European Management Journal 34 (2016) 243–257

Contents lists available at ScienceDirect

European Management Journal

journal homepage: www.elsevier.com/locate/emj

Do marketing activities enhance firm value? Evidence from M&A transactions

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A R T I C L E   I N F O

Article history:
Received 5 February 2015
Received in revised form
25 September 2015
Accepted 13 November 2015
Available online 11 December 2015

JEL classification:
M30
G34

Keywords:
Marketing strategy
M&As
Deal premium
Announcement returns
Institutional ownership

A B S T R A C T

In this paper, we use an event study approach and find that aggressive marketing activities of target firms prior to the mergers and acquisitions (M&A) deal are not always compensated with greater premiums and favorable market reactions, which would represent the presence of a potential "window-dressing." Further analysis shows that the positive association between marketing activities and deal performance is conditional on the change in institutional ownership prior to the deal, suggesting that institutional investors cherry-pick good targets with value-enhancing marketing activities. The results hold for both OLS and 2SLS after accounting for potential endogeneity. This paper contributes to the marketing–finance interface literature by providing more precise and direct evidence on how marketing strategies affect firm value.

"In today's more strategically motivated mergers, marketing synergy is a more critical determinant of merger success or failure."——Weber and Dholakia (2000, p. 158).

1. Introduction

Marketing activities have long been excluded from the study of a firm's financial performance. While the firm valuation research in finance has significantly evolved for many years, researchers recently began questioning the competency of the firm valuation that is exclusively based on financial and accounting metrics. For example, Rappaport (1986) notes that the shareholder value is not reliably measured by accounting metrics, giving little credit to empirical evidence. Lev and Zarowin (1999) find that the correlations between stock returns and corporate earnings have become weaker due to the failure to incorporate critical but intangible elements such as marketing efforts. The deteriorating predictive power of analysts is also attributable to a heavy reliance on financial metrics, with less weight on intangible elements (Aksoy, Cooil, Groening, Keiningham & Yalçın, 2008; Gupta, Lehmann, & Stuart, 2004; Hogan et al., 2002).

In response to such concerns, the marketing-finance interface research has in recent years investigated the effects of the firm's marketing strategies on the shareholder value. Anderson, Fornell, and Mazvancheryl (2004), for example, show that customer satisfaction through marketing activities positively affects shareholder value by influencing future customer behavior. Luo (2008) finds that marketing spending prior to initial public offerings (IPOs) helps reduce underpricing and boost trading after the issuance. Luo and Jong (2012) also find evidence that a firm reducing advertising spending is more likely to experience a decrease in abnormal returns, whereas stock analysts play a role in mediating the impact of advertising on stock returns. Consistent with the aforementioned studies, Chemmanur and Yan (2009) argue that product markets are tightly linked to financial markets in terms of marketing, which is not surprising in that investors pick stocks with familiarity (Merton, 1987).

Although earlier empirical studies make important contributions to furthering our understanding of the effects of the

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http://dx.doi.org/10.1016/j.emj.2015.11.004

marketing activities on firm value, such as Tobin's q (Tobin, 1969) and stock returns, the role of product market strategies on financial performance may be endogenously determined. That is, it is statistically too ambiguous to enable us to draw valid conclusions, in general, because marketing is too far removed from firm value and there would be many missing links between those two variables (Luo & Jong, 2012). While asking the same question in this study, we attempt to reduce this problem by focusing on a firm specific event, mergers and acquisitions (M&As), which allows us to provide more precise and direct evidence on the issue using an event study approach.

M&As are one of the most important and largest corporate events that typically involves huge pecuniary transactions. Marketing efforts usually do not reveal any identifiable event date while M&As provide an uncontroversial, clean-cut event window, which is hardly available in other contexts. The high economic significance of the M&As and its consequential strong incentive to exert marketing efforts will make the effect of marketing investments more pronounced, which makes it more opportune to immediately capture the effect of marketing on M&A outcomes. Thus, M&As are well-suited events for our purpose and they offer a natural and unique laboratory in which we can evaluate whether and how marketing activities affect firm value in the well-defined manner. Having more plausible and visible marketing effect around the neighborhood of the event also makes it feasible to more effectively control for potential sources of the endogeneity bias compared to prior literature. Further, our empirical setting allows us to address our questions using market-based performance measures——deal premium and announcement returns——rather than accounting-based measures, which is backward looking. This aspect enables us to evaluate firm value that accounts for investor's assessment in the forward looking manner. We choose M&As as the setting for empirical tests of our hypotheses and can increase our confidence on our results for these reasons.

The rest of the paper proceeds as follows. In Section 2, we review the related literature and develop hypotheses. Section 3 describes the data, variables of interest, and research design. In Section 4, we provide summary statistics and empirical results. We summarize our findings and discuss their implications in the marketing-finance interface literature in Section 5.

2. Related literature and hypothesis development

2.1. Related literature

The literature linking marketing activities and financial performance uses various measures for firm value.[1] First, Tobin's q is a frequently used proxy for financial performance. Anderson et al. (2004), for example, show that customer satisfaction positively affects Tobin's q by influencing future customer behavior. Using the panel analysis, Rao, Agarwal, and Dahlhoff (2004) show that the firm's branding strategy is positively and the mixed branding strategy is negatively correlated with Tobin's q. Ittner and Larcker (1996) find the same conclusion using the return on assets, market-to-book ratio, and price-to-earnings ratio, the last two of which are somewhat similar to Tobin's q.

Another approach is to examine the effect of marketing strategies on stock returns. Fornell, Mithas, Morgeson, and Krishnan (2006) show that a portfolio of firms with greater customer satisfaction, on average, achieves higher returns with lower risk than do major stock market indices. Joshi and Hanssens (2010) find that advertising spending has a positive impact on stock returns. Luo and Jong (2012) find a similar line of evidence that a firm reducing advertising spending is more likely to experience a decrease in abnormal returns, while stock analysts play a role in mediating the impact of advertising on stock returns. Srinivasan, Pauwels, Silva-Risso, and Hanssens (2009) show that adding marketing actions to the finance benchmark model significantly improves the explanatory power for stock returns, concluding that the stock market benefits from pioneering innovations.

The impact of marketing on firm volatility or risk has also been investigated. McAlister, Srivinasan, and Kim (2007) test the relationship between advertising and R&D expenditures, and firm systematic risk, derived from the capital asset pricing model (CAPM). Gruca and Rego (2005) report that customer satisfaction, as a fundamental value driver through marketing actions, increases the growth of future cash flows and reduces its variability. Luo (2007) tests the harmful impact of consumers' negative voice on stock returns. He finds that the negative voice of current consumers significantly increases the idiosyncratic risk of stock returns.

The last strand of approach regarding the relationship between marketing strategies and firm value is to test corporate events or governance, to which our paper belongs. Examining 133 M&A deals, Bahadir, Bharadwaj, and Srivastava (2008) show that both the acquirer's and target's marketing capabilities positively affect the value of the target's brands. Luo (2008) finds that marketing spending prior to initial public offerings (IPOs) helps reduce underpricing and boost trading after the issuance. Luo, Zhang, Zhang, and Aspara (2014) study the relevance of customer satisfaction information for IIs. They show evidence that an increase in customer satisfaction is more attractive for transient IIs. We extend this strand of literature. This study focuses on a firm specific event, mergers and acquisitions, allowing us to provide more precise and direct evidence on the effect of marketing with regard to financial performance. Unlike the empirical settings in most of the prior studies, M&As provide an unambiguous event window in which the effect of marketing activities can be more cleanly captured.

2.2. Hypothesis development

In this paper we examine whether marketing activities enhance firm value in M&A transactions. Specifically, we raise three main questions: i) what determines the degree of marketing activities on the side of the target firm in relation to the M&A; ii) whether marketing activities represent value enhancement——positive M&A outcomes——or window dressing/overinvestment problems; iii) whether institutional ownership results in a pro-marketing effect.[2] Based on our M&As sample in which we study the effect of marketing activities on firm value, we relate marketing and advertising spending to our measures of the M&A performance: deal premium and announcement returns using CARs (cumulative abnormal returns).

In the M&A literature, great efforts have been made to further our understandings on the nature of deal premium and announcement returns. Prior research has examined deal premium and announcement returns in the perspective of agency costs, firm characteristics, and economic conditions (e.g., Bates, Becher, &

[1] A body of research uses accounting-based measures of firm performance although they receive criticism that these accounting measures do not adequately measure firm value. Accounting-based measures include sales, operating margin, accounting returns, and return on investment (Anderson, Fornell, & Rust, 1997; Bolton, 1998; Ittner & Larker, 1998; Leone, 1995; Rust, Zahorik, & Keiningham, 1995; Zeithaml, 2000).

[2] Literature has confirmed that institutional ownership has a desirable effect in several contexts. See Section 2.2.3 for detailed discussions.