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Credit Ratings and the Premiums Paid in Mergers and Acquisitions

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Abstract

We examine the contribution of credit ratings in the information set that bidders use to price targets. Using a sample that includes U.S. domestic deals completed between 1986 and 2012, we find that the presence of ratings significantly affects the M&A premiums paid in mergers and acquisitions (M&As). M&A premiums paid are lower in deals involving rated as opposed to nonrated firms. Assuming that the presence of ratings mitigates the problem of information asymmetry and allows bidders to pay a fair price for a target, then the post-M&A performance of bidders of rated targets would be superior. Indeed, we find that the presence of ratings and bidders' post-M&A operating performance are positively related.

JEL Classification:

G14; G24; G34

Keywords:

Credit Ratings, Mergers and Acquisitions, Premiums

1. Introduction

Bidders' ability to select between good and bad targets is not always perfect. Thus, the premiums paid in mergers and acquisitions (M&As) may be suboptimal when the bidder miscalculates the true potential of a target firm. We study how credit ratings on target firms' bonds assist bidder firms in their determination of target firms' quality and the M&A premium paid.

The information gleaned from credit rating agencies (CRAs) would assist bidders to distinguish better between targets. By using ratings as an independent, unbiased "second opinion," a bidder can more accurately match the premium it pays to the true worth of the

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