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Acquisition premiums when investment banks invest their own money in the deals they advise and when they do not: Evidence from acquisitions of assets in the UK

Aris Stouraitis *

Department of Economics and Finance, City University of Hong Kong, 83 Tat Chee Avenue, Kowloon Tong, Hong Kong, People's Republic of China

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Abstract

This paper shows that investment banks that advise acquirers of assets negotiate favourable terms when they invest their own money in the deal, but lead their clients to overpay when they do not have financial incentives. Acquirers pay the smallest premiums in divisional MBOs when advised by the investment bank that finances the deal, and the largest premiums in interfirm asset sales when advised by an investment bank remunerated contingent on deal completion. Premiums are in between the two extremes when acquirers do not use advisors. These results are attributed to investment bank incentives, which exacerbate the information asymmetry between buyers and sellers of assets.

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1. Introduction

Recent research has questioned whether the incentives implicit in the compensation of investment banks advising acquirers in mergers and acquisitions lead to

* Tel.: +852-2788-8450; fax: +852-2788-8806.
E-mail address: efstoura@cityu.edu.hk (A. Stouraitis).

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better deals for their clients. For example, McLaughlin (1990) documents that financial advisors whose compensation consists, at least partly, of contingent fee payments (paid only if the deal is completed), have incentives to complete deals at any price, even if their advice leads clients to overpay. The literature has examined investment banks only when they are remunerated with contingent fee compensation and their incentives are not aligned with the acquirer's interests (McLaughlin, 1990, 1992; Rau, 2000). In contrast, this paper examines investment bank behaviour when their incentives are very closely aligned with the acquirer's interests. More specifically, it compares the premiums paid for acquisitions of assets under three different scenarios: when the acquirers are advised by investment banks that also finance the deal; when they are advised by investment banks that do not provide financing; and when the acquirers do not use financial advisors. The paper uses the provision of financing by the advising investment bank as the criterion for evaluating its incentives during the acquisition negotiations. Investment banks that invest in the deal have strong incentives to negotiate favourable terms in order to safeguard their investment.

Unit management buyouts (divisional MBOs) and interfirm asset sales are appropriate transactions for this direct comparison. Investment banks that advise MBO acquirers often participate in financing the deal. The combination of a management team with inside information about the acquired division working with an investment bank that invests its own money in the deal increases the likelihood that the assets can be acquired at a low price. In contrast, in interfirm asset sales, the combination of an investment bank with incentives to complete the deal at any price (subject to contingency fee compensation) working with an acquirer who has an information disadvantage vis-à-vis the seller, can lead to the acquirer paying higher premiums for the acquisition of the assets.

The paper uses a sample of 600 sell-offs (91 unit management buyouts and 509 interfirm asset sales) undertaken by UK selling firms during the period 1984–1994. The findings show that in divisional MBOs, acquirers who use financial advisors pay lower acquisition premiums compared to acquirers who do not use advisors. [1] However, these low premiums are observed only in transactions in which the advisors participate in financing the deal. In contrast, in interfirm asset sales acquirers who use advisors pay higher premiums compared to acquirers who do not use advisors. When all acquirers use advisors, the average premium in divisional MBOs is significantly smaller compared to interfirm asset sales. Any differences in the sample are driven exclusively by deals whose acquirers use advisors. There are no significant differences between deals whose acquirers are not advised by investment banks. The results are robust in cross-sectional regressions of premiums and seller abnormal returns using a

[1] The acquisition premium is defined as the difference between the selling price and the intrinsic value of the divested assets. Since these assets are not publicly traded and have no observable market value, their intrinsic value is estimated based on accounting fundamentals, using insights from the literature on the relevance of balance sheet and income statement information for firm valuation (Copeland et al., 2000; Ohlson, 1995; Collins et al., 1997; Hayn, 1995; Berger et al., 1996; Burgstahler and Dichev, 1997; Barth et al., 1998; Collins et al., 1999).