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The sources of value destruction in acquisitions by entrenched managers ☆

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ABSTRACT

Prior work has established that entrenched managers make value-decreasing acquisitions. In this study, we determine how they destroy that value. Overall, we find that value destruction by entrenched managers comes from a combination of factors. First, they disproportionately avoid private targets, which have been shown to be generally associated with value creation. Second, when they do buy private targets or public targets with blockholders, they tend not to use all-equity offers, which has the effect of avoiding the transfer of a valuable blockholder to the bidder. We further test whether entrenched managers simply overpay for good targets or choose targets with lower synergies. We find that while they overpay, they also choose low synergy targets in the first place, as shown by combined announcement returns and post-merger operating performance.

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1. Introduction

One particularly costly manifestation of the agency conflict between shareholders and managers is a bad acquisition (see, for example, Jensen, 1986). Masulis, Wang, and Xie (2007) present evidence that acquisitions that destroy the most bidder value are made by managers who can be considered partly entrenched. In this paper, we ask how partly entrenched managers destroy value in their acquisitions. Specifically, we study the types of acquisitions they make with respect to the target's attributes, the method of payment, and the synergies created.

We find that a significant portion of value destruction comes from entrenched managers' avoidance of private targets, and from their attempts to preserve their position of entrenchment. Prior research, such as Chang (1998) and Fuller, Netter, and Stegemoller (2002), has shown that acquisitions of private targets are generally value-increasing,

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and those of public targets are more likely to be value-decreasing. Most evidence points to the capture of the illiquidity discount (see Officer, 2007) and to the creation of a monitoring blockholder in an equity-based transaction, as discussed in Chang (1998) and Fuller, Netter, and Stegemoller (2002). In addition, an equity offer for a private company is effectively a large private placement and carries similar scrutiny and certification effects (Moeller, Schlingemann, and Stulz, 2007). We find that when entrenched managers do target private companies, they are more likely to use cash. While we can never perfectly assign motivation, paying cash has the effect of avoiding both scrutiny and the potential creation of a blockholder. We also find that entrenched managers prefer not to use stock when acquiring public firms with large blockholders. Nonetheless, even controlling for the form of the target, entrenched managers make worse acquisitions, so target form is not the whole explanation.

We next examine synergies and overpayment across acquisitions. All value destruction involves overpayment. The question we ask is whether entrenched managers select low synergy targets in the first place or whether they select high or normal synergy targets but simply pay too much for them. The post-merger operating performance for acquisitions by entrenched managers is worse than for others, suggesting that poor target selection, as opposed to simply overpaying for good targets, explains the value destruction.

We also examine premiums paid by entrenched and nonentrenched managers. Notably, on average entrenched managers pay lower premiums than nonentrenched managers. Thus, the net effect of paying somewhat lower premiums for much worse targets is value destruction. Some evidence suggests that the higher premiums paid by nonentrenched managers are justified by greater synergy creation.

We conduct a variety of robustness checks. We use the Bebchuk, Cohen, and Ferrell (2009) Entrenchment Index instead of the GIM (Gompers, Ishii, and Metrick, 2003) index. We also confirm that poor governance is not simply picking up older, mature, low-growth firms. Finally, we address endogeneity concerns. Our results remain robust and our inferences are unchanged.

The paper contributes to the literature in several ways. First, we show that entrenched managers select targets and methods of payments differently from nonentrenched managers in ways that are consistent with trying to preserve their entrenchment. Specifically, they are less likely to pay stock for private targets or for public targets that have significant blockholders, implying an attempt to preserve entrenchment. Second, we show some collateral support for the idea that stock acquisitions of private targets create a monitoring blockholder. Specifically, we show that the benefits of stock acquisitions of private targets increase with deal size (and, thus, increase with the potential size and power of the monitoring blockholder). Third, we establish that the source of value destruction goes beyond simply overpaying for good targets. That is, entrenched managers also select targets that yield low synergies.

The paper proceeds as follows. In the next section we develop the hypotheses. We follow with a description of the sample in Section 3. Section 4 presents the empirical results, and Section 5 describes some robustness tests. Section 6 concludes.

2. Hypotheses development

Acquisitions are a well-established point of potential agency conflict between managers and shareholders. The potential for value destruction is greater when the agency conflict is not well controlled. In keeping with this, early work by Byrd and Hickman (1992) shows that firms with outsider-dominated boards make better acquisitions than those with insider-dominated boards. Recently, the GIM index has been proposed as a direct measure of managerial entrenchment because it aggregates antitakeover provisions. Further, even ignoring a direct entrenching effect of the provisions, a preponderance of these provisions at a firm likely indicates a generally self-serving approach by management and an accommodating board (see e.g., Davila and Penalva, 2006). As such, the GIM index serves as an indicator of firms in which agency problems are most severe. Masulis, Wang, and Xie (2007) provide evidence consistent with the hypothesis that high GIM index firms (so-called dictators) engage in value-destroying acquisitions on average, even controlling for a wide variety of firm and event characteristics. Our goal is to explore the source of this value destruction. In doing so, we test the following hypotheses.

2.1. Target selection

There is a continuum of entrenchment. Even if a manager is relatively entrenched, that does not mean that he or she could take no action that would weaken his or her position. On the contrary, such a manager actively seeks to maintain his or her level of entrenchment. Thus, entrenched managers could promote investments that increase (or at least do not decrease) their level of entrenchment. Target selection is one way to do this.

Avoiding private targets helps entrenched managers to preserve their entrenchment and avoid further internal scrutiny. When a bidder buys a private target with stock, particularly one that is nontrivial in terms of relative size, it creates a large shareholder because the ownership of the private firm is concentrated. This large shareholder then has the ability and motivation to monitor bidding management going forward. Chang (1998) and Fuller, Netter, and Stegemoller (2002) find evidence consistent with this, showing that, in contrast to the case of public targets, bidders using equity to buy private targets receive higher announcement returns on average. Entrenched managers prefer to avoid any additional monitoring and so would not acquire a private firm using equity. A solution is to effect the acquisition with cash. However, if they do not have sufficient cash on hand, they would need to turn to external capital markets for financing, at which point they would be subject to similar monitoring or scrutiny. The net effect would be fewer private targets overall, with a preference for cash payment when private firms are targeted.

Another, complementary hypothesis regarding private targets comes from the certification effect that a company

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