



Acquirer Valuation and Acquisition Decisions

Posted by R. Christopher Small, Co-editor, HLS Forum on Corporate Governance and Financial Regulation, on Monday September 12, 2011 at 11:09 am

Editor's Note: The following post comes to us from Itzhak Ben-David of the Department of Finance at The Ohio State University, Michael S. Drake of the School of Accountancy at Brigham Young University, and Darren T. Roulstone of the Department of Accounting and MIS at The Ohio State University.

In the paper, *Acquirer Valuation and Acquisition Decisions: Identifying Mispricing Using Short Interest*, which was recently made publicly available on SSRN, we provide new evidence helping to resolve an ongoing academic debate about the factors that lead firms to acquire other firms. In the center of the debate are two views. According to the neoclassical approach, acquisitions are an efficient way for firms to expand. The prediction of this school of thought is that mergers are more likely to take place for firms with high Tobin's Q which is indicative of high investment opportunities. In contrast, the behavioral school of thought argues that firms that are temporarily overvalued have an incentive to engage in stock acquisitions in order to exchange their overvalued equity for real assets. Resolving the debate requires distinguishing overvaluation from high investment (or growth) opportunities. To date, most studies use variations of the market-to-book ratio to measure overvaluation as well as to measure investment opportunities. Hence, in order to distinguish between the two hypotheses, one needs an instrument to separate these two economic variables.

In our study, we use short interest (i.e., the number of shares shorted by investors scaled by the name of shares outstanding) to measure misvaluation. High short interest means that a significant amount of investor capital is devoted to short a stock, suggesting a consensus among many investors that a stock is overvalued. The advantage of this measure is that it is not confounded with growth expectations (as empirical proxies of Tobin's Q may be).

Using this measure, we show that overvalued firms (firms in the top quintile of short interest) are 54% more likely to engage in a stock acquisition and 22% less likely to engage in cash acquisitions in the following six months. Furthermore, we show that pre-merger short interest predicts post-merger stock performance. In the first six months following merger announcements, stock acquirers in the top two quintiles of short interest underperform by -4.0%, while cash acquirers in the bottom two quintiles overperform by 5.3%. Overall, our study presents new evidence supporting the idea that overvalued firms self-select to become stock acquirers, while undervalued firms engage in cash acquisitions.

The full paper is available for download [here](#).

2 Comments

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