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The Value Creation Potential of High-Tech Mergers

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Abstract

The distinctive high-growth, high-risk nature of technology-based industries raises important questions about the creation of wealth in high-tech takeovers. Do investors perceive acquisitions of high-tech targets to have strong potential for value creation? Or, given the large degree of uncertainty associated with many high-tech companies, is the market skeptical of the potential benefits of high-tech acquisitions? Our results show that acquirers of high-tech targets experience significantly positive abnormal returns, regardless of whether the merger is financed with cash or stock. Factors influencing bidder returns are the time period in which the merger occurs, the ownership structure of the acquirer, the high-tech affiliation of acquirers, and the ownership status of the target.

High-tech companies have emerged as leaders in the economy through their technological advancements, job growth creation, and efficiency gains. This article provides important information to the investment analyst who is charged with valuing mergers and acquisitions in these distinctively high-growth/high-risk industries.

The rapid growth of technology-based industries suggests that targets from these sectors may be able to provide greater shareholder wealth benefits for acquiring companies than slower-growth target companies. In addition to their high-growth potential, however, another feature of high-tech industries is the uncertainty associated with any company whose value relies on future outcomes or developments in unproven, uncharted fields. For example, the value of a biotechnology company may depend on the success or failure of a single new drug or medical device. Furthermore, some high-tech companies are not expected to generate any cash flow in the near future, which makes the valuation process notably riskier for the bidder in a high-tech valuation. Thus, from the perspective of a bidder's shareholders, the attractive growth prospects offered by a high-tech target may come with a high price tag.

Given such risk factors, we expected that the bidders that engage in these transactions would have confidence in their ability to successfully manage the acquisition. Furthermore, these acquirers would need to instill such confidence in their investors. To find out, we studied 1,634 mergers in the various high-tech areas that occurred from January 1987 through April 1996. We found that the average performance of the acquirers prior to the merger was significantly higher than that of their industry-matched competitors, which would help to convince investors that these acquirers are capable of creating value through the acquisition.

Moreover, considering the high premiums acquirers have been willing to pay for these high-risk investments, we also investigated whether shareholders in bidder companies perceive the deals favorably. Are investors generally optimistic about the potential synergies of acquiring high-tech targets? Our results show that acquirers of high-tech targets experience significantly positive abnormal returns at the time of the merger announcement—regardless of whether the merger was financed with cash or stock. This finding, together with the relatively high premiums that high-tech targets receive, suggests that the market is optimistic about the future benefits of high-tech mergers. The wealth gains to acquirers indicate that high-tech acquisitions are value enhancing in the short run. The finding that the use of stock to finance the merger or acquisition did not result, on average, in significantly negative excess returns for the acquiring company suggests that investors consider the nature of the investment for which the financing is being used rather than simply react to the financing decision by assuming that stock offerings imply overvaluation.

We found that the factors that influenced bidder returns in the study are as follows: the time period in which the merger was announced (with higher abnormal returns in more recent acquisitions); the high-tech affiliation of the acquirer; the growth stage of the target (with takeovers of private targets generating higher bidder abnormal returns than takeovers of public targets); the bidder ownership structure (with moderate levels of insider ownership having a positive relationship and institutional ownership having a negative relationship with bidder returns); and the size of the transaction relative to the bidder (with larger transactions associated with larger bidder returns).