Will I Get Paid? Employee Stock Options and Mergers and Acquisitions

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Paper overview

- Research questions:
  - Do acquisitions harm value of target employee stock options?
  - How do target employee options affect merger outcomes, such as offer premium, announcement returns, Pr (targeting)?

- Empirical approach: (Hand) collect data on employee stock option treatment for 1,000+ M&A deals.
  - Sources: 8-K, Form 425, DEFA, and DEFM
  - Important contribution

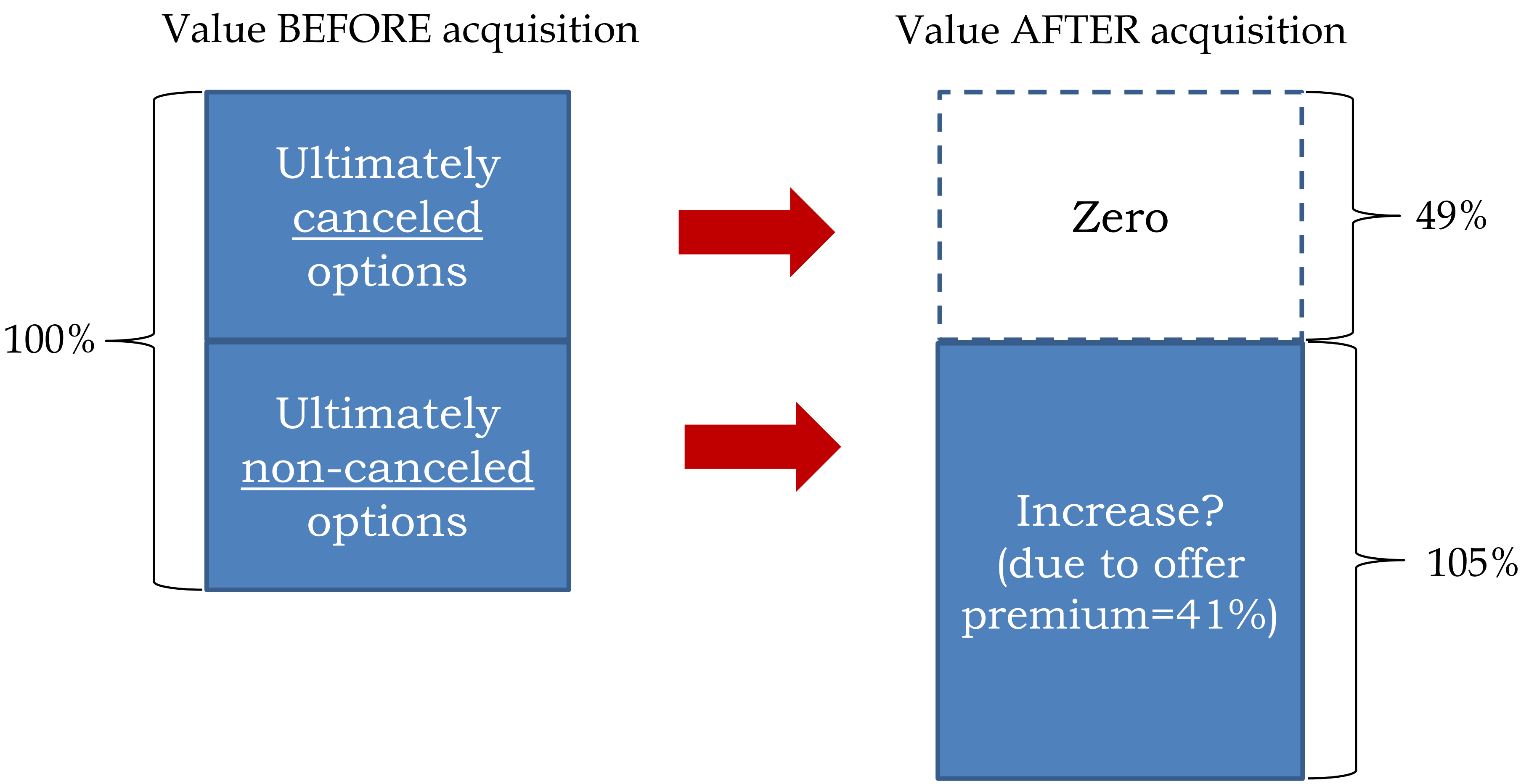
Main findings & interpretation

- Outcomes for target employees:
  - 81% of deals experience cancelation of target employee options.
    - Concentrated in OTM, unvested options
  - Target employees lose 49% of option value.
    - But turn into slight gain, once offer premium (41% at mean) is taken into account

- Outcomes for mergers:
  - Offer premium is larger when target granted "many" options.
  - Bidders canceling target options earn 1.5% higher announcement return.
  - No evidence of "strategic targeting" of firms with options.

- Authors' interpretation: canceling target employees' options is an (important) way to transfer value from labor to acquiring firm

Empirical findings in a nutshell - option value



Wealth transfer from target employees to acquirer?

- Claim: "Target employees lose about half of option value after acquisition."
  - This is only true if ignoring effect of offer premium on employee stock option value.
- Once offer premium (41%) is taken into account, target employees appear to gain 5% on net.
- Paper uses **-49%** as a preferred estimate for target employee wealth impact, but why should we ignore offer premium?
  - Under what assumptions this could be justified? Perhaps behavioral?
- If there is no economic loss for employees on net, adjusting employee options may not be a source of "wealth transfer" to the acquirer (or "expropriation" of employees).

Interpretation of result: offer premium and # of options

- Finding: Offer premium is positively correlated with # of (unvested, OTM) employee options.
  - Interpretation: target managers are "tougher" in negotiation given stronger push back from employees with more options.

- Isn't this ultimately a mechanism through which target employees are "compensated for" their (expected) loss in stock options?

- Also, this interpretation appears consistent with no evidence for "strategic targeting" of firms with many options (Table 9).

- But this is at odds with the authors' preferred interpretation: Acquirer values potential expropriation of target's labor via canceling options.

Value of unvested options

- Unvested options, by definition, have value only when employees meet minimum employment requirement (e.g., 4 years).

- Given presumably high employee turnover at (smaller) target firms, adjusting for vesting could significantly reduce unvested option value.
  - Recall value loss is concentrated in OTM, unvested options

New companies let nearly 25% of their employees go in the lead-up to their first birthday, according to the Bureau of Labor Statistic's most recent survey, which tracked employment changes between March 2012 and March 2013.

Yammer, a social network for companies that last year was acquired by Microsoft Corp., fired about 30% of its engineering staff in its first four years, says Adam Pisoni, its technology chief.

- How much value of unvested options decrease relative to simple BS value if taking into account Pr (employee exit) at target?

What make firms cancel target stock options?

- If average net effect of acquisition on employee option value is close to zero, examining drivers of heterogeneity in option cancelation should be (perhaps more) important.
  - No option is canceled in 20% of deals (extensive margin): employee option value ↑ 51%
  - Some options are canceled in 80%: employee option value ↓ 6%
  - There may be further heterogeneity in fraction of canceled options (intensive margin – not explored)

- What are the frictions that prevent some firms from canceling target stock options?

- Paper (informally) argues it is due to difference in target employees' bargaining power, but ultimately what drives x-s variation in bargaining power?

Can optimal contracting/risk sharing drive findings?

- Employees of target firms become employees of a potentially very different firm, acquirer (if they stay).
  - E.g., Acquirer is larger, more profitable, less volatile than target
  - Think about MS acquiring Skype/FB acquiring WeChat

- This implies that optimal labor contracts for previous target employees should be different at new firms due to:
  - Different economic environments: perhaps optimal level of risk taking is lower at merged firms
  - Different employees selection: many of "risk-loving" employees at target might leave around merger

Can optimal contracting/risk sharing drive findings?

- E.g., optimal risk sharing between firm and workers would suggest less of (idiosyncratic) risk to be shared by employees. (e.g., Baily, 1974; Guiso, Pistaferri, Schivardi, 2005).
  - Merged firm may optimally increases cash portion of comp but reduce option portion for target employees.

- (Indirect) test of this hypothesis: Do labor contracts (on options and others) for target employees become more 'unified' with those of existing employees at acquirer?
  - Assuming that existing contracts at acquirer are optimal, finding that the new contract becomes more comparable to existing employees would support the alternative story.

Do acquirers want to expropriate target employees?

- Paper draws analogy with previous papers on how M&As affect employees (negatively).
  - Wages: reduction for unionized labor in hostile takeovers (Rosett, 1990)
  - Pension funds: 15% cut in hostile takeovers (Pontiff et al., 1990)
  - Job stability: Employment cut in LBOs (Lichtenberg and Siegel, 1990)

- Caveat: Existing evidence is well developed mostly for hostile takeovers/LBOs.

- Incentives of acquires likely different between "corporate raiders" vs. "long-term strategic buyers" (e.g., MS-Skype).
  - Which better characterizes average deals in current sample?
  - (Natural) test: Are (negative) effects on target employee options more pronounced for hostile deals?

Conclusions

- Impressive, new dataset on treatment of employee options in M&A transactions
  - Important contribution

- Rich set of findings regarding wealth effects of acquisitions on target employee options and acquiring firms.

- Clarifying a couple of issues would strengthen economic messages of paper.
  1) What justifies paper's focus on canceled options (but not net effect including offer premium on option values)?
  2) Can the authors disentangle expropriation of employees vs. optimal contracting views?

Could there be ex-ante compensating differentials for this "risk?"

- What would results imply for target's compensation policy prior to acquisition.

- If there is real wealth appropriation conditional on acquisition, forward-looking, rational employees should take this into account in their labor contracting with firm.

- E.g., Compensating differentials would imply that they are compensated ex ante (before target is actually acquired), perhaps in the form of larger # of options granted.