How Do CEOs Matter? The Effect of Industry Expertise on Acquisition Returns

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Abstract

CEOs with previous experience in the industry outperform industry outsiders in diversifying mergers and acquisitions. Their performance, measured as abnormal announcement returns, is two to three times higher. The outperformance is generated by the industry insiders' ability to bargain better prices with the target shareholders. Their bargaining skills are most valuable in bilateral negotiated deals and if the quality of the target is harder to access.

Executive Summary

A variety of studies show that chief executive officers (CEOs) affect corporate policies and corporate value. Yet, we still know very little about how CEOs create value. This research provides new evidence on this topic. Data on their career paths show that in takeovers CEOs with previous work experience in the target industry outperform CEOs who are new to the industry. Acquirers' abnormal announcement returns are two to three times higher if the CEO has previous experience in the target industry. We differentiate between the CEOs' abilities to create a larger merger surplus and their abilities to capture a larger fraction of this surplus for their shareholders in the bargaining and price-setting process. CEOs with experience in the target's industry perform better because they negotiate better acquisition prices. They also engage in lower surplus acquisitions, on average. This finding is consistent with CEOs rationally anticipating that they will secure a larger fraction of the surplus during negotiations with the target company.

The business strategy literature makes the distinction between *value creation* and *value capture*. We apply this terminology to CEO activity. CEOs can create value by fostering innovation, training employees, or optimizing processes. They can also capture value through negotiation. For example, they can negotiate with suppliers for better prices, with labor over lower wages, or with local governments over subsidies. Negotiations do not necessarily create value but can change its distribution in favor of shareholders. Thus, it is possible for both value-creation and value-capture activities to increase shareholder value. There is little evidence that top decision makers such as CEOs affect outcomes through bargaining (value-capture activity). We show that experience in an industry makes a CEO better able to capture value when bargaining with a firm.

Mergers and acquisitions (M&As) are the setting for this study. Takeovers typically represent the largest investments that companies undertake. The market for corporate control is also significant from an economic perspective: firms in the United States spent more than $3.4 trillion on over 12,000 transactions over the past two decades (1988-2008), which represents about 6.6% of U.S. stock market capitalization. Many empirical studies document that mergers create a surplus. However, most of this surplus seems to be captured by the target companies' shareholders. Indeed, announcement returns to acquirers' shareholders are usually around zero on average or even slightly negative. We find significant CEO-specific variation in merger outcomes for acquirers and targets, which is consistent not only with a conclusion that CEOs have an effect on these outcomes, as well as with the presence of different bargaining abilities. We contribute to this literature by adding to the fairly short list of factors that appear to lead to profitable merger transactions for acquirers.

We start by establishing a novel empirical finding: companies with CEOs who have prior work experience in the target industry perform significantly better in diversifying M&As than their counterparts without experience. Analysis of U.S. data on 4,844 acquisitions announcements over 1990-2008 indicates that three-day abnormal announcement returns to the bidding company, controlling for firm and deal characteristics, time-industry fixed effects, are 1.3 percentage points higher for companies with CEOs who have top management experience in the target's industry. This effect is meaningful in both relative and absolute dollar terms, given an average abnormal return of 0.5 percentage points for diversifying acquisitions and an average market value of about $8,000M. This is consistent with evidence from the private equity and venture capital sectors that often rely on industry experts when investing in a company.

We differentiate between the value creation and value capture mechanisms. A CEO with industry experience might increase the value that is created in a merger. Such CEOs might be better at integrating assets or at running the merged company. They might also be better at identifying high-surplus targets in the pre-merger stage. On the other hand, industry experience could be advantageous in the bargaining process. Industry insiders might possess information that allows them to better estimate the true value of the target. Experience in the industry might also be helpful in assessing a target's outside options and thus strengthen the bidding CEO's bargaining position.

Our findings suggest that industry experts do better in negotiating with a target, allowing them either to secure a greater fraction of the surplus or to pay less for the target company. Industry experts pay a significantly lower premium for target shareholders' shares, when measured as offer price premiums and as final price premiums. We also find lower relative dollar gains of the target when the bidding CEO comes from the target industry. In terms of the value created by an acquisition, using combined abnormal announcement as a proxy for synergies, and ex-post profitability, there is no evidence that industry experts perform better. Various proxies for profitability consistently show negative estimates (not statistically different from zero, though).

Better bargaining ability by the CEO also explains what seems to be a counterintuitive finding: Industry experience has a negative effect on surplus creation. A stronger position in the bargaining stage affects the composition of deals that are announced. CEOs who anticipate securing a larger fraction of the surplus are willing to undertake acquisitions with a lower total surplus at first. CEOs thus substitute greater bargaining power for a higher surplus, and the negative effect is likely not causal but due to selection.

One possible explanation for why industry experience improves bargaining ability is information-based; industry information may help a CEO better estimate the true value of a takeover target. Therefore, we expect there is higher industry insider value when there is greater information asymmetry. We find that experienced CEOs are able to generate about 2.7 percentage point higher abnormal returns if the target is a private company (compared to 0.5% and 0.7% for public and subsidiary targets). We further exploit heterogeneity across target industries by using alternative proxies for information asymmetries at the industry level, such as R&D intensity and the intangibility of assets. We confirm that experience is particularly valuable in settings with high information asymmetry (1.5 percentage points to 1.7 percentage points higher). Finally, we show that greater benefits of industry expertise on bargaining outcomes in bilateral negotiations than in auctions, which is also evidence in favor of the bargaining mechanism.