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Acquirer-target social ties and merger outcomes ☆

Joy Ishii [a], Yuhai Xuan [b,*]

[a] Stanford Graduate School of Business, Knight Management Center, Stanford, CA 94305, USA
[b] Harvard Business School, Soldiers Field, Boston, MA 02163, USA

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ABSTRACT

This article investigates the effect of social ties between acquirers and targets on merger performance. We find that the extent of cross-firm social connection between directors and senior executives at the acquiring and the target firms has a significantly negative effect on the abnormal returns to the acquirer and to the combined entity upon merger announcement. Moreover, acquirer-target social ties significantly increase the likelihood that the target firm's chief executive officer (CEO) and a larger fraction of the target firm's pre-acquisition board of directors remain on the board of the combined firm after the merger. In addition, we find that acquirer CEOs are more likely to receive bonuses and are more richly compensated for completing mergers with targets that are highly connected to the acquiring firms, that acquisitions are more likely to take place between two firms that are well connected to each other through social ties, and that such acquisitions are more likely to subsequently be divested for performance-related reasons. Taken together, our results suggest that social ties between the acquirer and the target lead to poorer decision making and lower value creation for shareholders overall.

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1. Introduction

Boards of directors and top corporate executives occupy a rich and complex network of social ties. These ties can take many forms, including alumni networks from educational institutions, connections through employment activity, or other activities such as clubs or charitable organizations. Considerable evidence shows that social networks can influence decision-making processes or economic outcomes in a variety of settings, and a small but emerging literature considers the corporate finance implications of these connections in particular. This literature, however, has largely focused on *within*-firm ties such as social connections between board members or between the chief executive officer (CEO) and the board of directors of the same firm. Relatively little is known about the role of *cross*-firm social connections in driving corporate decisions.

In this paper, we investigate the impact of social ties between the senior executives and directors of the acquiring and the target firms on merger outcomes, focusing on

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* Corresponding author.
E-mail addresses: ishii_joy@gsb.stanford.edu (J. Ishii), yxuan@hbs.edu (Y. Xuan).

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ties across the two merging firms. We examine cross-firm social connections in the context of mergers and acquisitions because these are important events in the lives of firms that could have sizable impacts on shareholder wealth and require complex decision making on the part of the board of directors and top managers from both firms involved. The interactive nature of the negotiation and decision-making processes makes mergers corporate events in which cross-firm social ties are likely to be especially relevant. Understanding whether and how such connections between the acquirer and the target impact decision making and ultimately affect merger outcomes and shareholder value is, therefore, of particular importance.

One hypothesis is that extensive social ties across merging firms foster an enhanced flow of information, leading to better decision making. Under this view, connections lower the costs of gathering information, providing a means of efficient information exchange. For example, Cohen, Frazzini, and Malloy (2008) find that information is dispersed via educational networks between mutual fund managers and corporate boards. Gompers and Xuan (2008) and Cai and Sevilir (2012) show that a link such as a common venture capital investor or a common board member between the acquirer and the target helps reduce information asymmetry. Ingram (2000) shows that competing hotels have larger revenue per room when they share social ties, an effect at least partially credited to exchange of information. Under this hypothesis, social ties improve merger performance.

An alternative hypothesis is that extensive social ties between an acquirer and a target lead to less successful mergers due to flawed decision making based on weaker critical analysis, a lowering of standards, or missed opportunities. This kind of flawed decision making in the presence of social ties has a number of sources. First, social ties could lead to a heightened sense of trust. The principle of homophily implies that people are more likely to interact and be influenced by those who are similar to them (the “birds of a feather” concept well known in sociology; see, for example, McPherson, Smith-Lovin, and Cook, 2001). Decision makers could be more comfortable with one another and shift from a purely exchange-based mode of interaction to one based more on norms of trust. Social ties could then lead to more favorable interpretations of events and others' actions (Uzzi, 1996). In the merger context, the existence of considerable social connections across top decision makers at acquirers and targets could lead firms to lower due diligence standards or overestimate the resulting synergistic gains and make firms more inclined to forgo better opportunities outside the network.

Second, significant empirical evidence now exists showing a familiarity bias under which individuals prefer status quo choices and familiar goods or people.[1] In financial markets, for example, investors display a home bias in domestic as well as international investing (Coval and Moskowitz, 1999; French and Poterba, 1991), and their preferences depend on the firm's distance, language, and culture (Grinblatt and Keloharju, 2001). Many individuals also invest large amounts of their discretionary pension fund contributions in their own company stock (Benartzi, 2001; Meulbroek, 2005). Firms also tend to cross-list their stocks in countries where investors are more familiar with them (Sarkissian and Schill, 2004). In the context of corporate mergers, this familiarity bias can manifest itself in a tendency toward inefficient deal making with firms with which top managers and directors have social ties, with insufficient regard for whether the merger makes sense strategically and intrinsically or whether a better candidate firm exists outside the network.

A third source of flawed decision making that could lead social ties to have a negative impact on merger outcomes is social conformity and groupthink. The social psychology literature demonstrates that individuals in group settings tend to conform to social norms. This is true even when the social consensus is clearly incorrect (Asch, 1951). Groupthink refers to a type of thinking in a cohesive group when critical analysis is dominated by a desire for unanimity, and groupthink behaviors are thought to be more likely to occur when the group is more homogeneous in terms of attitudes, approaches, or ideologies. Homophily and direct interactions based on educational and employment backgrounds provide a measure of the sort of homogeneity that is conducive to groupthink and poor decision making. Defects in decision making in cohesive groups often include consideration of only a limited range of options, failure to reexamine any options initially rejected, forgoing opportunities to consult with experts outside the group, ignoring information that does not support the favored policy, and insufficiently considering disadvantages of the favored decision (Janis, 1982). In the merger setting, these flaws in decision making by socially connected acquiring and target firms could again translate to failure to consider other potential merger candidates and overestimation of the synergistic gains as well as lowering of due diligence standards for the favored deal. Cross-firm social ties in the merger context are thus predicted to lead to weaker merger performance.

We test these hypotheses by estimating the relation between merger announcement returns and the extent of social ties between the top managers and directors of the two merging firms. We focus on educational background and employment history as the basis of the social networks that we use in our analyses. Educational institutions can be expected to form an effective basis for social ties for a variety of reasons, as discussed in Cohen, Frazzini, and Malloy (2008). Facilitated by alumni associations, college sports, and donation programs, the relationships formed during undergraduate or post-graduate programs often last well beyond the graduation date. Individuals from a common educational institution could also have other common interests or backgrounds that strengthen the ties formed there or foster later relationships. These educational ties can also be expected to be fairly exogenous. In addition to academic institutions, we use individuals' past employment history as a basis for our network measure, as strong relationships could be formed through work

[1] See, for example, Samuelson and Zeckhauser (1988), Zajonc (1968), and Saegert, Swap, and Zajonc (1973).

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