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Do managerial behaviors trigger firm exit? The case of hyperactive bidders

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ABSTRACT

This paper investigates the effects of managerial mergers- and acquisitions-related investment strategies on the exit risk of firms. Using a sample of hyperactive bidders, I show that managerial excessive acquisitiveness can precipitate firm exit. Overbidding is associated with weak corporate governance and lower disclosure quality within firms. I find that hyperactive bidders take more risk compared to conservative bidders. Such bidders also misallocate firms' resources and dent firms' reputational capital. Eventually, the external corporate control market is more effective compared to mechanisms such as bankruptcy reorganization, forced liquidation, leveraged buy-out, and expulsion from stock exchanges in disciplining hyperactive bidders by turning them into targets of takeover. These results suggest that a hyper acquisition-induced growth strategy is, on average, detrimental to the long-term survivability of firms and that the internal and external corporate-control mechanisms may not be effective enough to forestall falling value of an excessively acquisitive firm.

1. Introduction

Academics disagree on whether and to what extent managers are responsible for their firms' demise. There are two diametrically opposed views on this issue. On the one hand, the standard rational economic theory posits that corporate exits are the results of external economic disturbances beyond managerial control (Cabral, 1993; Denis & Denis, 1995; Ericson & Pakes, 1998; Hopenhayn, 1992; Jovanovic, 1982; Khanna & Poulson, 1995; Nelson & Winter, 1978). On the other hand, the behavioral theory argues that managerial cognitive biases lead to systematic errors in corporate investment and financing policies precipitating inefficient firm exit (Baker, Ruback, & Wurgler, 2006; Barberis & Thaler, 2003; Camerer & Malmendier, 2007; Conlisk, 1996; Heaton, 2002; Hirshleifer & Thakor, 1992; Lovallo & Kahneman, 2003). Despite our best efforts, the empirical validity of different theories remains an open question (Asquith, Gertner, & Scharfstein, 1994; Jensen, 1993; John, Lang, & Netter, 1992; Lang & Stulz, 1992).

The purpose of this paper is to investigate a behavioral mechanism under which managerial actions can trigger firm exit. To this end, I focus on managerial hyperactive mergers and acquisitions (M&A) bidding behavior and examine the effect of such strategy on an extreme measure of firm performance, i.e., firm exit. It is well documented in the literature that most mergers and acquisitions destroy bidding firms' shareholder value (Agrawal & Jaffe, 2000; Andrade, Mitchell, & Stafford, 2001; Dodd, 1980; Firth, 1980; Malmendier, Moretti, & Peters, 2012; Moeller, Schlingemann, & Stulz, 2005; Ruback & Mikkelson, 1984). Despite the negative effects of M&A on shareholder wealth in general, some managers remain excessively acquisitive (Rahaman, 2009). In the academic literature, such behaviors have been interpreted as evidence of empire building (Jensen, 1986), misaligned personal objectives of managers (Morck, Shleifer, & Vishny, 1990), managerial hubris and overconfidence (Malmendier & Tate, 2005, 2008; Roll, 1986) and uncertainty regarding manager's own ability.[1] In the popular press,

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[1] Researchers such as Holmstrom (1999), Narayanan (1985), and Stein (1989) have developed models showing that managers choose short-term projects to quickly resolve uncertainty regarding their abilities. Hirshleifer and Chordia (1991) and Bebchuck and Stole (1993) show that this preference for resolution of

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it is often noted that "acquisitions may have less to do with a cunning business calculation than the inflated managerial ego."[2] In sum, the extant studies in the academic literature and the popular press suggest that hyper-acquisitiveness of a manager is (in an ex-ante sense) detrimental to firm value.

Indeed, using a sample of hyperactive bidders and a discrete-time hazard methodology, I find that excessive acquisitiveness is positively associated with the likelihood of inefficient exit of the bidding firm. After removing the exit hazard arising from various exogenous economic disturbances and idiosyncratic firm characteristics, I find that a one-standard-deviation increase around the mean of the hyperactive bidding measure is associated with a 61% increase in the conditional exit hazard of an overbidding firm. These results are robust to alternative specifications of estimation strategies, alternative definitions of firm exit, endogeneity, and reverse causality issues. These results point to the failure of the internal control systems of firms to cause hyperactive bidders to maximize efficiency. Substantial data also support this proposition as Jensen (1993) argues that the internal control systems of publicly-held corporations have generally failed to cause managers to maximize efficiency and value. Consistent with this argument, I find evidence that overbidding is associated with weak corporate governance and lower quality of accounting disclosure within firms.

I then propose three channels via which excessive acquisitiveness translates into heightened exit risk for firms. First, excessive acquisitiveness of a manager can increase the underlying business risk of the firm, thereby increasing the likelihood of inefficient exit. Second, hyperactive bidders may misallocate firms' capital, thereby distorting corporate investment policy and increasing the likelihood of inefficient exit. Finally, overbidding may dent the reputational capital of the firm, thereby limiting a firm's access to the capital market and increasing its exit risk. Using a mediating instrument methodology, I find that hyperactive bidders do take more idiosyncratic risk (compared to conservative bidders) that is not rewarded by the market. They also distort the firms' investment policies and dent the reputational capital of firms. As a result, such firms are also more likely to exit inefficiently compared to other acquiring firms in the industry.

The natural question that arises is: How effective are the external control mechanisms in disciplining managerial hyperactive bidding behaviors? To this end, I examine the relative importance of various capital-market disciplinary mechanisms to curb excessive acquisitiveness by redeploying the assets of overbidding firms to other higher-value users. I find that the capital market, on average, punishes hyperactive bidders by reacting negatively to their stock prices at the time of bid announcements, but the negative market reaction is not uniform across all quantiles of the conditional distribution of bidders' cumulative abnormal returns from bid announcements; at some quantiles the market reacts positively, while at others it reacts negatively revealing a sense of myopia in the capital market reaction. Despite this seeming myopia, I find that the external corporate control market eventually reins in the hyperactive bidders by turning them into future targets of takeover as suggested by Mitchell and Lehn (1990). Assets of hyperactive bidders are more likely to be redeployed via the external corporate control market than through other mechanisms such as bankruptcy/liquidation. However, given the positive announcement effects for some hyperactive bidders, the market discipline may not be swift enough to forestall falling value of the excessively acquisitive firm.

This paper makes three contributions to the literature on managerial behavior and firm exit. First, by identifying the effect of hyper-acquisitiveness on firm exit and various channels associated with this effect, it provides additional understanding of the competing theories of corporate exit in the literature. Lee and Malmendier (2011) show that overbidding in auctions is inconsistent with rational behavior. Malmendier and Tate (2008) show that overconfident CEOs overestimate their ability to generate returns and, as a result, they overpay for target companies and undertake value-destroying mergers. Contrary to Fuller, Netter, and Stegemoller (2002) who suggest that acquiring private and subsidiary firms creates value for bidding firms, Antoniou, Petmezas, and Zhao (2007) show that frequent bidders experience significant wealth losses regardless of the target type acquired over longer time horizon. This paper complements the extant studies by establishing a key relationship between overbidding and an extreme measure of firm performance, i.e., firm exit. Second, it illustrates the effectiveness of various market mechanisms in dealing with managerial sub-optimal behaviors. In particular, it shows that the capital market eventually disciplines any sub-optimal managerial behavior and redeploys the assets to other firms, and that this disciplinary role of the capital market is more pronounced when there exists a vibrant external market for corporate control. Finally, this study highlights the twin roles of the external corporate control market related to firm exit: managers can use it to pursue an aggressive corporate growth strategy to the detriment of the long-term survival of their firms, but outsiders can also use it to curb such behaviors.

Immediately following, Section 2 describes the data and main variables. Section 3 develops the empirical strategy and estimates the relationship between overbidding and firm exit. Sections 4 and 5 deal with the role of internal and external governance mechanisms in curbing the effect of hyperactive bidding on firm exit. Section 6 concludes the paper.

2. Data and main variables

2.1. Data

I use the Thomson Financial SDC Platinum Merger and Acquisition data set to identify the corporate M&A decisions. SDC details all public and private acquisition transactions involving at least 5% of the ownership of a company where the transaction was valued at $1 million or more, but after 1992, deals of any value (including undisclosed values) are covered. I focus on the U.S. industrial firms and collect all SDC documented M&A deals involving U.S. acquirers and targets from 1979 to 2006 totaling 208,105 deals. I then match the SDC deals with the merged quarterly COMPUSTAT-CRSP industrial file using the 6-digit CUSIP, ticker symbol, and company name. I apply a filter and keep only the deals for which I have CRSP daily stock price data on the transaction date, one day after the transaction date, and at least two months of daily stock price data prior to the transaction date. This filter ensures that I have a sufficient record of daily stock price data prior to and after the transaction date to calculate the cumulative abnormal return to the equity holders as a result of the transaction. The final deal data set contains 63,613 transactions involving 10,779 distinct bidding firms and 3582 deals involving 2124 distinct target firms. Firms that are in the merged quarterly COMPUSTAT-CRSP but do not

uncertainty regarding managerial ability may result in overinvestment in long-term projects such as M&As.

[2] Acquisitive Egos, The Economist, 1995. Other relevant business press articles include: "Why Do So Many Mergers Fail?" (Knowledge@Wharton, March 30, 2005); "Avoiding Decision Traps" (CFO Magazine, June 1, 2004); "Enron's Bust: Was It the Result of Over-Confidence or a Confidence Game?" (US Newslink, December 13, 2001); "Mergers & Acquisitions: Irreconcilable Differences" (Accenture Outlook Journal, January, 2000); "Mergers: Why Most Big Deals Don't Pay Off" (Businessweek, October 13, 2002).