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Does relationship matter? The choice of financial advisors

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ABSTRACT

This study evaluates whether and how relationships influence acquirers' choice of financial advisors in mergers and acquisitions (M&As). Specifically, it examines how acquirers' relationships with their advisors, including their optimism of analyst recommendations and the outcome of their past services, determine the choice of advisors in current transaction. Findings suggest that banking relationships have significant yet limited influence on a firm's choice of M&A advisor. The evidence reveals that firms without recent M&A experience are more likely to choose their underwriters as financial advisors in stock-paid deals, especially when they provide overly optimistic analyst coverage prior to the transactions. Firms with recent M&A experience, however, are more likely to switch financial advisors with poor outcomes in past deal(s).

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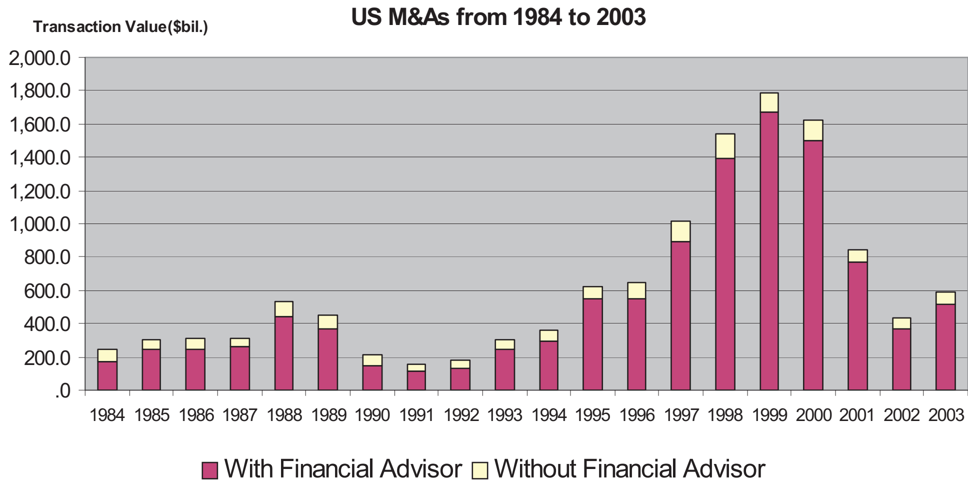

Fig. 1. M&A transactions from 1984 to 2003 and the use of financial advisors.
Source: Elaboration from SDC database.

1. Introduction

U.S. firms have experienced a merger and acquisition wave since the 1980s' (M&A hereafter). The total transaction value in the U.S. market increases from $243 billion in 1984 to a peak of $1.8 trillion in 1999 (according to the Securities Data Corporation, Mergers and Acquisitions Database, SDC hereafter). A common characteristic of these transactions is that they usually involve financial advisors. For instance, financial advisors are used in over 82% (see Fig. 1) of M&A deals (by transaction value) between 1984 and 2003.[3]

Although M&As are one of the most significant strategic decisions firms make, and although financial advisors are shown to play an important role in reducing information asymmetry and transaction costs in such deals (Servaes & Zenner, 1996), there is an important yet less explored question about how acquirers choose their financial advisors, especially from the relationship perspective. The traditional banking literature suggests that banks provide more effective and efficient services to clients through lasting relationships (e.g., Castelli, Dwyer, & Hasan, 2011; Diamond, 1991; James, 1992; Rajan, 1992; Rajan & Winton, 1995).

We suspect that the traditional "relationship banking" hypothesis may be weak in the M&A advisory business, largely due to the heterogeneous nature of M&A practices (Zollo & Singh, 2004). For example, the information-production process in M&A involves not only acquirer-specific information, but also the target- and deal-specific information. Furthermore, there is both anecdotal and empirical evidence that financial firms are becoming more aggressive and proactive in retaining current clients and winning future ones. *Business Week*, for example, cited this proactive side of investment banking as one of the underlying factors in the M&A wave that started during that period.[4] Besides the media stories and the scholarly evidence (see Ellis, Michaely, & O'Hara, 2004), there is also good reason to suspect the solicitous side of investment banks because of the significant fees they received during the last two decades of M&A waves.[5] It is therefore not clear whether and how relationships are maintained in the

[3] Securities data corporation: league table.

[4] "There's been steady movement away from the traditional role as counselor toward activity initiated by the investment banker himself." (*Business Week*, November 24, 1986, p. 77).

[5] The fee data is sparse in the SDC database because such information is rarely disclosed. And the Securities Industry Association (SIA) also does not track how much investment banking revenue is from M&A advisory fees, because the data falls into the category of "revenues from other investment banking related business." We estimate the revenue from M&A advisory work

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