



Determinants and implications of arbitrage holdings in acquisitions [☆]

Jim Hsieh^a, Ralph A. Walkling^{b,*}

^aGeorge Mason University, School of Management, MSN 5F5, Fairfax, VA 22030, USA

^bOhio State University, Fisher College of Business, Faculty of Finance, 2100 Neil Ave, Columbus, OH 43210, USA

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Abstract

We find evidence of passive and active roles for arbitrageurs in the acquisition process. Using a simultaneous-equation framework to recognize endogeneity, we analyze 608 acquisition bids over the 1992–1999 period. Our results indicate that the change in arbitrage holdings is greater in successful offers. However, changes in arbitrage holdings are also related to the probability of success, bid premia, and arbitrage returns. In addition, the change in arbitrage holdings is positively associated with both revision returns and the occurrence of subsequent bids. Overall, we find that merger arbitrageurs play an important role in the market for corporate control.
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*Corresponding author. Tel.: +1 614 292 1580; fax: +1 614 292 2418.

E-mail address: walkling.1@osu.edu (R.A. Walkling).

1. Introduction

Nearly 15 years after the era of Ivan Boesky, the role of arbitrageurs in the acquisition process is receiving renewed attention in the financial literature. Existing empirical studies report significant and substantial positive arbitrage returns (see, e.g., [Dukes et al., 1992](#); [Karolyi and Shannon, 1999](#); [Mitchell and Pulvino, 2001](#); [Baker and Savasoglu, 2002](#); [Jindra and Walkling, 2004](#)). However, the role of arbitrageurs in the acquisition process remains unclear. [Larcker and Lys \(1987\)](#) suggest a passive role for arbitrageurs, arguing that superior ability to predict offer outcomes leads to their abnormal returns.

Recent theoretical work by [Cornelli and Li \(2002\)](#) and [Gomes \(2001\)](#) suggests an active role for arbitrageurs. Cornelli and Li develop an information-based model in which the information advantage that an arbitrageur possesses arises from his or her own holdings, and these holdings influence offer outcomes and deal characteristics. Gomes shows that arbitrageurs are capable of attaining hold-out power by accumulating large blocks of target shares. This potential threat forces bidders to offer higher takeover premia ex-ante. Thus, while the existing empirical literature demonstrates positive abnormal returns to arbitrage, the theoretical studies suggest testable hypotheses concerning the active involvement of arbitrageurs in the takeover process. In particular, Cornelli and Li and Gomes suggest that the change in arbitrage holdings is positively related to both the probability of deal success and the level of bid premia.

The primary objective of our research is to examine the role of arbitrageurs in the takeover process, testing empirical implications of [Larcker and Lys](#), [Cornelli and Li](#), and [Gomes](#) while controlling for the inherent endogeneity of key acquisition characteristics. We also investigate the factors that motivate arbitrage trading during acquisitions and the relation between arbitrage holdings and key takeover variables such as bid premia and arbitrage returns. As one example, a higher level of holdings can facilitate a takeover and provide greater arbitrage returns. Alternatively, increased competition among arbitrageurs could reduce returns. In the model of [Cornelli and Li](#), arbitrageurs' profits initially increase when more arbitrageurs decide to participate. However, at some point, profits decline with increased competition among arbitrageurs.

Our methodology relies on an empirically based definition of arbitrageurs similar to that of [Baker and Savasoglu \(2002\)](#): Arbitrageurs are defined as those institutions that regularly increase their holdings of firms targeted for acquisition. Analyzing 608 offers over the 1992 to 1999 period, we find empirical evidence of an endogenous link among the changes in arbitrage holdings, bid premia, arbitrage returns, and offer outcomes. Arbitrage holdings increase in offers that are likely to be successful, even after controlling for the market's assessment of offer success. This is consistent with the work of [Larcker and Lys \(1987\)](#). At the same time, the change in arbitrage holdings is positively correlated with the probability of bid success, bid premia, and arbitrage returns. Thus, our results are consistent with both passive and active roles played by arbitrageurs. To the best of our knowledge, this is the first evidence to test the active influence of arbitrageurs and contrast the passive versus active arbitrage models.

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