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The market valuation of M&A announcements in the United Kingdom☆

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ABSTRACT

This paper investigates the short-term market reaction to UK acquirers announcing domestic and foreign mergers and acquisitions (M&As) from 2000 to 2010. We define acquirers as value, moderate and glamour acquirers based on equally weighted market-to-book terciles. We find that value acquirers outperform glamour acquirers during and after the M&A announcement. We also focus on the impact of institutional ownership and find that higher domestic, foreign and total institutional ownership leads to lower market reaction to M&A announcements. We also find that long-term institutional investors lead to a higher post-announcement market performance. Finally, we find that greater domestic institutional ownership mitigates the typical poor short-term performance following M&A announcements of glamour acquirers.

1. Introduction

A surge in M&A activity since the 1990s has imitated an extensive literature that addresses a number of issues surrounding M&As. For instance, Andrade, Mitchell, & Stafford (2001) show that shares is a preferred method of payment while Shleifer & Vishny (2003) suggest that acquirers use their overvalued equity in order to acquire targets and their respective assets at a discount. Emery & Switzer (1999) suggest that acquirers exploit information asymmetries for selecting the deal payment method with expectations of higher abnormal returns. Therefore, the choice of payment method of M&As can significantly influence the shareholders' wealth at the time of the M&A announcement and during the post-merger period.[1] Evidence in the literature supports the asymmetric information hypothesis that acquirers with cash offers experience higher abnormal returns than acquirers with share offers. Berkovitch & Narayanan (1990) report that both bidder and target firms have higher returns with cash payments compared to equity payments. Similarly, Houston & Ryngaert (1997) find that acquirers outperform when a greater proportion of cash is used for acquiring target firms.

Moeller, Schlingemann, & Stulz (2007) find a negative relationship between information asymmetry and the stock performance of acquirers of public firms. Andrade et al. (2001) show that acquirers using shares in the M&A payment, have a negative stock performance over the three days surrounding the M&A announcement, while acquirers with pure equity financing have a small positive performance. Moreover, acquirers that use stock as payment for M&As significantly underperform over a five year period compared to acquirers that use cash as the payment method (Loughran & Vijh, 1997). However, using equity as payment for M&As benefits acquirers during the announcement period when targets are difficult to value – especially private targets (Officer, Poulsen, & Stegemoller, 2009). Therefore, a stock payment can mitigate the potential risk of a target firm being overvalued.

While cross-border M&As can be an important entry mode for foreign markets they are related to higher levels of risk and uncertainty for both acquirers and targets. The wealth effects of cross-border M&As are lower compared to domestic M&As (Goergen & Renneboog, 2004). Cakici, Hessel, and Tandon (1996) find that while US acquirers do not gain from cross-border M&As, foreign firms acquiring US targets have a significant and positive market performance, in line with Akhigbe & Martin (2000). Moreover, Black, Carnes, Jandik, & Henderson (2007) report that US acquirers engaging in cross-border M&As experience significantly

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[1] Announcement returns to shareholders vary significantly across different samples and periods. See Kennedy & Limmack (1996); Sudarsanam, Holl, & Salami (1996); Rau & Vermaelen (1998); Akhigbe & Martin (2000); Sudarsanam & Mahate (2003); Conn et al. (2005); and Freund et al. (2007).

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negative long-run post-merger abnormal returns. However, Francoeur (2006) finds that Canadian firms acquiring foreign targets create great efficiency gains and increase their shareholder value while there are no sustained gains or losses for domestic M&As. In the UK, Conn, Cosh, Guest, & Hughes (2005) report negative announcement and post-announcement returns for domestic and public M&A targets, zero announcement returns and negative post-merger returns for cross-border public deals, and positive announcement returns for private targets. Meanwhile, foreign acquirers with UK targets have negative announcement returns (Danbolt, 1995), and UK firms acquiring domestic targets outperform their counterparts that acquire US and European targets (Aw & Chatterjee, 2004).

In the UK, which is the focal point of this study, the majority (approximately 80%) of target firms are privately held companies (Chang, 1998; Draper & Paudyal, 2008). Chang (1998) argues that takeovers of private targets via share payment tend to create large block shareholders as the ownership of private targets is highly concentrated. It is widely documented that large shareholders and institutional investors in particular can significantly influence firms' decision making and especially on M&As (Ambrose & Megginson, 1992; Andriosopoulos & Yang, 2015; Chen, Harford, & Li, 2007; Ferreira, Massa, & Matos, 2010; Stulz, Walkling, & Song, 1990). Moreover, institutional investors can be active investors and discourage poor decisions made by entrenched managers (Bushee, 1998; Duggal & Millar, 1999; Hartzell & Starks, 2003; Jensen, 1991). The shareholdings of institutional investors in the US and the UK has increased significantly since the 1990s (Aguilera, Williams, Conley, & Rupp, 2006) with approximately 50% of the UK equity markets being held by institutional investors (Andriosopoulos & Yang, 2015). Nevertheless, UK managers are more restricted compared to their US counterparts due to the greater influence and monitoring of institutional investors (Short & Keasey, 1999).

In support of the monitoring argument, the positive relationship between acquirer firms' stock returns with share payments and the new block shareholders from the target company suggests that large shareholders are effective monitors (Chang, 1998). Duggal & Millar (1999) report a positive relationship between institutional ownership and acquirers' abnormal returns in the US but argue this positive relationship is driven by firm size and the acquirers' listing on the S&P 500 index, casting doubt on the active monitoring role in the M&As' transactions. However, Kohers & Kohers (2001) show that acquirers with higher institutional ownership have superior post-merger long-run performance. Meanwhile, institutional investors have a significantly lower share turnover rate in the UK compared to the US (Aguilera et al., 2006; Black & Coffee, 1994) suggesting they can have a key role in the monitoring of firms and firms' decision making.

We assess the monitoring role of institutional ownership on acquirers' performance reflected by the market reaction during the announcement period of M&As and the short-term post-announcement period. Moreover, we delve deeper into the impact of institutional ownership by splitting institutional ownership between domestic and foreign investors. We find that total, foreign, and domestic institutional ownership has a negative impact on the market reaction during the M&A announcement. However, during the short-term post-announcement period acquirers with greater total and domestic institutional investors outperform their peers. In addition, the results show that acquirer firms with higher ownership concentration by long-term institutional investors have a smaller market reaction during the M&A announcement but outperform their peers over the 20 days following the announcement, consistent with Gaspar, Massa, & Matos (2005). Overall, our results suggest that a greater presence of institutional investors with a long-term investment horizon reduces information asymmetries and equity mispricing during the announcement, as evident by a small price reaction. Meanwhile the positive post-announcement performance is due to institutional and long-term institutional investors being effective monitors, therefore decreasing the likelihood of an M&A being a poor decision and resulting in a positive market performance.

Lakonishok, Shleifer, Vishny, Hart, & Perry (1992) and Del Guercio (1996) suggest that institutional investors are more likely to shift their investment toward 'good' or 'glamour' equity rather than basing their investment decisions on objective risk characteristics, especially for banks and mutual funds. Moreover, Carline, Linn, & Yadav (2009) report a poor performance for acquirers that target domestic firms and have lower growth opportunities. Glamour acquirers are firms with a high market valuation measured by the price-to-earnings ratio or the market-to-book value ratio (Sudarsanam & Mahate, 2003) and are considered to have higher future growth opportunities and experience higher announcement returns (Lang, Stulz, & Walkling, 1989; Megginson, Morgan, & Nail, 2004; Servaes, 1991). Rau & Vermaelen (1998) argue that glamour acquirers experience significantly higher announcement returns than value acquirers but with a reversal in performance over a three year period following the announcement. Kohers & Kohers (2001) find that the poor post-announcement performance of glamour acquirers is driven by the adverse effects of acquirers' agency problems. Sudarsanam & Mahate (2003) find that UK glamour acquirers experience negative long-run returns following M&A announcements. However, Conn et al. (2005) show that glamour acquirers perform poorly only when acquiring public firms, as opposed to private targets. Moreover, Alexandridis, Antoniou, & Zhao (2008) do not find a significant relationship between acquirers' returns during the M&A announcement and their market-to-book value.

We assess whether institutional ownership has a varying impact between value and glamour acquirers and their respective market performance during the short-term announcement and post-announcement periods. We find that value acquirers consistently outperform glamour acquirers during the announcement and post-announcement periods. Our findings are consistent with Sudarsanam & Mahate (2003). However, our results show that glamour acquirers with a higher concentration of domestic institutional investors have a better post-announcement performance.

In summary, our contribution to the literature is threefold. First, we assess the impact of institutional ownership on the market reaction to M&A announcements while providing a further breakdown of institutional investors between domestic and foreign investors. Second, we assess the short-term market performance of value, moderate, and glamour firms, surrounding M&A announcements and evaluate the marginal influence of domestic institutional ownership on glamour firms. Third, we ensure our findings are robust by controlling for an extensive number of deal-specific and firm-specific characteristics.

The rest of the paper is organized as follows. Section 2 discusses the literature and sets the testable hypotheses. Section 3 describes the data. In section 4 we provide and discuss the empirical results. Section 5 concludes.

2. Literature review and hypotheses

2.1. Glamour acquirers

Firms that are perceived to have high growth opportunities typically have high price valuations reflecting their past earnings and cash flow performance, and the expectation of sustainable future growth. The positive expectation of future growth allows glamour acquirers to make value-decreasing acquisitions for which the market may not penalise them (Sudarsanam & Mahate, 2003). This is in line with the hypothesis that managerial hubris plays an important role in the decision making process of glamour acquirer firms when managers may be overconfident about their ability to manage an M&A deal (Roll, 1986). Furthermore, firms with high market-to-book ratios are subject to higher information asymmetries because a large proportion of their market value comes from intangible assets (Moeller, Schlingemann, & Stulz, 2004). Therefore, these firms are more likely to be overvalued (Dong, Hirshleifer, Richardson, & Teoh, 2006). Due to information asymmetries, managers of glamour firms may know that their shares