

# Takeovers of Privately Held Targets, Methods of Payment, and Bidder Returns

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## ABSTRACT

We examine bidder returns at the announcement of a takeover proposal when the target firm is privately held. In stock offers, bidders experience a positive abnormal return, which contrasts with the negative abnormal return typically found for bidders acquiring a publicly traded target. On the other hand, bidders experience no abnormal return in cash offers. Our analysis suggests that the positive wealth effect is related to monitoring activities by target shareholders and, to an extent, reduced information asymmetries.

RECENT STUDIES ON TAKEOVERS document that the method of payment plays an important role in explaining bidding firms' stock returns. For example, Travlos (1987) reports negative abnormal returns for firms financing a takeover with common stock and no abnormal returns for those financing with cash.<sup>1</sup> Because financing a takeover of a publicly traded target with common stock parallels a public offering of a new equity, the negative abnormal returns for these bidding firms are consistent with the findings of the studies on public equity offerings (see Smith (1986) for a summary of the evidence on the wealth effects of equity issue announcements).

In this study, we examine the bidding firm's stock price reaction to a takeover proposal when the target firm is privately held. Takeovers of privately held targets are an especially interesting issue when they are financed with common stock. In this case, the financing of takeovers is similar to private placements of equity because target firms are owned by one or a small number of shareholders. Our evidence shows that bidding firms experience no abnormal return in cash offers, but they experience a positive abnormal return in stock offers. The positive abnormal return for stock bidders is consistent with the findings of Wruck (1989) and Hertz and Smith (1993) for private placements of equity (see also Fields and Mais (1991) on private placements of convertible debt).

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<sup>1</sup> For more empirical evidence, see Wansley, Lane, and Yang (1987), Asquith, Bruner, and Mullins (1987), and Servaes (1991), and for theoretical findings, see Hansen (1987), Fishman (1989), Berkovitch and Narayanan (1990), and Brown and Ryngaert (1991).

The paper is organized as follows: Section I discusses the hypotheses offered to explain bidder returns when targets are privately held. Section II describes the data and presents the results of the event study and cross-sectional regressions. Section III provides a summary and conclusions.

## **I. Hypotheses on Bidder Returns When Target Firms Are Privately Held**

### *A. The Limited Competition Hypothesis*

If the takeover market is competitive, the acquisition itself will be a zero net present value project. That is, acquiring firms will experience no abnormal stock returns when they finance an acquisition with cash. On the other hand, if the competition is limited for privately held targets,<sup>2</sup> bidding firms can experience positive stock returns because the likelihood of underpayment is high. Alternatively, bidder returns can be positive if the acquisition creates synergy gains and the gains are bidder-specific.

### *B. The Monitoring Hypothesis*

Firms acquiring privately held targets through common stock exchanges tend to create outside blockholders because the targets are owned by a small group of shareholders. The creation of outside blockholders can increase firm value because these blockholders can serve as effective monitors of managerial performance or facilitate takeovers (Shleifer and Vishny (1986)).<sup>3</sup> On the other hand, the resulting increase in ownership concentration can decrease firm value if it allows managerial entrenchment or makes takeovers more costly (Fama and Jensen (1983), Stulz (1988), and Morck, Shleifer, and Vishny (1988)).

### *C. The Information Hypothesis*

When firms offer stock to acquire publicly traded targets with a large number of shareholders, they can suffer from the asymmetric information problem of Myers and Majluf (1984). They demonstrate that issuing equity to the public reduces a firm's stock price when managers have superior information. In the context of their model, bidding firm managers offer stock when they believe the firm is overvalued. Hence, the market reaction to the takeover proposal will be negative.

On the other hand, when firms offer stock to acquire privately held targets with a small number of shareholders, the problem can be mitigated through the disclosure of bidding firm managers' private information to the target shareholders. Further, the target shareholders have an incentive to assess

<sup>2</sup> One possible reason is that the information search cost is high because of the scarcity of public information on privately held targets.

<sup>3</sup> See also Mikkelsen and Ruback (1985) for evidence on the wealth effects of 13-d filings.

the bidding firm's prospect carefully because they will end up holding a substantial amount of the bidding firm's stock after the merger. Thus, their willingness to hold a large block of shares conveys to the market favorable information about the bidding firm, resulting in a positive stock price reaction to the merger proposal.

## II. Data and Empirical Results

### A. Data

From W. T. Grimm's *Mergerstat Review*, 1981 through 1992, and from the Dow Jones News Retrieval service from 1988 through 1992, we collect a sample of firms that successfully acquired privately held firms. Announcement dates of the takeover proposals come from the *Wall Street Journal* (WSJ) and the Dow Jones News Retrieval. The following criteria are used to screen the data:

1. Bidding firms are contained in the Center for Research in Security Prices (CRSP) file or the CRSP Nasdaq file, and stock return data are available for at least 100 days before the takeover announcement.
2. No other major news announcements regarding the firms are reported in the *Wall Street Journal Index* in the three days surrounding the announcement date.
3. Financial firms (banks and insurance companies) are excluded.
4. The value of an acquisition is at least \$10 million.

The final sample consists of 281 merger proposals (no tender offers are found), divided into 131 cash offers, 100 stock offers, and 50 mixed offers where a combination of cash and stock is paid. Cash offers include nonconvertible debt exchanges, and stock offers include preferred stock and convertible debt exchanges. For our empirical tests, we combine stock offers and mixed offers, and call them stock offers collectively.

The comparison sample comprises firms that successfully acquired publicly traded firms as reported in the *Mergerstat Review* from 1981 through 1988. Using the same screening procedure, we obtain a sample of 255 merger proposals that consist of 101 cash offers and 154 stock offers. Tender offers are excluded to be comparable to the sample of privately held targets. Table I provides descriptive statistics for our sample and the comparison sample. The mean market value of bidder equity, measured 10 days before the announcement, reveals no significant difference between the two groups, but the mean value of the acquisition is significantly smaller for privately held targets than for publicly traded targets. The relative size of the acquisition is also significantly smaller for our sample than the comparison sample. Although not reported in the table, we compare the size characteristics for cash offers and stock offers within each sample. We find no systematic difference between the two groups in either sample.

Table I  
Characteristics of Acquisitions of Privately Held Targets  
Compared with Acquisitions of Publicly Traded Targets

The sample period of 281 acquisitions of privately held targets is from 1981 through 1992, and the sample period of 255 acquisitions of publicly traded targets is from 1981 through 1988. Cash offers include nonconvertible debt exchanges. Stock offers include preferred stock and convertible debt exchanges and mixed offers where a combination of cash and stock is paid. The market value of bidder equity is measured 10 days before the acquisition announcement. The relative size of acquisition is the value of acquisition divided by the market value of bidder equity. Blockholder is a beneficial owner of 5 percent or greater of outstanding shares. Statistics are the mean (median). *t*-test is used for the difference in means.

|                                                              | Acquisition<br>of Privately<br>Held Target<br>( <i>N</i> = 281) | Acquisition<br>of Publicly<br>Traded Target<br>( <i>N</i> = 255) | Difference<br>in Means |
|--------------------------------------------------------------|-----------------------------------------------------------------|------------------------------------------------------------------|------------------------|
| Number of cash offers                                        | 131                                                             | 101                                                              |                        |
| Number of stock offers                                       | 150                                                             | 154                                                              |                        |
| Market value of bidder equity in million \$                  | 2297<br>(523)                                                   | 2430<br>(794)                                                    | −133                   |
| Value of acquisition in million \$                           | 156<br>(64)                                                     | 262<br>(74)                                                      | −106*                  |
| Relative size of acquisition                                 | 0.27<br>(0.13)                                                  | 0.39<br>(0.17)                                                   | −0.12*                 |
| Number of observations with a new<br>blockholder from target | 41                                                              | 12                                                               |                        |
| Share ownership of new blockholder                           | 16.7%<br>(11.7%)                                                | 8.9%<br>(9.0%)                                                   | 7.8%**                 |

\* and \*\* indicate significance at the 5 percent level and 1 percent level, respectively.

Table I also reports the frequency of a new blockholder emerging from the target and share ownership of new blockholder. We define blockholder as a beneficial owner of 5 percent or greater of outstanding shares. The announcement articles and proxy statements following the merger are used to identify whether a blockholder is created through the merger. The frequency of having a new blockholder is higher and the average block size is also larger for acquisitions of private targets than those of public targets.

B. Event Study Results

In the event study we use the standard market model method, as in Brown and Warner (1985). The announcement date (day 0) is the day of the first *WSJ* announcement of an acquisition proposal or the day after the announcement appears on the Dow Jones newswire. Market model parameters are estimated over the period from day −210 to day −11. We measure announcement-period returns from day −1 through day 0.

Table II shows the average abnormal stock returns for bidding firms at the announcement of a merger proposal, grouped according to the method of

**Table II**  
**Average and Median Two-Day Abnormal Stock Returns**  
**for Bidders at the Announcement of a Takeover**  
**Proposal by Method of Payment**

Abnormal stock returns are estimated using the standard market model method as in Brown and Warner (1985). The announcement date (day 0) is the day of the first *Wall Street Journal* announcement of an acquisition proposal or the day after the announcement appears on the Dow Jones newswire. The two-day announcement-period abnormal returns are measured from day -1 through day 0. Market model parameters are estimated over the period from day -210 to day -11. Cash offers include nonconvertible debt exchanges. Stock offers include preferred stock and convertible debt exchanges and mixed offers where a combination of cash and stock is paid. The Wilcoxon signed-rank test is used for the percent positive.

|                                                | Number of<br>Observations | Average (median)<br>Abnormal Return | <i>t</i> -Statistic | Percent<br>Positive |
|------------------------------------------------|---------------------------|-------------------------------------|---------------------|---------------------|
| Panel A: Acquisition of Privately Held Target  |                           |                                     |                     |                     |
| Cash offers                                    | 131                       | 0.09%<br>(-0.18%)                   | 0.34                | 48.1                |
| Stock offers                                   | 150                       | 2.64%<br>(0.89%)                    | 7.49**              | 66.0**              |
| Panel B: Acquisition of Publicly Traded Target |                           |                                     |                     |                     |
| Cash offers                                    | 101                       | -0.02%<br>(-0.17%)                  | -0.06               | 46.5                |
| Stock offers                                   | 154                       | -2.46%<br>(-2.02%)                  | -9.85**             | 27.3**              |

\*\* indicates significance at the 1 percent level.

payment. Panel A contains the results for our sample of bidders acquiring a privately held target. Cash bidders earn an insignificant 0.09 percent average abnormal return ( $t = 0.34$ ), but stock bidders earn a significant 2.64 percent average abnormal return ( $t = 7.49$ ). The difference is significant at the 1 percent level ( $z = 4.09$ ).<sup>4</sup> The median abnormal returns are -0.18 and 0.89 percent for cash and stock bidders, respectively. Consistent with the  $t$ -test, the Wilcoxon signed-rank test for the proportion of positive returns is significant only for stock bidders. Panel B contains the results for the comparison sample of bidders acquiring a publicly traded target. Cash bidders

<sup>4</sup> The test of the difference between the two average abnormal returns is based on the abnormal returns standardized by the square root of estimated forecast variance for each observation. See Dodd and Warner (1983) for details. The test statistic is

$$z = \frac{AAR_1 - AAR_2}{\sqrt{\frac{2}{N_1} + \frac{2}{N_2}}},$$

where  $AAR_1$  and  $AAR_2$  are the mean of the two-day standardized abnormal returns for stock and cash bidders, respectively, and  $N_1$  and  $N_2$  are the corresponding number of observations.

earn an insignificant  $-0.02$  percent average abnormal return ( $t = -0.06$ ), and stock bidders earn a significant  $-2.46$  percent average abnormal return ( $t = -9.85$ ).<sup>5</sup> The medians are  $-0.17$  percent and  $-2.02$  percent for cash and stock bidders, respectively, and the Wilcoxon signed-rank test is significant only for stock bidders.

Our results indicate that the average share price reaction for cash bidders is zero and indistinguishable between the two types of target firms. The evidence does not support the limited competition hypothesis that the takeover market is less competitive for privately held targets than publicly traded targets. However, the positive average share price reaction for stock bidders acquiring privately held targets stands in sharp contrast to the negative average price reaction for stock bidders acquiring publicly traded targets. If we consider the financing of takeovers, the share price reactions are similar to the results of studies on private placements of equity for privately held targets,<sup>6</sup> and similar to the results of the studies on public equity offerings for publicly traded targets (Asquith and Mullins (1986), Masulis and Korwar (1986), and Mikkelsen and Partch (1986)). Further, the positive share price reaction is consistent with the monitoring hypothesis that the creation of an outside blockholder results in an increase in firm value through more efficient monitoring of managers or an increase in the probability of takeovers. The evidence is also consistent with the information hypothesis that shareholders of privately held targets are well informed of the prospects of the bidding firm; thus, their willingness to hold bidding firm stock signals positive information about the firm.

To provide additional evidence on the monitoring hypothesis, we investigate stock offers more closely and divide them into two groups based on whether a new blockholder emerges from the target. We predict the monitoring effects will be stronger; thus, the abnormal stock return should be higher when a merger results in the creation of a blockholder.

Blockholder activism can be illustrated by the acquisition of Electronic Data Systems (EDS) Corporation by General Motors (GM). In 1984 GM acquired EDS in a cash and stock transaction. Ross Perot, founder and chairman of EDS, owned 48 percent of EDS common shares, which, after the merger, made him GM's largest shareholder through a 17.2 percent stake in Class E shares (0.8 percent overall). He became a director of GM while retaining his position as chairman of EDS. GM's stock price went up by 2.1 percent at the acquisition announcement. Following the merger, Perot constantly criticized GM's management policy.<sup>7</sup> In 1986 GM bought back all of his shares at a substantial premium, and he resigned from the posts of EDS

<sup>5</sup> Travlos (1987) reports two-day abnormal returns of 0.24 and  $-1.47$  percent for cash and stock bidders, respectively.

<sup>6</sup> Wruck (1989) and Hertz and Smith (1993) report abnormal returns of 4.41 and 1.72 percent, respectively, for the  $\{-3, 0\}$  window.

<sup>7</sup> For example, Perot was the only director to oppose the 1985 acquisition of Hughes Aircraft Company (*The Wall Street Journal*, November 24, 1986, p. 21).

**Table III**  
**Average and Median Two-Day Abnormal Stock Returns**  
**for Bidders Offering Stock at the Announcement of**  
**a Takeover Proposal by Whether a New Blockholder**  
**Emerges from Target Firm**

Abnormal stock returns are estimated using the standard market model method as in Brown and Warner (1985). The announcement date (day 0) is the day of the first *Wall Street Journal* announcement of an acquisition proposal or the day after the announcement appears on the Dow Jones newswire. The two-day announcement-period abnormal returns are measured from day -1 through day 0. Market model parameters are estimated over the period from day -210 to day -11. Stock offers include preferred stock and convertible debt exchanges and mixed offers where a combination of cash and stock is paid. Blockholder is a beneficial owner of 5 percent or greater of outstanding shares. The Wilcoxon signed-rank test is used for the percent positive.

|                                                | Number of<br>Observations | Average (median)<br>Abnormal Return | <i>t</i> -Statistic | Percent<br>Positive |
|------------------------------------------------|---------------------------|-------------------------------------|---------------------|---------------------|
| Panel A: Acquisition of Privately Held Target  |                           |                                     |                     |                     |
| New blockholder from target                    | 41                        | 4.96%<br>(4.16%)                    | 6.03**              | 75.6**              |
| No new blockholder from target                 | 109                       | 1.77%<br>(0.60%)                    | 4.65**              | 62.4**              |
| Panel B: Acquisition of Publicly Traded Target |                           |                                     |                     |                     |
| New blockholder from target                    | 12                        | -1.24%<br>(-3.00%)                  | -1.05               | 41.7                |
| No new blockholder from target                 | 142                       | -2.56%<br>(-2.02%)                  | -10.02**            | 26.1**              |

\*\* indicates significance at the 1 percent level.

chairman and GM director. Upon the announcement of Perot's resignation, the price of Class E shares fell by 14.3 percent and the price of common shares fell by 1.9 percent. T. Boone Pickens of United Shareholders Association stated, "GM's attempt to silence the most outspoken advocate of constructive change at the company is a severe blow to GM's shareholders . . . ." Citing the stock price drop, Pickens said, "It's obvious that shareholders recognized the value of Ross Perot's influence at GM" (*The Wall Street Journal*, December 2, 1986, p. 27).

Table III presents the average abnormal returns for stock-financed bidders, grouped according to the creation of a new blockholder. The results for our sample in Panel A show that the average abnormal returns are 4.96 percent ( $t = 6.03$ ) when a new blockholder emerges from the target and 1.77 percent ( $t = 4.65$ ) when no blockholder emerges. The difference is significant at the 1 percent level ( $z = 3.11$ ), which is consistent with our prediction that the monitoring effects are stronger with a new blockholder. The median abnormal returns provide corroborating evidence, with 4.16 percent for the group with a new blockholder and 0.60 percent for the group without.

Note that the group without a new blockholder still consists of 3 percent and 4 percent blocks that can be large enough to influence managerial decisions, particularly in large firms where managerial ownership tends to be relatively low.

Panel B contains the results for the comparison sample. The average abnormal returns are  $-1.24$  percent ( $t = -1.05$ ) when a new blockholder is present and  $-2.56$  percent ( $t = -10.02$ ) when no new blockholder is present. The difference in means is not significant ( $z = 0.65$ ), consistent with the medians of  $-3.00$  percent and  $-2.02$  percent for the first and second group, respectively. Although the monitoring hypothesis predicts a positive average abnormal return for the new-blockholder group, our result does not support the prediction.<sup>8</sup> One possible explanation is that the block size of this group is smaller than that of the private target counterpart in Panel A. As shown in Table I, their respective means are 8.9 percent and 16.7 percent, and the difference is significant at the 1 percent level ( $t = -3.09$ ).<sup>9</sup> It may be that the monitoring effects are weaker with a smaller block size, and they are further dominated by the negative information effects associated with issuing stock to the public.

The frequency with which a new blockholder is created through a merger is strikingly different between the two types of targets: 27 percent (41 of 150) for privately held targets and only 8 percent (12 of 154) for publicly traded targets. The difference is significant at the 1 percent level using a chi-square test. Although, on average, the relative size of the acquisition is smaller for privately held targets, the frequency of creating a new blockholder is much higher. In fact, an acquisition of a publicly traded target rarely creates a large blockholder.

To provide more descriptive evidence on the monitoring hypothesis, we examine the activities of the 41 blockholders within the bidding firms. Thirty blockholders receive board representations. Among the 30 blockholders, 14 join the management team (these include 9 top managers (chairman, CEO, or president) and 5 vice-presidents), and 8 remain subsidiary (target firm) managers. These changes in board composition and management indicate these blockholders are not passive investors; rather, they become actively involved in the management or monitoring of the firm.<sup>10</sup> Efficiency gains can arise from the expertise and skills of the new blockholders, and these gains

<sup>8</sup> The sample size may be too small to generalize our findings. Also, the abnormal returns are closely examined for extreme negative values, but no outliers are detected (minimum =  $-8.86$  percent and maximum =  $9.09$  percent).

<sup>9</sup> Their respective medians are 9.0 percent and 11.7 percent, and the difference is significant at the 5 percent level ( $Z = -2.38$ ).

<sup>10</sup> It can be argued that the monitoring effects are stronger with more active blockholders: thus, the abnormal stock return should be more positive for the 30 firms with blockholders receiving board representations than the 11 firms with blockholders receiving no board representations. However, our results indicate that this is not the case. The average abnormal returns are 4.72 percent and 5.63 percent for the first and second group, respectively, and the difference is statistically insignificant.

from blockholder activities can be shared with other stockholders (Barclay and Holderness (1991)). Our overall evidence in Table III helps explain the positive wealth effects for bidders acquiring a privately held target through a stock exchange and lends further support to the monitoring hypothesis.

### C. Cross-Sectional Analysis

Many of these privately held targets are owned by a few shareholders closely tied through family membership or business relationship. If this is the case, a more relevant measure of the monitoring effects might be stock ownership of target shareholders as a group, as opposed to 5 percent block ownership by an individual shareholder.<sup>11</sup> We conduct cross-sectional regression tests to examine this issue and to explain further the variation in abnormal returns.

Table IV reports the results of weighted least squares regressions of abnormal returns for bidders acquiring privately held targets. Variables are weighted by the reciprocal of the standard deviation of the market model residual over the estimation period. Explanatory variables are the amount of common stock exchanged as a fraction of outstanding shares and a dummy variable that indicates whether a blockholder emerges from the target. Relatedness of business and relative size of acquisition also are included as control variables. Recent studies on corporate focus report that bidder returns are higher when bidder and target are in a related line of business (Morck, Shleifer, and Vishny (1990) and Maquieira, Megginson, and Nail (1995)). Synergy gains tend to be higher for focus-increasing mergers than diversification mergers, and thus the likelihood of overpayment is less. We set a dummy variable equal to one if the two merging firms share the same primary two-digit SIC code.<sup>12</sup> Our sources of the primary SIC code are COMPUSTAT for bidders and the *Dun and Bradstreet Million Dollar Directory* for targets. If the target is not listed in the *Million Dollar Directory*, we use *Ward's Business Directory of U.S. Private Companies*. The relative size of the acquisition is also included, because, for given benefits from an acquisition, bidder returns are greater when the target is larger relative to the bidder (Asquith, Bruner, and Mullins (1983)). Panel A provides regression estimates for the total sample.

The coefficient of the fraction of outstanding shares exchanged is significantly positive in regression (1). It is also significantly positive in regression (2), although the point estimate is smaller after controlling for the effect of having a new blockholder. This indicates that firm value increases as stock ownership of the target shareholder group increases. Similar findings are reported by Fields and Mais (1991) and Hertz and Smith (1993). The

<sup>11</sup> For example, a target is equally owned by five shareholders and each receives a 2 percent block of bidder stock. Although this case falls into the no-new-blockholder category, the 10 percent collective ownership might have a substantial impact on managerial decisions or the probability of takeovers.

<sup>12</sup> Similar results are obtained when the three-digit SIC code is employed.

Table IV  
Weighted Least Squares Regression Results Explaining  
Announcement-Period Abnormal Returns for Bidders Acquiring  
a Privately Held Target from 1981 through 1992

Variables are weighted by the reciprocal of the standard deviation of the market model residual over the estimation period. Stock offers include preferred stock and convertible debt exchanges and mixed offers where a combination of cash and stock is paid. The fraction of outstanding shares exchanged is the number of shares offered to the target shareholders as a proportion of total shares outstanding. Blockholder is a beneficial owner of 5 percent or greater of outstanding shares. Bidder and target are in a related line of business if they share the same primary two-digit SIC code. The relative size of acquisition is the value of acquisition divided by the market value of bidder equity 10 days before the acquisition announcement. *t*-statistics are reported in parentheses.

| Regression                                                | Panel A:<br>Total Sample<br>( <i>N</i> = 281) |                   | Panel B:<br>Stock Offers<br>( <i>N</i> = 150) |                   |
|-----------------------------------------------------------|-----------------------------------------------|-------------------|-----------------------------------------------|-------------------|
|                                                           | (1)                                           | (2)               | (1)                                           | (2)               |
| Intercept                                                 | 0.005<br>(1.11)                               | 0.005<br>(1.10)   | 0.011<br>(1.47)                               | 0.010<br>(1.39)   |
| Fraction of outstanding<br>shares exchanged               | 0.063<br>(3.79)**                             | 0.040<br>(2.14)*  | 0.059<br>(3.39)**                             | 0.039<br>(1.98)*  |
| Dummy = 1 if new blockholder<br>emerges from target       |                                               | 0.028<br>(2.57)** |                                               | 0.026<br>(2.08)*  |
| Dummy = 1 if bidder and<br>target are in related business | −0.001<br>(−0.11)                             | −0.002<br>(−0.41) | −0.000<br>(−0.02)                             | −0.003<br>(−0.34) |
| Relative size of acquisition                              | 0.006<br>(0.59)                               | 0.004<br>(0.46)   |                                               |                   |
| Adjusted <i>R</i> <sup>2</sup>                            | 0.07                                          | 0.09              | 0.06                                          | 0.08              |
| <i>F</i> -statistic                                       | 7.9**                                         | 7.7**             | 5.8**                                         | 5.4**             |

\* and \*\* indicate significance at the 5 percent level and 1 percent level, respectively.

coefficient of the new-blockholder dummy is significantly positive in regression (2), suggesting the wealth effect is on average 2.8 percent higher with a new blockholder. This implies that monitoring effects are stronger when a large block is owned by a single shareholder than when a block of comparable size is owned by a group of shareholders. The coefficients of related business and relative size of acquisition are both insignificant. The results for stock offers in Panel B are similar to those in Panel A. Note that the relative size variable is omitted because it simply reflects the fraction of outstanding shares exchanged in stock offers. The explanatory power of our regressions is generally low (adjusted *R*<sup>2</sup> ranges from 0.06 to 0.09), but this is not unusual for cross-sectional regressions of bidder abnormal returns.<sup>13</sup> Although the fraction of outstanding shares exchanged and new-blockholder variables can proxy for the monitoring effects, they can also proxy for the information effects in that larger blocks signal more credible information.

<sup>13</sup> For example, see Travlos (1987) and Morck, Shleifer, and Vishny (1990) for their low reported *R*<sup>2</sup>s.

We perform additional regression tests by including various combinations of the following variables: managerial ownership, change in managerial ownership, ownership concentration (managerial ownership plus 5 percent blockholder ownership), change in ownership concentration, Tobin's  $q$ , free cash flow, and firm size. None of these variables is significant.<sup>14</sup> Further, our coefficient estimates for the fraction of outstanding shares exchanged and new-blockholder variables remain qualitatively unchanged.

### III. Summary and Conclusions

We document bidding firm returns at the announcement of a takeover proposal when the target is privately held. On average, bidders offering common stock experience a positive abnormal return, and bidders offering cash experience a zero abnormal return. The positive abnormal return earned by our stock bidders sharply contrasts with the negative abnormal return earned by stock bidders acquiring a publicly traded target. Our findings are in line with Allen and Sirmans (1987) who report a positive bidder return in real estate investment trust mergers where the method of payment is predominantly stock.<sup>15</sup>

Because ownership is highly concentrated in privately held firms, takeovers of these firms through stock exchanges tend to create large blockholders. Further analysis reveals that bidding firm returns in stock offers are positively correlated with the presence of a new blockholder from the target and the amount of common stock issued to target shareholders. The evidence is consistent with the view that large shareholders are effective monitors of managerial performance and enhance the takeover prospects of the firm (Demsetz and Lehn (1985) and Shleifer and Vishny (1986)). To an extent, our evidence is also consistent with the argument that the willingness of well-informed investors to take large positions in a firm conveys favorable information about the firm (Hertzel and Smith (1993)).

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<sup>14</sup> For managerial ownership and ownership concentration, we also test the nonlinear specification employed by Wruck (1989), but the results are the same.

<sup>15</sup> Allen and Sirmans (1987) also report that only 3 of the 38 targets are listed firms, suggesting that most of their targets may be privately held.

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