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Taking stock or cashing in? Shareholder style preferences, premiums and the method of payment[☆]

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ABSTRACT

We develop and test hypotheses on the impact of target shareholders' investment style preferences on the method of payment and premiums in acquisitions. Stock offers (unlike cash offers) allow target shareholders to defer capital gains taxes. This deferral value, however, depends on target shareholders' willingness to retain acquirer stock. The empirical findings support our hypotheses. Bid premiums in stock offers are negatively and jointly related to target shareholder tax liabilities and to variables proxying for target shareholder willingness to hold acquirer stock. Moreover, the difference between predicted cash and stock premiums due to these factors significantly explains the method of payment choice.

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1. Introduction

The literature identifies a variety of factors that affect the choice between stock and cash as the method of payment in corporate acquisitions. These explanations, for the most part, are rooted in the circumstances and attributes of the bidder. For instance, prior literature finds that financing constraints faced by the bidder, the potential dilution of acquirer–shareholder control rights and asymmetric information between targets and acquirers influence the method of payment. The level of the overall stock market, and that of the acquirer's stock in particular, also seem to affect the method of payment, with stock-financed mergers more prevalent when stock values are higher.[3] Not only do acquirers paying stock have relatively high valuations, but their bids also tend to follow recent increases in their stock prices.[4]

In this paper we raise the question of whether bid premiums and the method of payment are influenced by the investment preferences of *target* shareholders, given that it is target shareholders that must ultimately accept the terms of any bid that succeeds. When trading frictions are small, the extent to which shareholders favor (or disfavor) the acquirer's stock should not

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[3] Other factors include managerial ownership, institutional ownership, block ownership, and capital gains tax rates. A partial list of relevant studies of U.S. mergers includes Hansen (1987), Amihud et al. (1990), Eckbo et al. (1990), Martin (1996), Ghosh and Ruland (1998), Ayers et al. (2004), and Gu and Lev (2008).

[4] See Jovanovic and Rousseau (2001) and Maksimovic and Phillips (2001) for evidence regarding overall merger activity and the economic climate or the general level of the stock market.

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materially affect the merger process because shareholders can exchange one form of payment for the other at little cost. However, when there is a significant wedge between cash and stock from the target-shareholder perspective, shareholder investment preferences may be important. We argue that capital gains taxes can create such a wedge, and that tax effects can distort the merger process and result in acquisitions that may not be welfare maximizing.

Although the notion that target-shareholder tax liabilities could affect the acquisition process is well recognized in the literature, the empirical evidence is mixed.[5] For instance, consistent with a tax disadvantage to cash-financed acquisitions, Ayers et al. (2007) find that cash-financed acquisition activity is lower when capital gains tax rates are higher. On the other hand, empirical studies (Auerbach and Reishus, 1988; Erickson, 1998) find that the target stock price run-up prior to the acquisition offer, which affects the capital gain received by target shareholders, has no significant effect on acquisition premiums and the method of payment. We argue that the lack of empirical evidence in the existing literature may be a consequence of not accounting for target shareholder preferences.

To see why preferences can matter in the presence of capital gains taxes, note that when target shareholders are strongly averse to owning acquirer stock, they will view payment in stock and cash as near substitutes. This is because, given their investment preferences, they expect to sell rather than retain any acquirer shares they receive in exchange for their holdings. Hence, even when the method of payment is stock, target shareholders will sell right away and recognize any capital gains received on their target shares. This makes stock and cash offers equivalent from a tax perspective. Conversely, when target shareholders are more willing to retain acquirer stock from an investment perspective, payment in stock is tax advantaged (relative to cash). This is because retention of the shares they receive allows target shareholders to defer the recognition of any capital gains in target stock.[6]

Keeping shareholder investment preferences fixed, larger capital gains and higher tax rates on capital gains will make stock offers relatively more attractive due to larger tax deferral values. As a result of such tax deferral benefits, we argue that acquirers may be able to offer lower premiums in stock deals in which target shareholders face larger capital gains tax liabilities relative to stock deals with smaller tax liabilities. This is because when capital gains tax liabilities are large, target shareholders will more highly value the tax deferral benefit that a stock offer provides.[7]

In our empirical analysis, we use the preference for growth vs. value stock by the target's institutional shareholder base, information that is readily available, as a way to identify the style preferences of the firm's shareholders as a whole. Our argument is that if growth-oriented institutions comprise a larger portion of a target's institutional ownership base, this also indicates that the overall target shareholder base is more likely to be growth-oriented. Because the literature reports that acquirers in stock-for-stock mergers are predominantly growth firms (as are the acquirers in our sample), we expect target firms with more growth-oriented ownership to be, on average, more receptive to stock offers. We develop and investigate two testable predictions. The first is that target stocks that are largely owned by growth-oriented investors and experience substantial capital gains are more likely to receive stock offers, rather than cash offers. The second is that, conditional on stock being offered, the bid-premium will be decreasing in the magnitude of the capital gains tax liabilities and the extent to which the target firm is owned by growth-oriented investors. In our tests we also develop alternative ways to match the characteristics of acquirer stock with the preferences of target shareholders and undertake a variety of robustness tests.

Our sample consists of 1881 completed and failed U.S. merger deals over the 1981–2006 period. To proxy for capital gains tax liabilities, we incorporate both the target's prior stock return and the variation in capital gains tax rates: for instance, the capital gains tax rates were at a high of 28% during 1989–1996 period and substantially lower at other times over the sample period. Consistent with our predictions, we find that stock bid premiums are negatively and jointly related to the portion of the target-shareholder base that consists of growth-oriented institutions and the capital gains in the target stock they own. This result holds both before and after controlling for a wide variety of factors including the level of dedicated vs. transient (i.e., long-term vs. short-term) institutional investors (Chen et al., 2007; Gaspar et al., 2005) and the endogeneity of the method of payment choice. In terms of economic significance, a one-standard deviation increase in our measure of capital gains for growth-oriented shareholders is associated with an 8% lower bid premium in absolute terms.

This result is somewhat stronger when we restrict the sample to stock deals that are completed (i.e., offers that target shareholders accept). Moreover, in robustness work we find the results are more striking when we redefine institutional ownership on the basis of the types of institutions that are more likely to care about capital gains (i.e., mutual funds and investment advisors). Results are also more pronounced when we focus on deals in which the acquirer would be more likely considered a growth firm. This robustness check strengthens our confidence that capital gains tax liabilities play their strongest role in the merger process when target shareholders are more likely to find acquirer stock acceptable from an investment perspective.

To address the possibility that mergers with higher portions of growth-oriented target shareholders have smaller synergistic gains (and hence lower premiums) due to some sort of selection bias, we construct a variable that measures the relative values that target and acquirer shareholders receive while holding overall merger gains constant. We find that in stock deals, acquiring

[5] Among those papers recognizing or investigating the potential effect of taxes on acquisitions are Mandelker (1974), Huang and Walkling (1987), Brown and Ryngaert (1991), and Ayers et al. (2003, 2004, 2007).

[6] The US tax code provides that in a stock-for-stock acquisition, target shareholders transfer their target-share cost basis to the acquirer shares they receive. For example, suppose an investor has a $5000 cost basis in target shares for which he receives $9000 worth of acquirer stock at the close of a merger. The investor now has a $5000 cost basis in stock worth $9000 but does not have to recognize the capital gains and pay capital gains taxes as long as the acquirer shares are not sold. On the other hand, if the investor receives $9000 in a cash deal, this is treated as a sale of target stock for $9000. Thus, the investor must recognize (and pay taxes on) a capital gain of $9000–$5000 = $4000 that is assumed to be realized at the close of the merger.

[7] Later in the paper we illustrate these arguments with an intuitive model and simple numerical examples.

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