Mergers and acquisitions: Reducing the private firm discount

Owners of private companies normally sell their shares at a 20-30 per cent discount during mergers and acquisitions. The ‘private firm discount’ is one reason the stock market reacts more favorably when companies announce a private acquisition than when the target is a publicly-listed firm.

From the buyer’s point of view, says INSEAD Associate Professor of Strategy Laurence Capron, the discount reflects a presumed higher risk associated with the value of private assets due to a lack of information about the target firms, their lack of liquidity and their lack of visibility. From the seller’s point of view, the discount can reflect naivety, a lack of financial advice and the choice of a preferred buyer rather than the highest bidder.

Capron and co-author Assistant Professor of Strategy Jung-Chin Shen of York University, surveyed executives involved in 101 acquisitions of manufacturing companies in Europe and the United States to determine the effect of the acquisitions, and the strategy behind the choice of the target. The subject is important because 60-70 per cent of US acquisitions and even more in Europe are private, yet there has been little research on M&A activity involving private firms. The study, ‘Acquisitions of Private vs. Public Firms: Private Information, Target Selection, and Acquirer Returns’, was published in Strategic Management Journal.

"What we found is that the stock market reacts more positively to the acquisition of private targets, about plus four per cent," says Capron, while the average reaction to the acquisition of publicly-listed targets "tends to be negative or zero." The discrepancy is even more noteworthy because private acquisitions tend to be smaller than the average public acquisition, so the target’s weight in the combined equity is smaller, yet the effect is bigger.

Market reaction is an effect of the choice of target, while acquisition strategy is a cause.

When the acquirer is looking within its own industry, its knowledge of the potential target can help to reduce the risks, in spite of the information asymmetry. When companies want to diversify, however, they are more likely to choose public company targets, because there is less information asymmetry. Firms that have gone through an initial public offering (IPO) process must publish financial information that helps acquirers judge their worth, reducing the risk of entering a new industry. In the study, only 8 per cent of private targets were intended to be used for diversification purposes, while 24 per cent of public targets were outside the acquirer’s core business.

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Private sellers are free from the pressure of the market to accept the highest bid, which allows them to have other priorities, but nonetheless they can reduce ‘the private firm...
discount’ by approaching negotiations with a dispassionate attitude.

"Typically private sellers, small family firms, tend to be naïve when they come to the negotiating table," Capron says. They might negotiate for concessions other than financial ones because “they care a lot for employment retention, they care for the community and they will tend to accept a much lower price. And one of the issues is that, most of the time, the acquirers do not live up to their promises after the deal."

While public targets are often bought and sold in an auction atmosphere, private targets are typically bought and sold through negotiations. Private sellers have a smaller pool of potential bidders because of their lower visibility, and, says Capron, “most of the time they stop the search after they find the first bidder. They value … the cultural fit with the bidder, and usually they do not have the resources or the mindset to use financial advisors.”

The study argues that the rule of thumb of a 20-30 per cent discount for a private firm should not be taken for granted. Private sellers can reduce the discount by reducing the uncertainty associated with their assets and by promoting competition among bidders. There can come a point at which additional expense in increasing their marketability does not increase the value of their company, Capron says, but in any potential deal, "they should be careful when they negotiate not to accept a sharp discount."

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