CEOs reap financial benefits from mergers regardless of stock performance

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Following an acquisition of another company, chief executive officers' compensation levels usually increase, even when the purchase turns out to be unprofitable, according to researchers at the University of Washington and University of British Columbia.

That's because while a bad merger can decrease the value of a company's stock and options, CEOs typically acquire new stock options once the deal goes through, thus making up for any financial losses suffered as a result of the buy.

"There are major personal financial gains to be made by CEOs after any merger or acquisition so even if it ends up being a financial loss, shareholders suffer but CEOs nearly always come out ahead financially," says Jarrad Harford, an associate professor of finance and business economics at the UW Business School and co-author of the study. "The net effect is that a CEO's wealth actually increases even if he makes a poor acquisition decision. The experience is quite different for the shareholders."

However, he adds, companies whose boards of directors are more independent from management and generally exercise stricter corporate governance are more likely to penalize executives for unprofitable merger deals.

For their study, the researchers examined 370 mergers of publicly traded U.S. companies between 1993 and 2000. They compared the wealth of

the CEOs of the purchasing companies a year before and a year after the acquisitions. Their wealth was determined by calculating their salaries, stock and option grants, and the value of their portfolio of existing stock and options.

They divided the purchasing companies into two groups: those whose stock increased after the merger, and those whose stock suffered. The stock value of the underperforming companies lagged the broader market by roughly 52 percent. Yet because of new stock and option grants, three-quarters of the time those CEOs became wealthier despite the downturn.

"While CEOs are still better off making good acquisition decisions, there is little penalty to making bad ones, so this sets up a strong incentive to acquire, even when the chance of failure is high. The sheer magnitude of new stock and options grants given when the firm's size increases more than offset the effect of the acquisition on the CEO's pre-merger portfolio."

The authors note that one way to evaluate the independence of a board is the proportion of board members who preceded the CEO, and therefore were not nominated to the board by the CEO.

"Investors who are concerned about evaluating a CEO's potential payoffs from undertaking future acquisitions should consider examining the strength of the board," said Harford.

Kai Li, an associate professor of finance at the University of British Columbia, co-authored the study, which appears in the April issue of The Journal of Finance.

Source: University of Washington

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