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What determines takeover premia: An empirical analysis

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ABSTRACT

We empirically analyze the determinants of takeover premia over the period of 1985–2005 and investigate four different factors affecting these premia over the sample period. Our results can be summarized as follows. First, takeover premia were affected by market misvaluation: they were higher during periods of investor pessimism and market undervaluation and were lower during periods of investor optimism and market overvaluation. Consistent with the above result, takeover premia were also negatively related to prior stock market return and positively related to stock market volatility. Second, takeover premia exhibited momentum, being positively correlated with the premia paid in other takeovers in the recent past. Third, takeovers which involved firms in regulated industries immediately prior to deregulation events were associated with significantly lower premia, while premia paid in takeovers which involved firms in deregulated industries after deregulation events were not significantly different from those in other industries. Finally, takeovers of firms in industries with excess capacity and too many firms (industries going through consolidation) commanded higher premia compared to takeovers in other industries.

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1. Introduction

When a firm takes over another firm it usually pays a "takeover premium," which is the excess amount paid by the acquirer over the target's pre-takeover market value. From time to time the financial press complains about how small takeover premia are compared to the premia paid in previous years. For example, an article in the November 26, 2013 issue of the *Wall Street Journal* observes that "M&As have been dominated by cheapskates this year. U.S. companies are paying just 19 percent more, on average, than their acquisition target's trading price one week before the deal is announced. That's the lowest takeover premium since at least 1995... Historically, the premia have averaged 30%." Another article in the March 14, 2005 issue of the *Financial Times* reads: "M&A volumes in the U.S. rose more than 40 percent last year and this year has also got off to a strong start. But takeover premia stayed relatively low, with an average for 2004 of about 24 percent... This is the lowest it has been in roughly 10 years and nearly half the 47 percent premium paid at the height of the bubble."

The above articles and many others provide ample evidence of considerable variability exhibited by takeover premia over time. Takeover premia greatly affect the rate of return on the investment of target firm shareholders and determine takeover profitability for acquiring firm shareholders. Thus, from the standpoint of investors in such firms it is important to identify what drives the variability in takeover premia. However, there are very few studies in the literature which explain such intertemporal variation.[1] The objective of this paper is to study the determinants of takeover premia over time and try to fill the gap in the literature by examining the factors which affect the magnitude of takeover premia.

There are a great number of studies in the literature which examine the determinants of the value and the number of mergers and acquisitions over time. However, there are very few studies which directly investigate the determinants of takeover premia.[2] The same factors which affect the aggregate number and the value of mergers and acquisitions may affect takeover premia as well. We contribute to the existing literature by identifying four of these factors in this paper: market misvaluation, momentum in takeover premia, deregulation, and industry consolidation.[3] We show, for the first time in the literature, that the above factors had a significant impact on the magnitude of takeover premia during our sample period even after controlling for various deal and firm characteristics. Thus, takeover premia are affected not only by the specifics of each deal, but also by the above-mentioned market- and industry-wide factors.

The first factor we consider is the market misvaluation. It is well documented in the literature that the stock market is characterized by periods of over- and undervaluation which greatly influence mergers and acquisitions. Specifically, periods of market overvaluation are associated with intense activity in the takeover market.[4] We hypothesize that, for several reasons, periods of market overvaluation should be associated with relatively lower takeover premia and vice versa.

First of all, an acquirer will be willing to take over a target if it estimates the combined entity to be worth more than the two firms separately. The increase in the value of the combined firm comes from the economic (synergistic) gain expected to be realized from the merger minus the cost associated with acquiring the target. This cost is the difference between what the acquirer pays for the target and the target's pre-acquisition market value, which by definition is the takeover premium. The higher the economic gain from the takeover the higher the premium the acquirer will be willing to pay. However, everything else held constant, the magnitude of the takeover premium can be affected by the target's pre-acquisition market value as well. If the transacting parties estimate the market value

[1] Jarrell and Bradley (1980) investigate cash tender offer premia in relation to the 1968 Williams Act and find that the Act caused such premia to increase due to "information leakages" resulted from its disclosure requirements. Nathan and O'Keefe (1989) show that takeover premia increased over the period of 1963–1985; however, they do not provide an explanation as to what caused such an upward shift.

[2] While there are many papers which study takeover premia in various contexts (see Section 4), takeover premia are not their main focus. Unlike these papers, we directly study the factors affecting the magnitude of takeover premia over time.

[3] There are other factors which significantly affect merger activity that we do not study in this paper since they are not well-defined in time and are difficult to analyze (e.g., technological changes, foreign competition, and others).

[4] See, e.g., Shleifer and Vishny (2003) and Rhodes-Kropf and Viswanathan (2004) for theory and Harford (2005) and Rhodes-Kropf, Robinson, and Viswanathan (2005) for empirical evidence.

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