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Role of single largest investors: Examples of mutual funds and acquisitions

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This study investigates the effect of collective holding by the largest mutual fund management company in acquiring companies on acquirers' post-event valuation. We find that total holdings by mutual funds is not a superior proxy to predict the acquiring firms' post-event valuation; however, the collective holding by the largest mutual fund management company in acquiring firms is significantly positively related to the valuation of acquiring firms.

1. Introduction

It has long been argued that institutional investors' monitoring role is important in corporate financial decisions, such as antitakeover amendments, investment decisions, management compensation and M&A announcements (Agrawal and Mandelker, 1990; Borokhovich et al., 2006; Brickley et al., 1988; Bushee, 1998; Chen et al., 2007; Fich et al., 2014; Hartzell and Starks, 2003). Previous studies typically use total holding by institutional investors (or holding by blockholders) as key proxy in their studies, and assuming higher holdings by all institutional investors and more blockholders in the firms will likely have positive effect on their invested firms. However, monitoring has costs, it includes the

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cost of gathering necessary information and influence managerial decisions, as well as coordination cost within various institutions (Chen et al., 2007). The coordination cost is severe when institutions have different investment philosophy, or even compete with each other,[2] thus total institutional ownership maybe a noisy measure of the role played by institutional investors (Fich et al., 2014). Given the potential cost of monitoring, the existing empirical evidence provides mixed evidence on the monitoring role of institutional investors, see for example: (Chen et al., 2007; Edmans, 2009; Hartzell and Starks, 2003).

In this study, we examine the influence of a specific large, independent institutional investor on firm's acquisition behavior. We argue that although the level of holding by a single institutional investor is low, this institutional investor may still have big impact on its target company through either effective monitoring or "threat of exit" from this institution. Both the effectiveness of monitoring and power of "threat of exit" can be further strengthened by increasing level of holding in the target company, which can help this "top" institution to further reduce the coordination cost among various institutions in this target company. In the event that the managerial teams' decision may potentially destroy shareholder value, this large and independent institutional investor has more incentives to correct inefficient management decision due to less "coordination cost" and less "free-rider" problem. Thus, understanding the potential monitoring role of a leading institution within a specific type of institutional investors is, therefore, of particular important to market regulators and other participants.

This paper focus on institutional ownership in M&A process, because acquisition process is an ideal laboratory to study the impact of such institutions, due to the substantial wealth effects that their monitoring can generate in that settings (Fich et al., 2014). Moreover, the acquisition process is frequently subject to a range of challenges from both market regulators and various stakeholders, the action of large institutional investors will have significant impact on the eventual outcome of acquisition process (Deng et al., 2013). In addition to the monitoring role, mutual funds may also help firms' acquisition activities through two main mechanisms. First, they can facilitate the deal approval by the board/government regulation agency, as the mutual fund ownership signals good governance, higher accounting quality and more transparency. Second, they can provide the financing by participating in the bidder's eventual Seasonal Equity Offering (SEO).

Unlike previous studies, we focus on the collective holding by the largest mutual fund management company **(thereafter, LgFund)**, rather than the total holding by all mutual fund investors, in order to emphasize the role of a leading institution within mutual funds investors. Using a sample of 446 acquisitions in China, we find that total holdings by mutual funds is not a superior proxy to predict the acquiring firms' post-event valuation; however, collective holding by the LgFund in acquiring firms is significantly positively related to the acquiring firms' valuation. The larger the LgFund's holdings, the higher the acquirer's post-event valuation. This dynamic is consistent with institutional investors' success in playing an efficient monitoring role. Upon examining the relationship between the LgFund and acquirer valuation, we also find that fewer mutual fund management companies in acquiring firms will generate higher post-event acquirer valuations. This finding also supports the view that lower coordination costs will improve the monitoring role of mutual funds as well as firm performance.

This paper builds on and contributes to two main strands of literatures. First, our study is complementary to voluminous studies that explore the role of institutional investors, such as (Brickley et al., 1988; Agrawal and Mandelker, 1990; Bushee, 1998; Hartzell and Starks, 2003; Borokhovich et al., 2006; Chen et al., 2007; Fich et al., 2014). However, our approach is different in that we focus not on total holding by mutual fund investors, but instead on the collective holding by the largest mutual fund management company (LgFund), for the reason of the potential coordination cost within different mutual fund companies.

In addition to the literature on corporate governance of institutional investors, this paper is related to the mergers and acquisition literature. Prior research has evaluated the success and performance of M&A by studying the short term abnormal return and long-term performance. The vast majority of their research focuses on deal or firm characteristics, such as method of payment, leverage, and

[2] Mutual fund tends to compete with each other on profits and on their annual ranking.