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Motivated monitors: The importance of institutional investors' portfolio weights ☆

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ABSTRACT

Studies of institutional monitoring focus on the fraction of the firm held by institutions. We focus on the fraction of the institution's portfolio represented by the firm. In the context of acquisitions, we hypothesize that institutional monitoring will be greatest when the target firm represents a significant allocation of funds in the institution's portfolio. We show that this measure is important in reconciling mixed findings for total institutional ownership in the prior literature. The results indicate that our measure of institutional holdings leads to greater bid completion rates, higher premiums, and lower acquirer returns. This empirical evidence provides support for theories predicting a beneficial effect of blockholders in monitoring the firm in general and in enhancing the gains to takeover targets in particular.

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1. Introduction

The importance of large shareholders has been long recognized in the finance literature. Shleifer and Vishny (1986) propose large shareholders as a solution to the free-rider problem of Grossman and Hart (1980). Yet, despite Shleifer and Vishny's explicit prediction that large shareholders can facilitate acquisitions even if they do not initiate them, unambiguous empirical evidence of such a role is absent from the literature, even when focusing on

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institutional blockholdings.[3] Most studies now treat institutional ownership in a realized or potential target as a control variable, that is routinely associated with target premiums that are either positive (Edmans, Goldstein, and Jiang, 2012; Gaspar, Massa, and Matos, 2005), insignificant (Bargeron, Schlingemann, Stulz, and Zutter, 2008; Ayers, Lefanowicz, and Robinson, 2003), or negative (Huang, 2011; Stulz, Walkling, and Song, 1990).[4]

However, when institutions have multiple holdings across firms, they accrue differing benefits to monitoring effort across firms as well. Just as independent directors value their directorships differently and exert more effort on the ones they perceive to be more prestigious (Masulis and Mobbs, 2014), institutions could have incentives to monitor portfolio positions more than others. While an institution could hold a block in a given firm, that firm can represent a small part of the institution's total portfolio. A shareholder, institutional or otherwise, focuses its efforts on its largest holdings. When institutions have differing portfolio weights on an individual firm, total institutional ownership is a noisy measure of the underlying variable of interest: the fraction of the equity held by institutions for which this is a significant holding.

In this paper, we argue that institutions allocate their monitoring effort to a firm based on the relative importance of the firm's stock in their portfolio. We define monitoring institutions as those whose holding value in the firm is in the top 10% of their portfolio. Using three measures based on the size of holdings by monitoring institutions in a given firm, we examine the role of institutional investors in the acquisition process. The acquisition process is an ideal laboratory to study the impact of such institutions because of their theoretically predicted role and the substantial external effects that their monitoring can generate in that setting.

Our results indicate that traditional institutional ownership proxies (measured relative to the target firm's outstanding shares) such as the number of (or the ownership by) blockholders are not related to the probability of deal completion, to the likelihood of bid revision, or to the premium offered for the target firm.

In contrast, we find that the probability of deal completion is increasing in the holdings of monitoring institutions in the target firm. A one standard deviation increase in the ownership of monitoring institutions results in a 6% higher probability of completion. Nonetheless, the presence of these interested monitoring institutions results in higher final premiums and lower acquirer returns. A standard deviation increase in their holdings leads to a 4% higher probability of a bid revision and a 2.9% higher final premium (which translates into an additional $43 million for the average deal value of $1.49 billion). The end result is an acquirer announcement return that is lower by 0.6%. This lower return is economically important. It translates to a value reduction of more than $79 million for the average acquirer in our sample. We also investigate monitoring institutions in the acquirer, noting that most of the improvements from shareholder action that we hypothesize are sensible in the context of the target, not the bidder. Controlling for monitoring institutions of the bidder does not affect our main results and does not incrementally explain bidder returns.

Thus, as the theory predicts, these investors facilitate completion of the deal, but at terms that are more favorable than average for the target. In a way, their presence as a monitoring institution with some negotiating power produces effects similar to those found in Hartzell, Ofek, and Yermack (2004). The difference is that, unlike target Chief Executive Officers (CEOs), they cannot be boughtoff with private benefits, so the benefits they negotiate for completion certainty accrue to all target shareholders.

Given that the terms are less favorable for the bidder, we test whether the presence of more monitoring institutions decreases the frequency of receiving a bid and find that it does. Relative to the 4% unconditional probability of receiving a bid, a standard deviation increase in monitoring institution ownership decreases the probability by 0.6%. Nonetheless, the net effect of lower bid frequency against higher premium and completion rate conditional on a bid is approximately zero in terms of the overall wealth impact on firm shareholders [as shown by unconditional premium regressions following Comment and Schwert (1995)]. This evidence is consistent with the expected effect of monitoring institutions being incorporated into the price of the firms they monitor.

A clear concern is the endogeneity of the shares owned by monitoring institutions. We use exogenous changes in institutional holdings generated by Russell index reconstitutions to establish causality. Also, all of our tests control for the traditional measures of institutional ownership. Further, we extend the results and demonstrate their robustness with an extensive battery of additional tests. Besides confirming robustness, these results are consistent with our hypotheses about monitoring institutions and would be hard to reconcile with alternative explanations. We conclude that, as theory predicts, institutional investors are important to the outcome of an acquisition bid. However, due to limited resources and attention, these effects are present only when the stockholdings themselves are an important part of the institution's portfolio.[5] Thus, our contribution comes both from suggesting a

[3] Recent studies examine the role of specific institutions in special situations. For example, Officer, Ozbas, and Sensoy (2010) find that institutional ownership and premiums are positively correlated in the particular context of club deals (situations in which two or more private equity firms jointly sponsor a leveraged buyout). Likewise, Greenwood and Schor (2009) study a subset of institutions (hedge funds) that endogenously invest in firms to force them into a takeover. They find that such investments exhibit good performance if the firms are eventually acquired.

[4] The mixed results in the literature related to the effect of institutional ownership on takeover premiums obtain under different empirical specifications and alternative ways to proxy for institutional ownership and premiums.

[5] Concurrent work provides evidence that reaffirms this conclusion. Qayyum, Nagel, and Roskelley (2014) find that total payout to shareholders increases with the firm's portfolio importance to institutional investors. Pedersen (2014) finds that firms in which a blockholder has invested a large amount of capital lower the compensation of overpaid CEOs, reduce pay-for-luck for overpaid CEOs, strengthen the relation

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