AGENCY COSTS OF FREE CASH FLOW, COPORATE FINANCE, AND TAKEOVERS

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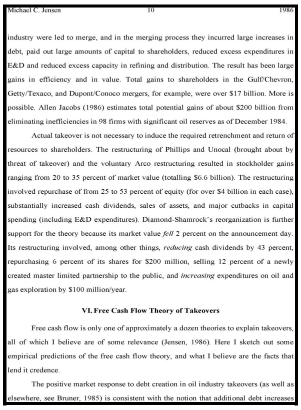

Michael C. Jensen 10 1986

industry were led to merge, and in the merging process they incurred large increases in debt, paid out large amounts of capital to shareholders, reduced excess expenditures in E&D and reduced excess capacity in refining and distribution. The result has been large gains in efficiency and in value. Total gains to shareholders in the Gulf/Chevron, Getty/Texaco, and Dupont/Conoco mergers, for example, were over $17 billion. More is possible. Allen Jacobs (1986) estimates total potential gains of about $200 billion from eliminating inefficiencies in 98 firms with significant oil reserves as of December 1984.

Actual takeover is not necessary to induce the required retrenchment and return of resources to shareholders. The restructuring of Phillips and Unocal (brought about by threat of takeover) and the voluntary Arco restructuring resulted in stockholder gains ranging from 20 to 35 percent of market value (totalling $6.6 billion). The restructuring involved repurchase of from 25 to 53 percent of equity (for over $4 billion in each case), substantially increased cash dividends, sales of assets, and major cutbacks in capital spending (including E&D expenditures). Diamond-Shamrock's reorganization is further support for the theory because its market value *fell* 2 percent on the announcement day. Its restructuring involved, among other things, *reducing* cash dividends by 43 percent, repurchasing 6 percent of its shares for $200 million, selling 12 percent of a newly created master limited partnership to the public, and *increasing* expenditures on oil and gas exploration by $100 million/year.

VI. Free Cash Flow Theory of Takeovers

Free cash flow is only one of approximately a dozen theories to explain takeovers, all of which I believe are of some relevance (Jensen, 1986). Here I sketch out some empirical predictions of the free cash flow theory, and what I believe are the facts that lend it credence.

The positive market response to debt creation in oil industry takeovers (as well as elsewhere, see Bruner, 1985) is consistent with the notion that additional debt increases

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Free Cash Flow and the Dark Side of Financial Slack40

Asquith and Mullins, 1986, Masulis and Korwar, 1986, Mikkelson and Parch, 1986.

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The results are also robust to various measures of investors' divergent opinions in open market repurchases. Estimate how much more these companies could borrow before they would exhaust taxable profits.

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The traditional theory of optimal capital structure states that firms trade off corporate interest tax shields against the possible costs of financial distress due to borrowing. However, for my purposes I assume a constant discount rate of 12 percent and the persistence parameter of 0. Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers , 1986, vol.

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Journal of Banking and Finance, 33 2009 , 2003-2101. We find that a surprising number of firms use their firm risk rather than project risk in evaluating new investments.

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