THE INFLUENCE OF CASH OWNERSHIP ON FIRM PERFORMANCE AMONG U.S. ACQUIRERS: ALTERNATE SIGNALING MECHANISMS

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ABSTRACT

Cash holdings and annual cash flows emit strong positive signals. Cash holdings consist of a war chest that may be used by firms to fund expansion, develop new products, or hire talent. Cash flows, earned annually, are the excess cash left upon payment of expenses, cash debt, and taxes. Information signaling suggests that the positive signals originate from management's belief that the firm is making profitable investments. Conversely, the cash flow hypothesis maintains that excess cash may be spent on unprofitable projects, increasing agency costs. We test the influence of alternative positive and negative signals on the performance of 902 U.S. acquirers from 2000-2021. We find that cash holdings increase return on assets jointly with size of the acquisition. Dividends increase return on assets, while share repurchases increase both return on assets, and return on equity. However, agency costs in the form of free cash flows are able to reverse the positive effects of dividends on firm profitability.

***Keywords**: cash holding, cash flow, dividends, share repurchases, agency costs*

1.INTRODUCTION

Cash ownership emits a powerful positive signal. Cash ownership may take the form of cash holdings, which are a war chest of cash holdings accumulated over time. Imperfect capital markets increase the cost of external finance, so that cash holdings become a buffer to be used to invest in profitable projects (Drobetz et al., 2010). Thus, cash holdings have been found to maximize firm value (Martinez-Sola et al., 2013). During the Covid-19 crisis, cash-rich firms experienced lower reductions in stock prices (Ding et al., 2021).

Another source of cash is cash flows. Cash may be generated by cash flows from operations. Cash flows may be used to pay dividends, or to repurchase stock. As dividend payments require withdrawals from annual cash flows, dividend payouts send the positive signal that the firm has sufficient cash flows. Alternatively, firms may distribute cash to shareholders by repurchasing stock. The purchase of stock from cash flows transmits the positive signal that the firm has the cash flow to buy back its own stock. If significant growth opportunities exist, and a firm undertaking investment in growth opportunities employs cash flows productively, followed by payment of dividends, the dividends paid by this firm will transmit positive signals (Kao and Wu, 1994). In contrast, if limited growth opportunities exist, agency costs may abound.

We perceive a research gap in the existing literature, in that the signaling effects of cash holdings and cash flows on firm performance, have not been considered, along with the effect of agency costs. While the signaling effects of cash and cash flows (including dividends and share repurchases), and agency costs have been examined empirically (Abraham et al., 2023; Kaestner and Liu, 1998; Louis and White, 2006; Okofo-Durty and Kwende, 2021), there is a paucity of research on the opposing effects of signals on the same sample. If cash holdings, dividends, and share repurchases emit positive signals, increasing stock returns, increasing return on assets, and increasing return on equity, do agency costs succeed in eliminating these increases partially, or entirely ? Likewise, there is no study examining the agency costs of cash flow left after paying for share repurchases. Do positive signals prevail in the presence of agency costs ? Or, do agency costs dominate positive signals ?