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Premium, merger fees and the choice of investment banks: A simultaneous analysis ☆

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Abstract

We analyze 635 US M&A transactions from 1985 to 2004. In contrast with prior research, we distinguish between the target and acquirer fees, and examine their independent effects on the level of the merger premium. The study provides evidence of a positive (negative) association between target (acquirer) fees and the level of the premium. It indicates that the reputation of investment banks affects the level of merger fees, but does not affect the level of the premium. The findings confirm the conflict of interests between target and acquirer firms where the investment banks' efforts are positively related to shareholders' interest. The study also finds that when acquirers pay higher fees than target firms, they pay lower premiums. The findings also imply that for the small proportion of mergers (13%) resulting in relatively large value gains for buying firms, an acquirer might be willing to pay large advisory fees even though this may result in a higher premium.

JEL classification: G34

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1. Introduction

The volume of worldwide announced mergers and acquisitions (M&A) climbed to over US $2.7 trillion during 2005, which is estimated to have generated over $31 billion for financial

☆ The paper has benefited from presentation at the European Financial Management Association meeting, Madrid, 2006, and the American University of Beirut. All errors are our own.

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advisors. These figures represent an average fee of 1.15% of the deal value.[1] A key question of interest is whether these massive fees are justifiable and result in economic benefits to the merging parties. In other words, if two firms have similar characteristics why would one pay a higher fee than the other? Furthermore, how does the decision to pay high fees and employ a more or less prestigious investment bank affect the level of the premium paid by the acquirer? To our knowledge, this is the first paper which examines the determinants of merger fees and their effects on the premium paid to target firms.

Most of the prior research in mergers and acquisitions (M&A) focuses on the abnormal returns earned by both acquirer and target firms at the M&A announcement date. The empirical evidence has produced the general consensus that target firm shareholders earn significant positive abnormal returns; however, the findings regarding the acquirer firm's gains remain, for the most part, without concurrence (see for example Bruner, 2002; Jensen & Ruback, 1983; for a review of the evidence). In this paper, we focus on the premium paid to target firms. Within this framework, we adhere to the notion that the decisions made by both target and acquiring firms at the time of a merger are driven by conflicting goals so that the former would try to maximize the level of the premium, whereas the latter would try to minimize it. Hence, we focus on the effects of the choice of the investment bank and the merger advisory fees on the premium paid. More specifically, while acquirers hire a more reputable investment bank and/or pay a larger fee to reduce the premium paid, targets will inevitably make efforts to increase the premium received.

Controlling for problems related to our truncated sample, which ignores unsuccessful deals, in this study we control for the endogenous level of merger fees. We investigate the consequences of merger-related decisions made by both targets and acquirers for 635 US M&A transactions that were completed between 1985 and 2004. Our main contributions are two-fold. Firstly, in contrast with prior research, this paper distinguishes between the target and acquirer company's fees, and shows their independent effects on the level of the merger premium. In this framework, our empirical findings confirm the existence of a positive and significant association between target fees and the level of the premium, whereas the acquirer fee is negatively and significantly related to the premium. In other words, our results confirm the conflict of interests between target and acquirer firms where the investment banks' efforts, proxied by merger fees, are positively related to shareholders' interest in respect of each party. Additionally, the analysis also shows that the larger the acquirer fees relative to those paid by the target firm, the lower the premium paid.

Secondly, this study verifies the endogenous level of merger fees, and provides evidence on the positive association between the quality of investment banks and merger fees. However, even after controlling for the endogenous level of merger fees, our empirical results do not point to a significant relation between the investment bank's reputation and the merger premium.[2]

Additionally, we find that acquirers are more likely to generate a larger dollar gain than the premium when, among other things, they pay higher advisory fees. Our results imply that if the investment bank's efforts result in larger merger synergies that in turn lead to higher acquirer

[1] Source: Thomson Financial SDC database, M&A and Advisors' Summary Report, Fourth Quarter 2005.

[2] Further robustness tests were re-estimated by dropping the fee variables to verify whether the results related to investment bank reputation are driven by model specifications. Empirical results remain the same and suggest that investment banks do not significantly affect the level of the premium, which might cause a violation of the transitivity between investment bank reputation, the level of fees and the premium paid to target firms. This is consistent with prior results in McLaughlin (1992), as well as in Da Silva Rosa et al. (2004) and Walter et al. (2005) using the abnormal return around the announcement of M&As.