



# Information uncertainty and target valuation in mergers and acquisitions



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## ABSTRACT

We examine how a target's information uncertainty level affects an acquirer's valuation of the target and the acquirer's gain realized from the transaction. Based on a simple perpetual discounted cash flow model, we argue that the valuation will be lower for a target with higher information uncertainty and acquiring a target with high information uncertainty can potentially create value for an acquirer's shareholders. The empirical findings lend support to our arguments. Specifically, we observe that a target's valuation multiple obtained from an acquirer is negatively correlated with the target's information uncertainty level. An acquirer's announcement return is negatively correlated with the valuation multiple given to the target but positively correlated with the target's information uncertainty level. The results are robust against various measurements of valuation multiples and information uncertainty.

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## 1. Introduction

Whether a takeover market creates value for shareholders, especially shareholders of the acquiring firm, is still unclear. Traditional evidence typically shows that acquirers earn at most non-positive returns upon bid announcement.<sup>1</sup> Moeller et al. (2004) even notice some massive scale-of-wealth destruction in some big mergers in the late 1990s. Nonetheless, Fich et al. (2016) argue that there is similar cyclicity in the time-series distribution of both large gain and large loss mergers and acquisitions deals and show that large gain deals are just as concentrated in the bull market of the late 1990s as large loss deals are. Alexandridis et al. (2017) document that acquiring firms realize substantial gains in mega-deals announced after year 2009. They interpret that as due to profound improvements in the quality of corporate governance among acquiring firms in the aftermath of the 2008 financial crisis. International evidence also finds that acquiring public firms earn significant positive returns when outside US, UK, and Canada region (e.g., Alexandridis et al., 2010).

These studies generally explore the value creation function of takeover from the perspectives of acquirer and deal characteristics.<sup>2</sup> Much less is known about the impact of target characteristics on takeover transactions. In this study, we try to explore this issue by examining the association of target characteristics and acquirer's gain realized in takeover transactions. Specifically, we focus on

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<sup>1</sup> See Jensen and Ruback (1983) and Andrade et al. (2001) for a review of takeover literature.

<sup>2</sup> These include market valuation (Shleifer and Vishny, 2003), managerial overconfidence/hubris (Hayward and Hambrick, 1997; Roll, 1986), diversifying strategy (Morck et al., 1990), payment method (Loughran and Vijh, 1997; Rau and Vermaelen, 1998), acquisition form (Berkovitch and Khanna, 1991; Bhagat et al., 2005), acquisition attitude (Cotter and Zenner, 1994), accounting recording method (Robinson and Shane, 1990), etc. See Section 3.4 for a detailed discussion of these factors.

how a target's level of information uncertainty affects its valuation obtained from an acquirer in a takeover transaction and how such valuation associated with information uncertainty affects the acquirer's returns from the acquisition.

We propose that a target's information uncertainty could be an important source of value creation for an acquirer's shareholders. The intuition is that the value of target shares would be heavily discounted by the market when the target suffers serious information uncertainty problems. The acquirer, however, has an information advantage over the market about the target due to additional information acquired through the process of due diligence.<sup>3</sup> As a result, the target share is more valuable to the acquirer than to the market, the difference of which will be the source of the potential gain to the acquirer.

The target's information uncertainty also works to the advantage of the acquirer through the merger negotiation process. A merger is a bargaining process between the acquirer and the target (Berkovitch and Khanna, 1991; Subramanian, 2005). To the extent that serious information uncertainty problems put the target in a weak position to bargain with the acquirer, the latter would hence be able to complete the deal at a bargain value and/or negotiate for a bigger portion of the potential synergetic gain from the merger.

Our proposition carries several testable implications. First, a target's valuation obtained from an acquirer would be negatively correlated with the target's level of information uncertainty. Second, a target's bid premium would be positively related with the target's level of information uncertainty. Third, an acquirer's announcement return would be negatively correlated with the valuation given to the target but positively correlated with the target's level of information uncertainty.

We test the predictions with a sample of 2676 acquisitions announced during the period 1986–2015. We find that targets with high information uncertainty receive a low valuation multiple from the acquirers. This result holds in a series of robustness tests with different measures of information uncertainty and valuation multiples. Evidently, when it is difficult to evaluate a target with high information uncertainty, an acquirer tends to be more conservative in their bidding. This is particularly true for non-overconfident acquirer CEOs. We find that non-overconfident CEOs in acquiring firms give an even lower valuation to opaque targets than their overconfident peers.

We also find that a target with high information uncertainty receives a high bid premium in the takeover transaction, consistent with earlier studies (e.g., Cheng et al., 2016; Raman et al., 2013). We examine the association between valuation multiple and bid premium but find no constant relationship.

Acquirer announcement return falls if an acquirer gives a high valuation multiple to a target. On the other hand, the acquirer announcement return increases with the target's level of information uncertainty. These results show that an acquirer benefits from the acquisition of an opaque target, and the low valuation multiple given to the opaque target could be a significant factor in making the deal profitable for the acquirer.

Our study establishes a direct link of acquirers' announcement returns with valuation bargains based on the targets' information uncertainty. The literature on takeovers finds that, while acquiring firms experience zero or negative announcement returns in the acquisitions of US listed firms, they earn significant positive returns when acquiring public firms outside US, UK, and Canada region (e.g., Alexandridis et al., 2010). Acquiring firms also experience significantly positive abnormal returns when acquiring unlisted firms or subsidiaries of other firms (e.g., Chang, 1998; Fuller et al., 2002; Hansen and Lott, 1996; Moeller et al., 2004).<sup>4</sup> Although studies report the existence of acquisition discounts for unlisted targets (Koeplin et al., 2000; Officer, 2007), a specific association between such acquisition discounts and positive announcement returns for acquirers has never been formally established, and no reason behind such an association has ever been proposed.

In this study, we establish such a link in a general setting (i.e., not limited to unlisted targets) by arguing that the underlying reason is the target's information uncertainty. Targets with information uncertainty suffer valuation discounts by the market, which opens a window of opportunity for acquirers to grab and enjoy positive acquisition returns.<sup>5</sup> The logic is conceptually the same as the value created by stock analysts through searching for information on the stocks they follow. In the takeover context, an acquirer acts like a stock analyst, searching for the true value of a target firm not realized by market investors due to information uncertainty. Moreover, our argument needs not assume mispricing for targets. In our view, the acquirer buys the opaque target whose shares are correctly priced, though discounted. The acquirer profits through paying a "cheap" target that is actually worth more. Using Bradley et al.'s (1983) terminology, the target is "sitting on the goldmine", which is unnoticed and unpriced. The acquirer reaps the "goldmine" alongside the acquisition without paying for it.

Our study therefore provides a simple but useful implication to corporate acquirers and acquisition advisors. For companies thinking of acquisitions, advisors could propose to them those public firms – if not private ones – with serious information uncertainty. They are potentially good acquisition targets, as their value is typically discounted heavily by the market. As long as the acquirers have the ability to see through the true values of these targets, significant value will be created through acquisitions.

Our study also clarifies the link between the valuation multiple, a measure commonly adopted by practitioners to value takeover targets, and the bid premium, a measure widely used by researchers to measure acquirers' pricing of takeover targets. Extant research on the valuation process in takeover transactions has investigated the bid premium received by a target, but only a few examine target valuation from the perspective of valuation multiples.<sup>6</sup> Specifically, studies find that a target's information uncertainty level

<sup>3</sup> In Povel and Singh's (2006) model, a target suffering from serious information uncertainty may invite the bidder to conduct investigation about the target or disclose information to potential bidders.

<sup>4</sup> Faccio et al. (2006) find that such a pattern persists after controlling for any hypotheses proffered in the literature, such as the creation of a blockholder in the bidder, the method of payment, the relative size of the target, pre-announcement leakage of information about the transaction, and so on.

<sup>5</sup> As for private firms, they generally have more information uncertainty than public firms have. As such, private firms would get a lower valuation from acquirers, and the acquirers would accordingly get a higher return from the acquisitions. Officer (2007) views that the sources of the discounts of unlisted targets come from the liquidity needs of these targets, although he acknowledges that information uncertainty is the likely explanation for the portion of acquisition discounts that cannot relate to aggregate or firm-specific liquidity factors (p. 597). Cooney et al. (2009) have an interesting finding that positive acquirer announcement returns are mainly driven by targets being subsequently acquired for more than their prior valuations.

<sup>6</sup> Koeplin et al. (2000) and Officer (2007) investigate the pricing discounts of private companies relative to public firms in takeover transactions from the perspective of valuation multiples.

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