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Crossing takeover premiums and mix of payment: An empirical test of contractual setting in M&A transactions

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A B S T R A C T

The analyses of the tender offer premiums and of the means of payment should not be performed separately. In the empirical literature, these two variables are often considered independently, although they may have an endogenous relationship in a contractual setting. Using a sample of European M&As over the 2000–2010 decade, we show that these two variables are jointly set in a contractual empirical approach. The relationship between the percentage of cash and the offer premium is positive: higher premiums yield payments with more cash.

We highlight that the payment choice is not a continuum between full cash and full share payments. Two different regimes of payment in M&A transactions are empirically characterized. We analyze the major determinants of M&A terms when the offer premium and the means of payment are jointly set. The underlying rationale of an asymmetry of information and a risk-sharing calculus is found to be significant in the setting of the agreement.

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1. Introduction

The empirical literature of mergers and acquisitions (M&A) transactions largely examines the acquirer's point of view: Why decide to bid for a target? How to set the offered price? How to determine the means of payment? However the target shareholders may not agree the proposal and it may fails. Even through a public takeover bid, the investors, the board or the managers of the target may influence the bidder to review the terms of his offer. Finally, in most cases the deal will be successful but its terms may have changed since the inception of the process. The targets may influence the final terms of an M&A deal (Faccio and Masulis, 2005). Successful takeovers are contractual agreements in which both parties find enough interest to agree on an offer. The two key variables defining this contract are the takeover premium and the offered means of payment. The basis of a contractual approach is that these key variables are jointly determined and agreed on as a package. We need to examine the way these terms will interfere. This paper will question how far that global contractual setting introduces a balance between the takeover offer premium and the means of payment.

Acquisition premium is a well-known measure, but the choice between means of payment is manifold: cash payment and share payment can be combined and an important number of European transactions are paid using hybrid cash-share schemes. The determinants of the means of payment are known; contextual pressure or challenge for control may, for instance, explain the use of cash payment. Empirical regularities have also been identified for international cross border acquisitions, which are frequently paid in cash. The European context is an interesting empiric field to analyze M&A transactions. The scope of share ownership is extensive, from dispersed ownership to controlled and family firms (Faccio and Lang, 2002). Using a sample of European firms, Faccio and Masulis (2005) focus on the univariate determinants of the means of payment. Martynova and Renneboog (2009) analyze the financing decision and thus showed that the latter does not follow the same rationale as the payment decision. However the European context has not been used as an empirical field to complete these findings by testing the interdependency between the means of payment choice with the acquisition premium explicitly. We focus on European deals because very different schemes of payment are effectively used. However transactions develop in a homogenous regulatory context in the European Union countries; consequently the external and institutional determinants weigh less. The intrinsic characteristics of a deal will explain better the balance between the acquisition premium and the choice of means of payment specific to each transaction.

From an analytical point of view, a merger or acquisition is an economic project that generally poses some economic risks for

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the shareholders whether targets or acquirers. Both face an asymmetry of information which leads to the "double lemon" problem identified by Hansen (1987). This risk can be dealt with when setting the contract and using an appropriate choice of means of payment. Cash payment is a way for the seller to avoid risks by receiving liquidity, while shares payment is a way to make the seller bear some of the risks introduced by the project. The means of payment decision is a part of the contract, which is as important as the price itself because it is a way of sharing the expected risk (and profit) from the transaction. This should be particularly true in mixed payment schemes where the relative percentage between shares and cash payment is a parameter to set. In these contexts, the package of a mixed payment percentage and a takeover premium will define the contract, and both depend on the asymmetry of information.

The endogenous nature of the link between the takeover offer premium and the means of payment has not been extensively analyzed in empirical literature. Empirical studies often analyze either the takeover premiums or the means of payment, but rarely both (Eckbo, 2009). It has an important methodological consequence as a one-dimensional analysis of the premium or the means of payment is incomplete and so ignores their joint dependency. We will not pursue numerous empirical studies that look individually at premiums or means of payment because such approaches are incomplete and their results can be misleading. We need to use a methodology explaining jointly the setting of both the means of payment and the premium.

An empirical analysis is developed with regard to a sample of 528 European Union (EU) deals. Our contribution is to show a positive relationship between the percentage of cash and the offer premium: higher premiums yield payments with more cash. From a methodological point of view, we show that systems of simultaneous equations are better suited to the problem as they give different and better results compared to univariate analyses of either the premiums or the means of payment. Our findings support the view of M&A deals as global and complex contractual equilibriums. We outline that the means of payment is not a continuous variable but refers to two different regimes of payment in M&A transactions in which full cash or full share payments are "corner solutions." We find that the major determinants of M&A terms when the premium and means of payment are jointly set include information asymmetry, the risk-sharing calculus between parties and the specific characteristics of the deal, such as cross border acquisitions, competition and same-sector transactions.

This paper is organized into three parts. Section 1 presents a review of the literature, and Section 2 presents the sample and variables. The empirical results are analyzed in Section 3. A conclusion follows.

2. Literature review

2.1. Takeover premium

The empirical corporate finance literature extensively analyze takeover premiums in relation to ownership structure or to the acquirer's or target's characteristics. The takeover premium level is often linked with the ownership structure of the target. For example, the high bargaining power of a large blockholder may force acquirers to offer higher bids (Stulz, 1988). The use of controlling devices, such as double voting rights, the separation of votes and cash flow rights, may enhance that positive relationship. Shareholder agreements – are an efficient mechanism of coordination inside the controlling group which is commonly observed in Europe. It leads to higher firm valuation (Volpin, 2002; Belot, 2010), and it results in higher takeover premiums. Either the existence of an agreement between blockholders or the aggregate voting rights of the controlling party positively influences the takeover premiums for French firms (Belot, 2010). However, premiums are also the consequence of private benefits paid to the inside owners or to incumbent blockholders. The latter trade their benefits for a higher premium; otherwise, the incumbent shareholder will not accept losing his/her control and/or his/her private benefits. Bebchuk (1994), Burkart et al. (2000) and Burkart and Panunzi (2004) all support this view theoretically, and Moeller et al. (2005) provides empirical support.

Deal characteristics are also important. For example, the contestability of the offer can lead to higher prices (Stulz et al., 1990; Song and Walking, 1993). The empirical literature documents a positive relationship between the target cumulative abnormal returns and the competitive nature of the bid.

When the target and the acquirer are from the same economic sector, merging may yield economies of scale and higher profitability. This motivation is measured by the similarity or identity of the SIC codes of the buyer and the seller. Synergy gains will explain higher bids by the bidder (Sundarsanam, 1996). The toehold is defined by the percentage of shares owned by the bidder and should yield a lower asymmetry of information. Betton and Eckbo (2000) show that a toehold negatively influences the takeover premium.

On the target's side, size is a traditional control variable. A larger target firm size allows the premium to be spread over a larger investment. In line with Officer (2003), we can expect a negative relationship between size and the premium. The financial leverage of the target is also important because it may signal a monitoring of the target firm by debtors. This is particularly true for blockholder-controlled companies or family firms. Debt leverage will limit private benefits, causing lower premiums. In contrast, higher debt leverage may be used as a power-enhancing tool for the controlling group and, consequently, may help appropriate private benefits. Stulz (1988) mentions that a target's controlling shareholder may force a bidder to pay a higher premium. Thus, the sign of the relationship is not defined.

The takeover process develops in the context of a double information asymmetry between the acquiring and target firms. Hansen (1987) is the first to mention the so-called "double lemons effect," in which each party has private information on his/her own value and has incomplete information on the nature of the assets he/she will receive. The bidder buys assets of uncertain value. Being risk averse, he/she is willing to pay less when facing an information risk. He/she may also want to share the valuation risk by paying with equity of the newly merged group. The target's shareholders will receive shares based on a new economic project, itself based on forecasted profits and synergies. They may also insure themselves by receiving cash and avoiding share payment. Asymmetries of information explain the risk-sharing attitudes of the buyer and the seller and, consequently, the choice of a mix of payments. Hansen (1987) measures the double asymmetry of information using the relative size of the target compared with the size of the bidder. Berkovitch and Narayanan (1990) develop the risk-sharing explanation and introduce the sharing of the synergy gains between the buyer and the target firm's shareholders into the analysis. The seller's appropriation of the synergy gains depends on the difference in information between the two parties. Chang and Mais (2000) expand the idea that an exchange of information can help to solve the problem of double information asymmetry. They introduce a prior holding in the target's capital (a "toehold") as a means to reduce the buyer's asymmetry of information. In such a situation, the buyer has better inside knowledge of the target, especially if he/she holds a large share of capital (Goldman and Qian, 2004). Cheng et al. (2008) use a sample of US firms to compare asymmetries of information, bid premiums and the means of payment. They show that the means of payment and bid premiums are

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