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The effect of bidder conservatism on M&A decisions: Text-based evidence from US 10-K filings☆

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ABSTRACT

This paper examines whether and how bidders' conservative tone in 10-K filings influences the subsequent mergers and acquisitions (M&A) investment decisions of these US firms from 1996 to 2013. Based on 39,260 firm-year observations, we find, consistent with behavioural consistency theory, that conservative bidders are less likely to engage in M&A deals. Further, those that decide to engage in M&As are likely to acquire public targets and within-industry firms. These bidders are inclined to employ more stock acquisitions than cash acquisitions. Our results also indicate that conservative bidders experience abnormally poor stock returns around the announcements of M&A investments. This provides new insights on the mechanism through which bidders' sentiments influence shareholders' wealth. Overall, these findings highlight the implications of the textual sentiment of corporate disclosure for the forecasting of corporate investment and financing decisions. Our results have practical implications, since they shed light on the value relevance of the information content of major Securities Exchange Commission (SEC)-mandated 10-K filings.

1. Introduction

The textual analysis of corporate disclosure provides insights into managerial expectations and identifies important qualifiers and caveats that are absent from financial measures (Loughran & McDonald, 2015a). Barber and Odean (2008), Engelberg and Parsons (2011) document that the sentiment of qualitative corporate news drives market trading. Feldman, Govindaraj, Livnat, and Segal (2010) find that the disclosure tone of the 10-K has incremental information content beyond that of financial measures. Loughran and McDonald (2011) observe that firms that convey more negative tones in their 10-K filings experience negative market reactions around the filing dates. Arnold, Fishe, and North (2010) quantify the words used in the risk factors sections of IPO prospectuses and find that they capture most of the IPO returns. Yan (2015) shows that the tone of 10-Ks gives accurate predictions of firms' long-term performance. Thus, extant literature suggests that words selected by managers in textual corporate communications have significant predictive power for firms' future stock returns, earnings, and performance. However, relatively little is known about whether the sentiment of corporate disclosure could be employed to anticipate investment activity. This paper addresses this gap by investigating the impact of textual sentiment on corporate mergers and acquisitions (M&A) investment decisions.[1]

Further, Ferris, Hao, and Liao (2013) introduce the concept of issuer conservatism, measured as the proportion of negative words in the IPO prospectus. They find that issuer conservatism is inversely related to

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[1] Kearney and Liu (2014) argue that the textual sentiment of corporate disclosure provides a good reflection of firms' internal and external conditions and thus has significant power to explain subsequent corporate investment decisions.

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subsequent operating and stock return performance.[2] We adopt the same proxy of the proportion of negative tone in the 10-K to examine the effect of textual conservatism on M&A decisions. M&A deals constitute one of the most strategic investment decisions, with substantial effects on firms' current and future value (Custódio & Metzger, 2013). The 10-K is a major and critical public document that provides a comprehensive review of corporate policies and practices. It is also more informative than any other business communication (Loughran & McDonald, 2014). Consequently, this paper examines the impact of cautionary language in 10-K reports (henceforth bidder conservatism) on subsequent M&A decisions.[3]

Cronqvist, Makhija, and Yonker (2012) argue that, consistent with the notion of the endogenous matching of managers with firms' mechanisms, firms choose managers with characteristics that fit their own beliefs and behaviours. They find that CEOs who are more conservative in terms of their personal leverage are optimal at managing firms with more conservative debt policies. They further observe that a firm may even replace a CEO with another who has the same attributes and behaviours. Accordingly, examining the information content of the 10-K provides a strong understanding of board, manager and firm-matched traits and their implications for future investment decisions. In view of the nature of M&A deals, which require intense board-manager discussions in the bid for final approval (Levi, Li, & Zhang, 2014), such deals constitute an ideal platform on which to test the ex-ante impact of bidder conservatism on M&A investment decisions. These M&A investment decisions include the likelihood of making an acquisition, the type and size of acquisitions (public vs. non-public, within-industry vs. cross-industry targets), the payment method, and how the market perceives those investment decisions.

Behavioural consistency theory states that the behaviour of an individual in one situation could forecast his/her future behaviours in other situations (Funder & Colvin, 1991). Motivated by this theory, we posit that managers who convey a conservative tone in their 10-K filings can be expected to later make conservative corporate decisions. Conservative behaviour is defined as opposition to change and a tendency toward risk aversion (Wilson, 2013). On the other hand, M&As are viewed as risky investments due to the uncertainty associated with forecasting their outcomes (Levi et al., 2014).[4] Thus, we expect that bidders with a prior conservative tone will be less likely to engage in M&A activities. Further, bidders might have better access to the information needed to estimate the real value of public targets than that required for non-public targets (Capron & Shen, 2007). Consequently, we posit that conservative bidders will want to avoid the uncertainty and asymmetry of information related to acquiring non-public targets. Similarly, we expect that conservative bidders will prefer to acquire familiar and same-industry targets rather than risky, industrially-diversified acquisitions.[5] Eckbo (2009) documents that bidders prefer stock financing if there is more uncertainty about the target. Consequently, we conjecture that conservative bidders are likely to engage in stock acquisition deals. Prior literature (i.e.Ferris et al., 2013; Loughran & McDonald, 2011; Tetlock, 2007) documents that the market reacts negatively to a conservative tone in different business communications. Accordingly, we expect that conservative bidders will experience negative market reactions around the announcements of M&A deals.

Based on 39,260 firm-year observations over the period between January 1996 and December 2013, we find significant evidence that firms with a more negative tone in their prior 10-Ks are less likely to be involved in subsequent acquisitions and have a small portion of M&A investments. This confirms our conjecture that conservative behaviour is related to risk-averse attitudes and a lower tendency to invest in risky investments such as M&As. We further find that, conditional on the making of acquisitions, conservative bidders are more willing to acquire public targets. This might be due to information asymmetry between public and non-public firms (Capron & Shen, 2007). In addition, these firms prefer to pursue within-industry acquisitions. This finding is consistent with the proposition that corporate conservatism is more inclined towards familiar and safe than unfamiliar stimuli (Glasgow, Cartier, & Wilson, 1985). Our results also indicate that conservative bidders prefer stock acquisitions over cash acquisitions. Finally, we find that these firms experience a negative market reaction after engaging in these kinds of investments. This supports the notion that the sentiment of qualitative corporate reports drives market trading (e.g.Barber & Odean, 2008; Engelberg & Parsons, 2011).

Our paper contributes to the area of the information content and value relevance of Securities Exchange Commission (SEC)-mandated filings, the 10-K. To the best of our knowledge, no previous study has explored the link between the sentiment of corporate disclosure and subsequent corporate investment decisions in the context of M&As. We provide novel evidence that cautionary language plays a significant role in predicting the likelihood of a firm making an acquisition, and its value. These findings support the prior premises that conservative behaviour is associated with risk aversion and preserving the status quo. Similarly, we add to the literature by showing that the textual analysis of 10-Ks provides significant predictive power for not only the likelihood, but also the type and size, of subsequent acquisitions. These findings confirm the ability of the non-financial information revealed in the narrative sections of 10-Ks to forecast managers' decisions regarding M&As. They also add to the emerging evidence on the usefulness of SEC filings, including 10-Ks (Loughran & McDonald, 2011, 2014, 2015a).

We contribute to a growing literature that uses text analysis in finance, by investigating the implications of bidders' pre-textual sentiment for the anticipation of sources of finance in M&A deals. We observe that bidders that use a conservative tone in their corporate disclosure also have conservative financing policies. Our findings provide new evidence to support the proposition of behavioural consistency theory that individuals behave in a consistent way across different situations (Funder & Colvin, 1991). Further, this paper provides novel evidence on the interdependence between corporate disclosure and shareholders' wealth. We find evidence that soft information embedded in the descriptive sections of the 10-Ks plays a significant role in how the market evaluates firms' stock returns after they have engaged in M&A events. Collectively, these results confirm that a conservative tone in bidders' 10-Ks conveys information that is economically relevant to the prediction of corporate M&A decisions.

Our findings have several implications for both theory and practice in the area of corporate disclosure and behavioural finance. First, with regard to theory, our results provide some insights on the implications of bidders' sentiment and attitude for future M&A investment choices. Our findings reveal that investors and stakeholders might not be able to fully grasp corporate policies and decisions unless they carefully analyse the sentiment of the narrative sections of the 10-K. This suggests the interesting possibility that major corporate investment decisions are derived from more than traditional economic trade-offs and incentives. It also confirms that the textual sentiment of the 10-K enables us to gain an in-depth understanding of firms' conditions, private information, managers' incentives, and expected behaviours by seeing the world through their eyes. Besides this, managers should comprehend the mechanism through which their corporate communications influence their firms' value and shareholders' wealth. They should assess their prior negative disclosure tone before engaging in M&A deals, since

[2] In line with that, Tetlock et al. (2008) find that the proportion of negative words in firms' specific news stories forecast firms' future earnings and returns above and beyond stock analysts' forecasts and historical accounting data.

[3] We focus on the negative tone of firms' 10-K filings, since our main independent variable is bidder conservatism, which is proxied by the ratio of negative words to total words, as in Ferris et al. (2013).

[4] Potential outcomes of M&As might be positive, negative or even losses that exceed the initial investment value (Christensen et al., 2014). For instance, Microsoft Corporation experienced a loss of $12.6 billion in their market value after announcing they had acquired Nokia's mobile phone business for $7.2 billion (Amihud, DeLong, & Golubov, 2013).

[5] Berger and Ofek (1995) report that, in 1995, multiple-segment firms with valuation discounts experienced total value losses of $800 billion. This issue is known as a diversification discount problem.