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Takeovers and (Excess) CEO Compensation

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Abstract.

We study if a CEO's equity-based compensation affects the expected value generation in takeovers. When the objectives of management and shareholders are more aligned, as proxied by the use of equity-based compensation, more value-maximizing acquisitions are expected. Whereas in widely-held firms the decision power is with the management, in firms with concentrated ownership the decision power may be with major blockholders. This may entail that ownership concentration and equity-based pay are substitutes. We find a strongly positive relation between equity-based compensation and cumulative abnormal announcement returns at takeovers, but this relation is eroded when dominant share blocks are held by corporations, which confirms the substitution effect. Powerful CEOs in companies with weak boards and without actively monitoring shareholders may set their own pay which could lead to excesses. We relate excess pay to how takeover decisions are received by the market, and demonstrate that excess compensation negatively affects the acquirer's stock valuation at a takeover announcement. The market is thus able to identify firms with agency problems and is cautious in its expectations about potential value creation by means of acquisitions.

Keywords: equity-based compensation, mergers and acquisitions (M&As), takeover, shareholder protection, ownership concentration.

JEL codes: G30; G32; G34, F30.

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