Journal of Corporate Finance 26 (2014) 201–224

Contents lists available at ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

Getting to know each other: The role of toeholds in acquisitions☆

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ARTICLE INFO

Article history:
Received 5 November 2013
Received in revised form 4 February 2014
Accepted 1 April 2014
Available online 12 April 2014

JEL classification:
G34
G24
G32
D44

Keywords:
Mergers & acquisitions
Takeovers
Toeholds
Auctions

ABSTRACT

We analyze the role of toeholds (non-controlling but significant equity stakes) as a source of information for a bidder. A toehold provides an opportunity to interact with the target and its management and in the process get a better sense of the possible synergies from a merger or takeover. A bidder considering taking over a target will take a toehold beforehand if the informational benefits are large. Our model makes the following predictions: (i) a toehold is more beneficial if a target is opaque, i.e., if it is generally harder to value potential synergies with the target; (ii) a toehold is incrementally more beneficial if a bidder initially finds it harder than others to assess the value of potential synergies; (iii) that incremental benefit is less important, however, if the target is opaque; and (iv) the benefits from having a toehold are smaller if the number of potential rival bidders is higher. We test these predictions using a large sample of majority acquisitions of private and public companies for which we have information regarding whether the acquirer had a toehold in the target company prior to the majority acquisition. We find evidence consistent with our hypotheses, and thus with the idea that potential acquirers of a target use toeholds to improve their information about possible synergies with the target.

1. Introduction

The main threat to the success of a takeover or merger is that synergies expected from a combination are not realized. Targets and acquirers hope to realize synergies from combining operations or distribution networks, because of complementarities, economies of scale and scope, market power, or because of overlaps that can be eliminated. Predicting the value of synergies, however, is far from trivial. Acquisitions are therefore high-risk decisions, and potential acquirers would benefit from being able to improve their estimates of possible synergies.

In this paper, we study the use of toeholds to improve the assessment of possible synergies. Toeholds are non-controlling equity stakes (less than 50% of the outstanding equity of the target), which can give their owner the opportunity to interact with the target or its management in ways that are not available to other bidders. For example, a toeholder may have the right to nominate a director on the target's board, helping her get a better sense of the target's operations and management. A toeholder may also cooperate with the target on the development of a product, or they may combine parts of their distribution networks. After cooperating for a while, the parties should find it easier to tell whether a full combination promises significant synergies, or whether the prospects are bad and a combination should not be attempted.

☆ We thank an anonymous referee, Audra Boone, Harold Mulherin, Gordon Phillips, Raj Singh, and seminar participants at the University of Houston, York University, University of Texas Austin and Rice University for helpful comments. Sertsios gratefully acknowledges the financial support of FONDECYT Iniciación (project/folio 11130073).

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http://dx.doi.org/10.1016/j.jcorpfin.2014.04.001
0929-1199/

We propose a simple model of competitive bidding in which a potential acquirer can make her estimate of the possible synergies from an acquisition more reliable by first taking a toehold in the target. We study under what conditions a potential acquirer, considering a full takeover of the target, expects the largest informational benefits from having a toehold. Under those conditions, the benefits are most likely to exceed the financial and non-financial costs of acquiring a toehold (costly negotiations, management distraction, possible losses in the value of the toehold if a takeover does not take place, etc.). We test the predictions of the model using a large sample of majority acquisitions of private and public companies for which we have information regarding whether the acquirer had a toehold in the target company prior to the majority acquisition. To the extent that toeholds are more beneficial for potential acquirers, we should also observe a higher proportion of acquirers having a toehold prior to a takeover.

The key assumption in our paper is that toeholds give their owners more reliable information about possible synergies with a target. An initial inspection of our data suggests that the basic conditions for a toehold to improve information are satisfied: Toeholds are large (the average toehold in our sample is 27%) and they are held for fairly long periods of time (75% of the toeholds are held for at least 8 months prior to the majority acquisition).

We derive and test several results. Our first result is very intuitive: Toeholds are more beneficial if it is hard to value the possible synergies from an acquisition. For example, when targets are more opaque and thus generally harder to analyze for outsiders. Consistent with this prediction, we find that acquisitions are more likely to be preceded by toeholds if the target is younger and when it operates in an R&D-intensive industry.

Our second result concerns situations in which a potential acquirer is initially at a disadvantage, because her information about possible synergies with the target is less precise than other potential acquirers' information. We show that the benefit of acquiring a toehold prior to a takeover attempt is higher for such a disadvantaged bidder. The data support this prediction. We find that acquirers operating in different industries or originating from other countries than the target are more likely to have a toehold.

Next, we ask how sensitive a disadvantaged bidder's benefit from a toehold is to the opaqueness of the target. We find that although a less well-informed bidder benefits more from a toehold, the benefit is relatively less important when the target company is opaque. The intuition is that the initial disadvantage of the bidder is less important when the target becomes harder to evaluate for other bidders. Consistent with this prediction, we find that the likelihood that an acquirer from another country and other industry than the target has a toehold decreases when the target is younger and operates in an R&D-intensive industry.

We also consider how the intensity of competition affects our results. We find that the benefits of having a toehold are less important when there are more potential bidders. Intuitively, it is harder to exploit the benefits of more accurate information in a bidding contest when the number of competitors is larger. We use two measures to test this prediction empirically. First, we construct a measure of the potential number of bidders, using data on past acquisitions, both within an industry and across industries, and the number of public companies that operate in each industry. We use the *potential* number of bidders and not the *realized* number of bidders, because the realized number of bidders is endogenous to the toehold decision and because there is no comprehensive source of information for the real number of interested bidders (see Boone and Mulherin, 2007). Our measure of the potential number of bidders tries to capture the fact that a target should attract more potential bidders if it operates in an industry with many companies, or if its industry has historically seen many acquirers from *other* industries with many companies. We also use the target's size as a proxy for the number of potential bidders: The larger a target, the smaller the number of potential bidders, since acquirers are usually larger than their targets. Using either measure, the empirical evidence suggests that more competition makes it less likely that an acquirer has a toehold.

We use the ownership status (publicly traded vs. privately owned) of the targets to test whether alternative explanations exist for our findings. Specifically, we test whether agency considerations can explain our results. Agency problems should be less of a concern in privately held firms, compared with publicly traded firms. Thus, if agency considerations were to explain the coefficients we find on the targets' characteristics, we should expect more significant coefficients for publicly traded firms in our regressions. We find, however, that the coefficients on the targets' characteristics tend to be larger for privately held firms. This suggests that informational concerns are the stronger driver in the decision to take a toehold than agency considerations: The aim is to hold a toehold temporarily, to learn about possible synergies from a combination with the target, and then either to take over the target or to dispose of the toehold.[1]

Our theoretical and empirical results shed new light on the role of toeholds as “strategic stakes” in acquisitions. Our main contribution is to show that toeholds play an important informational role for potential acquirers. This role of toeholds has not been studied before. Most of the literature has focused on the role of toeholds in making a bidder more aggressive (referred to as the “strategic effect” below). In Burkart (1995) and Singh (1998), a toeholder bids above her valuation because doing so increases the price she receives for the toehold if she loses the takeover contest.[2] Their results are derived using auction models with

[1] Equity stakes aimed at resolving agency problems (see, e.g., Shleifer and Vishny, 1986) are usually built up secretly but must be revealed in SEC or FTC filings if they exceed 5% or certain nominal values, typically triggering takeover resistance from the target. The toeholds we observe in our data tend to be much larger, which supports our conclusion that agency concerns do not explain our findings.

[2] For theoretical extensions, see Bulow et al. (1999), Dasgupta and Tsui (2004), and Mathews (2007). For empirical tests of overbidding predictions, see Betton and Eckbo (2000).