The timing and method of payment in mergers when
acquirers are financially constrained*

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Abstract

While acquisitions are a popular form of investment, the link between firms’ financial constraints and acquisition policies is not well-understood. We propose a model that connects bidders’ financial constraints to their incentives to initiate deals, bids, and payment method. Because of ability to pay in stock, financial constraints do not affect bidders’ maximum willingness to pay. However, both own and rivals’ constraints discourage a bidder from approaching the target. In equilibrium, auctions are initiated by bidders with low constraints or high synergies. The use of cash in the payment is positively related to synergies, acquirer’s gains from the deal, and negatively to financial constraints.

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1 Introduction

Ample research shows that firms’ financial constraints are a key determinant of their investment policies.\footnote{See Fazzari, Hubbard, and Petersen (1988), Lamont (1997), Almeida and Campello (2007), and Whited and Wu (2006), among others.} Because acquiring other firms or divisions of firms is one of the most common forms of corporate investment, it is important to understand how financial constraints of potential acquirers affect the market for corporate control. Both anecdotal and empirical evidence suggest that bidders pay considerable attention to their existing cash reserves and ability to raise cash when deciding on their acquisition policies.\footnote{For anecdotal evidence, see article “Stock or Cash? The Trade-Offs for Buyers and Sellers in Mergers and Acquisitions” by A. Rappaport and M. Sirower in Harvard Business Review, November-December 1999. For empirical evidence, see Harford (1999) and Faccio and Masulis (2005).} The goal of our paper is to understand the theoretical connection between bidders’ financial constraints and their acquisition decisions: maximum willingness to pay for the target, whether to make the payment in cash or stock, and the decision to approach the target in the first place. We argue that the effects of financial constraints are not obvious. For example, one might expect a more financially constrained bidder to be less aggressive at bidding, conditional on having the same valuation of the target. Similarly, one might expect that financial constraints of rival bidders encourage a potential acquirer to initiate a bid, as it expects weaker competition. Among other results, we show that these conjectures are incorrect and the interplay between financial constraints and acquisition policies is more subtle.

To study this connection, we propose a tractable dynamic model. In our model, there are three agents: a target and two potential acquirers. Their stand-alone values fluctuate with the state of the market. Each bidder has a private signal about potential synergies it can realize by acquiring the target. At any time, each bidder can approach the target by expressing an interest in acquiring it, thereby initiating the auction. Participation in the auction is costly, implying that a bidder does not initiate before the state reaches a high enough threshold. Upon being approached, the target invites the other bidder to participate, opens its books, and both bidders learn their synergies. The bidders then compete for the target in an ascending-price auction, in which the winning bidder wins at the price, at which the losing bidder quits. The winner then decides on the combination of stock and cash that it pays to the target to deliver the promised payment. On one hand, paying in cash is costly, because there is a wedge between the value of a dollar to shareholders of the target and to the bidder, which measures how financially constrained the bidder is. On the other hand, paying in stock can be costly, because a rational target understands
that the acquirer has a lower incentive to pay in stock when its synergies are higher. Thus, paying in cash becomes a costly signal of the acquirer’s synergies.

The equilibrium in this model has the following structure. First, consider the auction stage. Perhaps surprisingly, financial constraints do not affect a bidder’s maximum willingness to pay for the target and, hence, how “strong” the bidder is. Regardless of its financial constraint, the bidder continues bidding up to the point at which the price equals the value of the target under the bidder’s ownership. This result comes from the bidder’s ability to pay in stock. When a bidder wins the auction at the price equal to its maximum willingness to pay, it is the lowest-synergy type who could possibly win at this price. A rational target then perceives that only this type of bidder will submit an all-stock offer: Any lower type would have dropped out of the auction before, while any higher type would have included some cash in the bid to signal its type. The bidder then indeed submits an all-stock offer when its net payoff from the deal is zero, so its financial constraint does not affect its maximum willingness to pay, i.e., how aggressive the bidder is. However, the financial constraint does affect the bidder’s expected payoff from the auction through the payment method it uses. If a bidder wins at a price below its valuation of the target, it submits a mixed cash-stock offer, where the cash portion of the bid is just enough to signal the bidder’s synergy. A higher constraint increases the cost of this signaling, reducing the payoff of the bidder from the auction. It also reduces the cash portion of the total payment, because the same cash portion is a stronger signal of the bidder’s valuation when it is more constrained.

Second, consider the initiation stage. In equilibrium, the bidder initiates the auction when the state of the market reaches an upper threshold. This equilibrium threshold is affected by the bidder’s signal about its synergy as well as by its own and the rival bidder’s financial constraints. First, it is decreasing in the signal of the bidder: All else equal, a more optimistic bidder is more likely to be the initiator and, hence, the winner. Second, the equilibrium threshold is increasing in the bidder’s own financial constraint because it reduces the bidder’s expected payoff from initiating the auction. Thus, even though a financial constraint does not affect the bidder’s strength (maximum willingness to pay) when it is able to pay in stock, it does affect the bidder’s decision to initiate a bid. Interestingly, the equilibrium initiation threshold is also increasing in the financial constraint of the rival bidder. This effect is subtle, since the maximum willingness to pay of the rival bidder is unaffected by how constrained it is. Intuitively, when the rival bidder is more constrained, it is more reluctant to initiate the auction, given the same information. Hence, observing that the rival bidder has not approached the target yet, the bidder does not downgrade
its belief about the rival bidder’s signal as much as if it were less constrained. Hence, the bidder perceives that the rival is a stronger competitor at each date. As a result, it expects to obtain a lower payoff from the auction, which reduces the incentives to initiate it in the first place.

The model delivers three groups of implications, many of which are consistent with empirical evidence and some have not been tested yet. The first group of implications concerns the impact of bidders’ financial constraints on their acquisition activity. As discussed above, financial constraints do not make bidders weaker, because they have the ability to bid in stock, in contrast to models of auctions with financially constrained bidders in which bids must be made in cash (e.g., Che and Gale, 1998). Despite this, they reduce each bidder’s incentives to initiate a bid. Thus, financial constraints do not affect who acquires the target – they impact efficiency by changing when the acquisition occurs. Importantly, both a bidder’s own and the rival bidder’s constraint reduce a bidder’s incentive to approach the target. Thus, an unexpected tightening of financial constraints in the economy reduces a bidder’s propensity to acquire targets even if its own ability to pay in cash is unaffected, in line with Harford (2005), who finds that the occurrence of mergers is strongly related to aggregate liquidity in the market.

The second group of implications concerns the method of payment used in acquisitions. In equilibrium, the cash portion of the total payment is determined by the acquirer’s financial constraint and by the difference between its valuation of the target and the valuation of the target by the rival bidder. The former implies that acquisitions rely more on cash when bidders are less financially constrained. The latter implies that the payoff to the winning bidder and synergies in a deal are positively related to the cash portion of the payment, consistent with empirical evidence on acquisition announcement returns (Travlos, 1987; Eckbo, Giammarino, Heinkel, 1990).

Finally, because the model endogenizes both initiation and bidding decisions, it delivers implications about the identities of initiating and winning bidders, which have not been empirically examined yet. All else equal, the auction is more likely to be initiated by a less constrained bidder and by a bidder with more positive information about its synergies. In contrast, the identity of the winner is determined by synergies, but not by financial constraints. As a consequence, the initiating bidder is more likely to have high maximum willingness to pay and to win the auction than the non-initiating bidder in the same auction. Our model implies that this effect is stronger if the initiating bidder is more constrained than the non-initiating bidder. Whether the initiating bidder ends up winning the auction is also related to the payment method. If bidders have similar constraints, then the cash portion of the payment is higher when the identities of the initiating and
winning bidders coincide than when they are different. Intuitively, because the initiating bidder
is more likely to have high synergies, events in which the initiating bidder wins the auction are
more likely to correspond to events in which the gap between bidders’ synergies is substantial,
implying that the initiating bidder needs to signal its valuation by including substantial cash in
the payment.

Our paper is related to two strands of the literature. First, it is related to the literature
that studies mergers and acquisitions as stopping time problems, such as Lambrecht (2004) and
Hackbarth and Morellec (2008). Existing papers assume that acquirers and targets have the
same information, which makes bids in cash and in securities equivalent and financial constraints
irrelevant, because the parties can always transact in securities. Our contribution is to introduce
private information of bidders into their dynamic decision-making process. Private information is
central for the implications of our paper: It makes bids in cash and stock different, leading to the
importance of financial constraints for initiation decisions and auction outcomes.

Second, the paper is related to information-based models of means of payment in mergers
and acquisitions and, more generally, to the literature on auctions in which bids can be made
in securities, recently summarized by Skrzypacz (2013). Information-based models of means
of payment are provided by Hansen (1987), Fishman (1989), Eckbo, Giammarino, and Heinkel
(1990), Berkovitch and Narayanan (1990), and Rhodes-Kropf and Viswanathan (2004). These
papers consider static models with different information structures and assumptions about the
bidding process. In contrast, our model focuses on bidders’ financial constraints and their dy-
namic decision-making: Each bidder not only decides on bids but also on when to initiate the
contest. Hence, the model delivers implications about the role of financial constraints and the
identities of initiating and winning bidders, relating them to payment method and the timing of
the deal. Finally, our paper is related to two recent papers that study initiation of auctions and
bargaining in models with privately informed players, but with different ingredients and results.
Cong (2015) studies the interplay between post-auction moral hazard and the seller’s strategic
initiation of mergers in a bargaining problem with two-sided private information.

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3 Other papers that study mergers and acquisitions as real-options problems include Morellec and Zhdanov
(2005, 2008), Alvarez and Stenbacka (2006), Lambrecht and Myers (2007), Margiisi, Mello, and Ruckes (2008), and
Hackbarth and Miao (2012).

4 Security-bid auctions are studied by Hansen (1985), Rhodes-Kropf and Viswanathan (2000), DeMarzo, Kremer,
and Skrzypacz (2005), Gorbenko and Malenko (2011), and Liu (2013). Vladimirov (2015) shows the link between
making bids in securities and the financing of cash bids via issuing securities to investors.
The remainder of the paper is organized in the following way. Section 2 describes the setup of
the model. Section 3 considers the subgame in which the auction takes place at an exogenous time
t and solves for the equilibrium in it. Using results of Section 3, Section 4 solves for the equilibrium
in the initiation game. Section 5 studies implications of the model. Section 6 discusses extensions.
Section 7 concludes. The proofs of propositions are provided in the appendix.

2 Model Setup

Consider a setting in which the risk-neutral target attracts two potential risk-neutral acquirers,
or bidders. The roles of the target and the bidders are exogenous. As stand-alone entities, the
target yields a cash flow of $T X_t$ per unit time, and each bidder yields a cash flow of $B X_t$ per unit time. Common state $X_t$ evolves as a geometric Brownian motion:

$$dX_t = \mu X_t dt + \sigma X_t dB_t,$$

where $\mu$ and $\sigma > 0$ are constant growth rate and volatility, $dB_t$ is the increment of a standard
Brownian motion, and $X_0$ is low enough. The discount rate $r$ is constant. To guarantee finite
values, we assume $r > \mu$.

If bidder $i$ acquires the target at time $\tau$, the combined firm produces a cash flow of $(T + B + v_i) X_t$
per unit time at any time $t > \tau$. Here, $v_i \in \{v_l, v_h\}$, $v_h > v_l > 0$ is the synergy that captures an
improvement from combining operations of the target and bidder $i$. At the start of the game, bidder $i$ privately learns signal $s_i$ about its synergy $v_i$, where $\Pr[v_i = v_h | s_i] = s_i$. Each bidder’s
signal is a draw from a distribution with p.d.f. $f(s) > 0$ on $[s_l, \bar{s}]$, where $0 < s_l < \bar{s} < 1$. Both the
signals and synergies are independent between the two bidders. We make the standard assumption
that both are soft signals of each bidder that cannot be credibly conveyed other than via initiation
and bidding decisions described below.

The model consists of two stages: the initiation stage and the auction stage, illustrated in
Figure 1. We describe each stage below.

1. **Stage 1: Initiation.** Prior to the auction, each bidder $i$ knows $s_i$, but not $v_i$. In practice,
acquisitions by strategic buyers are usually initiated by a bidder (Fidrmuc et al., 2012). To
reflect this practice, we assume that each bidder has a real option to approach the target

\footnote{For example, a bidder and the target can reduce the cost of making a product by a certain percentage. As the
size of the market grows, the value of this synergy also grows one-to-one with the size of the market.}
at any time. When the bidder exercises this option, the target invites the other bidder to participate in the auction and opens its books. Participating in the auction costs $I > 0$ to each bidder, which is a one-time non-monetary cost prior to the start of the auction. Cost $I > 0$ is small enough so that both bidders choose to participate in the auction in equilibrium (the parameter restrictions are provided in Section 4). After the auction is initiated, each bidder learns its synergy $v_i$.

2. **Stage 2: Auction.** At the auction stage, the bidders compete in an ascending-bid (English) auction, in which offers can be made in combinations of cash and stock. We formalize the auction in the following way. The auctioneer (the target) raises price $p$ continuously from zero. As $p$ rises, each bidder confirms its participation until it decides to quit. Once one bidder withdraws, the remaining bidder is declared the winner. The winning bidder chooses a combination of $b \geq 0$ in cash and fraction $\alpha \geq 0$ of the stock of the combined company, subject to the “no default” condition that the value of the bundle, evaluated according to the beliefs of the target, is at least $p$, the price at which the rival bidder quit. This formalization extends “clock” models of an English auction in all-cash bids (Milgrom and Weber, 1982) and all-stock bids (Hansen, 1985) for bids in combinations of cash and stock.\(^6\)

Finally, each bidder is financially constrained. Specifically, the cost to bidder $i$ of a payment of $b$ in cash is $\lambda_i b$, where $\lambda_i > 1$. Difference $\lambda_i - 1$ reflects the wedge between the value of a dollar in cash to the shareholders of the target and the cost to the acquirer. It is related to the concept of external finance premium in financial accelerator models in macroeconomics (Bernanke and Gertler, 1989).

It remains to define the equilibrium concept. At the auction stage, when a bidder chooses a combination of stock and cash to offer to the target, we have a signaling game where the target guesses the synergy of the bidder from the offer $(b, \alpha)$ she makes. We assume that the belief of the seller following off-equilibrium offers satisfies the Cho and Kreps (1987) Intuitive Criterion (CKIC), defined as:

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\(^6\)This bidding protocol is robust to allowing the method of payment to be part of the auction process in the following sense. Consider a modified bidding protocol, in which at each price $p$, a bidder confirms participation or drops out. If it confirms participation, the bidder also picks any combination of cash and stock, whose value the target estimates to be $p$ if this bidder were to acquire it for this combination. After the rival bidder drops out, the remaining bidder picks the final combination of cash and stock. An equilibrium in our bidding game is also an equilibrium in this modified bidding game, since only the final combination of cash and stock is relevant for the payment that the winner makes.
Assumption 1 (CKIC). Suppose that bidder $i$ wins the auction at price $p$ and makes an off-equilibrium offer $(b, \alpha)$ to the target. If type $v_l$ is worse off acquiring the target for $(b, \alpha)$ than playing its equilibrium strategy, while type $v_h$ is better off acquiring the target for $(b, \alpha)$ than playing its equilibrium strategy, then the target believes that bidder $i$’s synergy is $v_h$.

Assumption 1 is a standard restriction in signaling games. Intuitively, it is unreasonable for a low-synergy bidder to submit an offer, which makes it worse off even if the offer gets accepted. As we show in the next section, the auction has a unique equilibrium satisfying Assumption 1.

At the initiation stage, we look for separating equilibria in continuous and monotone threshold strategies. These are equilibria where bidder $i$ with signal $s$ follows a strategy of initiating the auction at threshold $\bar{X}_i(s)$, provided that the rival bidder has not initiated the contest before, where $\bar{X}_i(s)$ is continuous and monotone. In what follows, we refer to them simply as equilibria. As we show below, $\bar{X}_i(s)$ is strictly decreasing in $s$, implying that all else equal the bidder approaches the target earlier if it is more optimistic about potential synergies.

3 Equilibrium at the Auction Stage

Consider the auction that occurs at time $t$. We present a heuristic derivation of the equilibrium in this section and formalize it in the proof of Proposition 1 in the appendix. It is useful to introduce the post-auction value of the combined firm with synergy $v$, $V(v) = \frac{\Pi_T + \Pi_B + v}{r-\mu}X_t$, and the post-auction value of the losing bidder, $V_o = \frac{\Pi_B}{r-\mu}X_t$, where we supersede the time subscript for brevity.

Suppose that bidder $i$’s equilibrium strategy is to bid up to price $p_i^*(v)$ for $v \in \{v_l, v_h\}$. If bidder $i$ wins the auction when the rival drops out at price $p$, which is very close to $p_i^*(v_h)$, the target infers that bidder $i$ has high synergies, as otherwise it would have dropped out earlier. Since paying in cash is costly and the target believes that the synergies are high, it is optimal for bidder $i$ to make an all-stock offer in this case. Because the bidder does not make a cash payment and its valuation of the stock coincides with the target’s valuation of stock, the cost of the payment to bidder $i$ is $p$. It follows that a high-synergy bidder finds it weakly dominant to bid up to its valuation of the target:

$$p_i^*(v_h) = p^*(v_h) = V(v_h) - V_o = \frac{\Pi_T + v_h}{r-\mu}X_t. \tag{2}$$
Similarly, consider the case, in which bidder \( i \) wins the auction when the rival drops out at price \( p \leq p^*_i(v_l) \). In this case, the target is uncertain about the synergy of bidder \( i \). It can signal its synergy via the mixed cash-stock offer. Since raising cash is costly and the bidder values stock of the combined company more if it has high synergies, the high-synergy bidder can separate from the low-synergy bidder by including a sufficient amount of cash in its offer. Since the most pessimistic belief that the target can have is \( v_l \), it is optimal for the low-synergy bidder to make an all-stock offer. It follows that a low-synergy bidder also finds it weakly optimal to bid up to its valuation of the target:

\[
p^*_i(v_l) = p^*(v_l) = V(v_l) - V_o = \frac{\Pi_T + v_l}{r - \mu} X_t.
\]

It remains to solve for the amount of cash that the high-synergy bidder \( i \) offers if it wins against the low-synergy rival, i.e., at price \( p^*(v_l) \). The combination of cash and stock \((b_i^*, \alpha_i^*)\) must satisfy:

\[
(1 - \alpha_i^*) V(v_l) - \lambda_i b_i^* \leq V_o,
\]

\[
\alpha_i^* V(v_h) + b_i^* \geq p^*(v_l)
\]

The first condition ensures that the low-synergy bidder does not want to deviate from its all-stock bid and payoff of \( V_o \) to mimicking the high-synergy bidder. The second condition is the requirement that the value of the offer to the target is no lower than price \( p^*(v_l) \), at which the bidder wins the auction. The optimal offer for the high-synergy bidder that satisfies the above conditions is such that both inequalities bind. That is, it uses just enough cash so that the low-synergy bidder does not mimic it, and the value of the mixed offer is exactly \( p^*(v_l) \).

The above argument does not imply that the equilibrium is unique. In standard signaling models with two types, the Intuitive Criterion (Assumption 1) selects the least-cost separating equilibrium as the unique one. In the proof of Proposition 1, we show that this is also the case in our model.

**Proposition 1 (equilibrium bidding).** There exists a unique equilibrium at the auction stage, in which bidding is in weakly dominant strategies and the beliefs satisfy CKIC (Assumption 1). A bidder with synergy \( v \in \{v_l, v_h\} \) drops out at price

\[
p^*(v) = V(v) - V_o = \frac{\Pi_T + v}{r - \mu} X_t.
\]

(3)
If bidders’ synergies are equal at \( v \in \{v_l, v_h\} \), both bidders drop out at price \( p^*(v) \), the winner is determined at random, and it makes an all-stock payment of fraction \( \frac{p^*(v)}{V(v)} \) of the stock of the combined company. If bidders’ synergies differ, the high-synergy bidder wins at price \( p^*(v_l) \) and makes a payment of \( (1 - \gamma_i) p^*(v_l) \) in cash and fraction \( \gamma_i \frac{p^*(v_l)}{V(v_l)} \) of the stock of the combined company, where \( \gamma_i = \left(1 + \frac{1}{\lambda_i - 1} \left(1 - \frac{V_o + p^*(v_l)}{V(v_h)} \right)\right)^{-1} \left(1 + \frac{1}{\lambda_i - (\Pi_T + \Pi_B + v_h)} \right)^{-1} \) represents the proportion of stock in the total offer value.

The economics of Proposition 1 are as follows. In the presence of financial constraints, the acquirer’s internal valuation of cash exceeds that of the shareholders of the target. Hence, it pays in cash only if its all-stock offer gets undervalued by the target. This happens if the acquirer’s valuation of the target exceeds the payment it makes to the target, determined by the rival bidder’s drop-out price. In contrast, if the acquirer already commits to pay a high takeover premium, which is the case when the rival’s bidder synergy is high, there is no benefit in paying in cash, since the high takeover premium by itself signals the high synergy of the acquirer. Proposition 1 implies that the synergies of both bidders are revealed in the course of the auction: The price at which the losing bidder drops out reveals its synergy, while the method of payment reveals the synergy of the winning bidder.

3.1 Expected payoffs from the auction

Given the equilibrium in the auction derived in Proposition 1, we can calculate the expected surplus from the auction for each bidder, defined as its post-auction value less the stand-alone value of \( V_o \). If a bidder loses the auction or wins against the rival with the same synergy, its surplus from the auction is zero. If the two bidders differ in synergies, the high-synergy bidder wins and gets the surplus equal to its maximum willingness to pay, \( V(v_h) - V_o \), less the cost of a bid, which is the sum of the value of the bid to the target, \( p^*(v_l) \), and the cost of signaling, \( (\lambda_i - 1) (1 - \gamma_i) p^*(v_l) \). Simplifying, this is equal to \( \psi_i(v_h, v_l) \frac{X_i}{r - \mu} \), where

\[
\psi_i(v_h, v_l) \equiv v_h - v_l - (\lambda_i - 1) (1 - \gamma_i) (\Pi_T + v_l).
\]

To get bidder \( i \)'s expected surplus from the auction, we need to multiply the conditional surplus \( \psi_i(v_h, v_l) \frac{X_i}{r - \mu} \) by the probability that its synergy is high and the rival’s synergy is low. The post-auction payoff of this bidder is then the sum of this surplus and its stand-alone value \( V_o \).
Using this logic, consider the expected surplus of the initiating bidder, denoted bidder 1, given its initiation of the auction at time \( t \). Because the payoff from the auction is increasing in the bidder’s signal \( s \), the equilibrium initiation threshold of each bidder is decreasing in signal \( s \). Since a bidder with a higher signal approaches the seller at an earlier threshold, at time \( t \) bidder 1 believes that the signal of the rival bidder \( s_2 \) is below some cut-off, denoted \( \bar{s} \), to be determined in equilibrium. In addition, bidder 1 knows its signal \( s_1 \). Therefore, the expected surplus of the initiating bidder from the auction is

\[
s_1 \left(1 - \mathbb{E}[s_2 | s_2 \leq \bar{s}]\right) \psi_1(v_h, v_l) \frac{X_t}{r - \mu}. \tag{5}
\]

Prior to the auction, the expected payoff of the initiating bidder is the sum of its expected surplus from the auction (5) and its stand-alone value \( V_o = \frac{\Pi_B}{r - \mu} X_t \), less the cost of participating in the auction \( I \).

Similarly, consider the expected surplus of the non-initiating bidder, denoted bidder 2, from the auction initiated by bidder 1 at threshold \( X_t \). If bidder 2 observes initiation at \( X_t \), it believes that the signal of bidder 1 is \( \bar{s}_1 = X_t^{-1}(X_t) \). In addition, bidder 2 knows its signal \( s_2 \). Therefore, the expected surplus from the auction of the non-initiating bidder is

\[
s_2 \left(1 - \bar{s}_1\right) \psi_2(v_h, v_l) \frac{X_t}{r - \mu}. \tag{6}
\]

Prior to the auction, the expected payoff of the non-initiating bidder is the sum of (6) and its stand-alone value \( V_o = \frac{\Pi_B}{r - \mu} X_t \), less the cost of participating in the auction \( I \).

### 4 Equilibrium at the Initiation Stage

Having derived the equilibrium in the auction, we solve for the equilibrium at the initiation stage.

To obtain the present values of bidders’ payoffs, we use the following result (e.g., Dixit and Pindyck, 1994). If \( \tau \) is the first passage time by \( X_t \) of an upper threshold \( \bar{X} \), then the time-0 present value of a security that pays $1 at time \( \tau \) equals \( \mathbb{E}[e^{-\tau r}] = \left(\frac{X_0}{\bar{X}}\right)^\beta \), where \( \beta \) is the positive

\[^7\text{See Lemma 1 in the appendix. This result follows from an application of the Topkis’s theorem (Topkis, 1978).}\]
root of the quadratic equation \( \frac{1}{2} \sigma^2 \beta (\beta - 1) + \mu \beta - r = 0: \)

\[
\beta = \frac{1}{\sigma^2} \left[ -\left( \mu - \frac{\sigma^2}{2} \right) + \sqrt{\left( \mu - \frac{\sigma^2}{2} \right)^2 + 2r\sigma^2} \right] > 1. \tag{7}
\]

We start with the case in which bidders have the same financial constraints: \( \lambda_i \equiv \lambda \). We then consider the case in which financial constraints are different.

### 4.1 Same Financial Constraints

If bidders face the same costs of paying in cash, their bidding strategies in the auction are the same, as shown in Proposition 1. In particular, when bidders differ in synergies, the proportion of the stock in the total offer of the winner, \( \gamma_i = \gamma = \left( 1 + \frac{1}{\sum_{l=1}^{r} \Pi_{l} \frac{v_{h_l} - v_l}{v_{h_l} + v_l}} \right)^{-1} \) is the same for both bidders. The surpluses from the auction of the initiating and the non-initiating bidders are given by (5) and (6), respectively, with \( \psi_i(v_h, v_l) = \psi(v_h, v_l), i \in \{1, 2\} \). Note that because \( \psi(v_h, v_l) \) does not depend on \( X_t \), expected payoffs of bidders depend on \( X_t \) linearly.

If bidders face the same financial constraints, there is a symmetric equilibrium, in which a bidder with signal \( s \) initiates the auction at threshold \( \bar{X}(s) \), provided that the rival bidder has not initiated yet. Consider bidder \( i \) with signal \( s \), who expects the rival bidder \( j \) with signal \( z \) to initiate at threshold \( \bar{X}(z) \), where \( \bar{X}(z) \) is a strictly decreasing function. As time goes by and bidder \( i \) observes that bidder \( j \) has not initiated the auction yet, bidder \( i \) truncates its belief about bidder \( j \)'s signal by tracking the highest realization of \( X_t \): at time \( t \), the highest possible signal of bidder \( j \) is \( \bar{X}^{-1}(\max_{u \in [0,t]} X_u) \). Therefore, if bidder \( i \) initiates at threshold \( \bar{X} \), its expected value at any time \( t \) prior to reaching threshold \( \bar{X} \) is

\[
\begin{align*}
\Pi_{B} \frac{X_t}{r - \mu} + \left( \frac{X_t}{\bar{X}} \right)^{\beta} & \int_{z}^{\bar{X}^{-1}(\bar{X})} \left( s(1-z)\psi(v_h, v_l) \frac{\bar{X}}{r - \mu} - I \right) \frac{dF(z)}{F(\bar{X}^{-1}(\max_{u \in [0,t]} X_u))} \\
& + \int_{\bar{X}^{-1}(\bar{X})}^{\bar{X}^{-1}(\max_{u \in [0,t]} X_u)} \left( \frac{X_t}{\bar{X}(z)} \right)^{\beta} \left( s(1-z)\psi(v_h, v_l) \frac{\bar{X}(z)}{r - \mu} - I \right) \frac{dF(z)}{F(\bar{X}^{-1}(\max_{u \in [0,t]} X_u))},
\end{align*}
\tag{8}
\]

where we set \( \bar{X}^{-1}(x) = \bar{s} \) for any \( x < \bar{X}(\bar{s}) \). The intuition behind (8) is as follows. Prior to the auction, bidder \( i \)'s value is \( V_o = \Pi_{B} \frac{X_t}{r - \mu} \), which is the first summand in (8). The second and third summands in (8) represent the adjustments to bidder \( i \)'s value following the auction. If bidder \( j \)'s signal \( z \) is low, so that \( \bar{X}(z) > \bar{X} \), then the auction is initiated by bidder \( i \) at threshold \( \bar{X} \). In this case, the rival’s signal is inferred to be below \( \bar{X}^{-1}(\bar{X}) \). Using expression (5), the expected surplus of bidder \( i \) from the auction in this case is \( s \left( 1 - \mathbb{E} [z | z \leq \bar{X}^{-1}(\bar{X})] \right) \psi(v_h, v_l) \frac{\bar{X}}{r - \mu} \). In addition,
the bidder incurs the participation cost $I$. Combining the two yields the second summand in (8). If bidder $j$’s signal is high, so that $X(z) < \bar{X}$, then the auction is initiated by bidder $j$ at threshold $\bar{X}(z)$. In this case, bidder $i$ infers that the signal of bidder $j$ is $z$ from its initiation threshold. Using expression (6), the expected surplus to bidder $i$ from the auction in this case is $s(1 - z)\psi(v_h, v_l)\frac{X(z)}{r - \mu}$. Integrating over the possible realizations of bidder $j$’s signal yields the third summand in (8).

To solve for the equilibrium $\bar{X}(s)$, we maximize (8) with respect to $\bar{X}$ and apply the equilibrium condition that the maximum must be reached at $\bar{X}(s)$. To ensure existence and uniqueness of the equilibrium, we impose the following assumptions:

**Assumption 2 (monotone payoff of the initiating bidder).** $sm(s)$ is strictly increasing in $s$, where $m(s) \equiv 1 - \mathbb{E}[z|z \leq s]$ is the probability that the synergy of the rival bidder is $v_l$, conditional on its signal being below $s$.

**Assumption 3 (no entry deterrence).** The parameters of the model satisfy conditions (25) and (29) in the appendix.

Assumption 2 means that the expected payoff from the auction of the initiating bidder is strictly increasing in its signal. Intuitively, if the signal of the initiating bidder is higher, there are two effects. The first-order effect is that the initiating bidder is more likely to have a high synergy. This effect increases the payoff of the initiating bidder. The second-order effect is that the rival bidder facing a stronger initiating bidder is also more likely to have a high synergy, because its distribution is truncated less at the initiation stage. This effect decreases the payoff of the initiating bidder. Assumption 2 restricts the distribution of types to be such that the latter effect does not dominate the former, meaning that a higher signal is always “good news” for the payoff of the initiating bidder. As an example, it is satisfied for uniform distribution over $[s, \bar{s}]$, used in our numerical examples, if $\frac{s}{2} + \bar{s} < 1$.

Assumption 3 ensures that the equilibrium features participation of both bidders in the auction. Specifically, condition (25) means that a bidder always prefers to join the auction initiated by the rival bidder at threshold $\bar{X}(s)$, $s \in [s, \bar{s}]$. Condition (29) means that the bidder with the highest signal is better off initiating the auction at threshold $\bar{X}(\bar{s})$ and facing competition from the rival bidder rather than speeding up to initiate the auction earlier and deterring the entry of some types.
of the rival bidder.\footnote{If Assumption 3 is violated, the equilibrium would feature non-competitive acquisitions, in which one bidder has a sufficiently high signal, while the other bidder has a sufficiently low signal. This case is technically challenging within our framework, so we do not consider it here.}

Proposition 2 shows that under Assumptions 2 and 3, there exists a unique symmetric equilibrium in the initiation game:

**Proposition 2 (equilibrium initiation when financial constraints are the same).** There exists a unique symmetric equilibrium in the initiation game. A bidder with signal $s$ initiates the auction when $X_t$ reaches upper threshold

$$
X(s) = \frac{\beta}{\beta - 1} \frac{(r - \mu)I}{sm(s)\psi(v_h, v_l)},
$$

provided that the target has not been approached before. If the auction is initiated by a rival bidder at $\hat{\lambda} \in [\hat{\lambda}(s), \hat{\lambda}(g)]$, the bidder always participates in it.

It is useful to consider two special cases: when the bidders have no financial constraints ($\lambda \rightarrow 1$) and when the financial constraints are extreme ($\lambda \rightarrow \infty$). In this case, (9) yields

$$
\lim_{\lambda \rightarrow 1} \tilde{X}(s) = \frac{\beta}{\beta - 1} \frac{(r - \mu)I}{sm(s)(v_h - v_l)},
$$

(10)

$$
\lim_{\lambda \rightarrow \infty} \tilde{X}(s) = \frac{\beta}{\beta - 1} \frac{(r - \mu)I}{sm(s)(v_h - v_l)} \left(1 - \frac{\psi(v_l)}{V(v_h)}\right),
$$

(11)

In particular, (11) is always higher than (10). In general, $\tilde{X}(s)$ is increasing in $\lambda$: Higher financial constraints make it costlier for a high-synergy winner to signal its type when it acquires the target at a low price. This results in a lower expected profit at the initiation stage and further initiation delay. We provide formal proofs in Section 5.

### 4.2 Heterogeneous Financial Constraints

Consider the case in which bidders differ in their financial constraints, $\lambda_1 \neq \lambda_2$. In this case, the expected payoffs from the auction differ for the two bidders. As a consequence, the equilibrium in the initiation game is asymmetric. Consider bidder $i$ with signal $s$, who expects the rival bidder $j$ with signal $z$ to initiate at threshold $\tilde{X}_j(z)$, where $\tilde{X}_j(z)$ is a strictly decreasing function. As time goes by and bidder $i$ observes that bidder $j$ has not initiated the auction yet by time $t$, bidder $i$
updates the belief about the signal of the rival bidder to  \( a, \hat{X}_j^{-1}(\max_{u \in [0, t]} X_u) \). Therefore, if bidder \( i \) follows the strategy of initiating the auction at threshold \( \hat{X} \), provided that the rival has not initiated the auction yet, its expected payoff at any time \( t \) prior to reaching threshold \( \hat{X} \) is

\[
\Pi_i \frac{X_i}{r - \mu} + \left( \frac{X_i}{\hat{X}} \right)^\beta \int_{\hat{X}}^{\hat{X}_j^{-1}(\hat{X})} \left( s(1 - z)\psi_i(v_h, v_l) - \frac{\hat{X}}{r - \mu} - I \right) \frac{dF(z)}{F(\hat{X}_j^{-1}(\max_{u \in [0, t]} X_u))} \\
+ \int_{\hat{X}_j^{-1}(\hat{X})}^{\hat{X}_j^{-1}(\max_{u \in [0, t]} X_u)} \left( \frac{X_i}{\hat{X}_j(z)} \right)^\beta \left( s(1 - z)\psi_i(v_h, v_l) - \frac{\hat{X}_j(z)}{r - \mu} - I \right) \frac{dF(z)}{F(\hat{X}_j^{-1}(\max_{u \in [0, t]} X_u))},
\]

(12)

where we set \( \hat{X}_j^{-1}(x) = \bar{s} \) for any \( x < \hat{X}_j(\bar{s}) \) and \( \hat{X}_j^{-1}(x) = \bar{s} \) for any \( x > \hat{X}_j(\bar{s}) \). The logic behind (12) is similar to that in the model with same financial constraints. The notable difference concerns the impact of bidder \( i \)'s own and its rival’s constraints. Bidder \( i \)'s constraint, \( \lambda_i \), affects its expected payoff through \( \psi_i(v_h, v_l) \), because it determines how costly it is to signal its type when the acquisition price is low. The rival’s financial constraint, \( \lambda_j \), affects the payoff indirectly through the rival’s initiation strategy \( \hat{X}_j(\cdot) \), which bidder \( i \) uses to infer the rival’s signal.

To solve for the equilibrium initiation thresholds, we maximize (12) for each bidder with respect to \( \hat{X} \), and apply the equilibrium condition that the maximums must be reached at \( \hat{X}_i(s) \). We impose restrictions, analogous to Assumptions 2 and 3, which correspond to the monotone payoff of the initiating bidder in its signal \( s \) and entry deterrence not occurring. The equilibrium is summarized in Proposition 3, which is similar to Proposition 2:

**Proposition 3 (equilibrium initiation when financial constraints are different).** Let a pair \( \hat{X}_i(s), i \in \{1, 2\} \) be a solution to the system of equations:

\[
\hat{X}_i(s) = \frac{\beta}{\beta - 1} \frac{(r - \mu)I}{s\psi_i(v_h, v_l)\max \left( \hat{X}_j^{-1}(\hat{X}_i(s)) \right)},
\]

(13)

where \( j \neq i \) and \( \psi_i(v_h, v_l) \) is defined in (4). Suppose that \( sm(\hat{X}_1^{-1}(\hat{X}_2(s))) \) and \( sm(\hat{X}_2^{-1}(\hat{X}_1(s))) \) are strictly increasing in \( s \), and conditions (24) and (28) in the appendix hold. Then, thresholds \( \hat{X}_i(s), i \in \{1, 2\} \) give an equilibrium. Bidder \( i \) with signal \( s \) initiates the auction when \( X_i \) reaches upper threshold \( \hat{X}_i(s) \), provided that the target has not been approached before. If the auction is initiated by a rival bidder at \( \hat{X} \in [\hat{X}_j(\bar{s}), \hat{X}_j(\bar{s})] \), bidder \( i \) always participates in it. Furthermore, no separating equilibrium in continuous threshold strategies that does not solve (13) exists.

Note that if \( \lambda_i \equiv \lambda \) then \( \hat{X}_j^{-1}(\hat{X}_i(s)) = s \) and \( \psi_i(v_h, v_l) = \psi(v_h, v_l) \), so Proposition 3 embeds
Proposition 2. Unlike in Proposition 2, we could not prove existence and uniqueness of the equilibrium in the model with asymmetric financial constraints. However, the unique equilibrium exists in all our numerical examples.

5 Model Implications

The model delivers three groups of implications. First, it relates the financing constraints of a bidder and its rival to the bidder’s propensity to initiate an acquisition. Second, the equilibrium features endogenous selection of deals into stock-only deals and deals that involve cash payments. Finally, the model derives links between identities of initiating bidders and winning bidders. In the next subsections, we discuss these implications one by one.

5.1 Role of Financial Constraints

The following proposition shows the comparative statics of the equilibrium initiation threshold \( X_i(s) \) in the parameters of the model:

**Proposition 4 (comparative statics).** Suppose that the equilibrium is continuous and differentiable in the parameter of interest \( \theta \in \{\sigma, r, \mu, I, \Pi_T, \Pi_B, v_h, \lambda_i, \lambda_j\} \) and consider a marginal change in \( \theta \). For any \( s \), \( X_i(s) \) is: (1) strictly increasing in \( \sigma, r, I, \Pi_T, \), and \( \lambda_i \); (2) strictly increasing in \( \lambda_j \) for \( s \) such that \( X_i(s) \in [\bar{X}_j(\bar{s}), \min_{i \in \{1,2\}} \bar{X}_i(\bar{s})] \) and weakly for remaining \( s \) in \([\bar{s}, \bar{s}]\); (3) strictly decreasing in \( \mu, \Pi_B, \) and \( v_h \).

Our central comparative statics are with respect to the bidder own’s (\( \lambda_i \)) and its rival’s (\( \lambda_j \)) financial constraints. The effect of the bidder’s own constraint is intuitive. If it has a high synergy and faces a low-synergy rival, the bidder needs to include cash in the bid to signal its synergy and thereby avoid having its stock undervalued by the target. The cost of such signaling is higher if the bidder’s valuation of cash is higher, i.e., if it is more constrained. Therefore, a higher financial constraint reduces the expected payoff of the bidder from initiating the auction and leads to more delay.

The effect of the rival bidder’s financial constraint is subtler. A naive conjecture could be that an increase in the rival bidder’s constraint makes it a weaker rival, which increases the payoff of the other bidder giving it more incentive to initiate the auction. This conjecture is incorrect. As
we saw in Section 3, the expected payoff of a bidder from the auction depends only on its own
constraint, but not on the constraint of its rival, which would be different if bids were restricted
to be in cash (Che and Gale, 1998). Furthermore, each bidder learns about the strength of its
opponent by observing that the rival has not initiated the auction yet. If the rival bidder is more
constrained, it initiates the auction later for any fixed signal $s$. Thus, conditional on the rival not
initiating the auction, the bidder believes that the rival is more optimistic about its synergy than
if it were less constrained. Therefore, a bidder is also less likely to approach the target if the rival
bidder’s financial constraint goes up. Figure 2 illustrates the result of Proposition 4 that both a
bidder’s own and a rival bidder’s financial constraint delay the initiation of the auction. Figure 3
illustrates the comparative statics of all parameters in Proposition 4.

Proposition 4 yields an empirical prediction: An unexpected tightening in the aggregate finan-
cial constraint reduces acquisition activity. In fact, a bidder’s acquisition activity declines even
if it is unaffected by the shock, as long as other potential acquirers are affected. Empirically,
Harford (2005) finds that the timing of mergers is related to aggregate liquidity in the market,
which is in line with Proposition 4.

A related question is about the cross-sectional relation between potential acquirers’ financial
constraints and their propensity to initiate acquisitions. Figure 2 illustrates that for any set of
parameters and any given signal $s$, the more financially constrained bidder initiates the auction
later than the less constrained one. Proposition 5 formalizes this result:

**Proposition 5.** If $\lambda_i > \lambda_j$, then $X_i(s) > X_j(s)$ for any $s \in [\underline{s}, \bar{s}]$.

It is also interesting to explore the role of financial constraints for efficiency of the M&A
market. Because they do not affect the identity of the winner, they do not lead to inefficiency of
the allocation within the auction. However, tighter financial constraints delay its timing. In the
appendix, we solve for the optimal initiation of the auction from the social planner’s point of view
and show that it can happen either later or earlier that the competitive equilibrium initiation.
Intuitively, there are two effects. On one hand, the initiating bidder pays a portion of the total
value to the target but bears the full cost $I$. On the other hand, the initiating bidder imposes an
externality on the rival bidder by forcing it to participate in the auction and pay the cost earlier
than it would want to. The former effect delays the timing of the auction compared to the efficient
one, while the latter speeds it up. Thus, financial constraints may reduce or increase inefficiency
by delaying the timing of the auction, but they do not affect efficiency of the allocation within the auction.

5.2 Method of Payment

In the equilibrium at the auction stage, the use of cash in the payment increases in the difference in the valuations of the winning bidder and its rival and decreases in the financial constraint of the winning bidder. Two implications follow. First, the payoff to the winning bidder is higher in deals involving a cash payment than in all-stock deals, in line with empirical evidence that acquirers’ announcement stock returns are lower in stock acquisitions than in cash and mixed deals (Travlos, 1987; Eckbo, Giammarino, Heinkel, 1990). In fact, if the market has the same information about bidders’ valuations as the target, the announcement of an all-stock deal leads to a decline of the acquirer’s stock price, also consistent with empirical evidence. The price reaction is negative neither because the acquisition in stock is necessarily a signal of low valuation (indeed, a high-synergy acquirer pays in stock if the rival bidder’s synergy is also high) nor because the acquirer overpays, but rather because the acquirer pays in stock if the required payment is close to its valuation. Participation costs then outweigh the acquirer’s gains from the deal. Second, cash deals have higher synergies than stock deals on average. Intuitively, a cash deal requires the winning bidder to have high synergies, since otherwise it would have been better off paying in stock. This implication also appears to be consistent with the data (e.g., Andrade, Mitchell, and Stafford, 2001; Bhagat et al., 2005).

Because the timing of the deal is endogenous, the model links payment method to the size of the deal and expected synergies. To evaluate this, we perform the following numerical analysis. For a set of parameters in Table 1, we draw bidders’ signals from uniform distribution over $[\mathbb{E}[s] - \Delta, \mathbb{E}[s] + \Delta]$ and simulate their synergies. We then relate the average deal size (measured by the threshold at which the deal takes place) and the average fraction of cash in the total payment. For illustrative purposes, we define “cash” (“stock”) deals as deals that contain more (no more) than 50% cash of the total payment. Table 2 gives definitions of all studied quantities.

The bottom panels of Figure 4 illustrate that selection into cash and stock deals based on synergies leads to a smaller expected size of cash versus stock deals. This result arises because for baseline parameters the bidder is more likely to have low synergies than high synergies, implying a positively skewed distribution of synergies. Thus, a typical stock deal occurs when both bidders

---

Positive skew is arguably more plausible than negative for the distribution of synergies.
have low synergies, who tend to have low signals and hence approach the target late. In contrast, a cash deal occurs when one of the bidders has high synergies. This bidder typically also has a high signal and hence approaches the target early.

The top panels of Figure 4 illustrate the effect of parameters on the average proportion of cash in the total payment. It is driven by two factors: first, by the proportion of cash in the payment, $1 - \gamma$, when the high-synergy bidder wins against the low-synergy rival, and, second, by the probability of this event. An increase in $\Pi_B$, $\Pi_T$, or $\lambda$ leads to a decrease in the proportion of cash $1 - \gamma$. On the other hand, the probability of unequal synergies is given by $2\mathbb{E}[s] (1 - \mathbb{E}[s])$, which is independent of $\Pi_B$, $\Pi_T$, or financial constraints, and increases in $\mathbb{E}[s]$ when $\mathbb{E}[s] < \frac{1}{2}$, i.e., the distribution of synergies has a positive skew. Thus, the model implies that more cash is used on average when bidders are less financially constrained and more optimistic about synergies, consistent with evidence in Martin (1996), Faccio and Masulis (2005), and Alshwer, Sibilkov, and Zaiats (2011).

Summarizing the above discussion, the model implies that more cash in a deal is associated with higher synergies, higher payoffs to the acquirers, and lower financial constraints of the acquirer. In addition, if the distribution of synergies has positive skew, mergers of smaller companies are more likely to rely on cash.

### 5.3 Initiating and Winning Bidders

Because each potential acquirer in the model makes both initiation and bidding decisions, the model derives links between the identities of initiating and winning bidders. Information about deal initiation is available in deal backgrounds, so these implications can be empirically examined. As shown in Section 3, the identity of the winning bidder is determined by the bidders’ synergies: The bidder with the highest synergy wins the auction. However, as shown in Section 4, the identity of the initiating bidder is also affected by relative financial constraints of the two bidders: Given the same signal $s$, the less financially constrained bidder is the initiator. An implication follows:

**Implication 1.** The probability that a bidder initiates the contest is decreasing in its financial constraint, holding the financial constraint of the rival bidder constant.

The left panel of Figure 5 illustrates this implication. Combined with the fact that the identity of the winning bidder is determined by synergies and not by financial constraints, it leads to the
following implication:

**Implication 2.** The probability that the initiating bidder is also the acquirer exceeds 50%, if \( \lambda_i = \lambda_j \). If \( \lambda_i \neq \lambda_j \), the conditional probability that the initiating bidder wins the auction is higher for the more constrained bidder.

The first part follows from the fact that the initiating bidder has a higher signal than the non-initiating bidder, when the two bidders have the same financial constraints. The second part follows from Proposition 5: Initiation is a less positive signal about the rival for the less constrained bidder, so upon initiation, such bidder is more likely to lose the contest if it is the less constrained one. The central panel of Figure 5 illustrates this implication.

Finally, the right panel of Figure 5 examines how the payment method relates to the identities of the initiating and winning bidders. When \( \lambda_i = \lambda_j \), the average proportion of cash in the deal is higher when the identities of the initiating and the winning bidder coincide than when they are different. Recall that cash is used when the synergies of the two bidders differ but not when they are equal. Because the initiating bidder is more likely to have high synergies, the events in which the initiating bidder wins are more likely to correspond to events in which the two bidders’ synergies are unequal. These are exactly the events in which the high-synergy bidder uses cash in the payment. On the other hand, the events in which the non-initiating bidder wins, for a positively-skewed distribution of synergies, are more likely to correspond to events in which the two bidders’ synergies are low, resulting in stock payments. If one bidder is more constrained than the other, it includes less cash in the payment, so the average proportion of cash in deals done by the more constrained bidder declines.

## 6 Extensions and Discussion

### 6.1 Continuous Distribution of Synergies

In the base model, we assume a binary distribution of synergies, which simplifies the solution. The downside of this simplification is that the base model does not deliver rich implications for the takeover premium. With binary valuations, the equilibrium takeover premium takes only two values. In addition, it implies that the average takeover premium is lower in cash deals than in stock deals, because a cash deal only occurs when the rival bidder’s synergy is low. In this section,
we show how the model can accommodate continuous distribution of synergies.

Consider the following modification. Instead of \( v_i \in \{v_l, v_h\} \) with \( \Pr[v_i = v_h|s_i] = s_i \), suppose that synergies are distributed with conditional c.d.f. \( G(v_i|s_i) \) with full support on \([v_l, v_h]\). In addition, suppose that a higher signal corresponds to a more optimistic distribution of synergies in the sense of first-order stochastic dominance: \( \forall s < s' \) and \( v \in (v_l, v_h) \), \( G(v|s) > G(v|s') \). We restrict the analysis to the case of equal financial constraints \( (\lambda_1 = \lambda_2 = \lambda) \) here, but the model can be generalized to capture heterogeneous financial constraints.

Consider the auction that occurs at time \( t \). The analogous equilibrium to the one in the base model is as follows. Each bidder drops out from the auction when the price reaches its valuation of the target, \( V(v) - V_0 \). The winning bidder makes an all-stock offer if its valuation of the target equals the price at which it wins the auction (i.e., if its synergy equals the synergy of the rival bidder). If the winning bidder’s valuation of the target exceeds the price at which it wins the auction, the winning bidder’s payment is a combination of cash and stock with the proportion of cash strictly increasing in the gap between the bidder’s valuation and the winning price.\(^{10} \)

Formally:

**Proposition 6.** At the auction stage, there exists a unique equilibrium in weakly dominant bidding strategies, in which different types of the winning bidder separate via cash-stock mixes, whose equilibrium values equal the price at which the losing bidder drops. A bidder with synergy \( v \) drops out once the price reaches

\[
p^*(v) = V(v) - V_0 = \frac{\Pi_T + v}{r - \mu} X_t. \tag{14}
\]

The higher-synergy bidder wins. If bidder \( i \) with synergy \( v \) wins after the rival drops out at \( p \), it offers

\[
(b^*(p, v), \alpha^*(p, v)) = \left( p \left( 1 - \gamma(p, v) \right), \frac{p}{V(v)} \gamma(p, v) \right), \tag{15}
\]

where \( \gamma(p, v) = \left( \frac{V_0 + p}{V(v)} \right)^{\frac{1}{\lambda-1}} \) represents the proportion of stock in the total offer value. In particular, for any \( v \), \( \gamma(p^*(v), v) = 1. \)

\(^{10}\)The difference from the binary model is that the separating equilibrium is no longer the unique equilibrium satisfying the CKIC criterion (Assumption 1). A stronger refinement, such as D1, needs to be imposed to rule out non-separating equilibria. Ramey (1996) shows that D1 selects the separating equilibrium as the unique one in a large class of signaling games with a continuum of types. We conjecture that his result extends to our model.
Bidding strategies in Proposition 6 are similar to the ones in the model with binary synergies. Consequently, the implications are also similar. First, the financial constraint of a bidder affects the offer and its payoff from the auction but has no effect on the bidder’s maximum willingness to pay. Second, the proportion of cash in the offer is driven primarily by two factors: the financial constraint of the acquirer and by how much the acquirer’s valuation of the target exceeds the price at which it wins.

The equilibrium at the auction stage pins down the expected payoffs from the auction of the initiating and the non-initiating bidder. Similarly to the base model, we can proceed with solving for the separating equilibrium in the continuous threshold strategies. The resulting equilibrium initiation threshold is similar to that in Proposition 2:

**Proposition 7.** Let $m(v|s) \equiv E[G(v|z)|z \leq s]$ be the probability that the rival’s synergy is below $v$, conditional on its signal being below $s$. Let $m'(v|s) \equiv E[g(v|z)|z \leq s]$ be the corresponding density, and assume that $g(v|s)m'(w|s)$ is strictly increasing in $s$ for any $v$ and $w$. Let

$$
\bar{X}(s) = \frac{\beta}{\beta - 1} \int_{v_1}^{v_h} \int_{v}^{\bar{v}} g(v|s)M'(w|s)\phi(v,w)dw dv,
$$

and suppose that conditions (38)–(39) in the appendix are satisfied. Then, there exists a unique symmetric equilibrium in the initiation game. A bidder with signal $s$ initiates the auction when $X_t$ reaches upper threshold $\bar{X}(s)$, provided that the target has not been approached before. If the auction is initiated by the rival bidder at $\bar{X} = \bar{X}_t$, the bidder always participates in it.

The assumptions behind Proposition 7 are similar to Assumptions 2 and 3 in Section 4.1. Specifically, the assumption that $g(v|s)m'(w|s)$ is strictly increasing in $s$ ensures that the payoff of the initiating bidder is increasing in its signal, and conditions (38)–(39) ensure that there is no entry deterrence of the non-initiating bidder.

The novel aspect of this model is that it generates richer implications for the acquisition premium. Figure 6 illustrates that the ranking between the average, across synergies, takeover premium in cash deals and in stock deals depends on model parameters. This is in contrast to the takeover premium conditional on the acquirer’s synergy, which is always higher in stock deals. When the distribution of synergies has a positive skew and financial constraints are low, stock deals typically occur when both bidders have low synergies, leading to lower average premiums in
stock deals. As Figure 6 shows, the average takeover premium in cash deals is higher than in stock deals when $\Pi_B$ is high, the distribution of synergies is less skewed, or the financial constraints are high. For example, when bidders have high financial constraints, even deals with moderate differences between synergies are mostly completed in stock. As a result, average synergies of both the winning and the losing bidders in stock (cash) deals increase (decrease), leading to an increase (decrease) in average premiums in stock (cash) deals.

6.2 Active Target

In the base model, we assume that the auction is always initiated by a bidder, rather than the target. In this section, we show that this assumption is consistent with an equilibrium even if we allow for the target to be active. Consider the version of the base model in which the agreement of the target is necessary for the transaction to occur. In addition, suppose that initiation is publicly observed: If a bidder approaches the target to initiate the auction and the target declines, the rival bidder observes it.

First, we argue that the target has no incentive to delay the auction further when it gets approached by a bidder. Suppose that the target is approached by bidder $i$ at some threshold $\bar{X}_i(s_i)$. At this point, the target infers bidder $i$’s signal $s_i$, as well as the posterior distribution of bidder $j$’s signal $s_j \sim [\bar{s}, \bar{s}(s_i)]$, where $\bar{s}(s_i) \equiv \tilde{X}_j^{-1}(\bar{X}_i(s_i))$. The payoff of the target from selling itself immediately when it gets approached is thus $\frac{X_i(s_i)}{r-\mu} \phi(s_i)$, where $\phi(s_i) \equiv \left( \Pi_T + E \left[ \min_{i \in \{1,2\}} v_i(s_i, s_j \leq \bar{s}(s_i)) \right] \right)$. Suppose that if the target deviates to delaying the auction when the bidder approaches it, the other bidder does not approach it before the target initiates the auction voluntarily. Then, the expected payoff of the target from delaying the auction until threshold $\bar{X} > \bar{X}_i(s_i)$ is $\left( \frac{X_i(s_i)}{X} \right)^{\beta} \frac{\bar{X}}{r-\mu} \phi(s_i)$. This payoff is strictly decreasing in $\bar{X}$. Thus, the target does not benefit from delaying the auction when it gets approached by the bidder.

Second, consider incentives of the target to accelerate the auction prior to being approached by either bidder. Suppose that the target invites both bidders to participate in the auction at time $t$ prior to either bidder approaching it. Suppose that each bidder believes that no type of the rival bidder accepts the target’s offer to sell itself. By backward induction, if the target’s offer rejected by bidders and later, bidder $i$ initiates the auction, the target would strictly prefer to sell itself then, as the base model shows. Hence, in this subgame, the target sells itself after it is approached by a bidder, which leads to bidders playing as if the target’s offer at time $t$ is absent. Consequently, the target not conducting the auction prior to being approached by either bidder
is an equilibrium outcome. This model probably has other equilibria, in which target-initiated auctions occur, whose characterization goes beyond the scope of this paper.

7 Conclusion

This paper studies how potential acquirer’s financial constraints affect the M&A market: Their incentives to approach targets, size of bids, and the payment method. We propose a tractable model based on three building blocks: dynamic decision-making, private information of bidders, and financial constraints. Four main results are derived. First, because of ability to pay in stock, financial constraints do not affect bidders’ maximum willingness to pay, in contrast to models in which bids are restricted to be made in cash. Second, even though financial constraints do not affect the strength of each bidder, they impact bidders’ decisions to approach the target in the first place. Specifically, both a bidder’s own and a rival bidder’s constraint discourage the bidder from initiating the auction. Third, auctions are initiated by bidders with low financial constraints or high synergies. Finally, the use of cash as a method of payment is positively associated with synergies and the acquirer’s gains from the deal, and negatively associated with financial constraints.

Several extensions of our model could be fruitful. First, it can be interesting to relax the parameter restriction that ensures no entry deterrence in equilibrium. In this case, a bidder with low enough synergy chooses not to participate in the auction if the rival bidder initiates it early enough. Thus, by signaling that it is strong enough, the initiating bidder will sometimes deter the rival bidder’s entry, as in Fishman (1988). The difference is that such signaling occurs via timing by initiating a very early deal, as opposed to signaling via the size of the bid, as in Fishman (1988). Second, it can be interesting to incorporate aggregate shocks to financial constraints, for example, by modeling them as a two-state Markov chain, as in Bolton, Chen, and Wang (2013). Finally, the structure of private information could be made richer by allowing for two-sided private information, when the target is privately informed about its stand-alone value, in addition to bidders being informed about synergies.
References


Appendix: Proofs

Proof of Proposition 1. Consider bidder $i$. Let $p_i^*(v)$ be the drop out price for bidder $i$ with synergy $v \in \{v_1, v_h\}$. Let $(b_i^*(p,v), \alpha_i^*(p,v))$ be the equilibrium offer of bidder $i$ with synergy $v \in \{v_1, v_h\}$ if it wins at price $p \leq p_i^*(v)$. We prove the proposition in a sequence of seven steps.

Step 1: Consider $p \leq p_i^*(v)$. If $(b_i^*(p,v), \alpha_i^*(p,v)) \neq (b_i^*(p,v_h), \alpha_i^*(p,v_h))$, then $(b_i^*(p,v), \alpha_i^*(p,v)) = \left(0, \frac{p}{V(v)}\right)$. By contradiction, suppose otherwise. Since $(b_i^*(p,v), \alpha_i^*(p,v)) \neq (b_i^*(p,v_h), \alpha_i^*(p,v_h))$, offer $(b_i^*(p,v), \alpha_i^*(p,v))$ reveals that the bidder's type is $v_1$. Therefore, it must satisfy:

$$\alpha_i^*(p,v_1)V(v_1) + b_i^*(p,v_1) \geq p.$$

Consider a deviation by type $v_l$ from offer $(b_i^*(p,v_l), \alpha_i^*(p,v_l))$ to offer $\left(0, \frac{p}{V(v_l)}\right)$. The value of this offer is $p$, if perceived as coming from type $v_l$, and above $p$, if perceived as coming from type $v_h$ with positive probability. Thus, it satisfies the "no default" condition that its value, evaluated according to the beliefs of the seller, is at least $p$. However, the payoff from this offer to type $v_l$ is strictly higher:

$$V(v_l) - p \geq V(v_l) - \alpha_i^*(p,v_l)V(v_l) - b_i^*(p,v_l)$$
$$> (1 - \alpha_i^*(p,v_l))V(v_l) - \lambda_i b_i^*(p,v_l).$$

since $\lambda_i > 1$. Therefore, $(b_i^*(p,v_l), \alpha_i^*(p,v_l)) = \left(0, \frac{p}{V(v_l)}\right)$.

Assumption 1 (CKIC). According to Assumption 1 (CKIC), if bidder $i$ submits offer $(b, \alpha)$ satisfying

$$1 - \alpha V(v_h) - \lambda_i b \geq \max \left\{ (1 - \alpha_i^*(p,v_h))V(v_h) - \lambda_i b_i^*(p,v_h), V_o \right\},$$

(17)

$$1 - \alpha V(v_l) - \lambda_i b < \max \left\{ (1 - \alpha_i^*(p,v_l))V(v_l) - \lambda_i b_i^*(p,v_l), V_o \right\},$$

(18)

then the seller must believe that bidder $i$'s synergy is $v_h$. The intuition is as follows. The left-hand sides of (17) and (18) are the payoffs of bidder $i$, if it acquires the target for $(b, \alpha)$, if its synergy is $v_h$ and $v_l$, respectively. The right-hand sides of (17) and (18) are the payoffs of bidder $i$ with synergy $v_h$ and $v_l$, respectively, if it follows the equilibrium strategy. Thus, conditions (18)–(17) mean that the low-synergy bidder is strictly worse off deviating to offer $(b, \alpha)$, while the high-synergy bidder is potentially better off. According to CKIC, it is unreasonable for the seller to believe that such an offer comes from type $v_l$, so the seller must believe that it comes from type $v_h$.

Step 2: Consider $p \leq p_i^*(v)$. If $(b_i^*(p,v_l), \alpha_i^*(p,v_l)) \neq (b_i^*(p,v_h), \alpha_i^*(p,v_h))$, then $(b_i^*(p,v_l), \alpha_i^*(p,v_l)) = \left(1 - \gamma_i \right) p, \frac{p}{V(v)}\gamma_i \right)$, where $\gamma_i = \left(1 + \frac{1}{\lambda_i - 1} \left(1 - \frac{V(v_l)}{V(v_h)}\right)^{-1}\right)^{-1}$. Since $(b_i^*(p,v_l), \alpha_i^*(p,v_l)) \neq (b_i^*(p,v_h), \alpha_i^*(p,v_h))$, offer $(b_i^*(p,v_h), \alpha_i^*(p,v_h))$ must satisfy:

$$\alpha_i^*(p,v_h)V(v_h) + b_i^*(p,v_h) \geq p$$

(19)

$$\left(1 - \alpha_i^*(p,v_h)\right)V(v) - \lambda_i b_i^*(p,v_h) \leq V(v_l) - p$$

(20)

The first inequality is the condition that the value of offer $(b_i^*(p,v_h), \alpha_i^*(p,v_h))$ is at least $p$. The second inequality is the condition that type $v_l$ is not better off deviating from $\left(0, \frac{p}{V(v_l)}\right)$ to $(b_i^*(p,v_h), \alpha_i^*(p,v_h))$. Let
us show that $(b^*_{i}(p, v_h), \alpha^*_{i}(p, v_h))$ must be such that both (19) and (20) bind. First, by contradiction suppose that (19) is slack. If $\alpha^*_{i}(p, v_h) = 0$, then type $v_h$ is better off deviating to offer $(b^*_{i}(p, v_h) - \varepsilon, \alpha^*_{i}(p, v_h))$ for an infinitesimal $\varepsilon > 0$. If $\alpha^*_{i}(p, v_h) > 0$, consider a deviation by type $v_h$ to $(b^*_{i}(p, v_h) + \varepsilon_1, \alpha^*_{i}(p, v_h) - \varepsilon_2)$ for infinitesimal $\varepsilon_1 > 0$ and $\varepsilon_2 > 0$, satisfying

$$
(1 - \alpha^*_{i}(p, v_h) + \varepsilon_2) V(v_h) - \lambda_i (b^*_{i}(p, v_h) - \varepsilon_1) > (1 - \alpha^*_{i}(p, v_h)) V(v_h) - \lambda_i b^*_{i}(p, v_h),
$$

$$
(1 - \alpha^*_{i}(p, v_h) + \varepsilon_2) V(v_i) - \lambda_i (b^*_{i}(p, v_h) - \varepsilon_1) < V(v_i) - p.
$$

For example, for an arbitrary infinitesimal $\varepsilon_2 > 0$, let $\varepsilon_1 = \frac{\varepsilon_2}{2\lambda_i} (V(v_h) + V(v_i))$. Then, according to CKIC, the target believes that offer $(b^*_{i}(p, v_h) + \varepsilon_1, \alpha^*_{i}(p, v_h) - \varepsilon_2)$ is submitted by type $v_h$. Since (19) is slack and $\varepsilon_1$ and $\varepsilon_2$ are infinitesimal, the value of offer $(b^*_{i}(p, v_h) + \varepsilon_1, \alpha^*_{i}(p, v_h) - \varepsilon_2)$, as perceived by the target, exceeds $p$. Furthermore, since (21) holds, type $v_h$ is better off buying the target for $(b^*_{i}(p, v_h) + \varepsilon_1, \alpha^*_{i}(p, v_h) - \varepsilon_2)$ than for $(b^*_{i}(p, v_h), \alpha^*_{i}(p, v_h))$, which is a contradiction with the statement that $(b^*_{i}(p, v_h), \alpha^*_{i}(p, v_h))$ is the optimal offer for target $v_h$. Hence, (19) binds. Second, by contradiction suppose that (20) is slack. Since $(b^*_{i}(p, v_h), \alpha^*_{i}(p, v_h)) \neq (b^*_{i}(p, v_h), \alpha^*_{i}(p, v_h))$ and $b^*_{i}(p, v_i) = 0$, it must be that $b^*_{i}(p, v_h) > 0$. Consider a deviation to $(b^*_{i}(p, v_h) - \varepsilon V(v_h), \alpha^*_{i}(p, v_h) + \varepsilon)$ for an infinitesimal $\varepsilon > 0$. Since (20) is slack and $\varepsilon$ is infinitesimal, $(b, \alpha) = (b^*_{i}(p, v_h) - \varepsilon V(v_h), \alpha^*_{i}(p, v_h) + \varepsilon)$ satisfies (18). Therefore, it is perceived as coming from type $v_h$. Hence, the seller values it the same as offer $(b^*_{i}(p, v_h), \alpha^*_{i}(p, v_h))$. Hence, since $(b^*_{i}(p, v_h), \alpha^*_{i}(p, v_h))$ satisfies (19), so does $(b^*_{i}(p, v_h) - \varepsilon V(v_h), \alpha^*_{i}(p, v_h) + \varepsilon)$. However, type $v_h$ is better off buying the target for $(b^*_{i}(p, v_h) - \varepsilon V(v_h), \alpha^*_{i}(p, v_h) + \varepsilon)$ than for $(b^*_{i}(p, v_h), \alpha^*_{i}(p, v_h))$:

$$(1 - \alpha^*_{i}(p, v_h) - \varepsilon) V(v_h) - \lambda_i (b^*_{i}(p, v_h) - \varepsilon V(v_h)) = (1 - \alpha^*_{i}(p, v_h)) V(v_h) - \lambda_i b^*_{i}(p, v_h) + (\lambda_i - 1) \varepsilon V(v_h)$$

$$> (1 - \alpha^*_{i}(p, v_h)) V(v_h) - \lambda_i b^*_{i}(p, v_h),$$

since $\lambda_i > 1$ and $\varepsilon > 0$. Therefore, both (19) and (20) bind. Solving this system of two equations yields $(b^*_{i}(p, v_h), \alpha^*_{i}(p, v_h)) = \left(1 - \frac{\varepsilon_1}{\lambda_i}, \frac{\varepsilon_2}{\lambda_i} + \frac{\varepsilon_1}{\lambda_i} \right)$, where $\gamma = \left(1 + \frac{1}{\lambda_i} \right)^{-1}$.

**Step 3:** Consider $p \leq p^*_{i}(v_i)$. It cannot be that $(b^*_{i}(p, v_i), \alpha^*_{i}(p, v_i)) = (b^*_{i}(p, v_h), \alpha^*_{i}(p, v_h))$. By contradiction, suppose there is such offer $(b_i(p), \alpha_i(p))$. If $\alpha_i(p) > 0$, consider a deviation by type $v_h$ to $(b_i(p) + \varepsilon_1, \alpha_i(p) - \varepsilon_2)$ for infinitesimal $\varepsilon_1 > 0$ and $\varepsilon_2 > 0$ satisfying

$$\varepsilon_2 V(v_h) - \lambda_i \varepsilon_1 > 0 > \varepsilon_2 V(v_i) - \lambda_i \varepsilon_1.$$

For example, for an arbitrary infinitesimal $\varepsilon_2 > 0$, let $\varepsilon_1 = \frac{\varepsilon_2}{2\lambda_i} (V(v_h) + V(v_i))$. Then, according to CKIC, the seller must believe that offer $(b_i(p) + \varepsilon_1, \alpha_i(p) - \varepsilon_2)$ comes from type $v_h$. Since $(b_i(p), \alpha_i(p))$ is valued by the seller at least at $p$, $\varepsilon_2$ and $\varepsilon_1$ are infinitesimal, and $v_h$ exceeds the average of $v_h$ and $v_i$, offer $(b_i(p) + \varepsilon_1, \alpha_i(p) - \varepsilon_2)$ is valued by the seller at more than $p$. Furthermore, since $\varepsilon_2 V(v_h) - \lambda_i \varepsilon_1 > 0$, type $v_h$ is strictly better off acquiring the target for $(b_i(p) + \varepsilon_1, \alpha_i(p) - \varepsilon_2)$ than for $(b_i(p), \alpha_i(p))$. Hence, there is a profitable deviation for type $v_h$, which is a contradiction.

**Step 4:** $p^*_{i}(v_i) = \frac{\mu + \varepsilon_i}{r - \mu} X_i$. Since $(b^*_{i}(p, v_i), \alpha^*_{i}(p, v_i)) = \left(0, \frac{p}{V(v_i)} \right)$, the bidder with synergy $v_i$ bids up to the price $p^*_{i}(v_i)$ at which it is indifferent between acquiring the target for $(0, \frac{p}{V(v_i)})$ and losing the auction:

$$\left(1 - \frac{p^*_{i}(v_i)}{V(v_i)} \right) V(v_i) = V_0,$$

which yields $p^*_{i}(v_i) = V(v_i) - V_0 = \frac{\mu + \varepsilon_i}{r - \mu} X_i$.

**Step 5:** Consider $p \in [p^*_{i}(v_h) - \varepsilon, p^*_{i}(v_h)]$ for an infinitesimal $\varepsilon > 0$. It must be that $(b^*_{i}(p, v_h), \alpha^*_{i}(p, v_h)) =$
\( b_i^* (p, v_h) > 0 \). By the argument in step 2, (19) binds. By contradiction, suppose that \( b_i^* (p, v_h) > 0 \).

Since \( p \in (p_i^* (v_h) - \varepsilon, p_i^* (v_h)) \), \( b_i^* (p, v_h) \) is such that the payoff of the bidder with synergy \( v_h \), \( (1 - \alpha_i^* (p, v_h)) V (v_h) - \lambda_i b_i^* (p, v_h) \), is in the neighborhood of \( V_o \). Consider a deviation to \( (b', \alpha') = (b_i^* (p, v_h) - \varepsilon V (v_h), \alpha_i^* (p, v_h) + \varepsilon) \) for an infinitesimal \( \varepsilon > 0 \). Since \( \varepsilon \) is infinitesimal, \( (1 - \alpha') V (v_h) - \lambda_i b' \) is in the neighborhood of \( V_o \). Since \( v_i < v_h \), we conclude that

\[
(1 - \alpha') V (v_i) - \lambda_i b' < V_o.
\]

Therefore, \( (b', \alpha') \) satisfies (18). In addition, \( (b', \alpha') \) satisfies (17):

\[
(1 - \alpha') V (v_h) - \lambda_i b' = (1 - \alpha_i^* (p, v_h)) V (v_h) - \lambda_i b_i^* (p, v_h) + (\lambda_i - 1) \varepsilon V (v_h)
\]

\[
> (1 - \alpha_i^* (p, v_h)) V (v_h) - \lambda_i b_i^* (p, v_h),
\]

since \( \lambda_i > 1 \). Therefore, offer \( (b', \alpha') \) is perceived as coming from type \( v_h \), and type \( v_h \) is better off deviating to \( (b', \alpha') \) from \( (b_i^* (p, v_h), \alpha_i^* (p, v_h)) \), which is a contradiction. Hence, \( b_i^* (p, v_h) = 0 \). Finally, notice that \( \left( 0, \frac{p}{V (v_h)} \right) \) satisfies CKIC. Indeed, there exists no deviation that benefits type \( v_h \) and satisfies (19), since (19) binds and \( b_i^* (p, v_h) = 0 \).

**Step 6:** \( p_i^* (v_h) = \frac{\Pi_T + \mu}{r - \mu} X_i \). Since \( (b_i^* (p, v_h), \alpha_i^* (p, v_h)) = \left( 0, \frac{p}{V (v_h)} \right) \) for \( p \) close to \( p_i^* (v_h) \), type \( v_h \) bids up to the price \( p_i^* (v_h) \) at which it is indifferent between acquiring the target for \( \left( 0, \frac{p}{V (v_h)} \right) \) and losing the auction:

\[
\left( 1 - \frac{p_i^* (v_h)}{V (v_h)} \right) V (v_h) = V_o,
\]

which yields \( p_i^* (v_h) = V (v_h) - V_o = \frac{\Pi_T + \mu}{r - \mu} X_i \).

**Step 7:** \( (b_i^* (p_i^* (v), v), \alpha_i^* (p_i^* (v), v)) = \left( 0, \frac{\Pi_T + \mu}{\Pi_T + \mu + v_h} \right) \), \( v \in \{ v_l, v_h \} \), and \( (b_i^* (p_i^* (v_l), v_h), \alpha_i^* (p_i^* (v_l), v_h)) = \left( 1 - \gamma_i, \frac{p_i^* (v_l)}{\Pi_T + \mu + v_h} \right) \), where \( \gamma_i = \frac{1}{\lambda_i - 1} \frac{v_h - v_l}{\Pi_T + \mu + v_h + v_l} \). Plugging \( p_i^* (v) = \frac{\Pi_T + \mu}{r - \mu} X_i \) into \( \left( 0, \frac{p_i^* (v)}{V (v)} \right) \) yields \( \left( \frac{\Pi_T + \mu}{\Pi_T + \mu + v_h}, 0 \right) \). Plugging \( p_i^* (v_l) = \frac{\Pi_T + \mu}{r - \mu} X_i \) into the expression for \( (b_i^* (p_i^* (v_l), v_h), \alpha_i^* (p_i^* (v_l), v_h)) \) from step 2 yields the last expression.

**Proof of Proposition 2.** Please refer to the proof of Proposition 3. The case \( \lambda_1 = \lambda_2 \) is discussed at the end of that proof.

**Proof of Proposition 3.** First, we solve the problem under the assumption that the non-initiating bidder participates in all initiated deals. We then characterize parameter restrictions, under which the derived equilibrium exists when the non-initiating bidder chooses whether to participate in the auction strategically.

Taking the derivative of (12) with respect to \( \hat{X} \) and canceling the terms, we obtain

\[
- \beta X^\beta \hat{X}^{\beta - 1} \int_{\hat{X}}^{X_j (X)} s(1 - z) \psi (v_h, v_l) \frac{\hat{X}}{r - \mu} - I \frac{dF (z)}{F \left( \frac{X_j^{-1} (\max_{u \in [0, \hat{X}]} X_u)}{X_j^{-1} (\max_{u \in [0, \hat{X}]} X_u)} \right)} \]

\[
+ X^\beta \hat{X}^{\beta - 1} \int_0^{X_j (X)} s(1 - z) \psi (v_h, v_l) \frac{1}{r - \mu} F \left( \frac{X_j^{-1} (\max_{u \in [0, \hat{X}]} X_u)}{X_j^{-1} (\max_{u \in [0, \hat{X}]} X_u)} \right) \frac{dF (z)}{F \left( \frac{X_j^{-1} (\max_{u \in [0, \hat{X}]} X_u)}{X_j^{-1} (\max_{u \in [0, \hat{X}]} X_u)} \right)}
\]

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The first order condition equates this derivative to zero, which yields
\[
s \psi_i(v_h, v_i) \frac{\dot{X}}{r - \mu} \left(1 - \mathbb{E}[z | z \leq X_j^{-1}(\dot{X})]\right) = \frac{\beta}{\beta - 1} I. \tag{23}
\]

Since $X_j(s)$ is decreasing in $s$, $X_j^{-1}(\dot{X})$ is decreasing in $\dot{X}$. Therefore, the left-hand side of (23) is strictly increasing in $\dot{X}$, taking values from zero to infinity. Hence, given $X_j(\cdot)$, there exists a unique threshold $\dot{X}$ that solves (23). This threshold is a local maximum. Since there is only one local maximum and there are no local minima, it is also a global maximum.

In equilibrium, threshold $\dot{X}$ that solves (23) must be given by $\dot{X}_i(s)$. We obtain a system of two equations:
\[
\dot{X}_i(s) = \frac{\beta}{\beta - 1} \frac{(r - \mu)I}{s \psi_i(v_h, v_i) m(X_i^{-1}(X_i(s)))}.
\]

If the system of two equations has solutions $\dot{X}_i(s)$ and $\dot{X}_j(s)$, then this is an equilibrium, since given $X_j(\cdot)$, threshold $\dot{X}_i(s)$ maximizes the payoff of bidder $i$, as shown in the previous paragraph. Otherwise, no separating equilibrium in continuous threshold strategies exists. For our numerical examples, we establish the existence and uniqueness of the equilibrium numerically.

For the case $\lambda_1 = \lambda_2$, $X_j^{-1}(X_i(s)) = s$, so instead of having a system of two equations, we have a single equation for $\dot{X}_i(s) = \dot{X}(s)$:
\[
\dot{X}(s) = \frac{\beta}{\beta - 1} \frac{(r - \mu)I}{sm(s)\psi(v_h, v_i)}.
\]

Hence, the symmetric equilibrium exists and is unique.

In the above derivations, we made two assumptions:

1. Any non-initiating bidder $i$ always joins the auction initiated at threshold $\dot{X}_j(s)$ for any $s \in [s, \bar{s}]$, $j \neq i$.

2. No bidder $i$ with signal $s$ is better off deviating to a low enough threshold $\dot{X}$ that deters entry of some of the types of the rival bidder.

We follow by deriving restrictions on the parameters of the model, such that these two statements hold as results. The restrictions depend on the expected payoff of the bidder in the auction without the rival bidder. To obtain conditions that guarantee the equilibrium for any possible such payoff, assume that it is the highest possible: If only the initiating bidder joins the auction, it acquires the target for the value of the low-synergy bidder $p^r(v_i)$. In this case, the payoff of a bidder with signal $s$ from initiating the auction at time $t$ is $s \psi_i(v_h, v_i) \frac{\dot{X}}{r - \mu}$.

Consider the first condition. Take a non-initiating bidder $i$ with signal $s$ and an auction initiated by bidder $j$ at threshold $\dot{X} \in [\dot{X}_j(\bar{s}), \dot{X}_j(\underline{s})]$. Using (6), bidder $i$ is better off participating in the auction if and only if
\[
s \left(1 - \dot{X}_j^{-1}(\dot{X})\right) \psi_i(v_h, v_i) \frac{\dot{X}}{r - \mu} \geq I.
\]

The left-hand side is strictly increasing in $s$ and $\dot{X}$. Therefore, it is optimal for a non-initiating bidder $i$ to participate in the auction for any signal $s \in [s, \bar{s}]$ and threshold $\dot{X} \in [\dot{X}_j(\bar{s}), \dot{X}_j(\underline{s})]$ if and only if
\[
s (1 - \bar{s}) \psi_i(v_h, v_i) \frac{\dot{X}_j(\bar{s})}{r - \mu} \geq I.
\]
Plugging in $\hat{X}_j(s)$ from (13),

$$\hat{s} \geq \frac{\beta - 1}{\beta} \frac{\psi_j(v_h, v_l)}{\psi_i(v_h, v_l)} \frac{\hat{s}}{1 - \hat{s}} m\left(\hat{X}_i^{-1}(\hat{X}_j(\hat{s}))\right).$$

Since this condition must hold for each bidder,

$$\hat{s} \geq \frac{\beta - 1}{\beta} \frac{\hat{s}}{1 - \hat{s}} \max\left\{\frac{\psi_i(v_h, v_l)}{\psi_2(v_h, v_l)} m\left(\hat{X}_2^{-1}(\hat{X}_1(\hat{s}))\right), \frac{\psi_2(v_h, v_l)}{\psi_1(v_h, v_l)} m\left(\hat{X}_1^{-1}(\hat{X}_2(\hat{s}))\right)\right\}.$$ (24)

When the two bidders have the same financial constraints, this inequality simplifies to

$$\hat{s} \geq \frac{\beta - 1}{\beta} \frac{\hat{s}}{1 - \hat{s}} m(\hat{s}).$$ (25)

To illustrate, consider our baseline parameters: $\beta = 1.285$, $\bar{s} = 0.25$, and uniform distribution of signals. Then, (25) implies $\bar{s} \geq 0.062$, which is satisfied by our baseline value $\bar{s} = 0.1$.

Consider the second condition. Suppose that bidder $i$ with signal $\hat{s}$ deviates to initiating the auction at threshold $\hat{X} < \hat{X}_i(\bar{s})$. Upon deviation, bidder $j$ perceives the signal of bidder $i$ to be $\hat{s}$. Using (6), bidder $j$ is better off entering the auction if and only if

$$s_j \geq \hat{s}_j\left(\hat{X}\right) = \frac{(r - \mu) I}{\hat{X}(1 - \hat{s}) \psi_j(v_h, v_l)}.$$ (26)

Thus, bidder $j$ with signal $s_j < \hat{s}_j\left(\hat{X}\right)$ does not participate in the auction, i.e., its entry is deterred. Let $U_i\left(s, \hat{X}\right)$ denote the expected payoff at the auction time to bidder $i$ with signal $s$, when bidder $i$ deviates to initiating the auction at threshold $\hat{X} < \hat{X}_i(\bar{s})$:

$$U_i\left(s, \hat{X}\right) = \Pi_B \frac{\hat{X}}{r - \mu} + s \psi_i(v_h, v_l) \frac{\hat{X}}{r - \mu} \left(1 - \int_{[\hat{s}_j(\hat{X})]}^{\hat{s}} z dF(z)\right) - I,$$ (26)

where $[\hat{s}_j(\hat{X})]_\hat{s}$ denotes $\min\left\{\max\left\{\hat{s}, \hat{s}_j\left(\hat{X}\right)\right\}, \hat{s}\right\}$, i.e., $\hat{s}_j\left(\hat{X}\right)$ truncated at $\hat{s}$ from below and at $\hat{s}$ from above. In contrast, bidder $i$’s expected payoff as of this time from following the strategy of initiating the auction at threshold $\hat{X}_i(s)$, if it has not been initiated before, is

$$V_i\left(s, \hat{X}\right) = \Pi_B \frac{\hat{X}}{r - \mu} + \int_{[\hat{s}_j(\hat{X})]}^{\hat{s}} \frac{\hat{X}}{\min\left\{\hat{X}_i(s), \hat{X}_j(z)\right\}} \beta \left(s (1 - z) \psi_i(v_h, v_l) \frac{\min\left\{\hat{X}_i(s), \hat{X}_j(z)\right\}}{r - \mu} - I\right) dF(z)$$

$$= \Pi_B \frac{\hat{X}}{r - \mu} + \max \int_{[\hat{s}_j(\hat{X})]}^{\hat{s}} \frac{\hat{X}}{\min\left\{\hat{X}, \hat{X}_j(z)\right\}} \beta \left(s (1 - z) \psi_i(v_h, v_l) \frac{\min\left\{\hat{X}, \hat{X}_j(z)\right\}}{r - \mu} - I\right) dF(z).$$ (27)

Let us show that it is sufficient to verify that the bidder with signal $\hat{s}$ does not benefit from deviating to initiating the auction at $\hat{X} < \hat{X}_i(\bar{s})$. Suppose that there exists a pair $\left(s, \hat{X}\right)$ at which $U_i\left(s, \hat{X}\right) >$
\[ V_i \left( s, \hat{X} \right) \]. Differentiating (26) and (27) in \( s \), where for the latter we use the envelope theorem:

\[
\frac{\partial U_i \left( s, \hat{X} \right)}{\partial s} = \psi_i \left( v_h, v_l \right) \frac{\hat{X}}{r - \mu} \left( 1 - \int_\hat{s}^{\hat{X}} zdF (z) \right)
\]

\[
\frac{\partial V_i \left( s, \hat{X} \right)}{\partial s} = \psi_i \left( v_h, v_l \right) \frac{\hat{X}}{r - \mu} \int_\hat{s}^{\hat{X}} \frac{\hat{X}^\beta}{\min \{ \hat{X}_i (s), \hat{X}_j (z) \}^{\beta - 1}} (1 - z) dF (z)
\]

\[
< \frac{\psi_i \left( v_h, v_l \right)}{r - \mu} \left( 1 - \int_\hat{s}^{\hat{X}} zdF (z) \right) \frac{\partial U_i \left( s, \hat{X} \right)}{\partial s},
\]

where the first inequality holds from \( \min \{ \hat{X}_i (s), \hat{X}_j (z) \} > \hat{X} \). Therefore, \( U_i \left( s, \hat{X} \right) > V_i \left( s, \hat{X} \right) \) implies \( U_i \left( s', \hat{X} \right) > V_i \left( s', \hat{X} \right) \) for any \( s' > s \). Hence, it is sufficient to verify the condition for the bidder with the highest signal \( \hat{s} \).

Given this, we obtain conditions for \( U_i \left( \hat{s}, \hat{X} \right) \leq V_i \left( \hat{s}, \hat{X} \right) \) for any \( \hat{X} < \hat{X}_i (\hat{s}) \). First, consider \( \hat{X} \geq \frac{(r - \mu) l}{2 (1 - s) \psi_j (v_h, v_l)} \). If bidder \( i \) deviates to initiating the auction at such threshold, all types of bidder \( j \) participate in the auction. Therefore,

\[
U_i \left( \hat{s}, \hat{X} \right) = \Pi_B \frac{\hat{X}}{r - \mu} + \hat{s} \psi_i \left( v_h, v_l \right) \hat{X} \frac{1}{r - \mu} \left( 1 - \int_\hat{s}^{\hat{X}} zdF (z) \right) - I
\]

\[
\leq \Pi_B \frac{\hat{X}}{r - \mu} + \int_\hat{s}^{\hat{X}} \left( \frac{\hat{X}}{\min \{ \hat{X}_i (\hat{s}), \hat{X}_j (z) \}^{\beta}} \left( \hat{s} (1 - z) \psi_i \left( v_h, v_l \right) \frac{\min \{ \hat{X}_i (\hat{s}), \hat{X}_j (z) \}}{r - \mu} - I \right) dF (z),
\]

since \( \hat{X}_i (\hat{s}) \) maximizes \( \int_\hat{s}^{\hat{X}} \left( \frac{\hat{X}}{\min \{ \hat{X}_i (\hat{s}), \hat{X}_j (z) \}^{\beta}} \right)^\beta \left( s (1 - z) \psi_i \left( v_h, v_l \right) \frac{\min \{ \hat{X}_i (\hat{s}), \hat{X}_j (z) \}}{r - \mu} - I \right) dF (z) \) over \( \hat{X} \). Hence, deviation to any \( \hat{X} \in \left[ \frac{(r - \mu) l}{2 (1 - s) \psi_j (v_h, v_l)}, \hat{X}_i (\hat{s}) \right] \) cannot be profitable. Second, consider \( \hat{X} < \frac{(r - \mu) l}{2 (1 - s) \psi_j (v_h, v_l)} \). If bidder \( i \) deviates to initiating the auction at such threshold, types \( s \in \left[ \hat{s}, \hat{s}_j \left( \hat{X} \right) \right] \) choose not to participate in the auction. Then, condition \( U_i \left( \hat{s}, \hat{X} \right) \leq V_i \left( \hat{s}, \hat{X} \right) \) can be re-written as:

\[
\hat{s} \psi_i \left( v_h, v_l \right) \frac{\hat{X}}{r - \mu} \left( 1 - \int_\hat{s}^{\hat{X}} zdF (z) \right) - I
\]

\[
\leq \int_\hat{s}^{\hat{X}} \left( \frac{\hat{X}}{\min \{ \hat{X}_i (\hat{s}), \hat{X}_j (z) \}^{\beta}} \left( \hat{s} (1 - z) \psi_i \left( v_h, v_l \right) \frac{\min \{ \hat{X}_i (\hat{s}), \hat{X}_j (z) \}}{r - \mu} - I \right) dF (z).
\]

Since this condition must hold for all \( \hat{X} < \frac{(r - \mu) l}{2 (1 - s) \psi_j (v_h, v_l)} \), it is equivalent to:

\[
\hat{X} < \frac{(r - \mu) l}{2 (1 - s) \psi_j (v_h, v_l)} \left\{ \hat{X} - \beta \left( \hat{s} \psi_i \left( v_h, v_l \right) \frac{\hat{X}}{r - \mu} \left( 1 - \int_\hat{s}^{\hat{X}} zdF (z) \right) - I \right) \right\} \leq \int_\hat{s}^{\hat{X}} \min \{ \hat{X}_i (\hat{s}), \hat{X}_j (z) \}^{-\beta} \left( \hat{s} (1 - z) \psi_i \left( v_h, v_l \right) \frac{\min \{ \hat{X}_i (\hat{s}), \hat{X}_j (z) \}}{r - \mu} - I \right) dF (z)
\]

(28)
When the two bidders have the same financial constraints, this inequality simplifies to

$$\sup_{\hat{X} < \frac{(x - \mu)^{\beta}}{\beta}} \left\{ \hat{X} - \beta \left( \frac{\hat{X}}{r - \mu} \left( 1 - \int_{\min\{\hat{X}, \bar{s}\}}^{\hat{X}} z dF(z) \right) - I \right) \right\} \leq \left( \frac{\beta - 1}{\beta} \frac{\bar{s}m(\bar{s}) \psi(v_h, v_l)}{(r - \mu)l} \right)^{\beta} \left( \frac{\beta - 1}{\beta} \frac{1 - \mathbb{E}[z]}{m(\bar{s})} - 1 \right) I dF(z)$$

(29)

**Lemma 1.** The only equilibrium in monotone initiation thresholds that can exist is the one in which $\bar{X}_i(s), i \in \{1, 2\}$ is decreasing in $s$.

**Proof.** By contradiction, suppose that $\bar{X}_i(s)$ is not decreasing for some $i \in \{1, 2\}$. Without loss of generality, suppose this is for $i = 1$. Since $\bar{X}_i(s)$ is monotone, there can be two cases: (1) $\bar{X}_i(s)$ is increasing in $s$ for both $i \in \{1, 2\}$; (2) $\bar{X}_i(s)$ is increasing in $s$, but $\bar{X}_2(s)$ is decreasing in $s$. For each case, consider bidder 1 with signal $s_1$ playing the strategy of initiating the auction at threshold $\hat{X}$, if it has not been initiated yet.

First, consider case (1). If $s_2$ is low enough so that $\bar{X}_2(s_2) < \hat{X}$, the auction is initiated by bidder 2 at threshold $\bar{X}_2(s_2)$. The expected surplus of bidder 1 from the auction in this case is

$$s_1 (1 - s_2) \psi_1(v_h, v_l) \hat{X}_1(s_2) \frac{\hat{X}_1(s_2)}{r - \mu}.$$

Otherwise, the auction is initiated by bidder 1 at threshold $\hat{X}$. Its expected surplus from the auction in this case is

$$s_1 (1 - s_2) \psi_1(v_h, v_l) \hat{X}_1(s_2) \frac{\hat{X}_1(s_2)}{r - \mu}.$$

Thus, the expected value to bidder 1 at any time $t$ prior to initiation of the auction is

$$\Pi_B \frac{X_t}{r - \mu} + \left( \frac{X_t}{\hat{X}} \right)^{\beta} \int_{\hat{X}^{-1}(\hat{X})}^{\hat{X}^{-1}(X_1)} \left( \frac{s_1 (1 - s_2) \psi_1(v_h, v_l) \hat{X}_1(s_2)}{r - \mu} - I \right) dF(s_2)$$

$$+ \int_{\hat{X}^{-1}(\hat{X})}^{\hat{X}^{-1}(X_2)} \left( \frac{X_t}{\hat{X}_2(s_2)} \right)^{\beta} \left( \frac{s_1 (1 - s_2) \psi_1(v_h, v_l) \hat{X}_2(s_2)}{r - \mu} - I \right) \frac{dF(s_2)}{1 - F\left(\hat{X}_2^{-1}(\max_{u \in [0, t]} X_u)\right)}.$$  

The optimal threshold $\hat{X}$ maximizes this expected value. Differentiating in $\hat{X}$ and $s_1$ yields

$$- (\beta - 1) X_t^{\beta} \hat{X} - \beta - 1 \int_{\hat{X}^{-1}(X_1)}^{\hat{X}^{-1}(X)} \left( 1 - s_2 \right) \psi_1(v_h, v_l) \frac{\hat{X}}{r - \mu} \frac{dF(s_2)}{1 - F\left(\hat{X}_2^{-1}(\max_{u \in [0, t]} X_u)\right)} < 0.$$  

Second, consider case (2). Since $\bar{X}_2(\cdot)$ is decreasing, the argument of Section 4.3 applies and the payoff to bidder 1 is given by (12). Differentiating in $\bar{X}$ and $s_1$ yields

$$- (\beta - 1) X_t^{\beta} \hat{X} - \beta - 1 \int_{\bar{X}_2^{-1}(X_1)}^{\bar{X}_2^{-1}(X)} \left( 1 - z_2 \right) \psi_1(v_h, v_l) \frac{\hat{X}}{r - \mu} \frac{dF(s_2)}{1 - F\left(\bar{X}_2^{-1}(\max_{u \in [0, t]} X_u)\right)} < 0.$$  

By Topkis’s theorem (Topkis, 1978), the optimal initiation threshold of bidder 1 is decreasing in $s_1$ in both cases, which is a contradiction.

**Proof of Proposition 4.** Let $\zeta_i(x) = \bar{X}_i^{-1}(x)$, i.e., the type of bidder $i$ that initiates the auction at threshold $x$. Note that $\zeta_i(x)$ is only well-defined on $x \in [\bar{X}_i(\bar{s}), \bar{X}_i(\bar{s})]$. To define $\zeta_i(x)$ for all $x > 0$, let
\( \zeta_i(x) = \bar{s}, \) if \( x < X_i(\bar{s}) \), and \( \zeta_i(x) = \bar{g}, \) if \( x > X_i(\bar{g}) \). Then, the system of equations (13) can be written as
\[
\delta_i(x, \zeta_i(x), \zeta_{-i}(x)) = 0, 
\]
for \( i \in \{1, 2\}, \) where
\[
\delta_i(x, \zeta_i, \zeta_{-i}) = x \zeta_i m(\zeta_{-i}) - \frac{\beta}{\beta - 1} \left( r - \mu \right) I \psi_i(v_h, v_l).
\]

The following auxiliary result will be useful to prove the proposition:

**Lemma 2.** \( \frac{\partial \delta_i(x, \zeta_i, \zeta_{-i}) \partial \delta_i(x, \zeta_{-i})}{\partial \zeta_i \partial \zeta_{-i}} - \frac{\partial \delta_i(x, \zeta_i, \zeta_{-i}) \partial \delta_i(x, \zeta_{-i})}{\partial \zeta_{-i} \partial \zeta_i} > 0 \) for any \( x \in [\min_{i \in \{1, 2\}} X_i(\bar{s}), \max_{i \in \{1, 2\}} X_i(\bar{g})] \).

**Proof of Lemma 2.** Take the full derivative of equations \( \delta_i(x, \zeta_i(x), \zeta_{-i}(x)) = 0 \) in \( x \):
\[
\frac{\partial \delta_i}{\partial x} + \frac{\partial \delta_i}{\partial \zeta_i} \zeta'_i(x) + \frac{\partial \delta_i}{\partial \zeta_{-i}} \zeta'_{-i}(x) = 0, \quad i \in \{1, 2\}. 
\]
Multiply the equation for \( \delta_i \) by \( \frac{\partial \delta_i}{\partial \zeta_i} \), the equation for \( \delta_j \) by \( \frac{\partial \delta_j}{\partial \zeta_j} \):
\[
\frac{\partial \delta_i}{\partial x} \frac{\partial \delta_i}{\partial \zeta_i} + \frac{\partial \delta_i}{\partial \zeta_i} \zeta'_i(x) + \frac{\partial \delta_j}{\partial \zeta_j} \zeta'_j(x) = 0; \\
\frac{\partial \delta_j}{\partial x} \frac{\partial \delta_j}{\partial \zeta_j} + \frac{\partial \delta_j}{\partial \zeta_j} \zeta'_j(x) + \frac{\partial \delta_i}{\partial \zeta_i} \zeta'_i(x) = 0.
\]
Subtract the latter equation from the former one, observing that the third term in the first equation and the second term in the second equation cancel out:
\[
\left( \frac{\partial \delta_i}{\partial \zeta_i} \frac{\partial \delta_j}{\partial \zeta_j} - \frac{\partial \delta_j}{\partial \zeta_j} \frac{\partial \delta_i}{\partial \zeta_i} \right) \zeta'_i(x) = \frac{\partial \delta_i}{\partial x} \frac{\partial \delta_i}{\partial \zeta_i} - \frac{\partial \delta_i}{\partial x} \frac{\partial \delta_i}{\partial \zeta_j}.
\]
In our case, \( \frac{\partial \delta_i}{\partial x} = \zeta_i(x) m(\zeta_j(x)) > 0 \); similarly, \( \frac{\partial \delta_i}{\partial \zeta_j} > 0 \). Also, \( \frac{\partial \delta_i}{\partial \zeta_i} = x \zeta_i(x) \frac{\partial m(\zeta_j(x))}{\partial \zeta_j} \leq 0 \) and \( \frac{\partial \delta_j}{\partial \zeta_i} = x m(\zeta_i(x)) > 0 \). Therefore, the right-hand side of (31) is strictly negative. Because \( X_i(s) \) is strictly decreasing in \( s \in [\bar{s}, \bar{g}] \), \( \zeta'_i(x) < 0 \) for any \( x \in [X_i(\bar{s}), X_i(\bar{g})] \). Therefore, \( \frac{\partial \delta_i}{\partial \zeta_i} \frac{\partial \delta_j}{\partial \zeta_j} - \frac{\partial \delta_j}{\partial \zeta_j} \frac{\partial \delta_i}{\partial \zeta_i} > 0 \) for any \( x \in [X_i(\bar{s}), X_i(\bar{g})] \). Because the derivations apply for any \( i \in \{1, 2\} \), we conclude that \( \frac{\partial \delta_i}{\partial \zeta_i} \frac{\partial \delta_j}{\partial \zeta_j} > 0 \) for all \( x \in \left\{ \min_{i \in \{1, 2\}} X_i(\bar{s}), \max_{i \in \{1, 2\}} X_i(\bar{g}) \right\} \), i.e., for all \( x \), at which the auction could occur in equilibrium.

With Lemma 2, we are equipped to prove comparative statics. We use notations \( \zeta_i(x|\theta) \) and \( \delta_i(x, \zeta_i, \zeta_j|\theta) \), where \( \theta \) is the parameter of interest. The derivative of \( \delta_i(x, \zeta_i(x|\theta), \zeta_j(x|\theta)|\theta) \) in \( \theta \):
\[
\frac{\partial \delta_i}{\partial \theta} + \frac{\partial \delta_i}{\partial \zeta_i} \frac{\partial \zeta_i}{\partial \theta} + \frac{\partial \delta_i}{\partial \zeta_j} \frac{\partial \zeta_j}{\partial \theta} = 0.
\]
Multiply the equation for \( \delta_i \) by \( \frac{\partial \delta_i}{\partial \zeta_i} \), the equation for \( \delta_j \) by \( \frac{\partial \delta_j}{\partial \zeta_j} \), then subtract the latter from the former:
\[
\frac{\partial \delta_j}{\partial \theta} \frac{\partial \delta_j}{\partial \zeta_j} \frac{\partial \delta_i}{\partial \zeta_i} \frac{\partial \zeta_i(x|\theta)}{\partial \theta} - \frac{\partial \delta_i}{\partial \theta} \frac{\partial \delta_i}{\partial \zeta_i} \frac{\partial \zeta_i(x|\theta)}{\partial \theta} = \frac{\partial \delta_i}{\partial \theta} \frac{\partial \delta_i}{\partial \zeta_i} \frac{\partial \zeta_i(x|\theta)}{\partial \theta} - \frac{\partial \delta_j}{\partial \theta} \frac{\partial \delta_j}{\partial \zeta_j} \frac{\partial \zeta_j(x|\theta)}{\partial \theta}.
\]
The term in the brackets on the left-hand side is positive by Lemma 2, so the sign of $\frac{\partial \zeta(x|\theta)}{\partial \theta}$ coincides with the sign of the right-hand side. Furthermore, as shown in Lemma 2, $\frac{\partial \delta_i(x, \zeta_i, \zeta_j)}{\partial \zeta_j} \leq 0$ and $\frac{\partial \delta_j(x, \zeta_i, \zeta_j)}{\partial \zeta_j} > 0$.

Therefore, if $\frac{\partial \delta_i(x, \zeta_i, \zeta_j)}{\partial \zeta_j}$ and $\frac{\partial \delta_j(x, \zeta_i, \zeta_j)}{\partial \zeta_j}$ have the same sign for all $x$, $\zeta_i$, and $\zeta_j$, then the sign of $\frac{\partial \zeta_j(x|\theta)}{\partial \theta}$ is the opposite of the sign of $\frac{\partial \zeta_j(x|\theta)}{\partial \theta}$.

Effects of $\sigma$ and $I$. Differentiate $\delta_i$ with respect to $\beta$:

$$
\frac{\partial \delta_i(x, \zeta_i, \zeta_j|\beta)}{\partial \beta} = \frac{1}{(\beta - 1)^2} \left( \frac{r - \mu}{\psi_i(v_h, v_l)} \right) > 0
$$

Therefore, $\frac{\partial \zeta_j(x|\theta)}{\partial \theta} < 0$. Because $\beta$ is decreasing in $\sigma$ and $\sigma$ affects the solution only through $\beta$, $\zeta_i(x)$ is increasing in $\sigma$. Therefore, $\tilde{X}_i(s)$ is increasing in $\sigma$. By the same argument $\tilde{X}_i(s)$ is increasing in $I$.

Effect of $r$. Taking the derivative of $\delta_i(\cdot)$ in $r$:

$$
\frac{\partial \delta_i(x, \zeta_i, \zeta_j|r)}{\partial r} = -\frac{I}{\psi_i(v_h, v_l)} \frac{d}{dr} \left[ \frac{\beta (r - \mu)}{\beta - 1} \right] = -\frac{I}{\psi_i(v_h, v_l)} \frac{d}{dr} \left[ \frac{r + \sigma^2 \beta}{\beta - 1} \right],
$$

where the transformation in the brackets comes from the quadratic equation defining $\beta$, $\frac{1}{2} \sigma^2 \beta (\beta - 1) + \mu \beta - r = 0$. By definition of $\beta$, $\beta$ is strictly increasing in $r$. Therefore, $\frac{\partial \delta_i}{\partial r} < 0$. Hence, $\tilde{X}_i(s)$ is increasing in $r$.

Effect of $\mu$. Similarly to the above, taking the derivative of $\delta_i(\cdot)$ in $\mu$,

$$
\frac{\partial \delta_i(x, \zeta_i, \zeta_j|\mu)}{\partial \mu} = -\frac{I}{\psi_i(v_h, v_l)} \frac{\sigma^2 d \beta}{2 d \mu},
$$

where

$$
d \beta = \frac{1}{\sigma^2} \left[ -1 + \left( \frac{\mu - \sigma^2}{2} \right) \sqrt{\mu - \sigma^2 + 2r\sigma^2} \right] < 0.
$$

Therefore, $\frac{\partial \delta_i}{\partial \mu} > 0$. Hence, $\tilde{X}_i(s)$ is decreasing in $\mu$.

Effects of $v_h$ (holding $v_l$ fixed), $\Pi_B$, and $\Pi_T$. For $\theta \in \{v_h, \Pi_B, \Pi_T\}$, we have

$$
\frac{\partial \delta_i(x, \zeta_i, \zeta_j|\theta)}{\partial \theta} = \frac{\beta}{\beta - 1} \frac{(r - \mu)I}{\psi_i(v_h, v_l)} \frac{d \psi_i(v_h, v_l)}{d \theta}.
$$

For $\theta = v_h$,

$$
\frac{d \psi_i(v_h, v_l)}{dv_h} = 1 - \left( \frac{\Pi_T + \Pi_B + v_l}{\Pi_T + \Pi_B + v_l + \frac{\lambda_i}{\lambda_i - 1} (v_h - v_l)} \right)^2 > 1 - \left( \frac{1}{1 + \frac{\lambda_i}{\lambda_i - 1} \frac{v_h - v_l}{\Pi_T + \Pi_B + v_l}} \right)^2 > 0,
$$

where the first inequality follows from $\Pi_B > 0$. For $\theta = \Pi_B$,

$$
\frac{d \psi_i(v_h, v_l)}{d \Pi_B} = \frac{(\lambda_i - 1)^2 (v_h - v_l) (\Pi_T + v_l)}{((\lambda_i - 1) (\Pi_T + \Pi_B + v_h) + v_h - v_l)^2} > 0.
$$
For \( \theta = \Pi_T \),
\[
\frac{d \psi_i (v_h, v_l)}{d \Pi_T} = \frac{((\lambda_i - 1) \Pi_B + \lambda_i (v_h - v_l)) (v_h - v_l) (\lambda_i - 1)}{(\lambda_i - 1) (\Pi_T + \Pi_B + v_h) + v_h - v_l)^2} < 0.
\]
Hence, \( \frac{\partial \delta_i}{\partial v_h} > 0 \), \( \frac{\partial \delta_i}{\partial \Pi_B} > 0 \), and \( \frac{\partial \delta_i}{\partial \Pi_T} < 0 \). Therefore, \( \bar{X}_i (s) \) is decreasing in \( v_h \) and \( \Pi_B \) and increasing in \( \Pi_T \).

Effects of \( \lambda_i \) and \( \lambda_j \). Differentiating in \( \lambda_i \), we have
\[
\frac{\partial \delta_i (x, \zeta_i, \zeta_j | \lambda_i)}{\partial \lambda_i} = \frac{\beta}{\beta - 1} \frac{(r - \mu) I}{\psi_i (v_h, v_l)^2} \frac{d \psi_i (v_h, v_l)}{d \lambda_i},
\]
where
\[
\frac{d \psi_i (v_h, v_l)}{d \lambda_i} = - \frac{(\lambda v_h - v_l) (\Pi_T + v_l) (v_h - v_l)}{(\lambda_i - 1) (\Pi_T + \Pi_B + \lambda v_h - v_l)^2} < 0.
\]
Furthermore,
\[
\frac{\partial \delta_i (x, \zeta_i, \zeta_j | \lambda_j)}{\partial \lambda_j} = 0.
\]

Since \( \frac{\partial \delta_i (x, \zeta_i, \zeta_j)}{\partial \lambda_i} > 0 \), as shown in Lemma 2, the right-hand side of (32) is positive for \( \theta = \lambda_i \). Hence, \( \bar{X}_i (s) \) is increasing in \( \lambda_i \). As for \( \theta = \lambda_j \), as shown in Lemma 2, \( \frac{\partial \delta_i (x, \zeta_i, \zeta_j)}{\partial \lambda_j} \leq 0 \) with strict inequality for \( x \in [\hat{X}_j (\hat{s}), \min_{i \in \{1, 2\}} \bar{X}_i (\bar{g})] \) and strict equality for \( x \notin [\hat{X}_j (\hat{s}), \min_{i \in \{1, 2\}} \bar{X}_i (\bar{g})] \). Hence, when \( \theta = \lambda_j \), the right-hand side of (32) is positive, if \( x \in [\hat{X}_j (\hat{s}), \min_{i \in \{1, 2\}} \bar{X}_i (\bar{g})] \), and equals zero, otherwise.

Hence, \( \bar{X}_i (s) \) is increasing in \( \lambda_j \) in the range of values at which \( \bar{X}_i (s) \in [\hat{X}_j (\hat{s}), \min_{i \in \{1, 2\}} \bar{X}_i (\bar{g})] \), i.e., which correspond to the rival bidder with some signal approaching the target at the same threshold. If \( \bar{X}_i (s) \notin [\hat{X}_j (\hat{s}), \min_{i \in \{1, 2\}} \bar{X}_i (\bar{g})] \), then \( \bar{X}_i (s) \) is unaffected by a marginal change in \( \lambda_j \).

**Proof of Proposition 5.** Denote \( C_i = \frac{\beta}{\beta - 1} \frac{(r - \mu) I}{\psi_i (v_h, v_l)^2} \); \( C_i > C_j \) if and only if \( \lambda_i > \lambda_j \). By contradiction, suppose that there exists \( s \in [\underline{s}, \bar{s}] \) such that \( \bar{X}_i (s) < \bar{X}_j (s) \). Because \( \bar{X}_i (s) \) and \( \bar{X}_j (s) \) are continuous, either there exists signal \( s' \) satisfying \( \bar{X}_i (s') = \bar{X}_j (s') \) or \( \bar{X}_i (s) < \bar{X}_j (s) \) for all \( s \in [\underline{s}, \bar{s}] \). The former is not possible, because it implies that
\[
\bar{X}_i (s') = \frac{C_i}{s'm(s')} = \frac{C_i}{s'm(s')},
\]
which contradicts \( \bar{X}_i (s') = \bar{X}_j (s') \). It remains that \( \bar{X}_i (s) < \bar{X}_j (s) \) \( \forall s \in [\underline{s}, \bar{s}] \), in particular, \( \bar{X}_i (\bar{g}) < \bar{X}_j (\bar{g}) \). However, it is not possible, because in this case
\[
\bar{X}_i (\bar{g}) = \frac{C_i}{s' m(\bar{g})} = \frac{C_i}{s' m(\bar{g})} > \frac{C_j}{s' m(\bar{g})} = \bar{X}_j (\bar{g}),
\]
which contradicts \( \bar{X}_i (\bar{g}) < \bar{X}_j (\bar{g}) \). The second inequality is due to \( \mathbb{E}[z | z \leq s] > \mathbb{E}[z | z \leq \bar{X}_i^{-1}(\bar{X}_j(s))] \) if \( \bar{X}_i (\bar{g}) < \bar{X}_j (\bar{g}) \). Therefore, \( \bar{X}_i (s) > \bar{X}_j (s) \) \( \forall s \in [\underline{s}, \bar{s}] \).

**Social planner’s problem.** Consider the social planner’s problem of choosing the optimal timing of the auction, given bidders’ signals \( s_1 \) and \( s_2 \). Given \( s_1 \) and \( s_2 \), the probability that the highest bidder has high synergies is
\[
1 - (1 - s_1)(1 - s_2) = s_1 + s_2 - s_1 s_2
\]
It follows that the total expected value from the auction undertaken at time \( \tau \) is \( \frac{X_{v_r}}{r - \mu} (v_l + (v_h - v_l) (s_1 + s_2 - s_1 s_2)) \).
The equilibrium in which the target gets exactly the price at which the losing bidder dropped has true type belief that the target can hold in this subgame. Each type of paying with cash, but also its value could not be perceived worse, since would strictly benefit from deviating to the all-equity bid. Not only would this deviation reduce the cost of paying by the winner if the losing bidder drops out at price \( p \).

No other bid could be incentive compatible for type \( v \). Hence, the optimal threshold at which the social planner prefers to conduct the auction solves:

\[
X^* (s_1, s_2) = \arg \max_X \left( \frac{X}{X} \right)^\beta \left( \frac{\bar{X}}{r - \mu} (v_l + (v_h - v_l) (s_1 + s_2 - s_1 s_2)) - 2I \right) \tag{33}
\]

\[
= \frac{\beta}{\beta - 1} \frac{2I (r - \mu)}{v_l + (v_h - v_l) (s_1 + s_2 - s_1 s_2)}.
\]

To see that (33) can be higher or lower than the equilibrium initiation threshold, consider the model with same financial constraints. In the equilibrium, the auction is initiated at threshold

\[
\bar{X}(\max \{s_1, s_2\}) = \frac{\beta}{\beta - 1} \frac{(r - \mu)I}{\max \{s_1, s_2\} m(\max \{s_1, s_2\}) \psi(v_h, v_l)}, \tag{34}
\]

The comparison of (33) and (34) is equivalent to the comparison of \( 2s_m m(s_m) \psi(v_h, v_l) \) and \( v_l + (v_h - v_l) (s_1 + s_2 - s_1 s_2) \), which can go either way.

**Proof of Proposition 6.** Let the equilibrium strategy of bidder \( i \) with synergy \( v \) be to drop out at price \( p^* (v) \) and to submit bid \((b^* (p, v), \alpha^* (p, v))\), if it wins at price \( p \leq p^* (v) \). By analogy with the model with the binary distribution of synergies,

\[ p^* (v) = V(v) - V_o = \frac{\Pi_T + v}{r - \mu} X_t, \tag{35} \]

i.e., the value of the target as a stand-alone entity plus the value of additional synergies. Consider the payment by the winner if the losing bidder drops out at price \( p \). At this point, the target believes that \( v \in [p^{*-1} (p), v_h] \), where, from (35):

\[ p^{*-1} (p) = \frac{(r - \mu) p}{X_t} - \Pi_T. \]

In the separating equilibrium, the lowest type of the winner takes the efficient action, meaning that type \( p^{*-1} (p) \) submits an all-equity bid:

\[ b^* (p, p^{*-1} (p)) = 0, \quad \alpha^* (p, p^{*-1} (p)) = \frac{p}{V(p^{*-1} (p))}. \]

No other bid could be incentive compatible for type \( p^{*-1} (p) \). If this type submitted any different bid, it would strictly benefit from deviating to the all-equity bid. Not only would this deviation reduce the cost of paying with cash, but also its value could not be perceived worse, since \( p^{*-1} (p) \) is the lowest possible belief that the target can hold in this subgame. Each type \( v > p^{*-1} (p) \) pays a positive amount of cash \( b^* (p, v) \), which is increasing in \( v \). Consider offer \((b, \alpha)\) and fix the target’s belief at \( \bar{v} \). Because the value of \((b, \alpha)\) must at least be \( p \),

\[ \alpha V(\bar{v}) + b \geq p. \]

The equilibrium in which the target gets exactly the price at which the losing bidder dropped has \( \alpha V(\bar{v}) + b = p \). We can back out \( \alpha = \frac{p - b}{V(\bar{v})} \) and write the problem as a signaling problem with one signal \( b \). Given \( b \), the true type \( v \), and the belief \( \bar{v} \), the payoff to the bidder is

\[ U(v, \bar{v}, b) = \left( 1 - \frac{p - b}{V(\bar{v})} \right) V(v) - \lambda b = V(v) - (p - b) \frac{V(v)}{V(\bar{v})} - \lambda b. \]

If the separating equilibrium is differentiable, it can be found by solving the differential equation (e.g.,
Mailath, 1987):

\[ \frac{\partial b^* (p, v)}{\partial v} = - \frac{\partial}{\partial p} U(v, v, b^* (p, v)) = (p - b^*(p, v)) \frac{V'(v)}{(1 - \lambda)V(v)}, \]

subject to the initial value condition \( b^* (p, p^{*-1} (p)) = 0 \). Fixing \( p \), this equation implies

\[ - \log (p - b^*(p, v)) = \frac{1}{\lambda - 1} \log V(v) + C \]

for some integration constant \( C \). Re-writing and imposing the initial value condition \( b^* (p, p^{*-1} (p)) = 0 \) yields

\[ b^*(p, v) = p (1 - \gamma(p, v)), \]  \( (36) \)

\[ \alpha^*(p, v) = \frac{p}{V(v)} \gamma(p, v), \]  \( (37) \)

where \( \gamma(p, v) \equiv \left( \frac{V_v + p}{V(v)} \right)^{\frac{1}{1-\lambda}} \) is the proportion of stock in the total offer value. We need to verify the single-crossing condition to make sure that no type benefits from large deviations:

\[ \frac{\partial}{\partial \bar{v}} U(v, \bar{v}, b) = \frac{V(v)}{V(\bar{v})} - \lambda \frac{V'(v)}{(p - b)V(\bar{v})} = \frac{V(\bar{v})}{(p - b)V'(\bar{v})} - \frac{\lambda V'(v)^2}{(p - b)V(v)V'(\bar{v})}; \]

\[ \frac{\partial}{\partial \bar{v}} U(v, \bar{v}, b) = \lambda \frac{V'(v)^2}{(p - b)V(v)^2 V'(\bar{v})} > 0. \]

Hence, the single-crossing condition is satisfied. Finally, we verify the regularity conditions in Mailath and von Thadden (2013) to ensure that there is no non-differentiable separating equilibrium. Smoothness holds. Consider belief monotonicity:

\[ \frac{\partial}{\partial \bar{v}} U(v, \bar{v}, b) = (p - b) \frac{V'(v)}{V(\bar{v})^2} V'(\bar{v}) > 0, \]

so belief monotonicity is verified. Consider type monotonicity:

\[ \frac{\partial}{\partial v} U(v, \bar{v}, b) = V'(v) - \frac{p - b}{V(\bar{v})} V'(\bar{v}) - \frac{\partial^2}{\partial v \partial \bar{v}} U(v, \bar{v}, b) = \frac{1}{V(\bar{v})} > 0. \]

so type monotonicity is verified. Consider “relaxed” concavity:

\[ \frac{\partial}{\partial \bar{v}} U(v, \bar{v}, b) = \frac{V'(v)}{V(\bar{v})} - \lambda = 1 - \lambda \neq 0. \]

Hence, “relaxed” concavity is satisfied. Finally, it is without loss of generality to restrict \( \bar{b} \leq p \), i.e., to restrict signals to a compact set. Indeed, no equilibrium can feature \( \bar{b} > p \), since the bidder benefits from a deviation to \( \bar{b} = 0 \). Then, according to Theorem 3 in Mailath and von Thadden (2013), the separating equilibrium \( b^* (p, v) \) must be differentiable in \( v \). Hence, (36)–(37) is indeed the unique separating equilibrium.

**Proof of Proposition 7.** Similarly to Proposition 3, we first solve the problem assuming that bidders participate in any initiated auction. We later give sufficient conditions for this to be the case. It is useful
to calculate the payoff of bidder with synergy $v$ if it wins against the rival with synergy $w \leq v$:

$$\psi(v, w) \frac{X_t}{r - \mu} = V(v) - p^*(w) - (\lambda - 1) b^*(p^*(w), v).$$

Hence, the incremental payoff over the stand-alone (or over the losing bidder’s) value is

$$\psi(v, w) \frac{X_t}{r - \mu} = V(v) - p^*(w) - (\lambda - 1) b^*(p^*(w), v) - V_o.$$ 

Note that it is linear in $X_t$.

Suppose that the auction is initiated at time $t$; conjecture a symmetric equilibrium in strictly decreasing initiation thresholds. Let bidder 1 with signal $s_1$ be the initiating bidder. In any hypothetical separating equilibrium of the initiation game, bidder 1 believes $s_2$ is distributed over $[g, s_1]$ with p.d.f. $f(s \mid s_1)$. Consider the expected payoff of bidder 1. The synergy of bidder 1 is a draw from $G(v \mid s_1)$. The synergy of bidder 2 is a draw from $G(v \mid s_2)$. Bidder 1 perceives that $s_2$ is distributed over $[g, s_1]$ with p.d.f. $f(s \mid s_1)$. Hence, given information of bidder 1, the c.d.f. of bidder 2’s synergy is

$$\Pr\{v_2 \leq v\} = \int_{g}^{s_1} G(v \mid s) \frac{f(s)}{F(s_1)} ds = E[G(v \mid s) \mid s \leq s_1].$$

The corresponding density is $E[g(v \mid s) \mid s \leq s_1]$. Hence, the expected payoff of bidder 1 from the auction is

$$\Pi_B \frac{X_t}{r - \mu} + \int_{v_1}^v g(v \mid s_1) \left( \int_{v_1}^v E[g(w \mid s) \mid s \leq s_1] \psi(v, w) \frac{X_t}{r - \mu} dv - I \right) dv - I.$$

Consider a bidder with signal $s$ deciding when to initiate the auction when he expects the rival bidder with signal $z$ to initiate at threshold $X(z)$, where $X(z)$ is a strictly decreasing and differentiable function. If the bidder initiates at threshold $X$, its expected payoff at any time $t$ before initiation is

$$\Pi_B \frac{X_t}{r - \mu} + \int_{2}^{X(z)} \frac{X_t}{X(z)} dv - \frac{dF(z)}{F(X^{-1}(\max_{s \in [g, s]} X_r))} \left( \int_{v_1}^v g(v \mid s) g(w \mid z) \psi(v, w) \frac{X_t}{r - \mu} dw - I \right) \frac{dF(z)}{F(X^{-1}(\max_{s \in [g, s]} X_r))},$$

where we define $X^{-1}(X_0) = s$. We maximize the above expression with respect to $X$ and apply the equilibrium condition that the maximum must be reached at $X = \hat{X}(s)$. Then, we check that we have indeed found the maximum by taking the second-order derivative of the expected payoff and evaluating it at $X = \hat{X}(s)$. All the steps are the same as in the proof of Proposition 3. We obtain:

$$\hat{X}(s) = \frac{1}{\beta - 1} \int_{v_1}^v g(v \mid s) E[g(w \mid z) \mid z \leq s] \psi(v, w) dw.$$ 

Finally, we need to check two conditions to make sure that entry deterrence does not occur:

1. Any non-initiating bidder $i$ always joins the auction initiated at threshold $\hat{X}(s)$ for any $s \in [g, \hat{s}]$, $j \neq i$.
2. No bidder $i$ with signal $s$ is better off deviating to a low enough threshold $\hat{X}$ that deters entry of some of the types of the rival bidder.
Consider the first condition. The non-initiating bidder \( i \) with signal \( s \) is better off participating in the auction initiated at threshold \( \bar{X} \) if and only if

\[
\int_{v_i}^{v_h} \int_{v_i}^{v} g(v|s)g(w|\bar{X}^{-1}(\bar{X})) \frac{\bar{X}}{r-\mu} \psi(v,w)dw \geq I.
\]

Since the left-hand side is strictly increasing in \( s \) and \( \bar{X} \), it is sufficient to verify the condition for \( s = \bar{s} \) and \( \bar{X} = \bar{X}(\bar{s}) \):

\[
\int_{v_i}^{v_h} \int_{v_i}^{v} g(v|\bar{s})g(w|\bar{X}^{-1}(\bar{s})) \frac{\bar{X}}{r-\mu} \psi(v,w)dw \geq \frac{I(r-\mu)}{X(\bar{s})}.
\] (38)

Consider the second condition. Suppose that a bidder with signal \( s \) deviates to initiating the auction at threshold \( \tilde{X} < \bar{X}(\bar{s}) \). By the same argument as in Proposition 3, it is sufficient to verify the condition for the bidder with the highest signal \( \bar{s} \). The rival bidder with signal \( z \) is better off entering the auction if and only if

\[
\int_{v_i}^{v_h} \int_{v_i}^{v} g(v|z)g(w|\bar{X}^{-1}(\bar{s})) \frac{\bar{X}}{r-\mu} \psi(v,w)dw \geq I.
\]

Let \( \tilde{X} \) denote the lowest signal \( z \) at which this inequality is satisfied. Since the left-hand side is strictly increasing in \( z \), the rival bidder enters the auction if and only if \( z \geq \tilde{z}(\tilde{X}) \). Let \( \Upsilon(s,\tilde{X}) \) denote the expected payoff at the auction to the bidder with signal \( s \), if it initiates the auction at threshold \( \tilde{X} < \bar{X}(\bar{s}) \):

\[
\Upsilon(s,\tilde{X}) = \frac{\tilde{X}}{r-\mu} \left( \Pi_B + F(\tilde{z}(\tilde{X})) \int_{v_i}^{v_h} g(v|\bar{s}) \psi(v,w)dw + \int_{v_i}^{v_h} \int_{\tilde{z}(\tilde{X})}^{\bar{s}} g(v|\bar{s}) g(w|\tilde{z}) f(\tilde{z}) \psi(v,w)dw \right) - I.
\]

The second condition is satisfied if and only if

\[
\Upsilon(s,\tilde{X}) \leq V(s,\tilde{X}) \quad \forall \tilde{X} \leq \bar{X}(\bar{s}).
\] (39)
Table 1: Benchmark model parameters

<table>
<thead>
<tr>
<th>Variable</th>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>$r$</td>
<td>Discount rate</td>
<td>0.05</td>
</tr>
<tr>
<td>$\mu$</td>
<td>Growth rate of the state</td>
<td>0.03</td>
</tr>
<tr>
<td>$\sigma$</td>
<td>Volatility of the state</td>
<td>0.25</td>
</tr>
<tr>
<td>$\Pi_B$</td>
<td>Bidder’s cash flow multiple</td>
<td>2</td>
</tr>
<tr>
<td>$\Pi_T$</td>
<td>Target’s cash flow multiple</td>
<td>1</td>
</tr>
<tr>
<td>$I$</td>
<td>Participation cost</td>
<td>1</td>
</tr>
<tr>
<td>$\lambda$</td>
<td>Financial constraint</td>
<td>1.02 (low) or 1.2 (high)</td>
</tr>
<tr>
<td>$\mathbb{E}[s]$</td>
<td>Average signal</td>
<td>0.175</td>
</tr>
<tr>
<td>$F(s)$</td>
<td>Distribution of signals</td>
<td>$\mathbb{E}[s] + \text{Uniform}[-0.075, 0.075]$</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Distribution of synergies only (Sections 2-4)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$v_l$</td>
</tr>
<tr>
<td>$v_h$</td>
</tr>
<tr>
<td>$G(v</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Continuous distribution of synergies only (Section 5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$v_l$</td>
</tr>
<tr>
<td>$v_h$</td>
</tr>
<tr>
<td>$G(v</td>
</tr>
</tbody>
</table>

Table 2: Definitions of expected outcomes for Sections 5.2, 5.3, and 6.1

In definitions, the dependence of equilibrium $\gamma$ on both bidders’ synergies is made explicit. In computation of conditional expected outcomes for the model with binary synergies, we account for the fact that if $v_1 = v_2$, each bidder wins with 50% probability.

<table>
<thead>
<tr>
<th>Quantity</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected share of cash</td>
<td>$\mathbb{E}[1 - \gamma(v_1, v_2)</td>
</tr>
<tr>
<td>Expected size of a cash deal</td>
<td>$\mathbb{E}[\min_{i \in {1, 2}} X_i(s_i)</td>
</tr>
<tr>
<td>Expected size of a stock deal</td>
<td>$\mathbb{E}[\min_{i \in {1, 2}} X_i(s_i)</td>
</tr>
<tr>
<td>Expected premium in a cash deal</td>
<td>$\mathbb{E}[\min_{i \in {1, 2}} X_i(s_i)</td>
</tr>
<tr>
<td>Expected premium in a stock deal</td>
<td>$\mathbb{E}[\min_{i \in {1, 2}} X_i(s_i)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Conditional expected outcomes (Section 5.3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>% deals initiated by $i$</td>
</tr>
<tr>
<td>% deals won by $i$ if initiated by $i$</td>
</tr>
<tr>
<td>Expected share of cash if initiated (won) by $i$ (i)</td>
</tr>
<tr>
<td>Expected share of cash if initiated (won) by $i$ (j)</td>
</tr>
</tbody>
</table>
Figure 1. Timeline of the model.

Figure 2. Equilibrium initiation thresholds. The figure plots the equilibrium initiation threshold $X_i(s)$ as a function of the bidder’s signal for different combinations of its own ($\lambda_i$) and rival’s ($\lambda_j$) financial constraint parameters, constraints ($\lambda_i$) and the rival bidder’s constraint. The thick lines show the equilibrium initiation thresholds when both bidders have the same financial constraints. The thin lines show the equilibrium initiation thresholds when bidders have different financial constraints.
Figure 3. Equilibrium initiation threshold: comparative statics. The figure plots the equilibrium initiation threshold of a bidder with a signal fixed at the expected level, $E[s]$, as a function of various parameters of the model. The parameters are listed in Table 1. The solid (dashed) line is the initiation threshold of a bidder with low (high) financial constraints.

Figure 4. Average fraction of cash in the payment and average timing of cash and stock deals as functions of model parameters. The top panel of the figure plots the expected fraction of cash in the total payment of the acquirer as a function of model parameters. The bottom panel of the figure plots the expected initiation threshold, conditional on the deal being a “cash” deal (more than 50% of the payment is paid in cash; solid line) and a “stock” deal (no more than 50% of the payment is paid in cash; dashed line). We use $\lambda_1 = \lambda_2 = 1.02$. The other parameters are listed in Table 1.
**Figure 5. Initiating versus winning bidders.** The figure plots the probability that the deal is initiated by bidder $i$ (the left panel), the probability that the initiating bidder is the winner (the central panel), and the average fraction of cash in the total payment for different combinations of identities of the initiating and winning bidders (the right panel), as functions of bidder $i$’s financial constraint parameter $\lambda_i$. We use $\lambda_j = 1.02$. The other parameters are listed in Table 1.

**Figure 6. Acquisition premium in the model with continuous distribution of synergies.** The figure plots the average acquisition premium, as a function of parameters, conditional on the deal being a “cash” deal (more than 50% of the payment is paid in cash; solid line) and a “stock” deal (no more than 50% of the payment is paid in cash; dashed line). We vary one parameter and keep the others at the level listed in Table 1. We use $\lambda_1 = \lambda_2 = 1.02$. The dash-dotted line shows the average synergies, divided by the value of the target as a stand-alone.