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Overpaying in Corporate Takeovers: The Winner's Curse

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Overpaying in Corporate Takeovers: The Winner's Curse

Economic rationale suggests that the bidder in a corporate takeover situation expects the acquisition to generate positive returns. The "winner's curse" hypothesis suggests, however, that in the event of competition for a takeover candidate, the successful bidder will tend to be the one that most overestimates the target's value. In that case, subsequent returns may not be significantly positive and may, in fact, be negative.

An examination of 96 acquisitions completed between 1974 and 1983 reveals that the winning bid premium did, on average, overstate the market's estimate of the expected takeover gain. Furthermore, the cumulative average excess return to the winning bidder, measured over the period from 20 days before to 100 days after the acquisition announcement, was significantly negative. For the 58 per cent of the acquisitions in which the bid premium overstated expected takeover gain, average excess return to the winning bidder was −14 per cent; in the cases in which the bid premium did not overstate expected gain, average excess return was a positive 13.4 per cent.

To counteract the winner's curse, bidders should bid less (proportionate to their value estimates) as the degree of uncertainty about the size of takeover gains and the degree of competition for control of the target increase.

THE PRICING OR PREMIUM-setting decision is clearly critical to the success of any takeover, not only because of its impact on the acquirer's ability to obtain the targeted number of shares, but also because of its affect on subsequent rate of return. The takeover bid must be set high enough to induce the target shareholders to relinquish their control rights, but not so high as to make the acquisition economically undesirable.

Most corporate bidders have access to all publicly available information regarding the target company, but only imperfect information about the target company's future cash flow contribution and about the prospects of a competing bid or target management resistance. Using all available data, the corporate bidder forms an estimate of the value of the takeover candidate. If this estimate of value exceeds the target company's current market value, then a takeover offer can be expected; otherwise, no offer should take place.

In the absence of perfect information regarding the target company's future, the possibility of valuation (estimation) error becomes quite high. And as the level of uncertainty regarding the target's prospects increases, the likelihood of valuation error increases. In general, by invoking the law of averages, we would expect the corporate bidder's estimate of the target company's value to be sometimes overstated, sometimes understated, but on average approximately equal to the true value of the firm.

Not only can valuation error be a problem for the individual corporate bidder, but if multiple potential bidders exist, there may also be wide divergences in the estimates of value of the

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