

Determinants and financial consequences of the method of payment in corporate acquisitions

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Abstract

Although wide variation in the type of consideration offered in corporate acquisitions is observed in practice, little is known about how bidders or targets choose the method of payment in takeovers. Further, several empirical studies report that shareholders of both targets and bidders earn higher returns in cash offers than in equity offers, but the reasons for this more favourable impact of cash offers have not been empirically established. This study attempts to fill these gaps in the literature by addressing three research questions:-
1) What factors determine the method of payment used by bidders in corporate acquisitions?
2) How do target shareholders choose between cash and equity when the bidder has offered "equity with a cash alternative" as the method of payment?
3) Why are bid premia higher in cash offers than in equity offers?

In examining how bidders choose the method of payment this study in contrast to all previous studies, emphasises that there is a simultaneous and joint relationship between the method of payment and the choice of accounting policy. Accordingly, we adopt a simultaneous equations framework with payment method and accounting policy choices as endogenous variables. Our results show that payment method has a significant impact on accounting policy choice whereas the reciprocal effect is not significant. This result reflects the fact that UK accounting rules have eroded the distinction between merger and acquisition accounting which is more clearly observed in the US. We study how target shareholders choose the payment currency by examining how a choice is made between cash and equity when the bidder has offered "equity with a cash alternative" as the method of payment. We find that information about the opportunities for realising synergies in the acquisition have no influence on the choice of payment method by target shareholders. The choice is based primarily on the difference in value between the cash and equity offers. This is consistent with the theoretical predictions based on the efficient market hypothesis, that all publicly available information about a security can be reduced into a single index, namely the share price. We tested some of the popular explanations which have been advanced in the literature to explain the higher returns to cash offers. The capital gains tax compensation and the wealth redistribution hypotheses are rejected. Information asymmetry between managers and shareholders can explain some of the higher returns observed in cash offers. This is consistent with signalling models which predict that the use of equity to finance investments signals a belief by managers that their shares are overvalued.

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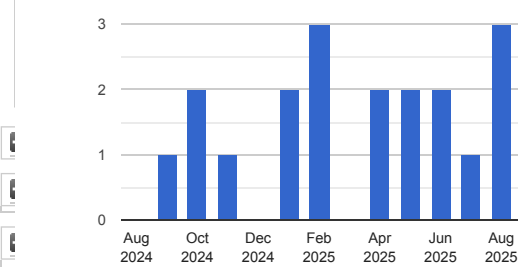
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