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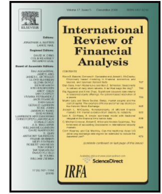

# Synergy disclosures in mergers and acquisitions

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ABSTRACT

We examine bidding firms' motives for disclosing a synergy forecast when announcing a merger or acquisition. Our sample consists of 1990 M&A deals, of which 345 announce synergy estimates. Our results suggest that synergy disclosures serve to obtain a more favorable market reception for deals that would otherwise induce highly negative bidder announcement returns. After controlling for the endogeneity of the disclosure decision, synergy forecast disclosures result in approximately 5% higher bidder stock returns. The main deterrents of disclosing synergy values are lack of precise information on synergy values available to bidding firm management, and shareholder litigation risk. Bidders do not seem to use synergy disclosures to strategically influence takeover premiums or competition for the target.

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## 1. Introduction

When engaging in a merger or acquisition, managers have the option to publicly release a forecast of the synergies associated with their planned deal. Approximately one-fifth of the deal announcements between U.S. public firms over the period 1995 to 2008 include a forecasted synergy value released by bidder management. The key question examined in this paper is why bidding firms engage in such voluntary synergy disclosures.

Drawing from studies on mergers and acquisitions (Fu, Lin, & Officer, 2013; Jensen, 1986; Jensen & Meckling, 1976; Moeller, Schlingemann, & Stulz, 2005; Morck, Shleifer, & Vishny, 1990) and voluntary corporate information disclosure (Dye, 1986; Healy & Palepu, 2001; Verrecchia, 1983, 1990), we develop five predictions on the determinants of bidders' decision to release a synergy forecast. We predict that bidding firm managers will be more inclined to disclose synergies when shareholders are likely to believe that they are overpaying for the target (the *signaling* hypothesis). Conversely, synergy disclosures are expected to be less likely when bidding firm managers lack accurate information to obtain precise synergy estimates (the *information quality* hypothesis), when they fear that disclosures will result in the loss of valuable private information to competitors (the *proprietary costs* hypothesis), or when they fear that disclosures might increase the risk of shareholder litigation (the *shareholder litigation* hypothesis). Bidding firms might also use synergy disclosures as a strategic tool during the deal negotiation process, to influence takeover premiums or the likelihood of competing bids (the *deal strategy* hypothesis).

We examine these five hypotheses using a sample of 1990 M&A deals involving U.S. public bidder and target firms over the period 1995 to 2008. We hand-collect publicly-disclosed information related to each of these deals, and find that 345 or 17% of the transaction announcements are accompanied with a synergy estimate provided by bidder management. We henceforth label these deals "disclosing deals".

Our empirical analysis consists of three parts. In the first step, we conduct a probit analysis of the determinants of bidders' synergy disclosure decisions. In line with the signaling rationale, our results indicate that disclosing deals are significantly more likely to be financed with equity. Akbulut (in press) and Fu et al. (2013) find that equity-financed acquisitions tend to be associated with excessive takeover premiums and insufficient synergy gains. Our probit results therefore suggest that bidding firms may use synergy forecasts to convince their shareholders that their equity-financed deal is motivated by the genuine wish to realize synergy gains, rather than by opportunistically cashing in on overvalued stock.

Furthermore, consistent with Verrecchia's (1990) information quality rationale, our findings indicate that managers' likelihood to disclose synergy forecasts increases significantly with the level of precision with which they can predict synergies. As expected, we also find that firms' propensity to disclose is negatively influenced by shareholder litigation risk. Proprietary costs do not seem to play an important role in explaining disclosure decisions.

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In the second part of our empirical analysis, we analyze the impact of synergy disclosures on bidder stock returns around deal announcements. If synergy disclosures are able to mitigate shareholders' concerns regarding bidder overpayment, we should observe a positive impact of synergy disclosures on bidder stock returns. Alternatively, if shareholders perceive synergy disclosures as cheap talk by managers trying to motivate an overpriced deal, we may observe a neutral or even negative impact of synergy disclosures. The impact of synergy disclosures on bidder stock returns is, therefore, an empirical question. After controlling for the endogeneity of the synergy disclosure decision, we find that synergy disclosures significantly reduce the negativity of bidder announcement returns. To give a sense for magnitude, everything else equal, disclosing deals would realize announcement effects in the order of −7.45%, on average, if they would omit the synergy value forecasts, compared with an actual average announcement effect of −2.65%. Thus, including a synergy value forecast in the deal announcement might turn a prohibitively negative predicted announcement effect into an acceptable one. We also find that bidder stock price reactions are increasing in the amount of the forecasted synergies accruing to bidding firm shareholders, suggesting that shareholders consider the forecasted information value relevant and credible. An analysis of long-term buy-and-hold returns indicates that shareholders do not over- or under-react to synergy disclosures.

In the third part of our empirical analysis, we obtain further insights into bidders' motives for synergy disclosures by examining whether disclosure decisions affect deal prices and competition for the target firm, as predicted by the deal strategy hypothesis. Using regression analyses that control for the endogeneity of the disclosure decision, we find no significant impact of synergy disclosure decisions on takeover premiums or on the likelihood of price revisions and competing bids.

Together, our empirical analyses suggest that synergy disclosures serve as an effective signaling device to narrow the information gap between bidder management and their shareholders regarding the synergy values associated with intended deals. The main deterrents of managerial synergy disclosures are lack of precise information on synergy values, and shareholder litigation risk.

Our paper contributes to a small but growing literature on managerial synergy forecasts. Previous studies take the synergy disclosure decision as given, and either focus on the credibility of managerial synergy forecasts (Bernile & Bauguess, 2011; Houston, James, & Ryngaert, 2001) or on the association of forecasted synergy values with certain deal characteristics (Ismail, 2011). We complement these papers by addressing the ex-ante determinants driving managers' decision to announce synergy forecasts. Knowledge of these determinants also helps us to better understand the drivers of the ex-post stock price impact of synergy value disclosures.

Our paper is also related to Devos, Kadapakkam, and Krishnamurthy (2009), who analyze the underlying sources of Value Line synergy forecasts for 264 large mergers. Their evidence suggests that mergers generate gains by improving resource allocation, rather than by reducing tax payments or increasing the market power of the combined firm. We differ from this study by analyzing the determinants of synergy value disclosures provided by bidder management, rather than the components of synergy forecasts provided by analysts.

On a broader level, our findings contribute to the literature on voluntary managerial disclosure. Previous studies use disclosure ratings or self-constructed disclosure measures, which may be subject to endogeneity issues (Healy & Palepu, 2001). Some studies examine managerial earnings forecasts (e.g., Baginski, Kassell, & Hillison, 2000; Lennox & Park, 2006). Similar to management earnings forecasts, voluntary synergy forecasts present the advantage that the exact timing of the disclosure can be identified, enabling researchers to conduct powerful tests of motivations for, and consequences of, voluntary disclosure. However, while managerial earnings forecasts are typically recurring events, synergy forecasts are rare events in the life of a firm, involve a long forecasting horizon, and occur at moments when the resolution of information asymmetry problems is very important.

The remainder of this article proceeds as follows. Section 2 discusses our testable predictions and motivates the associated empirical proxies. Section 3 describes the data set. Section 4 provides empirical results on the determinants of voluntary synergy disclosures. Section 5 analyzes the impact of synergy disclosure on bidder stock returns. Section 6 provides results on the impact of synergy disclosure on takeover premiums and competition. Section 7 concludes.

## 2. Testable predictions and empirical proxies

In this section, we discuss the different determinants of synergy disclosures suggested by the literature, and develop the empirical proxies for each determinant.

### 2.1. Signaling hypothesis

Within the M&A literature, it is a stylized fact that bidder announcement returns tend to be neutral or negative in acquisitions of public targets (see Eckbo, 2009; Martynova & Renneboog, 2008 for reviews of the literature). One often-cited reason for negative bidding firm announcement returns is that rational shareholders know that bidder managers may be overpaying because they pursue objectives other than shareholder value maximization (Fu et al., 2013; Jensen, 1986; Jensen & Meckling, 1976; Moeller et al., 2005; Morck et al., 1990), or because they overestimate their ability to manage the target firm (Roll, 1986). We hypothesize that bidding firm managers use synergy disclosures to signal that they are in fact not overpaying for the deal, and as such obtain a more favorable stock price reaction upon the deal announcement.

This signaling hypothesis relies on the assumption that bidding firm managers aim to maximize short-term stock prices. If not, they could simply wait until the market understands the true value of the synergies. Verrecchia (2001) states three general reasons for managers to be concerned with the short-term stock price impact of corporate announcements. First, executive compensation contracts are incomplete. It is easier to reward managers based on short-term stock price performance than on long-term stock prices. In fact, managers may not even be around to reap the benefits of long-term stock price increases. Second, the firm may intend to issue equity(-linked) securities in the near future. And, finally, anecdotal evidence suggests that maximizing current stock prices may simply be heuristic behavior on the managers' part. We believe that managers may be particularly sensitive to the short-term stock price impact of M&A announcements. The reason is that acquisitions tend to be rare, career-defining events for most CEOs, which substantial reputational repercussions if they go wrong.

The signaling hypothesis yields the testable prediction that the synergy disclosure decision is positively influenced by information asymmetry about synergy values between bidder managers and shareholders. Higher information asymmetry increases bidder managers' need to mitigate a highly negative stock market reception of the deal by closing the information gap with their shareholders.

To capture bidders' need for signaling synergy values through voluntary synergy disclosures, we construct a set of proxies for shareholders' uncertainty about the true synergy value. Appendix A includes a detailed description of all explanatory variables used in the paper. In line with Servaes and Zenner (1996), we assume that the information asymmetry problem is smaller for deals between firms in the same industry. For such deals, it may be easier for shareholders to evaluate the associated synergies. We also expect information asymmetry about synergy values to be smaller when the deal has been preceded by a large number of other deals targeted at the same industry. Observing these previous deals could make it easier for bidder shareholders to evaluate the synergy values associated with the proposed transaction. To capture uncertainty regarding synergy value faced by bidder shareholders, we therefore include a Same Industry dummy variable equal to one for deals between firms in the same industry, and an Industry Liquidity Index measuring the number of M&A transactions in the

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