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Skill differences in corporate acquisitions

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ABSTRACT

Are there skill differences in mergers and acquisitions? To investigate this question, we focus on persistence in the performance of corporate acquirers. We find persistence only when successive deals occur under the same CEO and conclude that skill differences in acquisitions reside with the CEO, not with the firm as a whole. These differences are economically meaningful. An acquirer that was successful in its last deal and kept its CEO earns 1.02% more on its next deal than does a previously-unsuccessful firm that kept its CEO. This percentage difference is equivalent to a $175 million difference in value creation.

1. Introduction

Our paper uses data on mergers and acquisitions to test whether corporations and their managers possess different levels of skill. Skill is clearly an important issue in business. Firms pay large sums to executives, presumably because they are skillful. And executives pursue educational and training opportunities to acquire skill. Nevertheless, research on skill differences across either firms or their executives has been limited. For example, Bertrand and Schoar (2003, p. 1170) state, “How much do individual managers matter for firm behavior and economic performance? Research in finance and economics so far has given little consideration to this question.” Our study provides evidence that, at least for corporate acquirers, there are significant differences in skill. These skill differences also appear to reside with the CEO, not the acquirer as a whole.

For two reasons, mergers are a natural place to look for skill differences. First, as Hartford and Li (2007, p. 918) point out, “[A]cquisition decisions may be the most significant corporate resource allocation decisions that managers make and the potential wealth destruction to firm shareholders is large, as Moeller et al. (2005) document.” Second, mergers have distinct announcement dates, allowing one to measure the consequences of skill through abnormal returns around these dates. In fact, a large body of literature has already examined short-run abnormal returns around merger announcements [see, for example, the review articles of Jensen and Ruback (1983) and Bruner (2002)]. However, the returns in this literature reflect the average performance or skill of acquirers, not the differences in skill across acquirers.

The methodology we use to investigate skill differences is simple; we relate the success of a firm's last acquisition, as defined by the acquirer's abnormal returns around the announcement date, to the success of its current acquisition. This approach follows from the literature on money managers. Beginning with Jensen (1969), academics have examined differential skill across money

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managers by measuring persistence; i.e., whether managers either over- or underperforming in one period are likely to repeat their performance in subsequent periods. Similarly, persistence in acquisition performance indicates differential acquisition skill.

Our results indicate acquirers do indeed have different levels of skill. These differences may reside with either the entire firm or specific executives. We find evidence of persistence only when successive deals occur under the same CEO, not when the CEO changes. Thus, our findings suggest that some CEOs possess more skill than others in mergers and acquisitions.

While the strong statistical relationship in our study may be due to our large dataset, we argue that it is economically significant as well. In particular, a firm that retains a CEO who was successful in her last deal earns, on average, 1.02% more on its next acquisition than does a firm retaining a previously unsuccessful CEO. This incremental return is far above the average return to acquirers and is equivalent to a $175 million difference in value creation for the shareholders of an average-sized bidder.

Our work is most closely related to two strands of merger research, serial acquirers and the role of CEOs in acquisitions. We now review the relevant literature, limiting ourselves to papers examining announcement period returns. We treat serial acquirers first and then move to the role of CEOs. Perhaps the initial paper on serial acquirers is Schipper and Thompson (1983), which investigates firms announcing acquisition programs. Based on announcement period returns and other results, the authors conclude that the market capitalizes these programs as positive NPV investments. Holderness and Sheehan (1985) study six investors popularly characterized as corporate raiders, reporting that, on average, a company's stock price rose on the announcement that one of these raiders took an equity position in the company. Fuller et al. (2002) examine firms making five or more acquisitions within a three-year period. Fuller et al. (2002) relate announcement period returns to both acquirer and target characteristics finding, among other results, positive returns to bidders when acquiring a subsidiary or private firm and negative returns when buying a public firm. Moeller et al. (2005) report that, from 1998 to 2001, equal-weighted announcement returns to bidders were positive while dollar-weighted returns were strongly negative, leading the authors to conclude that a few large deals accounted for most of these losses. The companies making these large loss deals were typically serial acquirers, with their earlier deals being successful. Klasa and Stegemoller (2007) examine firms making five or more acquisitions over an interval longer than one year. They find that announcement period returns are significantly above zero for the first and middle acquisitions, while insignificant for the last acquisition in a sequence. Billett and Qian (2008) report that announcement period returns are significantly greater for a CEO's first acquisition than for that CEO's later acquisitions. Aktas et al. (2009) argue that the previous literature's finding of falling CARs during acquisition programs can be consistent with learning. Aktas et al. (2011) find that the bid premium on the current deal of an acquiring company's CEO is positively related to both the premium of the CEO's previous deal and the interaction between the standardized bidder CAR and the bid premium of the previous deal, and the results are consistent with the learning model of Aktas et al. (2009). Aktas et al. (2013) posit a concave relationship between learning gains and time between deals (TBD) for acquirers. Their model implies that a reduction (increase) in TBD during the experience-building (memory-loss) phase should occur with learning, a result consistent with the paper's empirical findings. In addition, while the authors report a negative relation between TBD and deal order number (DON), TBD is positively affected by the interaction of DON and CEO change, implying that learning gains are greater under CEO continuity.

While all the papers reviewed above study serial acquirers, Billett and Qian (2008) and Aktas et al. (2011 and 2013), as mentioned above, also examine the role of CEOs in acquisitions. In addition, Falato (2007) finds a positive relationship between acquirer returns and executive pay, concluding that his results are consistent with the managerial-talent hypothesis that executive compensation reflects ability. Malmendier and Tate (2008) identify overconfident CEOs, reporting that announcement period returns are significantly lower for overconfident CEOs than for other CEOs.

Like our research, all of the above papers look at announcement period returns for serial acquirers and/or acquiring CEOs. However, as mentioned above, in order to examine skill differences across corporations and CEOs, we relate the success of a firm's (or CEO's) last acquisition to the success of its current acquisition. None of the above papers do that. To our knowledge only three papers, all currently unpublished, have used this approach. Conn et al. (2004) investigate the effect of the order of a bidder's acquisitions on bidder announcement returns, reporting that these returns are negative for acquisition numbers 5 through 9, while insignificantly different from zero for prior acquisitions. In addition, the authors perform a test of persistence, finding that the announcement returns of later acquisitions are lower if the first acquisition had a negative announcement return. Deighton (2006) separates those CEOs making one acquisition from those making two or more. The author reports that the first deals for single-acquisition CEOs have significantly lower announcement period returns than the first deals for multi-acquisition CEOs. In addition, the paper performs a persistence test, regressing the announcement return on two different variables proxying for persistence: a dummy variable set equal to one if the acquirer's announcement return on its previous acquisition was positive and another dummy variable set equal to one if the acquirer's announcement returns on the previous two acquisitions were positive. The coefficient on the first variable is marginally significant (at the 10% level) while the coefficient on the second variable is insignificant. Croci and Petmezas (2009) examine firms with five or more acquisitions in a five-year period. The paper finds that the bidder's announcement return is insignificantly different from zero for the first five acquisitions, while being marginally significantly negative (at the 10% level) for later deals. They also use the same two variables proxying for persistence that Deighton uses, finding the coefficient on the first significantly negative and the coefficient on the second significantly positive. These three papers consider persistence only in passing, since they each focus on other research questions. By contrast, our paper is devoted to skill persistence. We relate the bidder's acquisition return to both positive and negative skill, use a large sample, and separate persistence across firms from persistence across CEOs.

Our results are important for a number of reasons. Acquiring managers, as well as their directors, financiers and advisors, would like to predict the success of future acquisitions. These parties should care whether the success of their previous acquisitions is predictive of future success. Target firms care about this persistence as well. If an acquirer that earned high returns