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The acquisitiveness of youth: CEO age and acquisition behavior ☆

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ABSTRACT

I demonstrate that acquisitions are accompanied by large, permanent increases in Chief Executive Officer (CEO) compensation, which create strong financial incentives for CEOs to pursue acquisitions earlier in their career. Accordingly, I document that a firm's acquisition propensity is decreasing in the age of its CEO: a firm with a CEO who is 20 years older is ~30% less likely to announce an acquisition. This negative effect of CEO age on acquisitions is strongest among firms where CEOs likely anticipate or can influence high post-acquisition compensation, and is absent for other investment decisions that are not rewarded with permanent compensation gains. The age effect cannot be explained by the selection of young CEOs by acquisition-prone firms, nor by a story of declining overconfidence with age. This paper underscores the relevance of CEO personal characteristics and CEO-level variation in agency problems for corporate decisions.

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1. Introduction

Since 1992, CEOs have supervised over $7 trillion in value of mergers and acquisitions. But the literature has not found consistent evidence that acquisitions create value for acquiring firm shareholders (Andrade, Mitchell, and Stafford, 2001; Moeller, Schlingemann, and Stulz, 2005). To explain the apparent prevalence of value-destroying acquisitions, researchers have often turned to CEO agency problems (Jensen and Meckling, 1976) and the firm characteristics that exacerbate them. For example, weak governance (Bertrand and Mullainathan, 2003; Masulis, Wang, and Xie, 2007), excessive free cash flow (Jensen, 1986; Harford, 1999), or poor compensation practices (Lewellen, Loderer, and Rosenfeld, 1985; Datta, Iskandar-Datta, and Raman, 2001) can enable or encourage CEOs to pursue acquisitions.

Despite this conceptual interest in *CEO* agency problems, much of the prior work has focused on *firms*. The literature has largely ignored the possibility that agency problems can vary at the level of the individual CEO. In this paper, I demonstrate that incentives to pursue acquisitions vary with a CEO's career horizon. These incentives, in turn, predict that younger CEOs are more likely to undertake acquisitions.

I show that acquisitions are accompanied by higher levels of compensation: the median CEO in my sample experiences an annual compensation increase of $300,000 following a sizeable acquisition.[1] These gains represent a *permanent* increase in compensation, which do not subsequently revert. Therefore, younger CEOs face stronger incentives to pursue acquisitions since they have longer career horizons over which to reap the benefits.

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[1] Defined as acquisitions that exceed 5% of the firm's market capitalization (for the sample of CEOs of Standard & Poor's (S&P) 1500 firms in 1992–2007).

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These positive compensation incentives are not offset by a higher likelihood of being terminated following an acquisition. Both young and old CEOs who pursue acquisitions are *less* likely to be fired than non-acquiring CEOs. Even CEOs whose acquisitions are poorly received by the market do not face elevated termination risk.

The combination of permanent compensation benefits and limited termination risks creates stronger incentives for younger CEOs to undertake acquisitions. These incentives predict a negative relation between CEO age and firm acquisition propensity. Accordingly, I find that a firm with a CEO who is 20 years older is $\sim 30\%$ less likely to announce an acquisition.

The incentives-based explanation for the CEO age-acquisition relation also predicts that young CEOs will be particularly motivated to pursue acquisitions when the anticipated financial benefits are large. I find that the age effect on acquisition activity is stronger among firms where the CEO can expect a large compensation response to acquisitions, and where the CEO has the power to favorably influence post-acquisition compensation. Further, the acquisitions of such CEOs have the lowest announcement day returns. Therefore, age-varying incentives become a source of agency problems that drive value-destroying acquisitions.

In addition, the age effect is not present in other activities related to firm growth—capital expenditures and smaller acquisitions.[2] There is no permanent compensation response following these activities, so young and old CEOs have comparable incentives to pursue them. Therefore, I argue that the inverse relation between CEO age and acquisition activity is mediated through a permanent compensation response, and is not a general feature of growth-oriented firms.

I also examine the possibility that the age-acquisition relation is explained by declining overconfidence as the CEO ages, which then leads to decreasing acquisition activity. If age were a proxy for overconfidence, the age effect would also arise in other forms of investment such as capital expenditures, and be more pronounced among cash-rich firms.[3] However, as noted previously, the age effect is absent for capital expenditures—a fact consistent with the compensation incentives mechanism. In addition, the age effect is actually stronger for cash-*constrained* firms.

Finally, I consider a number of alternatives to the causal interpretation of the age effect. Although I argue that the negative relation between CEO age and firm acquisitions is a consequence of CEOs' age-varying incentives, it is possible that a CEO's age does not directly influence acquisition policy. First, a matching estimation analysis assures that the CEO age effect is not explained by observable differences (such as firm size, firm age, or valuation) between firms that have young versus old CEOs. Second, I consider whether the age effect reflects the selection of young CEOs by acquisition-inclined (acquisitive) firms. The inclusion of fixed effects shows that even within-firm, younger CEOs are more likely to engage in acquisitions. Alternately, if firm acquisitiveness is a time-varying characteristic and firms hire younger CEOs when they are *about* to engage in acquisitions, the age effect should be strongest in the years closest to hire. I find the opposite: the age effect is stronger among long-tenured CEOs.

Third, I examine the possibility that CEO age reflects the causal effect of fixed CEO characteristics that are correlated with age in the cross-section. These time-invariant traits may either be related to *becoming* a CEO at a young age (e.g., charisma) or be disproportionately possessed by younger cohorts of CEOs (e.g., an MBA, financial expertise). These fixed traits may make CEOs more acquisitive. However, the inclusion of CEO fixed effects shows that an individual CEO's acquisition propensity declines from the early to later periods of his career.

Finally, I examine the concern that CEO age captures the effect of various aspects of CEO wealth that may affect acquisition incentives. For example, the CEO's share of firm ownership, the value of his stock and option holdings, or the value of his company-sponsored pension likely varies with age, and affects incentives to pursue acquisitions. I find that inclusion of appropriate controls for these factors does not change the age effect.

This paper contributes to the literature on agency problems in mergers and acquisitions (M&A) by showing that CEO-level variation in agency problems can meaningfully affect acquisition policy. This paper also adds to the growing literature recognizing the importance of CEO characteristics for a range of corporate policies (Bertrand and Schoar, 2003). Whereas several papers have focused on the contributions of CEOs through their heterogeneous abilities (e.g., firm-specific versus general skills, Murphy and Zabojnik, 2004; leadership versus team skills, Kaplan, Klebanov, and Sorensen, 2012; industry expertise, Custodio and Metzger, 2010), this paper examines how heterogeneous CEO characteristics can be a source of varying agency problems.

This paper also highlights the difficulty boards face in devising effective compensation schemes. The incentives in this paper likely arise from common practices whereby acquisitions serve as opportunities to negotiate for higher compensation (Harford and Li, 2007; Grinstein and Hribar, 2004). The evidence suggests that this practice may give younger CEOs overly powerful incentives to pursue acquisitions. Prior work has explored the tradeoffs boards face in advising, monitoring, and incentivizing the CEO (Adams and Ferreira, 2007; Faleye, Hoitash, and Hoitash, 2011; Acharya, John, and Sundaram, 2000). This paper adds to the literature underscoring the complexity of their job: not only must boards anticipate the impact of CEO personal preferences on firm policy, they must be able to respond to them by devising proper compensation incentives.

The rest of the paper is organized as follows. Section 2 formalizes the intuition for why younger CEOs face stronger

[2] Acquisitions under 5% of the firm's market capitalization.

[3] According to Malmendier and Tate (2005, 2008), overconfident CEOs overinvest because they overestimate their ability to generate value from investments. However, they are also likely to believe that their firms are undervalued, and are reluctant to issue equity. Therefore, the overinvestment problem of overconfident CEOs is particularly severe in cash-rich firms.

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