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How the Lender–Borrower Relationship Influences M&As: an Analysis of a Strategic Action in Japan

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Abstract

Purpose - This study examines lenders' reactions to M&A, based on the strength of the lender–borrower relationship and the lender's expectations of the potential benefits or risks of the deal.

Research design, data, and methodology – This research addresses the lender's influence on the implementation stage of a large-scale strategic action such as M&A to understand the motivation and dynamics of lenders' responses and empirically examines how the lender–borrower relationship influences the focal firm's merger and acquisition (M&A) transactions, using data on 501 M&A deals in Japan from 1990 to 2010.

Results - The presented analysis found that lenders that have a strong lender–borrower relationship, especially those showing a high debt equity ratio, support borrowers' M&A progress and the target firm's lenders resist the deal progressing and may raise the acquisition premium if their current power relative to borrowers is weak.

Conclusions - Stakeholders including lenders do not favor strategies of focal firms that threaten their future benefits, while they also tend to estimate the potential benefits and losses by comparing their current circumstances with those of other stakeholders. The empirical results of the presented analysis help explain the mechanism of lenders' reactions and offer insights into the power of a closer and stronger lender–borrower relationship.

Keywords: Lender–Borrower Relationship, Acquisitions, Acquisition Premium, Stakeholder Theory.

JEL Classifications: G21, G34, G14, M10.

1. Introduction

Business activities are accompanied by a variety of interactions with many stakeholders. Firms reap the necessary resources and maintain their business operations through appropriate interactions with diverse stakeholders such as shareholders, employees, interest groups, and governments (Chimucheka, 2013). Lenders, one of the most important resource suppliers to firms, have received considerable research and managerial attention in recent years (e.g., Lummer & McConnell, 1989, Bharath et al., 2007, Dass & Massa, 2009). The supply of financial resources not only helps maintain financial balance and sustain business operations (Viatkina, 2014), but also highlights the capital market's recognition of a firm's future growth and business model strength (Petersen & Rajan, 1994; Mago, Musasa, & Matunhu, 2013). Hence, from borrowers' perspective, lenders serve as information generators in capital markets (Rajan & Winton, 1995).

Their various roles in a firm's financial activities enables lenders to access inside information (Lummer & McConnell, 1989), especially during the due diligence stage (Rajan & Winton, 1995). This access provides lenders with sufficient information to approve lending, which serves to externally verify the credit worthiness of a borrower. Thus, lenders take responsibility not only for supplying financial resources, but also for recognizing the reliability of a firm and ratifying its reputation in the capital market. To the end, borrowers receive financial resources and achieve credibility in the

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eyes of the capital market because of lenders' activities.

Research has addressed the benefits to lenders. For example, Dahiya et al. (2003) examined the negative influence of a borrower's default on a bank's stock price and Bharath et al. (2007) analyzed the lender–borrower relationship and its impact on lenders' benefits. Previous studies have also found that lenders serve as financial mediators and posited that they have the capability to generate information on borrowers (Ramakrishnan & Thakor, 1984). Once this relationship has been built, it can be repeated because of the convenience of collecting information and accumulated knowledge and experience about both parties, which provides two types of benefits. First, lenders' gradually accumulated information on borrowers allows them to make cost savings over time. Collecting and assessing basic information is one of the major costs for lenders since reliable information on borrowers helps them avoid potential risks (Petersen & Rajan, 1994). Second, lenders can pursue additional business opportunities based on this insider information.

Banks have expanded their service portfolios by establishing networks of financial conglomerates. They now offer many service offerings including loans, issuing bonds, underwriting, and IPOs as well as advice on merger and acquisition (M&A) transactions (Drucker & Puri, 2005). Lenders that have strong relationships with borrowers can also propose a variety of other services such as additional loans and other fee-based financial advisory services by leveraging their insider information. Drucker and Puri (2005) and Yasuda (2005) empirically examined the positive impact of a previous lender–borrower relationship on future investment and business opportunities (see also Bharath et al., 2007). In summary, the lender–borrower relationship allows lenders to acquire insider information and enhance the volume and depth of information on borrowers, which results in greater information asymmetry as well as provides convenient access to increase the provision of financial resources and enhance credibility in capital markets. In the same context as that described above, the focal firm's investment strategies (e.g., M&A) can be regarded as new business opportunities for lenders that possess strong lender–borrower relationships. Bharath et al. (2007), for example, found that lenders that have existing lender–borrower relationships have a much higher probability of winning future loan business compared with those without.

Then, what specific business opportunities arise for lenders in the case of M&A? A focal firm's M&A transactions can provide lenders with three major opportunities. First, lenders can expect to provide additional large-scale loans to cover the cost of acquisition. M&A requires significant investment in the early stage after the merger decision has been made (Schweiger, 2002). Thus, existing lenders that have close lender–borrower relationships can use their information asymmetries to become preferred suppliers of additional loans for implementing the proposed M&A.

<Table 1> Findings of Previous Literatures on Lender-borrower Relationship

Researcher	Points of lender-borrower research	Key findings
Lummer & McConnell (1989)	Capital marker response to loan agreement	Lender's benefits generated completing loan agreement
Boot (2000)	Literature review of relationship banking	Benefits and risks of lender-borrower relationship
Drucker & Puri (2005)	Concurrent lending and underwriting	Lender's benefits from the lender's generated completing loan agreement
Dass & Massa (2009)	Factors reinforcing the lender-borrower relationship	Lender's benefits generated completing loan agreement

Second, in addition to providing sufficient financial resources to close the deal, lenders can serve as comprehensive financial service providers, including advising on financing structure and participating in the financing process. Both the seller side and the buyer side need to maximize profits through the proposed transaction and must thus understand the bigger picture of the transaction from each side. Therefore, given that a comprehensive understanding by both sellers and buyers is necessary for financial advisors, existing lenders that have strong relationships with the focal firm can have a higher chance of winning their business.

Third, lenders can have fears and hopes in the post-acquisition stage. After the acquisition, acquirers try to realize the planned synergies as soon as possible by actively conducting post-merger integration activities to make their acquisition successful. Integrating suppliers and realizing economies of scale help the acquirer in this regard. Hence, the power of the supplier or vendor before M&A should be changed in most cases. Indeed, some parties such as the acquirer firm that have a strong relationship can enjoy the post-acquisition stage.

However, not all the strategic actions of the focal firm are welcomed by lenders. In addition, academic research has rarely addressed the relationship between corporate strategic decision and lender's reaction. For this reason, this study examines a lender's fundamental stance when a focal firm executes dynamic strategic initiatives such as M&A. Unlike the simple renewal of loan agreements or IPOs, M&As are complicated by the fact that the acquirer and target companies both have their own lenders when the deal is progressing, with which they may have close relationships. Nevertheless, after the deal is completed, the lender–borrower relationship can change based upon the acquirer firm's post-acquisition integration plans. In many cases, the two different pre-M&A suppliers can be forced to integrate to realize synergies or for other strategic reasons. If this occurs, some stakeholders related to the acquirer and target firms can lose the benefits they had enjoyed to that point.

This study examines lenders' reactions to M&A, based on the strength of the lender–borrower relationship and the lender's expectations of the potential benefits or risks of the deal. Although research has examined the lender–borrower relationship, few studies have covered this topic from a corporate strategy or management research perspective, which would be helpful for practitioners and researchers. Thus, this research addresses the lender's influence on the implementation stage of a large-scale strategic action such as M&A to understand the motivation and dynamics of lenders' responses. This should provide an important guideline to manage lenders' reactions when executing M&A.

2. Theoretical Prediction and Hypothesis Development

This section discusses testable theoretical predictions based on existing theories of the lender–borrower relationship. First, this study tests whether information accessibility and the relative cost efficiency of assessing the borrower's status, owing to the close lender–borrower relationship, is positively associated with a large-scale strategic action such as M&A. To measure the lender's response to a proposed M&A, this study applies the acquisition premium. The acquisition premium is affected by various economic factors such as the target's growth potential and synergies with the acquirer firm and includes a certain level of cost incurred by stakeholders' response or resistance (Laamanen, 2007). In this study, the acquisition premium serves as a parameter of the lender's resistance, which rises if lenders resist the proposed transaction.

Previous research has demonstrated that lenders' influence on corporate business activities has expanded over time (Boot, 2000). Lenders that already have stable relations with client companies can enjoy larger business opportunities by reinforcing information asymmetries (Lummer & McConnell, 1989). A firm's strategic decisions and the implementation of its strategic initiatives are thus a great opportunity for lenders that offer multiple financial services (Drucker & Puri, 2005).

In this context, this study hypothesizes that both acquirer and target firm lenders positively respond to the proposed M&A in the presence of a strong lender–borrower relationship owing to the depth of this relationship and quality of insider information (Rajan, 1992), which is connected to the possible extension of the post-integration relationship and provision of new business opportunities. Hence,

<H1> A stronger lender–borrower relationship results in a lower acquisition premium.

As discussed in the previous section, M&A brings about significant changes in stakeholders' business environments by transforming existing client relationships. Thus, a firm's major strategic decisions and subsequent changes are not always welcomed by lenders. In particular, in the case of M&A, which can lead to a major loss of current position and power post-integration, stakeholders must consider the views of all other stakeholders when considering potential benefits or losses (Schweiger, 2002). It must be attractive for lenders to enjoy new business opportunities when their clients agree an M&A. However, if the opposite side possesses stronger power than them that can be sustained after the deal, lenders with weaker power may lose the benefits garnered through the current relationship. In particular, acquirer-side stakeholders including lenders could be in a better position in the integration stage compared with the target firm's lenders and thus could be expected to benefit relatively from the deal (Fraser et al., 2011). If this is the case, target lenders would prevent the deal from progressing, resulting in a higher acquisition premium. Hence,

<H2> The stronger the acquirer's lender–borrower relationship than the target, the higher is the acquisition premium.

3. Research Methods

3.1. Sample and Data

This study used data on M&As carried out in Japan between 1990 and 2010. During this 20-year period, Japan went through a long depression after the collapse of its bubble economy in the 1980s. Hence, firms frequently restructured their business portfolios with M&A transactions to sell and buy business portfolios and reinforce the core business.

This study focused on listed companies to ensure the reliability of the data. In addition, it excluded financial industry samples to avoid misleading results owing to their special characteristics. The total number of observations used for the regression analysis was 501. Data on these M&As were acquired from the Securities Data Corporation's (SDC) worldwide merger, acquisitions, and alliance database. SDC provides detailed information and descriptions on public and private M&A deals internationally. Its database is popular in academic research because of its distinguished operating system and information from more than 200 foreign language news sources, SEC filings, and multinational partners including various proprietary sources from investment banks and financial advisors. Further corporate information was acquired from the Needs Financial Quest database.

3.2. Variables and Measures

Dependent Variables.

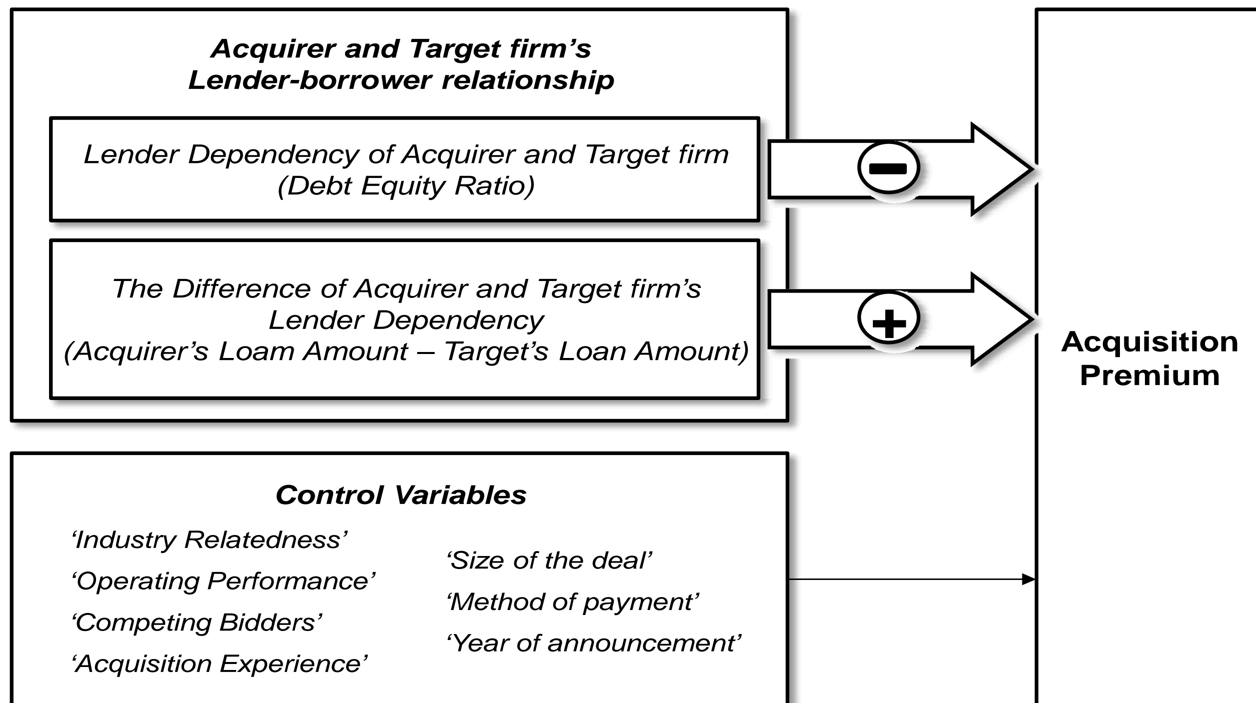
This study considered the acquisition premium to measure the influence of lenders on the M&A process (i.e., their reaction to the proposed deal). Laamanen (2007) defined the acquisition premium as an economic term representing capital market dynamics for M&As, measured by subtracting the target firm's stock price before the announcement from the acquirer's bid. However, the acquisition premium cannot be calculated only from an economic perspective, since it is affected by other issues that should be considered from a strategic perspective such as stakeholder resistance. Thus, this study considers the acquisition premium to be a measure of the additional economic and strategic costs that an acquirer must incur to close a deal, which is positively associated with stakeholder resistance.

Independent Variables.

To predict the influence of the lender–borrower relationship on the acquisition premium, this study focused on the strength and depth of this relationship and applied the following firm-level measures: a) the debt equity ratio of the acquirer and target firms and b) the difference in loan amount (acquirer – target firm). The loan amount difference was calculated by subtracting the target firm loan amount from the acquirer firm loan amount based on the financial statements for the year before the announcement.

To avoid alternative explanations of the acquisition premium, this study considered a set of control variables. For economic measures, to account for the acquirer and target firms' operational performance, it controlled for the acquirer and target firms' after-tax return on equity (ROE) for the year before the announcement. For financial measures, this study controlled for the transaction value and payment method. The M&A transaction value was acquired from the SDC database and measured as the natural log of total transaction value. According to previous research, cash is the target firm's preferred payment method that can affect the acquisition premium (Fuller et al., 2002). In this study, transaction value was measured by using a dummy variable coded 1 if the acquirer pays by cash more than 50% of the total transaction cost and 0 otherwise.

This study also controlled for industry relatedness because of the potential conflicts between acquirer and target firms, which were previously rivals in the same industry (Bergh, 1997). Dummy variables were again used to measure industry relatedness, coded 1 for conformance to the primary four-digit SIC code of the acquirer and target firms and 0 otherwise. Lastly, this study controlled for the existence of competing bidders, which reminds firms of the possibility of losing the benefits by winning the proposed deal and may lead firms to close the deal (Puranam et al., 2006). This dummy variable was coded 1 if there is another bidder and 0 otherwise.



<Figure 1> Research Model

Research Model.

To analyze how the lender–borrower relationship influences the acquisition premium, I used ordinary least squares (OLS), which regresses the dependent variable of the acquisition premium on i as a vector of the explanatory variables, with as a vector of the regression coefficients and as the error term:

Acquisition Premium i = + +

4. Results

<Table 1> summarizes the descriptive statistics and correlation matrix of all the variables excluding and year-dummy variables.

<Table 2> provides the findings from the OLS estimate of the effects of lenders on the acquisition premium. Model 1 includes only the control variables. I find that the coefficients of the acquirer's ROE (b = 0.02, se = 0.01, p < 0.10), the target firm's ROE (b = 0.01, se = 0.00, p < 0.05), deal size (b = 0.04, se = 0.01, p < 0.01), industry relatedness (b = -0.08, se = 0.04, p < 0.05), and competing bidder (b = 0.22, se = 0.05, p < 0.01) are statistically significant. Model 2 includes all the independent and control variables, showing that the regression coefficient of the acquirer's debt equity ratio is negatively and statistically significant at the 1% level, which lends support to <Hypothesis 1>. As <Hypothesis 1> predicts, the acquirer lender's debt equity ratio, as a measure of representing the depth and strength of the lender–borrower relationship (Dass & Massa, 2009), is negatively associated with the acquisition premium. In addition, the acquirer and target's loan amount difference is positively and statistically significant at 5% level, which supports <Hypothesis 2>. <Hypothesis 2> indicates that an acquirer lender's stronger power with higher loan amounts increases the acquisition premium. Models 4–6 test each of the independent variables separately.

<Table 2> Descriptive Statistics and Correlation Matrix

			Mean	Std. Dev.	1	2	3	4	5	6	7	8	9	10
1	acq_premium4w	Premium paid for acquisition (than 4weeks before announcement)	0.14	0.37										
2	DEr_A	Acquirer's Debt Equity Ratio	3.96	6.44	-0.15*									
3	DEr_T	Target's Debt Equity Ratio	4.74	18.78	-0.08	0.15*								
4	Loan_amt_Diff	Loan amount difference (Acquirer-Target) Mil. USD	689002.8	4060968.0	0.01	0.20*	0.00							
5	ROE_A	Acquirer's ROE	0.09	1.02	0.02	0.13*	0.03	-0.02						
6	ROE_T	Target's ROE	-0.39	4.07	0.08	0.00	-0.69*	0.01	0.02					
7	ln_deal_size	Transaction amount (Natural log of Mil. USD)	4.28	1.86	0.10*	0.01	-0.07	0.18*	-0.03	0.13*				
8	SIC_dummy	Industry relatedness b/w acquirer and target (Yes=1; No=0)	0.33	0.47	-0.06	0.02	0.03	0.09*	-0.04	0.03	0.25*			
9	method_pay2	Method of payment (+50% of cash=1; otherwise=0)	0.43	0.50	0.10*	-0.24*	0.01	0.04	0.10*	-0.06	-0.27*	-0.26*		
10	competing_bid	Existence of competing bidder (Yes=1; No=0)	0.00	0.07	0.03	-0.03	-0.01	-0.01	0.00	0.01	0.12*	0.00	0.07	
11	A_acq_exp_3	Acquirer's acquisition experience	0.39	0.97	-0.02	-0.07	0.01	0.03	0.01	-0.04	0.01	-0.04	0.21*	0.04

<Table 3> Regression Analysis of the Acquisition Premium**

Variables		Acquisition premium					
		Model1 (4week)	Model2 (4week)	Model3 (1day)	Model4 (4week)	Model5 (4week)	Model6 (4week)
H1-a	Acquirer's Debt Equity Ratio		-0.01** (0.00)	-0.01* (0.00)	-0.01** (0.00)		
H1-b	Target's Debt Equity Ratio		-0.00 (0.00)	0.00 (0.00)		-0.00 (0.00)	
H2	Acquirer and Target's Loan Amount Difference (A-T)		0.00* (0.00)	0.00* (0.00)			0.00 (0.00)
	Acquirer's ROE	0.02† (0.01)	0.02* (0.01)	-0.00 (0.01)	0.02* (0.01)	0.02* (0.01)	0.02† (0.01)
	Target's ROE	0.01* (0.00)	0.01* (0.00)	0.01 (0.00)	0.01* (0.00)	0.01 (0.00)	0.01* (0.00)
	Deal size	0.04** (0.01)	0.03** (0.01)	0.03** (0.01)	0.03** (0.01)	0.04** (0.01)	0.04** (0.01)
	Industry relatedness	-0.08* (0.04)	-0.08* (0.04)	-0.04 (0.04)	-0.08* (0.04)	-0.08* (0.04)	-0.08* (0.04)
	Method of payment	0.04 (0.04)	0.03 (0.04)	0.04 (0.04)	0.03 (0.04)	0.04 (0.04)	0.04 (0.04)
	Competing bidder	0.22** (0.05)	0.22** (0.05)	-0.01 (0.05)	0.22** (0.05)	0.22** (0.05)	0.22** (0.05)
	Acquisition experience	-0.02 (0.02)	-0.02 (0.02)	-0.01 (0.02)	-0.02 (0.02)	-0.02 (0.02)	-0.02 (0.02)
	Year dummy	Yes	Yes	Yes	Yes	Yes	Yes
	Intercept	-0.49** (0.10)	-0.41** (0.10)	0.91 (0.06)	-0.43** (0.10)	-0.48** (0.10)	-0.49** (0.10)
	R^2	0.14	0.15	0.17	0.15	0.14	0.14

† for p<0.10, * for p<0.05, and ** for p<0.01. One-tailed test.

5. Discussion and Conclusions

This research examined the influence of the lender–borrower relationship and its benefits on the focal firm's M&A progress in Japan over a recent 20-year period. The analysis results suggested two major implications. First, the presented analysis found that lenders that have a strong lender–borrower relationship, especially those showing a high debt equity ratio, support borrowers' M&A progress. As many previous studies have shown, lenders can benefit when a borrower takes strategic actions through a close lender–borrower relationship. Second, this study found that lenders estimate the potential gain and loss after the proposed M&A and respond to the deal progress by considering the relative power of their current relationships with borrowers. In particular, the target firm's lenders resist the deal progressing and may raise the acquisition premium if their current power relative to borrowers is weak.

In summary, stakeholders including lenders do not favor strategies of focal firms that threaten their future benefits, while they also tend to estimate the potential benefits and losses by comparing their current circumstances with those of other stakeholders. Lender and stakeholder support or resistance to the proposed M&A thus depends on the consideration of several key factors that decide the current lender's future situation. Therefore, the empirical results of the presented analysis help explain the mechanism of lenders' reactions and offer insights into the power of a closer and stronger lender–borrower relationship.

5.1. Theoretical and Practical Implications

This research contributed to the literature by expanding the lender–borrower relationship and its benefits to the implementation of M&A, based on an empirical analysis. For the critical factors affecting the progress of M&A deals, this study provided an "outward looking" perspective rather than focusing on "inward" elements such as the nature of the deal and economic assessment of focal firms, thereby shedding light on the strategic viewpoint when addressing the lender–borrower issue. This finding would help broaden the application of existing theoretical findings on the lender–borrower relationship toward the area of general

** Robust standard errors are in parentheses. n = 501.

management and corporate strategy. In addition, considering that most stakeholder studies examine static circumstances (Preston & Sapienza, 1990), this study addressed stakeholders' influence in dynamic situations such as M&A and suggested a more active way of considering stakeholders' interactions when implementing strategic actions.

From a practical perspective, the results provided implications for how lenders influence a firm's strategic decisions. Managers should estimate potential stakeholder resistance when evaluating strategic options to avoid unexpected difficulties during the implementation of strategic initiatives. In the case of M&A, particularly, firms may suffer by not progressing the announced M&A successfully (Muehlfeld et al., 2012). The results of this analysis thus provided managers with a better understanding of how lenders react to M&A and minimize the losses from unexpected resistance by lenders when proceeding such deals.

5.2. Limitations and Directions for Future Research

Although this study presented meaningful implications, several limitations should be noted. First, the measure of the lender–borrower relationship was the debt equity ratio and loan amount difference. However, as previous studies have pointed out (e.g., Dass & Massa, 2009), other indicators can show the depth or strength of this relationship, such as relationship length, geographical proximity, and shares owned by lenders. Second, the sample of this study was restricted to M&A transactions in Japan. Considering the different ways of perceiving relationships in other countries, regional bias might occur when addressing the lender–borrower relationship. Thus, it would be meaningful to include more countries' samples in future research. Lastly, the acquisition premium is influenced by many factors. While the research model of this study controlled for some of these issues affecting the acquisition premium, other issues remain. Therefore, developing research models that reflect these ideas would be fruitful.

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