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# Understanding merger incentives and outcomes in the US mutual fund industry

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ABSTRACT

This paper examines the incentives of acquirers and targets in the merger market. Using data on acquisitions among mutual fund management companies from 1991 to 2004, I estimate a two-sided matching model of the merger market jointly with equations representing merger outcomes. According to the empirical investigation, although the desire to achieve a sufficient scale to attract investors is a key driver for mergers, some mergers seem to be driven by objectives other than shareholder value maximization. I find that companies that are potentially prone to misaligned incentives between owners and managers are more acquisitive than others, yet have significantly worse post-merger operating performance. I also find that these acquirers, despite their higher willingness to pay for targets, are not any more likely to match with high-quality targets, potentially due to targets' incentive to avoid bad organizations.

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## 1. Introduction

A variety of motives may impel firms to pursue an acquisition. Companies may acquire to increase shareholder value or to obtain private benefits for managers. The idea that managerial incentives might diverge from shareholder value maximization is an old and influential one, and there has been a significant line of research examining how such divergent objectives may impact acquisition decisions (Baumol, 1959; Jensen, 1986; Roll, 1986; Shleifer and Vishny, 1988; Morck et al., 1990; Malmendier and Tate, 2008). Following on the literature, this paper studies how merger behavior and merger outcomes differ between the two types of acquirers, as well as how they may be differentially evaluated by targets in the merger market. I address these questions in the context of acquisitions among mutual fund management companies in the US from 1991 to 2004.

The key departure of this paper compared to the existing literature is that I examine how acquirers' incentives and targets' incentives *interact* in determining the equilibrium of the merger market, instead of focusing on only one side. In the merger market, companies that are at least partly driven by managerial private benefits, such as empire-building motives, might be more eager to pursue an acquisition than value-maximizing companies all else equal, because of the additional private benefits their managers get. However, if acquirers with managerial motivations are worse at managing the combined companies, targets might prefer value-maximizing acquirers, as targets' managers might share the success or failure of the merged firm through earn-out contracts or employment contracts that link pay to firm performance. One goal of this paper is to understand how these incentives of the two sides influence who matches with whom in the merger market.

To investigate these issues, this paper estimates a model of takeover market together with equations representing the outcomes of mergers (Shim and Okamuro (2011) similarly look at both merger behavior and merger outcome). I model the takeover market as a two-sided matching game in which pairings between acquirers and targets arise as a stable assignment. Since I want to study how the equilibrium matching in the takeover market is influenced by both acquirers' and targets' preferences, a single agent model such as probit or logit would not be sufficient and an equilibrium model such as matching game is called for. The existing literature that uses conventional regression methods to examine mergers largely ignores the fact that M&As are the results of joint selection of both the acquirer and the target, and consequently does not fully capture the endogenous nature of mergers in their analysis. The matching model of this paper offers a more rigorous and integrated way to investigate mergers and their outcomes by allowing both acquirers' and targets' incentives to influence the equilibrium matching.

Moreover, a matching model allows me to account for interaction among the choices made by different firms: Since a target

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cannot be sold to more than one firm, and a firm cannot acquire more than a certain number of targets in a given period, the feasible choice set for a given firm depends on other firms' choices. This interaction among the choices made by different firms makes a matching game a more suitable modeling framework for the merger market than a standard single-agent discrete choice model, because only the former accounts for the possibility that firm *A* chose target *X* instead of target *Y* not because firm *A* prefers *X* to *Y*, but rather because target *Y* was not available to firm *A* since *Y* had a better merger partner. Failing to account for such interaction among players is likely to lead to biased estimates of acquirers' preferences over target characteristics and targets' preferences over acquirer characteristics, as Gordon and Knight (2009) demonstrated in the context of school district mergers. This problem is analogous to the problems that arise when one uses a single-agent model for a game, and the literature has long shown pitfalls of such an approach (e.g., Berry, 1992).

Since a company's acquisition motive is never directly observed, I employ a proxy that might indicate acquirers with managerial motivations and empirically test whether the proxy captures any systematic behavioral patterns. The proxy is based on the following ideas: (1) public firms are more prone to incentive problems due to the separation of ownership and control and (2) companies that have performed poorly might be more vulnerable to incentive problems (Morck et al., 1990).[1] Based on the proxy, I identify a set of companies that could potentially have managerial motives for acquisitions, and *empirically test* whether their behavior systematically differs from others' in three key dimensions: tendency to pursue an acquisition, merger outcomes, and targets' evaluation of them in the merger market.[2]

As a merger outcome variable, I study post-merger asset growth. Economies of scale in marketing and distributing funds are important in this industry due to consumers' desire for the convenience of one-stop shopping, and post-merger asset growth is a good measure of the degree to which the newly merged firm captures such scale economies. I then jointly estimate the matching model and the outcome equations, allowing correlation between the errors of the matching model and the outcome equations (similar to Sorensen (2007)). The interdependence among players in the matching model presents numerical difficulties for estimation. Bayesian methods using Gibbs sampling and data augmentation provide an elegant solution to this numerical problem.

My estimation results provide an interesting picture about the merger market in the mutual fund industry. First, I find that value maximization is a key motive for many acquisitions in this industry. The results indicate that firms are more likely to merge with other companies that use the same channel of distribution (selling funds directly to investors or indirectly through intermediaries), suggesting that many firms engage in an acquisition in order to benefit from economies of scale in marketing and distributing funds. And they do benefit from such scale economies post-merger, as the outcome equations show that the merged firm attracts larger asset inflows when the two merging firms use the same distribution channel.[3]

However, the results also suggest that some acquisitions in this industry seem to be driven by objectives other than shareholder value maximization. In particular, I find that the proxy—public companies with poor recent performance—predicts the following three, distinctive things. First, all else equal, i.e., holding fixed the amount of efficiency gains from mergers, companies identified by the proxy are more acquisitive. This is consistent with the idea that because of the additional private benefits their managers get, these companies are more eager to pursue an acquisition than value-maximizing companies. Second, although they are more acquisitive, acquirers identified by the proxy are much worse at achieving asset growth post-merger when they make an acquisition. This finding is in line with much of the literature that finds worse outcomes for managerially motivated acquirers (Morck et al., 1990; Masulis et al., 2007; Carline et al., 2009). Third, despite their greater willingness to acquire, which under reasonable assumptions translates into higher willingness to pay for targets, acquirers identified by the proxy are not any more likely to match with high-quality targets. I interpret this finding to be consistent with the idea that targets would like to avoid bad organizations as their merger partners. In this industry where human capital is crucial, one of the assets that an acquirer tries to buy is often the people from the target company. As a result, a high proportion of targets' managers stay with the company after the merger instead of "cashing out," and this could explain why targets care about post-merger performance of merged organizations. These three behavioral patterns associated with the proxy portrait a unified picture of companies pursuing acquisitions for objectives other than value maximization.[4]

Using the model's estimates, I perform counterfactual analysis to examine the role of targets' incentive in resource allocation in the merger market. According to the analysis, targets' dislike of badly run organizations is a powerful mechanism to discourage inefficient takeovers: Without it, non-value-maximizing acquirers would buy many more firms.

This paper makes two contributions. First, unlike most prior work in the merger literature which examines either acquirers' incentives or targets' incentives but not both simultaneously, my paper explicitly addresses the fact that both acquirers' and targets' incentives are important in the merger market by employing a matching model. Second, researchers have studied various mechanisms that could discourage the non-value-maximizing behavior of managers, such as product market competition, labor market competition, compensation schemes, and monitoring by the board of directors (see, for instance, Jensen and Murphy (1990) and Holmstrom and Kaplan (2001)). I show that targets' dislike of badly managed organizations can provide partial discipline for inefficient acquirers. In that regard, this paper is related to the paper of Mitchell and Lehn (1990), which shows that bad acquirers later become takeover targets. The main difference between this paper and theirs is that I study targets' preference for efficient acquirers as a possible discipline mechanism whereas they focus on efficient acquirers taking over firms who previously made inefficient acquisitions.

[1] In contrast, a version of Roll (1986)'s hubris hypothesis could predict that well performing firms are more likely to acquire out of managerial motivations. Thus, it is an empirical question whether the proxy is associated with behavior that is indicative of non-value-maximizing acquisitions.

[2] My estimation allows the proxy to be irrelevant in explaining these three dimensions. Thus, if the proxy does not represent any meaningful distinction of the type of acquirer, empirical results would show it.

[3] Since cost-cutting is another important source of synergies but could not be included in the empirical analysis due to lack of data on costs, this paper does not claim that it captures the full extent of synergy-driven mergers. Rather, the claim is that its empirical finding on the distribution channels indicates that at least some aspects of synergies are considered in merger decisions.

[4] Even if we are reluctant to interpret the proxy as representing managerial motivations, the key empirical facts of the paper—underperforming public companies are much more acquisitive, have much worse outcomes when they do make an acquisition, and do not seem to be liked by targets as merger partners—still remain. I decided to interpret the proxy as reflecting managerial motives because these behaviors seem inconsistent with value maximization and also because the existing literature suggests that the proxy can be reasonably expected to capture managerial motives. However, since I do not provide any direct evidence that these firms have managerial rent-seeking motives, there could be alternative interpretations for the findings. Furthermore, there could be other proxies that reflect managerial motives. The particular one I use is simply one of those.

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