ACQUISITION VALUES AND OPTIMAL FINANCIAL (IN)FLEXIBILITY*

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Abstract

We analyze optimal financial structure for an incumbent and potential entrant accounting for feedback effects in secondary asset markets. By issuing sufficient debt, the incumbent creates overhang and credibly commits against acquiring entrant assets- This depresses asset values and entrant returns, thus reducing the likelihood, of entry. The cost of debt overhang is that the incumbent fails to make positive NPV acquisitions if entry deterrence fails. The implied trade-off between ex post efficiency and entry deterrence explains why growth firms eschew debt while value firms issue public debt. Contrary to the traditional view, if predation is feasible, the case, for shallow pockets is potentially stronger, since an unlevered incumbent prefers to acquire whereas a levered incumbent responds to entry with predation. Since predation reduces entrant returns and acquisitions raise them, the entry deterrence benefit from shallow pockets is magnified if predation is feasible. Optimal entrant contracts depend upon incumbent financial structure, with higher debt capacity and stronger financier, ownership rights if the incumbent has deep pockets.

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