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## M&A operations: Further evidence of informed trading in the CDS market



Paulo Pereira da Silva<sup>a,b,\*,1</sup>, Isabel Vieira<sup>b</sup>, Carlos Vieira<sup>b</sup>

<sup>a</sup> CMVM, Portuguese Securities Commission, Rua Laura Alves no. 4, Lisbon, Portugal

<sup>b</sup> CEFAGE, Universidade de Évora Palácio do Vimioso, Largo Marquês de Marialva 8, 7000-809 Évora, Portugal

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### ABSTRACT

Previous studies showed that private information gathered through banking services such as loans and syndicated debt is incorporated into CDS rates by large banks. Additionally, there is also evidence that innovations in CDS rates precede stock market returns prior to credit events. This paper adds to the literature by showing that the information obtained by major banks while providing M&A investment banking services is assimilated by CDS rates prior to the operation announcement. We also find strong supportive evidence that CDS innovations have incremental predictive power over stock returns before M&A announcements, and that this predictive power may be even greater when major dealers in the CDS market supplied investment banking services to one of the parts of the deal.

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## 1. Introduction

The credit default swap (CDS) market and other credit derivative markets have grown in importance and popularity over the last two decades. This trend, along with the fact that CDS rates constitute a cleaner measure of credit risk than bond credit spreads, raised academics' interest in knowing whether and how these derivatives contribute to price discovery. In the absence of market frictions, derivatives markets are, in general, redundant. However, in the real world there are frictions (such as limits to arbitrage, transaction costs, taxes, liquidity constraints and, no less important, information asymmetry), and therefore derivatives may have a role in price discovery.

The presence of an information flow from the CDS to the stock markets is well-documented in the financial literature. In a seminal article, [Acharya and Johnson \(2007\)](#) demonstrate an incremental information flow from the CDS to the stock markets around credit events, especially when the reference firm has a large number of banking relationships and during times of financial stress (i.e. credit rating downgrades). Large financial institutions are amongst the major players in the CDS market.

\* Corresponding author.

E-mail addresses: [paulosilva@cmvm.pt](mailto:paulosilva@cmvm.pt), [paulompsilva@yahoo.com](mailto:paulompsilva@yahoo.com) (P. Pereira da Silva), [impvv@uevora.pt](mailto:impvv@uevora.pt) (I. Vieira), [cvieira@uevora.pt](mailto:cvieira@uevora.pt) (C. Vieira).

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As they provide different kinds of financial services to other firms, they possess a large amount of private information about their customers' activity. [Acharya and Johnson \(2007\)](#) argue that they take advantage of such privileged access and impound their superior information in CDS quote revisions, before such information is available to stock market participants.

This paper addresses the informational content of CDS rates and a particular channel of information flow between CDS and stock markets. Up to now, the financial literature has concentrated on a specific channel of information transmission based on the lending activities of major banks. In contrast to the previous literature, and as a novelty, we explore the channel of investment banking services related to mergers & acquisitions (M&A, henceforth) or divestiture (sell-offs) operations of listed firms.

The key idea is that dominant players in the CDS market, i.e., major investment banks, are also important players in M&A operations. This prompts the question of whether private information related to those deals is impounded into CDS rates before it is revealed to uninformed stock market participants. We address this issue by comparing the run-up effects in the assimilation of information and the interaction between CDS and stock markets prior to M&A announcements. To the best of our knowledge, this is the first study assessing the relevance of this channel of information flow.

The main objective of this paper is to ascertain the existence of informed trading in the CDS market and to explore some key issues regarding its nature. This research topic is relevant for several reasons. First, it contributes to the long-lasting debate on whether derivatives markets, and particularly the CDS market, are redundant for price discovery. Secondly, it sheds some new light on how stocks and CDS markets interact and helps in explaining spikes in the cross-correlation of the returns of the two financial instruments, which is of interest to risk managers using CDS to hedge their exposure in the stock market. Thirdly, analysis of the channels of information flows between the CDS and stock markets may be of interest to dealers seeking to manage their adverse selection risk, because the presence of informed traders in the CDS market may affect the profits and losses of their liquidity provision activity. Finally, regulators and policy makers may also benefit from having more information on the use of private information in the CDS market. If the information is gathered or used illegally, it may affect the overall integrity and efficiency of the market.

A natural starting point for the analysis is the appraisal of whether M&A announcements constitute material information for CDS and stock market participants. Using a large database of U.S. and European firms, we find that M&A and sell-off operations produce relevant wealth changes for stockholders and creditors; in effect, while M&A operations yield negative stock returns for the bidder, sell-offs generate positive returns for the seller. These results agree with those of [Kaplan and Weisbach \(1992\)](#), [Asquith et al. \(1990\)](#), [Servaes \(1991\)](#) and [Schwert \(2000\)](#), who report a negative (though modest) impact of M&A operations on bidders' stock prices, and with those of [Klein \(1986\)](#) and [Lang et al. \(1995\)](#), who find a positive effect of sell-off announcements on the stock prices of sellers. These results closely follow the predictions of the non-synergistic theory of corporate restructuring, which states that agency conflicts between management and shareholders drive M&A and divesting activity. In effect, if M&A are fueled by management entrenchment, empire building, and managerial hubris, and not by shareholder value, these transactions will likely have a negative impact on stock prices. In contrast, asset sell-offs reduce diversification and agency conflicts, and consequently are expected to produce positive effects on stock prices.

With respect to creditors' wealth, we find that, on average, CDS spreads increase with acquisition announcements, and decrease with assets sell-off announcements. Not surprisingly, the effects of such operations are greater for firms that lack creditworthiness than for financially sound firms. These results show that the effect of diversification and cash-flow volatility reduction brought about by M&A on the default probability of the acquirer is offset by the effect of subsequent changes in its capital structure that undermine creditors' prospects. In general, our results agree with those of [Billett et al. \(2004\)](#), [Warga and Welch \(1993\)](#) and [Asquith and Wizman \(1990\)](#). As both shareholders and creditors of firms that lack creditworthiness benefit from asset sell-offs, our results are also in line with those of [Lang et al. \(1995\)](#) and [Datta and Iskandar-Datta \(1996\)](#). Asset sell-offs appear to be value-enhancing, perhaps because they allow firms in financial distress to raise funds more cheaply than by alternative means ([Shleifer and Vishny, 1992](#)).

Subsequently, we focus on the information flow between CDS and stock markets. More precisely, we investigate the lead-lag relationship between CDS innovations and stock returns. First, we examine the unconditional information flow between the markets. Although seemingly irrelevant when the entire sample of firms is considered, it is statistically and economically relevant for high-grade non-financial firms. However, this latter result should be interpreted with care given that our sample is limited to obligors involved in M&A operations (a selection bias problem). More importantly, our findings reveal an incremental information flow from the CDS to the stock market prior to M&A announcements. CDS innovations appear to have predictive power over stock returns of speculative-grade financial and non-financial firms. Furthermore, the incremental information flow from the CDS to the stock market tends to be greater when at least one of the top CDS dealers supplied investment banking services to one of the parts of the M&A operation.

Finally, we assess how liquidity provision in the CDS market evolved around M&A events. By means of time series regressions, we investigate the bid-ask spread pattern in the M&A pre-announcement period. Intuitively, an abnormal increment of the bid-ask spread may signal asymmetry of information prior to M&A operations because liquidity providers tend to raise bid-ask spreads when they perceive that other traders hold superior information ([Copeland and Galai, 1983](#); [Bagehot, 1971](#)). Our results show that the bid-ask spread tends to rise prior to M&A events when CDS dealers supply investment banking services to one of the parts involved in the M&A operations. This abnormal up-trend is consistent with dealers perceiving higher information asymmetry prior to M&A events. As transactions between dealers represent the

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