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The choice of sale method and its consequences in mergers and acquisitions

Inga Chira[a,*], Nikanor Volkov[b]

[a] California State University – Northridge College of Business and Economics, 18111 Nordhoff St, Northridge, CA 91330, United States
[b] Mercer University, Eugene W. Stetson School of Business and Economics, 3001 Mercer University Drive, Atlanta, GA 30341, United States

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ABSTRACT

We examine the method by which firms are sold, auctions or one-on-one negotiations. We define and describe a subset of transactions that result from auction failure (i.e., target-attempted auctions that secure only one bidder). Controlling for endogeneity, firm, and transaction specific characteristics, we show that attempted auctions that resulted in one-on-one negotiations are associated with lower final premiums and higher acquirer returns compared with both successful auctions and pure negotiations (negotiations with only one bidder from the outset to the conclusion of the transaction). We find that several target, acquirer, and deal-specific characteristics affect the likelihood of auction failure. The loss of latent (perceived) competition that results from an unsuccessful attempt to auction the target partially shifts the wealth created by a merger or acquisition from targets' to acquirers' shareholders. To maximize shareholders' wealth, targets should carefully consider the likelihood of securing more than one interested bidder prior to initiating an auction.

1. Introduction

Many sellers in corporate mergers and acquisitions (M&As) aim to identify a buyer that is willing to pay the highest price. To this end, the target considers two alternative methods of sale: (1) approach multiple potential buyers and attempt to conduct an auction, or (2) engage in a one-on-one negotiation with a single bidder (i.e., pure negotiation). If the seller decides to negotiate with only one potential buyer, it generally reserves the right to approach other potential bidders in the future and convert the negotiation into an auction, without any significant loss of bargaining power. The decision to auction the asset from the outset is more complex because a failed attempt to secure more than one interested bidder may lead to a loss of bargaining power and thus result in a lower sale price.

In this study, we identify M&A transactions that were intended as multi-bidder auctions but concluded in one-on-one negotiations. The review of takeover filings reveals that although about 60% of M&A transactions are bidder-initiated (consistent with Masulis & Simsir, 2013), the decision to engage in multi-party auction is always target-initiated. If a potential bidder approaches a target to initiate a purchase, target's management may make a decision to reach out to other potential bidders.[1] Thus, targets ultimately control the method of sale decision.

Using the sample selection methodology proposed by Boone and Mulherin (2007),[2] we identify transactions where target's management approached more than one party that may have had interest in acquiring the target (i.e., attempted an auction), but only attracted one bidder, who later became the buyer.[3] We label these transactions as *attempted auctions* and show that lack of competitiveness, both real and latent (see Aktas, de Bodt, & Roll, 2010), in such transactions results in target and acquirer wealth effects that differ from both successful auctions and pure negotiations. Controlling for endogeneity, firm-, and transaction-specific characteristics, attempted auctions exhibit a target premium that is 10.38

* Corresponding author. Tel.: +1 818 677 4615.
E-mail address: inga.chira@csun.edu (I. Chira).

[1] There are no transactions in our sample where two independent bidders simultaneously approach the target with an offer to acquire it without a prompt by the target.

[2] Refer to Section 3, for a detailed explanation of the sample collection methodology.

[3] For example, over the course of several months in early to mid-2010, Caliper Life Science, Inc., approached seven different parties that it believed might be interested in acquiring the company. The preliminary conversations identified a single interested party, PerkinElmer, Inc. Following a one-to-one negotiations, PerkinElmer purchased Caliper for about $600 million in cash.

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percentage points lower than that of successful auctions and 9.20 percentage points lower than that of pure negotiations. Furthermore, we find that attempted auctions result in significantly higher acquirer announcement returns when compared to both successful auctions (0.90 percentage points higher) and pure negotiations (0.69 percentage points higher).[4] Attempted auctions represent 8.7% of our sample and account for over \$130 billion in deal value over the seven-year period (2006–2012) examined in this study.

We investigate several possible factors that may affect the likelihood of auction failure: First, we find that attractiveness of the target, proxied for by the level of target's financial constraint, its market to book ratio, and liquidity, does not affect the probability of auction failure. Second, we show that the likelihood of auction failure is increased following economic crises. This finding is intuitive as the deteriorated credit conditions make it more difficult for the acquirers to finance the acquisition. Third, we show that targets in the high-tech industry are more likely to fail in an attempted auction. This finding can be explained by the high-tech industry being generally associated with more opaqueness and lack of public information (Luo, 2005). Fourth, we demonstrate that low liquidity acquirers are more likely to succeed in attempted auctions. This observation suggests that targets may not give enough consideration to potential lower liquidity acquirers as possible one-on-one negotiation counterparts prior to auction initiation. Finally, we find that attempted auctions are associated with aggressive bidding practices (i.e., preemptive bidding, see Fishman, 1988 and Eckbo, 2009).

Attempted auctions are an important sub-set of M&A transactions. Failure to secure more than one interested bidder in an attempted auction results in a significantly lower wealth creation for target's shareholders. We find some evidence that auction failure implies a loss of latent (perceived) competition that surrounds the transaction and results in a partial wealth shift from the target to the acquirer shareholders.[5] Thus, target's management should carefully consider the likelihood of auction failure prior to contacting multiple potential bidders.

The remainder of the paper is organized in the following way: in Section 2 we discuss relevant literature and outline our main hypotheses; Section 3 describes the data; Section 4 covers the methodology; Section 5 presents the results; Section 6 reports the firm and deal characteristics that affect the likelihood of auction failure; Section 7 explores the pre-announcement bidding process, and Section 8 concludes.

2. Hypotheses development

Recent studies that focus on the method by which firms are sold, auction or negotiation, examine transactions from their outset (i.e., the time when the target first considers the sale). As such, Boone and Mulherin (2007) find that the method of sale has no significant effect on the target announcement returns. In other words, the wealth created for the targets' shareholders is not affected by the method of sale. The authors' findings contrast with the auction theory, which suggests that auctions should always generate higher purchase prices (Bulow & Klemperer, 1996). Aktas et al. (2010) demonstrate that the lack of difference in target premiums between auctions and negotiations is a product of latent (unobserved) competition. Latent competition in negotiations (and, to some extent, auctions) arises from the perception that other interested parties may enter the bidding process. Failure to secure more than one interested bidder in an attempted auction may result in a loss of latent competition and thus, affect both target's and acquirer's shareholders wealth.

Bulow and Klemperer (1996) make several key assumptions in developing their model of auctions and negotiations, including that every bidder is willing to make an opening bid that equals the seller's current value. The expected revenue from an auction then can be written as the expectation of the maximum of the marginal revenues of a certain number of bidders. If the marginal revenue of N bidders is greater than or equal to the current value of the target for at least two bidders, it is always more beneficial for the target to hold an auction; no amount of bargaining power is as valuable to the seller as attracting one extra bidder to the sale process. The model thus implies that to maximize the marginal revenue of its sale, a seller should run an open auction and never consider a negotiation. Kirkegaard (2006) provides additional proof for this proposition. The empirical expectation that follows from theoretical predictions is that the final target premiums associated with auctions should exceed those of negotiations.

Boone and Mulherin (2007) determine that about a half of the M&A transactions at the end of the last century were settled via one-on-one negotiations.[6] The Boone and Mulherin study demonstrates that the method of sale does not affect target announcement returns or premiums. In a follow-up paper (Boone & Mulherin, 2009), the authors explain the lack of difference in target returns by citing the higher costs of auctions (see also French & McCormick, 1984) and the unwillingness of serious bidders to bid against potentially un- or less informed auction participants. Aktas et al. (2010) investigate the presence of latent competition and its impact on the bid premium; they show that, even when a seller engages in a negotiation, the potential for competition (auction) pushes the acquirer to offer a more competitive price.

The large number of transactions that settle via one-on-one negotiations may result from targets' awareness of presence of latent competition that pushes the price up, and (or) targets' inability to secure more than one interested bidder. Boone and Mulherin (2007) and Gentry and Stroup (2014) both note that less than a half of invited bidders participate in auctions, which may imply that the uncertainty that surrounds the level of latent competition is reduced as a result of auction initiation. In the case of a successful auction, the latent competition converts into a real one; when auction fails, the latent competition disappears. Thus, the wealth effects of intentional (pure) and unintentional negotiations (attempted auctions) may differ significantly. We argue that the characteristics of a specific subset of negotiations—namely, attempted auctions, differ from both successful auctions and pure negotiations. We propose that, because of the loss of the latent competition, attempted auctions are associated with the lowest target premiums and higher acquirer announcement returns when compared to successful auctions and pure negotiations. The loss of latent competition in an attempted auction reduces target's negotiating power and thus results in the partial wealth shift from the target to acquirer shareholders.[7]

According to Bulow and Klemperer (1996), the expected revenue from an auction with $n+1$ bidders is equal to $E\{\max(\mathrm{MR}_1, \mathrm{MR}_2, \ldots \mathrm{MR}_n, \mathrm{MR}_{n+1})\}$, whereas the expected revenue from a negotiation is $E\{\max(\mathrm{MR}_1, 0)\}$, where MR_n is the marginal revenue from a given bidder. This calculation assumes no latent competition, which may affect (improve) the target's bargaining power in a

[4] The reported statistic is for the (−1, +30) window. The results are 0.81 percentage points higher for the (−1, +1) window when compared to successful auctions.

[5] The results are robust controlling for recessionary periods (see Aktas et al., 2010, who use recessions as a proxy for latent competition).

[6] Our sample, which covers the period of 2006–2012 consists of 70% auctions and 30% negotiations.

[7] It is reasonable to expect that some firms recognize their disadvantageous position as a result of attempted auctions and do not proceed to a negotiation with a single interested party, abandoning the sale process.

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