ADDING BEHAVIOR TO RATIONALITY ON M&A DEALS ANALYSIS: DEVIATIONS OVER SPECIALIST'S USUAL PRAXIS AND THEIR SOURCES

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Abstract

Value creation may not be enough when considering deals. Avoiding deviations over mergers and acquisitions (M&A) advisor's standards is a useful behavioral add-on to deals rationality. The investigations on this theme revealed the presence of many different approaches and practices in the decision-making process and managing companies among different countries. This paper is focused on Spain through research built by in-depth interviews and surveys to specialists that shows the main three factors with a capacity to produce deviations and the main deviations created. The factors are the financing needs of the acquirer, the need to do the deal by the seller, and the different nature and role, whether industrial, managerial, or financial of the participants. Deviations found are agreements out of specialists' usual outputs and affect deal pricing. The presence of these factors should allow capacities of alert, analysis, and bargaining and increase the value of planning, training, and management at deals frames. Rationality based on value creation might be enhanced by the fulfillment of the advisors' criteria. The main contribution of the paper is that, to avoid deviations, might be considered a behavioral contribution to complement rationality in the complex and uncertain universe of M&A deals.

Keywords: M&A, Behavioral Corporate Finance, Rationality, Value Creation

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1. INTRODUCTION

Rationality involves some difficulties from the philosophical perspective. One of the main challenges is its relativism based on the need for the previous definition of the criteria to qualify its achievement as mentioned in Ferrater Mora (1994). The rational choice theory became one of the key scientific devices in the Social Sciences with decision-making as a central and essential element working for rationality.

Several critical contributions, specifically bounded rationality from Simon (1955) and prospect theory and many others from Tversky and Kahneman (1974), Kahneman and Tversky (1979, 1984), Kahneman (2011), challenged the mainstream in Economics enabling new targets. The interrelations among Economics and other sciences, particularly Psychology, might explain the origin of behavioral disciplines according to Camerer and Lowenstein (2004). Behavioral are subfields that work for the improvement of the economic and financial models as mentioned by Camerer (2005). Behavioral areas, including Behavioral Corporate Finance, are in continuous development and have a significant academic, professional, and market acceptance and divulgation.

Mergers and acquisitions (M&A) are an enduring phenomenon. Year after year firms acquire other firms both big and small, private and public, foreign and domestic, and inside and outside their industry. The merger decision involves corporations choosing to acquire existing companies as opposed to internal growth and expansion. Thus, in general, existing larger firms take ownership and control of other small firms (Cox, 2006).

Conventional M&A rationality is linked to value creation. Behavioural Corporate Finance adds studies and shows evidence of several items influencing the activity that are mainly regarding biases, heuristics, managerial traits, and horizons, offers characteristics and market valuations and reaction. Among many other sources, authors like Shefrin (2007), Ackert and Deaves (2010), Dong (2010), Weber (2010), and Ahern and Weston (2007) analyze and collect related theories and research outputs.

Behavioral studies, particularly those on biases and heuristics are still to be further developed as mentioned by Schwartz (2010) and Dowling and Lucey (2010). Overall, as stated by Haleblian, Devers, McNamara, Carpenter, and Davison (2009), M&A studies show the absence of theoretical unification, integration, and consolidation and do require better planning and improvements in metrics and sampling. The up-to-date conclusion is the need to count on value creation and with this behavioral theories and evidences when considering M&A deals.

The purpose of the following approach is to show an additional perspective focused on advisors' judgment of standard behavior.

The remainder of this paper is organized as follows. Section 2 reviews the literature regarding the factors that influence M&A operations. Section 3 describes the research framework by which this paper analyzes the factors with the capacity to provoke deviations and the main deviations observed over the usual professional practices in M&A agreements affecting price elements. Section 4 shows the results of the analysis. Section 5 discusses the results and relates them to the goal of the paper. Section 6 concludes the paper.

2. LITERATURE REVIEW

M&A deals vary according to a wide range of factors, making each deal to be unique. However, organized processes, leaving apart the deal's specificity, have become an international standard in the sectors of Private Equity, Venture Capital, Investment Banks, Institutional Investors, and specialized Advisors. These actors might be considered as the specialists as far as, apart from other strategic reasons, a significant stake of their profits comes from their temporary presence in the capital of the companies involving M&A deals. They have created specific language and frames that play in this international reference to contribute to certainty and comfort among the parties to the deal.

By documenting how biases affect even the most educated and influential decision-makers, the field has generated important insights into the hard-wiring of biases. Biases are significant elements of human decision-making at the highest levels of organizations (Guenzel & Malmendier, 2020).

M&A deals pricing result in a conditioned and evolutionary magnitude that is subject to modifications in accordance with the circumstances agreed by the parties. Price ingredients affect and are affected by company management, participants' profile, deal financing, and the propensity to do the deal. Processes and prices complexities may create non-wished distortions affecting the deals' planned value. For instance, the strategy of the purchaser does not influence the payment of the premium. This result leads us to think that the leaders, who are engaged in such operations, do not take systematically protect the interests of their shareholders (Mpasinas, 2007).

Previous research tries to explain the nature of the risk of overvaluation by shedding light on the errors and biases of the managers and directors responsible for decision-making. Biases that cause overvaluation include overconfidence by managers; an escalation in bidding price leading to winner's curse; anchoring in pricing; the endowment effect; and hindsight and confirmation biases (Asaoka, 2019).

According to the market timing theory, merger waves are driven by overvalued markets that have valuation dispersion, and managers try to time these markets by using their overvalued shares to acquire lesser valued companies and gain their real assets (Lorenzen, 2015).

A study from Klitzka, He, and Schiereck (2021) analyzes mergers and acquisitions payment methods in large transactions of public U.S. acquirers between 2009 and 2016. While they find evidence consistent with previous that asymmetric information between acquirers and targets significantly influences the choice of M&A payment methods, they show that contrary to prevailing findings in the literature, acquirers cannot exploit their overvaluation through stock-financed M&A at targets' disadvantage. Their results document that both acquirers and targets are rational in choosing M&A payment methods.

There has been a lot of literature research on M&A premiums, and scholars have analyzed it from various aspects (Wang, Zhou, Wu, & Wu, 2018). Summarized mainly include the causes of the M&A premium, the influencing factors of the M&A premium, the valuation model of the M&A premium, the economic consequences of the M&A premium, the impact on the performance of M&A, and the measurement method selection of the M&A premium.

The idea of the present approach is to complement rationality based in value creation with the behavioral perspective based on the specialist's judgment.

Advisors involvement, together with the information and the agreements, are key significant common factors in organized M&A processes, according to Tapies, Gallo, Estapé, and Romances (2004). Advisors are decision-making contributors, witnesses, and custodians of the experience gathered, becoming responsible for the evolving support of the related standards arising from their praxis.

By making the assumptions that expectations of rational behavior in M&A deal processes are equal to usual professional praxis on the agreements and that the advisors are qualified interpreters of the related decisions and its normality, it is possible to achieve the knowledge of the distortions over normal praxis and their sources and therefore the complementary limits from behavior to rationality. This allows knowing what is a deviation and its source under the specialist's judgment. This knowledge enables us to look not only for the essential value creation but to look also for avoiding behavior out of advisors' standards.

3. RESEARCH FRAMEWORK

The target was defined as the determination of the factors with a capacity to provoke deviations and the main deviations observed over the usual professional practices in M&A agreements affecting price elements.

The characteristics of the research in terms of its content, the scarcity and confidentiality of the related information, and the relative scarcity of the professionals involved led to the adoption of a qualitative exploration method.

Specifically, what Vallés (2007) calls a triangulation strategy has been selected, consisting of the result of a combination of in-depth interviews with a questionnaire according to the Delphi method.

The method provided, therefore, brings together two components. On the one hand, in-depth interviews whose objective is the production of the findings formed by the bias factors and deviations and the corroboration of the hypothesis. The second component, on the other hand, is the result of the completion of a questionnaire by the sample to establish, according to the Delphi method, and the degree of consensus among specialists.

The method is therefore mixed, gathering the qualitative results of the in-depth interviews and the quantitative results of the application of a questionnaire, as a result of the results of the interviews, to the sample expressing their degree of agreement in statistical terms.

The first step — in-depth interviews of the elite's kind, as stated by Vallés (2007), was done with the cooperation of five specialist M&A advisors, all of them having more than 10 years of individual professional and academic experience in the field. A Delphi survey based on the results of the interviews was prepared and fulfilled by twenty-five specialist M&A advisors from the fields of Investment Banking, Venture Capital, Private Equity, Consulting, Law, and M&A teams inside companies. Nine percent of them with 3 to 10 years of M&A experience and the rest with more than 10 years of related individual experience. The surveyed advisors included the market leaders in a number of deals and deal volumes and their firms, most of them multinationals, held the best positions on M&A rankings on a number of deals, volumes, related funds, and consulting activities.

Table 1. Description of the participants of this study

Job	All the professionals who are members of the expert sample are currently developing M&A activities, their firms occupy leadership positions in the market in a number of operations and volume of investment in M&A.
Training and experience	All have superior training, accompanied in 81% of the cases by a Master's and in 94% of the cases by specific training in M&A. Their experience is in 94% of cases over 10 years and in the remaining 6% between 3 and 5 years. On a personal level, 37% of the cases belong to professional associations. The firms they work for have in 56% of cases international support resources for operations.
Access to market information	It is obtained through specialized sector publications (46.8%), own elaboration (25%), market intelligence companies (18.7%), and with international origin in 9% of cases. All of them, 100%, or the firms for which they work carry out medium and long-term monitoring of the companies that are the object of the transaction in which they participate.

Source: Authors' elaboration.

The survey consisted of six chapters regarding 1) statistical data of the sample; 2) context confirmation; 3) sources of deviations; 4) deviations confirmation; 5) trends, and 6) preferences. The results obtained confirm the qualitative findings and corroborate the hypothesis by confirming the bias factors and the deviations found. The quality of the results made a second-round unnecessary.

4. RESEARCH RESULTS

The research revealed and confirmed first the sources of deviations, or biases producers, and their motivation according to the following details:

Factor 1: Financial needs of the acquirer. On different variants, the financing entity or entities of the deal for the acquirer increasingly intervene on the approval of the business plan of the target company, of the deal price, and of the related debt payment plan because these are the elements that form the financial plan involved. Financing is usually issued with guarantees affecting the target company and also the related shareholding of the acquirer. The deviations generated by this factor have their origin in the propensity of the financial entities to maximize their capacity to, under certain circumstances, force the advanced payment of the debt and the execution of the guarantees given.

Factor 2: The needs that due to different causes propel the seller to sell the company. Several reasons may drive the need to sell, including regulatory causes, absence of liquidity, debt agreements, internal pacts of private equity or venture capital firms, and distressing positions among others. In these situations propelled by the seller's needs to do the deal, it is less difficult to accept not only price reductions but also economic terms and conditions that would result unacceptable under other contexts.

Factor 3: Deal participant's profile. The participant's profile impact deal negotiation, pricing, process, and agreements. On one side, simultaneous belonging to shareholders and to the management team may mean a different price payment justified by its essential role on the viability of the project and by the support to a future transaction. The industrial nature of a deal participant, on the other hand, confers an undetermined staying horizon as well as a bigger trust in the project given the available knowledge. Finally, on the other side, financial participants and, in particular, those specialists oriented to a temporary presence involve specific demands of profitability, comfort, and bigger support to the importance of the management team.

The main deviations found in agreements revealed and confirmed by the research are:

– Use of investment vehicles residence. The legislation of certain countries, as is the case of Luxembourg, for example, allows the almost immediate execution of guarantees agreed.

– Sale mandates and purchase options favoring the financial entities to control the acquired company capital in distressed circumstances or in advanced debt payment situations.

– Debt payment schema based on interest rates of the kind denominated *pay if you can* that are related to the available cash of the company in comparison with the planned one. Non-payment of these interests in the planned dates does generate additional indemnification interests and its priority payment position.

– Variable rates of interest according to covenants materialization. This deviation represents a price increase in direct relation with company management meaning a penalty to their results.

– Assumption of the market break up. Once the M&A agreements are signed and in effect and the new company in full operations, it may happen due to the market break up pact that one of the involved financial entities find difficulties at its own financing source because of financial market disruptions allowing them to the requirement of the whole debt advanced payment and the execution of the guarantees.

– Grouping several commercial short-term loans for deal financing coming from commercial banks in order to avoid the unacceptable conditions from the traditional senior debt financing.

– Andorran pact's and other special shareholders' agreements vetoes. These deviations have their origin in those situations with the absence of finance making the seller continue being a minority shareholder in the investment vehicle of the acquirer. Looking to avoid the unwished prolongation of the planned term some special deviations may be generated in the form of special shareholders vetoes. One of these is known as the Andorran pact and compels the first one setting a share price, whether the seller or the acquirer, to purchase or sell to the other one all the shares at the price set.

– Guarantees of minimum profitability of the deal. This deviation consists in the minimum price granted of the share set in the agreements in favor of the shareholders represented by private equity or venture capital firms for their shares to be sold in the future next deal of the company even if this is in detriment of the rest of the other shareholders' profits of the deal.

– Minority shareholder option to decide the management team of the company. This deviation happens as a requirement from the financial investors, private equity, or venture capital firms, that are given the right to take off the management team appointed by the majority shareholder and select a new one under agreed risk situations.

– Due diligence absence and light processes. Under the frame of a successive plan of purchasing deals in the same sector, an investor of industrial nature may produce the deviation of non-doing the due diligence work given his available knowledge and a sufficient level of guarantees. Also, in M&A deals where new competitors arise, eventually provoked by the advisors, the processes followed by the new attendants may produce deviations caused by lower verification, and by the scarcity of representations and warranties. These light processes sometimes are due to the need of taking advantage of previous work done by other competitors and sometimes are based on the target of expense saving.

Main additional findings on context confirmation, trends, and preferences by the specialists are:

– On the context characteristics: reduced M&A market with lower valuations and scarcity of financing. Financial entities increasing their requirements on the agreements and financial investors doing fewer disposals due to lower pricing although increasing their demands when acting as purchasers even in minority positions. Deal negotiations getting longer and with stronger due diligence processes. Increase of the number of frustrated deals and increase of the number of distress operations.

– On the trends. The forecast for the midterm, 1 to 3 years horizon, considers an increasing number of deals while maintaining valuations and deals pricing. Increasing finance availability with similar to date conditions and granting. Financial investors will keep and increase their current requirements. The impact of regulatory changes will remain weak.

– On the advisors' preferences. The four main determinant factors on M&A deals for the specialists are the strengths of the business, the quality of the management team, the absence of deal financing needs, and the quality and speed of information during the deal process. The experts signal a profile difference between industrial and financial participants when acting as majority purchasers in the deals. Price is the only common factor to both of them in that situation. The industrial looks additionally for the agreement and for the results of the target company until the signature while the financial priories management team and due diligence process. Finally, regarding the environmental factors influencing bigger levels of M&A activity, the advisors remarked on the positive influence of an economic expansive context with low official rates of interest and the relevance of a stable regulatory frame.

5. DISCUSSION OF THE RESULTS

The results, on the one hand, confirm that the main factors that generate biases on the usual professional practices in M&A agreements are the financing required by the buyer, the sales needs of the seller, and the profile of the participants. On the other hand, the results show which are the deviations indicated by the experts produced by these factors. Examples of the related contractual documents provided by the interviewees are offered in the annexes chapter of some of these deviations.

It seems convenient, in order to contribute to a better understanding of the results, to begin by making a brief review of the current context, which, according to what was reported by the interviewees, could be characterized by:

– Shortage of operations. This is despite the relatively high age of the investee portfolio of a large number of venture capital and private equity firms. Also surprising given the crisis environment is the reduced number of distress operations or operations on companies in pre-bankruptcy situations.

– Lack of financing. The context is a reduction in the number of operations with bank financing. Those that are produced do so with an increase in rates and commissions, with lower multiples of EBITDA, and with an increase and tightening of obligations, covenants, and guarantees. Banks seem to be more focused on debt restructurings and introduce greater complexity and uncertainty in operations.

– An increase in private equity and venture capital operations in a minority, to which, due to lack of other types of financing, companies come with the objective of expansion.

– An increase in operations with financing from the seller, either through vendor loans or earn-outs.

– An increase in the number of operations frustrated by a greater inflexibility of the buyer, a lack of financing, and an increase in the proposal of expansion operations that seek to solve liquidity or solvency problems.

– An increase in the period and intensity of the consultants' participation due to the greater sensitivity to any incident. Due diligence periods and additional post-closing verifications of the buyer increase. Debt restructuring and claims for manifestations and guarantees of the seller, and for tensions between partners, are increasing. There is generally a greater fragmentation of the price in terms of negotiation and agreement with a view to the traceability of subsequent verifications and claims. In this sense, carrying trading, or management between signature and closing, and post-closing with additional verifications become more important in this regard, all of which has an impact on the significant increase in litigation.

6. CONCLUSION

M&A activity is developed under a frame of uncertainty. Rationality is the main ally to combat the involved risk. Rationality in mergers and acquisitions deals has its foundations in looking for and evaluating all potential economies of scale of any kind that base the potential synergies that contribute throughout the decision-making process to the ultimate target of value creation.

If rationality by means of the assumptions done in the research could also be linked to normal praxis behavior under the judgment of the advisors then it would be possible to conclude the importance of avoiding deviations when considering deals.

In any case, and with all the precautions driven by the need of considering the effects of potential changes due to different marketplaces and periods of time, avoiding deviations might be considered a behavioral contribution to complement rationality in the complex and uncertain universe of M&A deals.

Other potential conclusions from this research are the following:

– The majority of the deviations are on the financial side whose presence in M&A deals based on the research results deserves special attention. The presence of any of these factors or of their sources might generate in the deal participants capacity of alert, capacity to orient negotiations, and capacity of analysis.

– Two significant evolutions are in progress. The credit-granting function is changing the limits as far as continuity of the debt and certainty on the amounts are being questioned by some deals deviations. On the other side, another evolution is happening to the natural concept of equal rights for all shareholders as observed in some of the deviations.

– The presence of deviations increases the value of plans, management, and training. Planning details usually evaluated on financial data as a translation device might not consider the effects that deviations can produce affecting the results. Management as well may not be able to satisfy some of the requirements included in a demanding deviation. And above all training in the presence of distortions increases its value because of the new situation. As stated by Fendt (2011), training on M&A processes and the ability to communicate is the most missed and demanded item from managers involved in corporate deals. Planning, management, and training are of essential value in M&A deals. Its review with precaution is a good recommendation in the case of a potential or effective presence of a deviation.

Finally, strengths of the business, quality of management team, absence of financial needs, and quality and speed of information are the preferences of the advisors becoming in this sense recommendations. It is possible now to add further advice: while looking for value, listen to the advisors and behave normally, following the usual professional praxis in M&A agreements.

There are some limitations to this research. One is that cognitive-science experiments are typically conducted in laboratories, which do not necessarily reflect real corporate environments. These are admittedly hard to replicate in laboratory experiments. However, through this qualitative research and the in-depth interviews, we think we have overcome this problem.

There are some avenues for future research. The potential dangers that seem to be able to be drawn from this analysis would be focused, on the one hand, on the exclusive consideration of the financial aspects and lack of awareness of the effect of other factors and their interrelationships, and, on the other hand, in the lack of prudence equivalent overconfidence that can represent numerous factors included in the planning relative to the room for maneuver in relation to with the risk and debt assumed in the operations.

Finally, two new lines of research could be the object of interest, refer to the specialties of the public company as an acquirer or acquired, and to study the standards required or required return on M&A operations in the sector specialist and their relationships with the valuation of companies and returns of other investment alternatives.

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