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National culture, managerial preferences, and takeover performance☆

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1. Introduction

> "The dangers of taking too much risk are very clear. We're reminded of them in the news every day. Unfortunately, we rarely hear any warnings about playing it safe. The dangers of playing it safe are not sudden, obvious, and dramatic. They don't make headlines. The dangers of playing it safe are hidden, silent killers." (Sundheim, 2013)

Understanding the causes and performance of mergers and acquisitions (takeover performance, henceforth) has been explored extensively in the literature. While numerous studies have shown that shareholders of target companies enjoy significant abnormal returns, the empirical evidence on returns to bidders is still quite ambiguous. In fact, many studies have reported negative long-run post-acquisition returns for acquirers (Agrawal, Jaffe, & Mandelker, 1992; Mitchell & Stafford, 2000; Rau & Vermaelen, 1998). However, if most takeover deals destroy firm value in the end, why do we observe so many mergers and acquisitions in the market? What are the factors behind the post-acquisition underperformance of the acquirer?

A large body of literature reveals that behavioral elements are important driving forces of corporate decision making. Empirical evidence suggests that when managers are not carefully observed, they are more likely to follow goals that do not necessarily benefit investors. The literature has highlighted different managerial aspects that cause conflicting interests, such as exploitation for private benefits and the excessive tendency to avoid risks due to managerial risk preferences. Managers may indulge in value-destroying undertakings for their own benefit, such as empire building (Baumol, 1959; Marris, 1964), or due to career concerns, managers may play it safe and take too little risk or even actively reduce the firm's risk to circumvent negative corporation outcomes that are personally costly to them (Amihud & Lev, 1981; Smith & Stulz, 1985), thus following an entrenchment strategy. The existing empirical literature does not extensively address managerial preferences in the context of mergers and acquisitions, although they have implications for both economic outcomes and optimal corporate policy.

Our paper examines empire building and entrenchment in the context of mergers and acquisitions. While both theories have been discussed in the literature for decades, they have only infrequently been subjected to direct empirical testing. We rely on data from sociologists on national culture to study these managerial preferences in an international framework. We link managerial behavior to wealth effects in acquisitions. If managers act in the best interests of their shareholders, then an acquisition can be expected to increase shareholders' wealth. If mergers are undertaken for less benign reasons, our study may help explain why firms often experience significant underperformance over several years after an acquisition.

There is a growing awareness that culture is an important factor that affects fundamental economic decision making. Hofstede (2001) suggests that the cultural context determines individuals' choices in a crucial way. House et al. (2004) also argue that different cultural backgrounds influence individuals' values and preferences regarding management and leadership. As the cultural context impacts individuals' choices in a crucial way, cultural values are likely to be important for an understanding of global merger performance. Managers may engage in acquisitions for different reasons, and there may be distinct patterns in the global distribution of these reasons. To link managerial preferences to economic outcomes in an international

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framework, we rely on the cultural framework put forward by Hofstede, Hofstede, and Minkov, 2010.

Ahern, Daminelli, and Fracassi (2015), Chakrabarti et al. (2009), Ferris, Jayaraman, and Sabherwal (2013), and Frijns, Gilbert, Lehnert, and Tourani-Rad (2013) document that cultural values are important factors in explaining takeover characteristics. A cultural explanation can hence provide a valuable addition to the understanding of takeover outcomes. To the best of our knowledge, the current study is the first large-scale international endeavor to investigate the likely impact of managerial preferences as proxied by national culture on the long-term gains that takeovers, both domestic and cross-border, may create.

The remainder of this paper is organized as follows. The previous literature is reviewed and the research hypotheses are developed in the second section. The dataset and the research methodology are described in the third section. The main results are reported in the fourth section, various robustness checks are delivered in the fifth section, and additional checks are described in the sixth section. Finally, conclusions are drawn in the last section.

2. Agency motivations and takeover performance

The mergers and acquisitions (M&A) literature highlights the importance of CEOs' preferences in deal related decisions. However, managerial preferences are not easy to observe, so any direct empirical indication of the impact of managers' preferences in mergers is nearly non-available. As an alternative, the literature mainly talks about the impact of managers' explicit incentives (e.g., caused by equity stakes) on mergers.

Research reveals that managerial personal traits and interests influence takeover decisions to a greater extent. The research further suggests that firms not only engage in takeover activity when it is optimal from the firm perspective but also when it is beneficial from the managerial perspective. To examine the conflict caused by managers' risk preferences, we study a potential entrenchment behavior, while to assess the conflict of private benefits, we investigate a possible empire building behavior.

2.1. Entrenchment

Typically, a substantial portion of a manager's total income depends on firm performance. If a firm fails to reach its targets or at worst gets into bankruptcy, the manager is most likely to lose his or her employment and future earning potential. Managers cannot diversify away employment risk in their personal portfolio settings. Therefore, they are more inclined to mitigate it by other means, e.g., through diversifying merger deals that reduce risks related to managerial human capital such as losing one's job and reputation (Amihud & Lev, 1981; Comment & Jarrell, 1995; Shleifer & Vishny, 1989).

May (1995) supports this rationale by demonstrating that managers' personal risk preferences are associated with decisions that affect firm risk. Diversifying mergers generally even out a firm's earnings so that the diversification effect may have a positive net present value for managers. The diversification effect, however, is of no relevance to shareholders as they can easily control the risk of their portfolios in the capital market at a very low cost. Therefore, managers who are willing to invest in diversifying mergers and acquisitions primarily for the sake of risk reduction may destroy shareholder wealth. Consequently, we expect that entrenchment is negatively related to takeover performance.

2.2. Empire building

Jensen (1986) extends the free cash flow theory to takeovers. The hypothesis of agency costs of free cash flow predicts that excess cash leads managers to produce low-benefit or even value-decreasing investment decisions. If there is any cash available after all profitable investments have been made, realizing acquisitions is one of the preferred methods by which managers may use money instead of distributing cash to shareholders (Harford, 1999). Consistent with the free cash flow hypothesis, the economic losses resulting from deals motivated by personal benefits can be substantial, as reflected in the negative stock price reaction to the announcement of such deals and the subsequent poor operating performance (Grinstein & Hribar, 2004).

McClelland (1975) argues that the need for power is the main driving force for managers. Rhoades (1983) and Schneider and Dunbar (1992) have extended this concept to takeovers that result in empire building. Similarly, Tosi, Katz, and Gomez-Mejia (1999) demonstrate that in the absence of external monitoring executive compensation may be positively linked to an increase in firm size due to acquisitions, even when a firm's market value is reduced. Such contractual arrangements also seem to reflect managerial preferences. In summary, we therefore expect that empire building is negatively related to takeover performance.

2.3. Hypothesis development

To study the impact of managerial traits on takeover performance, we resort to the concept of national culture put forward by Hofstede et al. (2010) as a way of capturing information about the psychology of managers. Hambrick and Mason (1984) contend that social values embedded in national culture cast pronounced effects on managerial views and decision making. Similarly, Geletkanycz (1997) argues that culture has an important impact on the executive mindset and that cultural values strongly shape strategic orientations.

The Hofstede framework is, of course, neither free from criticism nor without alternatives. Doubts have been raised about its validity and generalizability (Shenkar & Luo, 2003; Kirkman, Lowe, & Gibson, 2006), as the framework was developed using specific single company data in the 1960s and 1970s. However, many replications on different samples have proved that the country ranking remains valid (Beugelsdijk, Maseland, & van Hoorn, 2015). Some authors have also criticized the framework for its overly simplistic conceptualization and non-exhaustiveness in cultural dimensions. Nevertheless, among all cultural approaches, the one by Hofstede provides the most straightforward link between cultural dimensions and individual preferences while this direct link is typically missing for other cultural approaches like that of Schwartz (1992, 1994) (see the comprehensive survey by Nadler & Breuer, 2017). Against this background, it is no surprise that Hofstede's framework is by far the most established in the international business literature and has become the standard tool for measuring cultural differences in several business disciplines (Karolyi, 2016, Nadler & Breuer, 2017). Moreover, the use of the Hofstede data allowed the largest sample of countries to be included in our research.

The following section discusses the managerial traits associated with the takeover motives outlined in the previous section and links them to the cultural dimensions of Hofstede et al. (2010).

2.3.1. Individualism versus collectivism

The concept of individualism versus collectivism captures information about how people in different cultures hold divergent views about the 'self', resulting in distinct conceptions about the relatedness of individuals to each other. The strong social bonding among individuals in a collective culture allows for the joint development of mechanisms to hedge against risk and turn to the social network for support, if needed.

The collectivist network would serve as a "cushion" that would hold its members in case they "fall". This "cushion hypothesis" proposed in Hsee and Weber (1999) links to the entrenchment motive. It conjectures that people from individualist societies are more prone to entrenchment in order to reduce their employment risk than people from collective societies. Since our literature review in the previous section indicates that entrenchment is negatively related to takeover performance, we

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