Adverse selection and M&A design: The roles of alliances and IPOs

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Abstract

This paper investigates strategic alliances and initial public offerings (IPOs) as factors that potentially mitigate the risk of adverse selection in acquisitions. It is hypothesized that prior alliances between acquirers and targets as well as IPOs undertaken by targets reduce adverse selection in M&A. Examining the consideration used in M&A transactions to reflect the allocation of overpayment risk, we find that targets’ prior alliances with acquirers and targets’ IPOs reduce the likelihood of using stock, or the amount of stock used, to finance acquisitions. We also present evidence that alliances and IPOs substitute for one another.

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1. Introduction

Acquisitions represent one of the most important means by which firms access and dispose of resources. However, the fact that information regarding the characteristics of these resources can be unevenly distributed across a target firm and a bidder creates inefficiencies in the market for corporate resources. Specifically, M&A markets can take on features of Akerlof’s (1970)
classic depiction of the “market for lemons” in product markets: buyers can find it costly to
discern target quality, and sellers have incentives to misrepresent their quality. In the absence
of suitable remedies, several unfavorable consequences arise. Some attractive deals may not be
consummated, such that the gains from trade that exist are not realized (e.g., Milgrom and Stokey,
1982). In other cases, deals become mired in protracted negotiations, targets receive discounted
offer prices, and buyers bear the risk of adverse selection. We suspect that these challenges will
be present in many acquisitions of new ventures since little historical and codified information
exists on them, their organizational routines and performance lack reliability and accountability
(Hannan and Freeman, 1989), much of their value can be tied to their intangibles and perceived
growth opportunities (e.g., Cooper et al., 1988), and they lack legitimacy and credibility (e.g.,

Our analysis extends prior applications of information economics in other market settings (e.g.,
Stiglitz, 2000; Riley, 2001; Garmaise and Moskowitz, 2004) to the domain of M&A in general, and
their deal structuring choices in particular. Specifically, we construct statistical models to examine
when acquirers use their stock instead of cash to pay for targets in all-stock or all-cash deals. We
also conduct analyses of the proportion of stock used to purchase targets in these transactions as
well as mixed-payment deals in order to examine the extent to which stock is used to reallocate
adverse selection risk in mergers and acquisitions.

Our focus on the consideration used to design M&A transactions is useful for two reasons.
Theoretically, the contractual design of M&A is one means by which firms can manage the risk
of adverse selection in acquisitions. Stock payments transfer this risk from the acquirer to the
target since the value of the merged entity’s stock, and hence the payment to the target firm, will
capture the target’s performance. Stock payments can be beneficial not only to acquirers, but
they can also be in the interests of targets since the contingent pricing effect of stock induces a
target with private information to accept this form of payment when it knows that its ownership
holding in the merged entity will increase in value (Hansen, 1987). Empirically, our tests
complement existing evidence of the role of adverse selection in M&A markets. This research
has focused upon firms’ organizational governance alternatives and equity markets’ reactions to
M&A investments (e.g., Balakrishnan and Koza, 1993), so our analysis represents a more direct
examination of parties’ intentions concerning the allocation of overpayment risk (e.g., Eckbo et
al., 1990; Allen and Lueck, 1999).

This paper examines two potential remedies to adverse selection in acquisitions of new ven-
tures. We first suggest that interfirm alliances between acquirers and targets may be useful to
reduce information asymmetries prior to completing an M&A transaction. Research on alliances
has examined many consequences of interfirm collaboration, and our analysis connects these
interfirm relationships to parties’ subsequent financing decisions. We find that both equity and
non-equity alliances between an acquirer and target lessen the likelihood of using stock consid-
eration over cash payments, as well as the amount of stock used to finance a deal. However,
alliances between the target firm and parties other than the acquirer have no significant impact
on the payment structure for the focal M&A transaction. Second, we suggest that initial public
offerings (IPOs) offer a way for new ventures to release information in a credible fashion as well
as offer signals on the quality of the resources they possess, which might lessen the need for stock
payments in acquisitions of these firms. The evidence is consistent with this argument, and we
also find that IPOs and alliances have substitutive effects.

The remainder of the paper is organized as follows. The next section provides some theoretical
background on strategic alliances and IPOs. Our discussion extends information economics to the
corporate strategy domain and uses this theory to explore some of the organizational governance
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