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High-tech acquisitions, firm specific characteristics and the role of investment bank advisors

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Abstract

The valuation effects of US acquirers of high-tech targets are dependent on factors specific to the acquirers or targets. Specifically, acquisitions of public high-tech targets yield negative valuation effects on average, while acquisitions of private high-tech targets yield favorable valuation effects. When acquisitions of public high tech targets are examined separately, we find that deals advised by top-tier banks elicit a more favorable share price response than those advised by either mid or third-tier banks. Acquisitions of private high-tech targets that are certified by an investment bank of *any* tier experience the most favorable announcement effects. Furthermore, the valuation effects are more favorable when the target has less intangible assets and when the targets receive more media exposure prior to the acquisition announcement.
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1. Introduction

Recent years have been marked by an unprecedented pace in the rate of technological change and innovation which, in turn, has forced companies to manage their assets aggressively. Since 1990, there has been a substantial increase in mergers and acquisitions (M&A) of high-tech companies. Most of these acquisitions involved the takeover of small, relatively young start-up companies and were motivated by the acquirers' need to obtain highly developed technical expertise and

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capabilities. As was stated by Rauft and Lord (2000): "Acquiring firms may not have the ability to develop these valuable knowledge-based resources internally or, alternatively, internal development may take too long or be too costly". Kohers and Kohers (2000) state: "The high-growth nature of technology-based industries distinguishes them from other types of industries. In addition to their high-growth potential, however, another distinctive feature of high-tech industries is the inherent uncertainty associated with companies whose values rely on future outcomes or developments in unproven, uncharted fields" [p. 40].

In fact, many "pure" technology stocks are young companies, underfunded and without prospects for generating any cash flows in the near future. Nevertheless, despite the inherent uncertainty of high-tech industries, investors seemed to disregard most equity fundamentals when valuing technology stocks, especially during the market upturn in the late 1990s. As a result, even though high-tech stocks were in general extremely volatile, many of them were trading at remarkable premiums.

The exploding rate of growth of M&A activity in high-tech industries can be partly attributed to those overly optimistic valuations (see Puranam, 2001). Many of these acquisitions were also motivated by the acquirer's need to obtain critical technologies and expertise in order to quickly enhance their own technological competence. According to the McKinsey Quarterly Report (2002) (Frick & Torres, 2002), "transactions and consolidations can often fill holes in a product line, open new markets, and create new capabilities in less time than it would take to build businesses internally. Such moves may be prerequisites to achieving a dominant position—the best assurance for survival". The burst of the tech bubble has lead to lower overall valuations, making more targets affordable.

Given the volatile environment in which high-tech stocks operate, as well as the recent developments in the M&A marketplace, the use of investment bank advisors in such deals should be especially valuable. Specifically, if top-tier investment banks have valuable experience and specialized insight to offer, then high-tech companies using them as advisors in their M&A deals should be able to create shareholder value. Although many acquirers still choose to identify a potential target on their own, investment banks may be able to conduct the search for acquisition candidates more efficiently than the firm itself. Superior expertise in the market for acquisitions and lower search costs due to economies of scale are two of the most common cited reasons. Furthermore, an experienced investment bank, whether representing the bidder or target, should be able to negotiate the offer at more favorable terms, increasing shareholder gains.

The investment bank's role in mergers and acquisitions is controversial, partly because the contingent fee payments to the investment bank contracts may force the investment bank to focus only on completing the deal. McLaughlin (1990, 1992) examined the nature of investment-banking contracts in tender offers. He indicated that most fee contracts are substantially contingent on offer outcome, offering an average of $7.96 million for a completed acquisition but only $1.56 million for no transaction. He argued that contingent fees, as well as other provisions in the contracts, give investment banks substantial incentives to complete a transaction and create potential conflicts of interest.

Studies have found that targets enjoy most of the expected merger and acquisition gains, while acquiring firms experience zero or even negative announcement effects. Acquirers are sometimes motivated to acquire for reasons that maximize managerial benefits rather than firm value (see Amihud, Kamin, & Ronen, 1983; Lloyd, Hand, & Modani, 1987; Malatesta, 1983; Morck, Shleifer, & Vishny, 1990). In addition, managers may be overly optimistic about the value of their targets, act on the presumption that their valuations are correct and fail to recognize that there are really no gains in takeovers (Roll, 1986).

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