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Payment Type Offers and the Free Cash Flow Hypothesis in Hospitality Acquisitions

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Abstract

The purpose of study is to understand whether free cash flow is a determinant of the payment type offered by acquiring firms in hospitality acquisitions. According to the pecking order theory, investments are financed using internal funds first, new issues of debt second, and new issues of equity last in order to use the cheapest financing source possible. This is consistent with using free cash flow first in the financing of acquisitions. To test this hypothesis in the context of acquisition payment type offers, a measure of free cash flow was formulated and regressed against the type of payment offer used by hospitality acquirers. Other motivators of cash financing were also tested in the model. Small firms tend to have large cash holdings and often limited access to the capital markets. Thus we tested the relationship between the acquirer's use of cash financing and size of acquirer. In addition, hospitality firms with strong growth opportunities hold significant cash balances to provide the flexibility to pursue positive NPV investment. Thus we included a measure of the acquirer's growth opportunities as well. The results of the model indicated that larger hospitality firms and hospitality firms with low growth opportunities tend to use cash financing in their acquisitions.