal returns for acquiring company. The stock payment method is also being more costly than cash payment method in terms of transaction costs. A number of studies proclaimed that, mixed payment method is more used method in M&A deal in the new century than the previous years.

From various literatures, we found that the factors like financial leverage, free cash flow, relatedness, relatedness, tax considerations, Tobin's Q, asymmetric information, ownership of managers, growth opportunities, relative size of the acquirer and target companies, business cycle and corporate governance are significantly impact the choice of payment method of M&A deal and affects the abnormal return of acquiring company. Very few studies argue that, GDP and macro-economic conditions are affected through the payment methods of M&A. It is found that target company abnormal returns are lower in mixed payment method than stock or cash each payment method separately.

This paper sheds light on the importance of payment methods of M&A that may lead to synergy gains and ultimate success of M&A deal. This study will help both acquiring Company's and Target Company's management to take proper decision for financing and making investment in M&A deal.

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