CEOs' zeal for acquisitions flags when their own money is at stake, Freeman researcher says

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Corporate-acquisition activity has been in the doldrums, and the finger of blame has tended to be pointed at investors. In the prevailing view, CEOs are typically empire builders, willing and able to buy, but shareholders have lately lacked the requisite "animal spirits," a contrast said to have been vividly on display recently in the collapse of Prudential's bid to buy AIA.

New research by Cynthia Devers suggests that CEOs are more likely to exercise stock options and sell company stock following acquisitions.

But now new research led by the Freeman School's Cynthia Devers suggests that CEOs may not be the fervent believers in acquisitions that the conventional wisdom suggests they are. For a group that supposedly has a fire to acquire, CEOs are apparently less than eager to leave their own money at risk once their deals are announced, according to a report to be presented at the annual meeting of the Academy of Management (Montreal, Aug. 7-10).

The study of more than 2,000 companies over a period of 12 years finds that CEOs are 28 percent more likely to exercise stock options and 24 percent more likely to sell company stock within three months following acquisition announcements than they are at times in which no acquisitions are announced.

"Although executives exercise options and sell shares for all sorts of reasons, it does seem odd that they're especially likely to do so in the aftermath of acquisitions that they presumably engineer for the future good of the company," says Devers, an associate professor of management at the Freeman School, who carried out the research with Gerry McNamara of Michigan State University, Michele E. Yoder of the University of Wisconsin, Madison and Jerayr Haleblian of the University of California, Riverside.

In the words of the study, "Our findings show that in the quarters following acquisition announcements, CEOs reduced their equity-based holdings by cashing out stock options and selling firm stock...presumably to reduce the exposure of their equity-based holdings to potential firm stock price decreases. Thus, their behavior is inconsistent with the idea that CEOs are confident that their acquisitions will generate substantial long-term shareholder value."

This evident lack of confidence extends to corporate directors as well, according to the study. "To the extent that directors perceive stock options as a motivational, long-term incentive, directors who believe that acquisitions will create long-term value should feel little need to grant their CEOs additional stock options following acquisition announcements," the professors reason. What they find, however, is that directors were 17% more likely to issue CEO stock options in the quarters following acquisition announcements than they were at other times, which "suggests that directors likely feel compelled to refocus CEOs on building long-term shareholder wealth."

In short, "both CEOs and directors appear to lack confidence in the potential for their acquisitions to create long-term value for their firms' shareholders."

This being the case, why do CEOs pursue acquisitions as frequently and as fervently has they do? In raising doubts about the chiefs' own confidence in the strategic value of this activity, the study is bound to add new fuel to suspicions raised by "significant research [revealing] that, on average, acquisitions produce neutral or negative acquirer returns," as the study puts it.

Thus, the professors take note of earlier research which suggests that, even as acquisitions often destroy value for shareholders, they may work to the benefit of CEOs by increasing the size, scope, and complexity of the firm and thereby providing a rationale for the chief to extract more pay. The finding in the new research that acquisitions increase directors' proclivity to grant CEOs additional stock options reinforces earlier research suggesting that substantial new stock and option grants render CEO wealth insensitive to poor post-acquisition performance even while it remains sensitive to good post-acquisition performance.

In cautioning against drawing hard and fast conclusions about CEO motivations, the authors observe that "another explanation for our findings may be...that CEOs often feel compelled to make acquisitions simply because they notice that their competitors are acquiring other firms. In this way, CEOs may rush to acquire because they do not want to be left behind. In such cases, upon further reflection, CEOs and directors may begin to doubt the long-term performance potential of these acquisitions and adjust CEO equity-based holdings in response."

At the same time, the authors concede that their own findings, combined with earlier research that points to "pure self-interest" as the primary driving force for acquisitions, "may lead some scholars to suggest that CEOs might opportunistically acquire other firms to maximize their own private benefits."

The research draws on a large database of publicly traded companies for the period 1996-2007, a sample consisting of 49,623 quarter-year observations representing 2,069 unique firms operating in a wide cross-section of industry sectors. About 13,500l acquisitions of $1 million or more and involving 51 percent or more of the target company were included in the study, with the researchers analyzing CEO options exercised, stocks sold, and options granted during the quarter directly following all acquisition announcements. Only announcements of acquisitions that were subsequently completed were included in the sample.

The study, entitled “What Were They Thinking? Post-Acquisition Announcement Changes to CEOs' Equity-Based Holdings," will be as among several thousand research reports at the Academy of Management annual meeting, to be held in Montreal from August 7 to 10. Founded in 1936, the Academy is the largest organization in the world devoted to management research and teaching. It has more than 19,700 members in 102 countries, including about 11,000 in the United States. This year's annual meeting will draw more than 9,000 scholars and practitioners for sessions on a host of subjects relating to business strategy, corporate organization and investment, the workplace, technology development, and other management-related topics.

-Ben Haimowitz