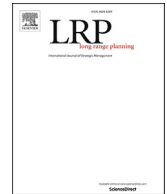


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# The financial crisis, acquisition premiums and the moderating effect of CEO power

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### A B S T R A C T

The recent financial crisis brought upon a period of increased information uncertainty for firms and market agents and in the context of mergers and acquisitions, increased information asymmetry between bidders and targets. This led to an overall increase in average acquisition premiums. However, the final realized premium can be moderated through CEO characteristics in dealing with such issues as uncertainty and asymmetry. Bidder CEOs can reduce these premiums through their expertise, networks and control: powerful CEOs will tend to pay smaller premiums than weaker CEOs because they are better equipped to deal with the increased information uncertainty and asymmetry, either through risk-averse behavior or better assessment of target quality. Our results based on a six-year sample of S&P500 firms engaged in M&A activity, and centered on the onset of the recent financial crisis, largely support our predictions. While earlier research suggested that CEO power could lead to higher premiums, our study points to the opposite conclusion: during times of financial crisis, CEO power effectively constrains premiums. This extends our understanding of why bidder CEOs overpay beyond the role of bidder anchoring bias, hubris, and target resistance by considering the role of macro-environmental conditions and power.

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### Introduction

The recent financial crisis<sup>1</sup> turned the world upside down, leading many business leaders to challenge their assumptions about industry and firm value. It upended the macro economic and capital market environment, impacting deal making, bidder-target interactions, takeover premiums, and executive behaviors (Latham and Braun, 2011; Moeller, 2005; Shelton, 2000). When such macro changes occur, they give rise to informational uncertainty and asymmetry. Information uncertainty increases because of difficulties associated with separating general market conditions from firm-specific developments. Information asymmetry, on the other hand, reflects how bidders will know less about the target's asset quality, transferability, and synergy prospects than the target management does (Coff, 1999), particularly in more volatile environments. The onset of the recent financial crisis exacerbated uncertainty in how target value was extracted from market information and agents. It also reduced the quality and degree of information that bidders knew about the target because of the difficulty in separating market effects from firm firm-specific effects. This was especially troubling for firms seeking to take advantage of the turmoil and acquire another firm at substantially discounted prices (Hotchkiss and Mooradian, 1998).

Even in less turbulent times, bidders searching for synergy (Seth et al., 2002) consistently pay a premium of 30–50% or more over the target's stock price to acquire the target firm (Laamanen, 2007). Bidder CEOs may overpay due to hubris (Hayward and Hambrick, 1997; Hietala et al., 2003; Roll, 1986), anchoring bias (Baker et al., 2012; Burghof and Prothmann, 2011; Malhotra et al., 2015), or securing personal benefits from the transaction (Hubbard and Palia, 1995; Shleifer and

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Vishny, 1998; Song and Walkling, 1993). Target CEOs also contribute to higher prices by resisting takeover offers (Baron, 1983), especially if they own little equity in the firm (Buchholtz and Ribbens, 1994; Cai and Vjih, 2007; Song and Walkling, 1993, 2000) or if their post-merger fate is unresolved (Hartzell et al., 2004; Qiu et al., 2014; Wulf, 2004).

In more stable environments, this tendency to overpay is more pronounced with powerful bidder CEOs. Power is the ability for an individual or group to exercise influence in having another individual or group to abide by their wishes (French and Raven, 1958). CEO power arises from three broad sources: their internal structural position, their access to resources, and their own expertise (Finkelstein, 1992; French and Raven, 1958). Powerful bidder CEOs are able to act on their decision-making biases and self-interest (Li and Tang, 2010), resulting in a negative effect on firm performance (Adams et al., 2005; Boyd, 1995; Desai et al., 2003; Desai, 2008; Tuggle et al., 2010).

But this relationship between CEO power and firm outcomes may not hold in more extreme macro environmental conditions. Environmental jolts upend established organizational practices and produce outcomes that may not appear during more stable times (Meyer, 1982; Meyer et al., 1990). The shock forces executives to question the validity of prior assumptions, including industry norms (Sine and David, 2003) and corporate governance practices (Perez-de Toledo et al., 2016). More specifically for acquisitions, an environment shock may lead many to question the stability and quality of markets and firms in general, effectively influencing valuations, merger activity and payments (Rhodes-Kropf and Viswanathan, 2004; Shelton, 2000). Powerful CEOs may have a positive effect on firm outcomes under these conditions. As a result, boards may prefer a powerful CEO at the helm to help steer the firm through the crisis and may discount concerns about CEO entrenchment (Finkelstein and D'Aveni, 1994) and hubris (Hayward and Hambrick, 1997) they would have during more stable conditions.

We therefore wonder whether powerful bidder CEOs are better positioned to minimize informational disadvantages arising from the financial crisis and thereby acquire targets for lower prices. We seek to better understand how CEO power influences premiums paid for targets, especially during challenging financial and economic conditions. While CEO power has been identified as having an amplifying effect on strategic change (Haynes and Hillman, 2010; Li and Tang, 2010), R&D investment (Chen, 2014) and M&A completion (Chikh and Filbien, 2011), our study seeks to extend our understanding of how CEO power moderates M&A bidding outcomes during such crises. Specifically, we address the issue of CEO bidding under information uncertainty and asymmetry through a power perspective (Carpenter and Golden, 1997; Daily and Johnson, 1997) during an environmental shock, the recent financial crisis, and how it impacts acquisition premiums. We consider how bidder CEOs curb or exacerbate these premiums through three sources of power: superior access to information via their social networks, expertise accumulated through prior experience as CEO, and superior influence over board decision-making (Finkelstein, 1992; French and Raven, 1958). By considering these distinct sources of power, we analyze how power may lower or increase premiums during times of environmental upheaval.

Our results point to a significant jump in premiums at the onset of the recent financial crisis, consistent with a dramatic increase in both information uncertainty and asymmetry. Stronger CEOs were better at reducing the effect of information uncertainty by steering the board to adopt risk-averse behavior and to make lower bids. Stronger CEOs also used their external networks and personal expertise to break through information asymmetry and to improve the quality of their assessment of the target's potential value. In short, powerful CEOs underbid while weaker ones tend to overbid when confronted with a financial crisis, suggesting that earlier studies on the effect of CEO hubris (Hayward and Hambrick, 1997; Roll, 1986) and power (Li and Tang, 2010) on premiums may have failed to discriminate between weak CEOs overbidding and stronger CEOs who can secure an acquisition for a lower price.

## Hypothesis development

The recent U.S. stock market financial crisis crippled the banking industry, devastated U.S. housing, and depressed capital markets. It was triggered by at least three major factors (Neuhauser, 2015): 1) unfettered expansion of credit that led to an unsustainable increase in U.S. housing values, resulting in a housing bubble, 2) the securitization of asset-backed securities and other derivative products that were backed by these housing assets, and 3) ineffective valuation of these securities by credit rating agencies and investment firms. Together, these factors led to a market meltdown that spilled over into the economy through banks with distressed debts, investors with junk securities, home owners with mortgages exceeding fair market value of the underlying assets, and firms with no access to credit or equity markets (Liao et al., 2010).

For potential targets, the crisis dramatically reduced their capacity to support debt thus making providers of credit more skittish; lenders were unsure how firms would be impacted. Recall that the turmoil around 2008 was a direct result of failures in primarily credit markets related to a collapse in housing assets, resulting in a period where capital, economic and employment markets were depressed, making cheap credit at the time only available to unscathed borrowers. Weak targets seeking to borrow to survive the crisis suffered from this lack of available capital and were highly motivated to accept discounted offers (Shleifer and Vishny, 1992).

The consequences of these cumulative actions led many to question the stability and quality of markets and firms in general payments (Schwert, 2011), effectively increasing information uncertainties, influencing valuations, merger activity and payments (Rhodes-Kropf and Viswanathan, 2004).

The recent financial crisis was an external environmental shock that distorted known antecedent-outcome relationships and industry boundaries (Meyer et al., 1990) and decreased environmental munificence (Wan and Yiu, 2009). This environmental dynamism (Milliken, 1990) increased information uncertainty (Duncan, 1972), resulting in more difficult decision-making (March and Simon, 1958; Mintzberg, 1990).

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