Effect of bid characteristics on post-acquisition performance

Danny Po examines a sample of studies focusing on the payment method for an acquisition, either for cash, stock or a combination of both. The ”mega-merger” between Pfizer and Allergan has recently been covered in much detail in the financial press, with huge numbers being quoted for the size of the overall transaction. However, size alone is not sufficient to determine whether the merger will add value to the combined group post-acquisition.

Importance of bid structure
Other factors must be considered in order to develop a view, such as the structure of the bid. A number of studies have identified several bid characteristics and proceeded to attempt to assess their impact on the future performance of the acquiring firms.

For example, a hostile takeover, a transaction in the same or related industries, the acquisition of a larger target were found to be associated with more positive stock returns.

The following studies attempt to determine whether there is a meaningful correlation between the financial success (or failure) post-acquisition and the method of payment. Depending on the outcome, an investor may feel more confident about the prospect of an investment once he or she understands the terms of a proposed acquisition.

An acquiring company may feel that its stock is overvalued and be keen to pay for an investment through the issuance of new shares. In another situation, a target company may have the upper hand in negotiations and only accept to proceed with a transaction in exchange for an all-cash consideration, especially if it feels that the acquirer is overpaying and will see its performance suffer post-acquisition. The motives for paying for an acquisition in cash or stock are diverse but they help reveal details that neither parties would disclose to the public (e.g. an overvalued acquirer or target). The business climate, such as the availability of cheap debt may also explain such choices, but an analysis of the payment methods may provide pointers as to whether a target anticipates that this is an attractive opportunity for the acquirer.

Evidence of post-acquisition value drivers in academic studies
The studies identified and examined different motivations for mergers and their bid characteristics, seeking to establish a strong association with merger and acquisition performance. In addition, different methodologies were applied to measure the outcome of post-acquisition operating and stock performance. The results varied due to the different sampling methods and the different periods examined. Furthermore, the potential determinants (or sources) of the value creation or the value destruction of strategic merger and acquisition transactions are still unknown.

Previous empirical evidence showed that the acquiring firms in hostile acquisitions may actually gain long-run stock returns, but suffer negative announcement returns. However, several studies revealed that hostile acquisitions are more likely to be paid in cash, whereas friendly acquisitions are more likely to be paid by a significant portion of equity (Agrawal et al., 1992; Rau and Vermaelen, 1998; Travlos, 1987). Most previous studies explored whether cash bids or equity bids create or destroy value.

A relatively consistent research finding has shown that cash offers are associated with better short-run announcement returns (Dong et al., 2005; Draper and Paudyal, 1999; Travlos, 1987; Walker, 2000) and long-run stock performance (Cosh and Guest, 2001; Linn and Switzer, 2001; Loughran and Vojh, 1997). A possible explanation for this finding could be that acquiring firms decide their payment method, according to whether they expect higher or lower stock performance in the forthcoming periods. More often than not, acquiring firms will pay in cash if they believe that their stock has been undervalued. On the contrary, if their stock is overvalued, they will pay the acquisition using their own stock. An acquisition payment in cash may send a signal to the market that the acquiring firm’s management anticipates an appreciation in firm value during the post-acquisition period (Myers and Majluf, 1984). However, by the same token, acquisitions paid by issuing shares to the target company’s shareholders will result in a dilution of the share price, assuming that the value of the firm is unchanged until the anticipated merger synergies have been realized (Mitchell, M. L., Pulvino, T. and Stafford, E., 2004). In the latter case, the acquiring firm’s management may also expect an appreciation in stock price over time after the announcement.

Some empirical studies have shown...
that significant positive announcement returns accrue from transactions paid by equity (Chatterjee and Kuenzi, 2001). They argued that because the acquisitions that took place during the period of their study (from 1991 to 1999) were dominated by mergers and acquisitions between high-technology companies (e.g. biotechnology and Internet providers), under this specific circumstance, payments by equity actually served as an incentive for the acquired firms’ shareholders, instead of signaling the valuation of the acquiring firms’ equity to the market. On the other hand, when a firm’s size was taken into account in comparing the announcement returns of equity and cash takeovers, researchers found that large acquiring companies of public targets lost 2.45 percent if they paid the acquisitions with equity, but suffered a loss of only 0.75 percent if they paid the acquisitions with cash. Smaller acquiring firms instead achieved a stock gain of 2.84 percent if they paid with cash and suffered a smaller loss of 0.42 percent if they paid with shares (Moeller, S. B., Schlingemann, F. P. and Stulz, R. M., 2004).

In their study on long-run stock performance, Antoniou and Zhao (2004) examined a sample of 179 successful British transactions and found that although equity transactions often underperformed significantly in the first and second years following the announcement, no significant abnormal returns were found for a combination of equity and cash payment or for cash-only payment transactions. However, Conn, C., Cosh, A., Guest, P. and Hughes, A. (2005) found that acquisitions paid for by any method other than only cash resulted in a loss of 0.47 percent over 36 months, post-announcement, whereas acquisitions paid for by only cash experienced insignificant losses. In contrast, Savor and Lu (2009) found that acquiring firms of overvalued stock created value for their long-term shareholders by using their overvalued stock as a currency to pay for acquisitions. Therefore, it has been shown that successful stock acquirers outperformed their unsuccessful industry peers significantly in the long run, even though they experienced negative stock returns in the short run. Thus, the available empirical evidence suggests that cash acquisitions perform better than equity acquisitions in the short-run returns from announcements. However, no evidence has shown that, similar to equity acquisitions, cash acquisitions will lead to positive abnormal stock returns in the long run.

### Acquisition structure and future performance: a complex and dynamic relationship

The studies above demonstrate that complex relationships exist between the method of acquisition of a target and financial performance. However, such relationships change with time and can occasionally be contradictory: buyers are aware that the chosen bid structure will provide signals to market participants. In other cases, the acquisition structure is imposed and the bid structure only reflects legal and regulatory imperatives, rather than financial strength or weakness. Sellers may also be reluctant to recognize a gain and pay taxes on a sale, whereas receiving shares in target may defer recognition of a gain. Nevertheless, it is clear that the bid structure provides colour when analysing an investment, although this must be considered together with other metrics in order to paint the full picture.

### Long lasting implications of acquisition structure

Buyers should be cautious when paying for acquisitions with their own shares. Warren Buffett’s “worst deal ever,” as described in his annual letter to Berkshire Hathaway shareholders was to acquire a group called Dexter Shoe Co. in 1993 for US$433 million using Berkshire Hathaway Class A stock to fund the purchase. Within a few years, by 2001, Dexter Shoe Co. ended shoe production. As Buffett noted: “By using Berkshire stock, I compounded this error hugely. That move made the cost to Berkshire shareholders not US$400 million, but rather US$3.5 billion. In essence, I gave away 1.6 percent of a wonderful business – one now valued at US$220 billion – to buy a worthless business.”

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