Third Annual Cass Mergers and Acquisitions Research Centre Conference Report

20 August 2018

Cass Business School, London


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Research Centre Conference
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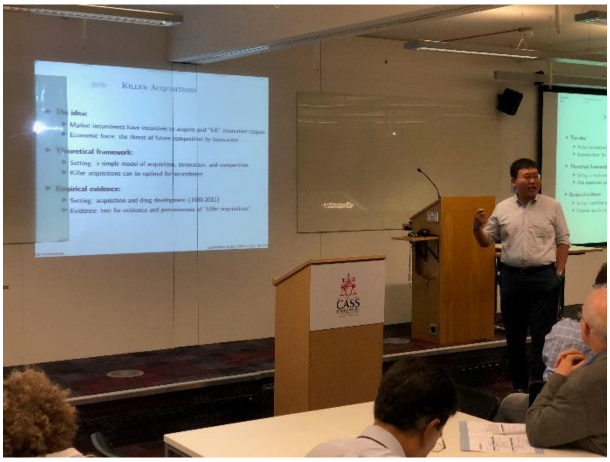
CASS



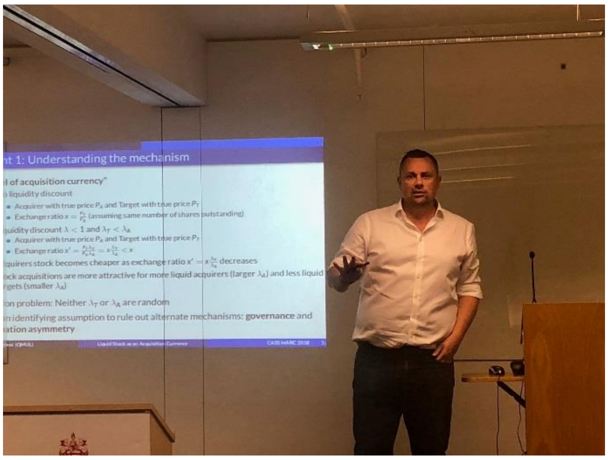
Song Ma, *"Killer Acquisitions"* (with Colleen Cunningham and Florian Ederer)

Song Ma presented a paper with an idea that market incumbents have incentives to acquire and terminate innovative targets. The paper develops a model, derives the implications and tests those using mergers and acquisitions (M&A) in the pharmaceutical industry. In the model, the paper uses backward induction, starts with product market competition in the last period, investigates the continuation decision in the intermediate period and resolves the acquisition decision in the first period. The key takeaway is that killer acquisitions can arise as an optimal incumbent, particularly when products overlap and current/future competition is low. Empirically, the paper measures product overlap by exploiting market delineations. The acquirer's product will overlap with that of the target if they are in the same market (same therapeutic class) and share similar technology (same mechanism of actions). The paper shows that acquired drug projects are less likely to be continued when there is product overlap and when the acquirer tries to maintain market power. Statistically, on a conservative basis, the estimates show that around 7% of the acquisitions in the sample are killer acquisitions and that eliminating their adverse effect on the drug project could increase the whole industry's aggregate drug project continuation rate by more than 5%.

The discussant, **Micah Officer**, worried about the generalizability of the paper. Killing innovative targets is a kind of "buy and burn" strategy and he argued that it hardly seems to be common. He was not convinced that this strategy is a common occurrence outside of acquisitions of small targets in the pharmaceutical industry. Further, he stated this strategy is difficult to rationalize with value-maximizing managers and questioned how acquirer managers can act in the best interests of their shareholders. The audience questioned why target managers allow the company to be acquired if the project is terminated in the end.

Johan Maharjan: *"Liquid Stock as an Acquisition Currency"* (with **Nishant Dass**, **Sheng Huang**, and **Vikram Nanda**)

More than half of acquisitions in the U.S. are fully or partially paid with acquirer stock and stock payment is a classic topic in the M&A literature. **Johan Maharjan**, presented a paper investigating the role of stock liquidity – for both of the acquirer and the target – in the M&A process. In stock-financed acquisitions, target shareholders prefer stock that is more liquid because they could trade the stock more quickly and with a lower price impact, and thus would be willing to accept a lower acquisition premium. The empirical results show that greater acquirer liquidity increases acquisition likelihood, and payment with stock reduces acquisition premiums and increases acquirer announcement returns in equity deals. To establish the causal link, the paper adopts the stock-market decimalization and reconstitution of Russell-1000/2000 as quasi-natural experiments and obtains similar results.

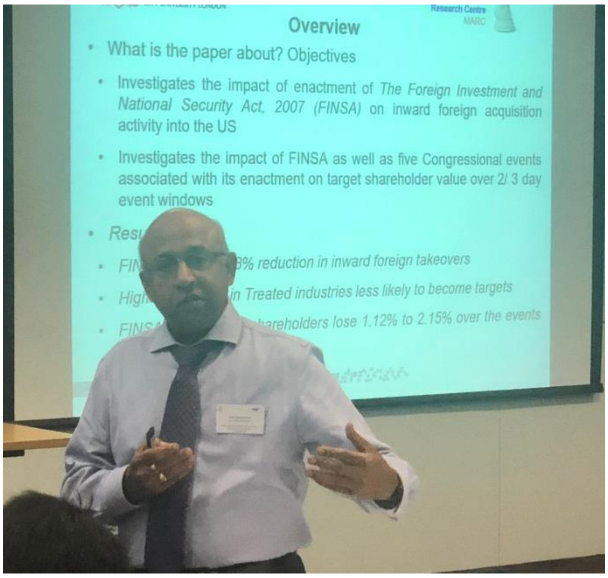


In his discussion, **Jason Sturgess** firstly challenged the mechanism behind the relationship of liquidity and acquisitions and argued that it is difficult to argue for the acquisition currency channel and completely rule out the governance and information asymmetry channels based on the main cross-sectional regressions. In addition to current cross-sectional tests, he made the following three recommendations to the author: within-firm analysis with industry-size-year fixed effects, propensity score matching and a larger sample over a longer time period. Further, he questioned the quasi-natural experiments as they only consider acquirer liquidity but not the relative liquidity of acquirer-to-target. In addition, two alternative settings could be brokerage mergers and exogenous fire-sale by constrained mutual funds. Also, he stated that liquidity is a greater concern in the developing markets and an international M&A sample is thus desirable. He suggested private equity firms which pay cash are also important M&A players and should therefore be considered.

Darius Miller: *"Financial Protectionism, M&A activity, and Shareholder Wealth"* (with **David Godsell** and **Ugur Lel**)

Darius Miller presented a paper which examines whether federally-legislated financial protectionism inhibits foreign investment and reduces shareholder wealth. The paper uses a significant law change as the empirical setting. The Foreign Investment and National Security Act of 2007 (FINSA) substantially increased scrutiny of M&A activity by the Committee on Foreign Investment in the U.S. (CFIUS) in a large array of U.S. industries. The difference-in-difference results show that compared to the control group of FINSA-unaffected firms, foreign takeovers of treatment firms declined by 68%. Acquisitions affected mostly by FINSA are firms with high pre-FINSA probability of foreign investment and technology firms. Further, FINSA-affected firms' value loss ranges from 1.12% to 2.15% on average (between $24.9 billion to $47.9 billion) over a three-day window surrounding five events related to the passage and implementation of FINSA.

Sudi Sudarsanam discussed the paper and made comments from several different perspectives. Firstly, he pointed out that there is a lack of theoretical framework and the costs and benefits of FINSA are not clear. The second comment was related to the conceptual issue and he argued that it could be beneficial to posit a corporate governance/managerial discipline angle to explain shareholder returns. He also questioned the sampling of the paper since some affected industries do not have any treated or control firms. Finally, he stated that because this paper is related to anti-trust regulation, a detailed discussion of policy implication would be necessary. The audience asked about joint venture and venture capital activities and whether they are affected by FINSA as well.



David Becher: *"Credit Control of Corporate Acquisitions"* (with **Thomas Griffin** and **Greg Nini**)

There are two views of creditor governance: Creditors could prevent risky projects and this might conflict with shareholders, but in the meantime, they could discipline managers and this is congruent with shareholders. **David Becher** presented a paper which examines how creditor monitoring impacts acquisition decisions and shareholder value. The paper uses covenant violations as an indicator of heightened creditor control since private credit agreements frequently impose restrictions on borrower acquisition decisions. Creditors will tighten these restrictions and limit acquisition activity if there is a covenant violation. Empirical results show that firms announcing an acquisition while in violation of a covenant earn average 1.8% higher stock returns, with the effect concentrated among firms with weak external governance. Managerial-agency conflicts appear to be the first order determinant of creditor restrictions.

In his discussion, **Francesc Rodriguez-Tous** questioned the randomisation of the paper. The size of treatment firms is much lower than that of control firms. The paper includes industry and year fixed effects. He argued that shocks to industries might trigger covenant violations and subsequent acquisition policies. Also, unobserved firm heterogeneity can increase the probability of covenant violation and acquisitions. He then suggested the industry times quarter fixed effect and firm fixed effects would be more appropriate. In addition, he questioned the role of creditors and asked whether the results are dependent on creditor characteristics. If all results are driven by creditors, and most are banks, he questioned how the results would be different compared to the pre-crisis period. The audience asked if many firms stay just below the covenant violation triggering point.

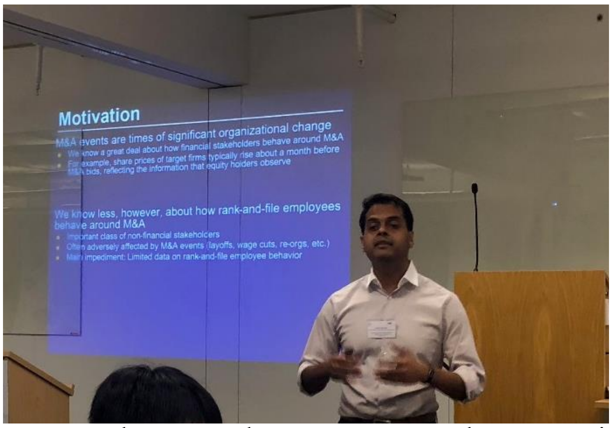
Keynote Speech

Philip Whitchelo: *"Confessions of an M&A dealmaker – insights from the intersection of theory and practice"*

The theme of the keynote speech was the intersection/cooperation of academic and M&A practitioners. To gain an overview of the composition of the audience and have a better interaction with them, **Philip Whitchelo** opened his speech by inviting everyone to participate in a poll. The poll result showed that most of the audience was academic. He then delivered a brief introduction of himself and Intralinks.

After that, he showed the M&A cycle since 1992 and stated that we are in the fifth M&A up-cycle. He then demonstrated the quarterly prediction of future trends in the global M&A market based on Intralinks' Proprietary Deal Flow Predictor. For the next six months, the number of deals will hit a new record high with deals concentrated in Asian-Pacific area. The key drivers will be economic growth, low inflation, low-interest rates, corporate tax cuts and a larger amount of private equity "dry powder". Further, M&A valuations are also reaching record highs and are 23% above their 25-year average.

After the macro M&A market outlook, he conducted a second poll and asked if M&A practitioners helped to set academic's research agenda and collaborated with academics in research. More than half of the audience responded that they have never collaborated with M&A practitioners. Philip claimed that Intralinks tries to bridge the gap between practitioners and researchers. There are three existential questions for M&A practitioners: 1) how do I create value from M&A; 2) what makes an attractive M&A target; 3) how can I avoid deal failure. Intralinks' research shows that active acquirers outperform the market and create more value for their shareholders. Two types of firms are attractive M&A targets: large size firms with high leverage and small size firms with low profitability. As for deal failures, the key driver for a public target is the target break fess and the key driver for private target is the firm size.



Ashwini Agrawal: *"Mergers and Acquisitions and Employee Job Search"* (with **Prasanna Tambe**)

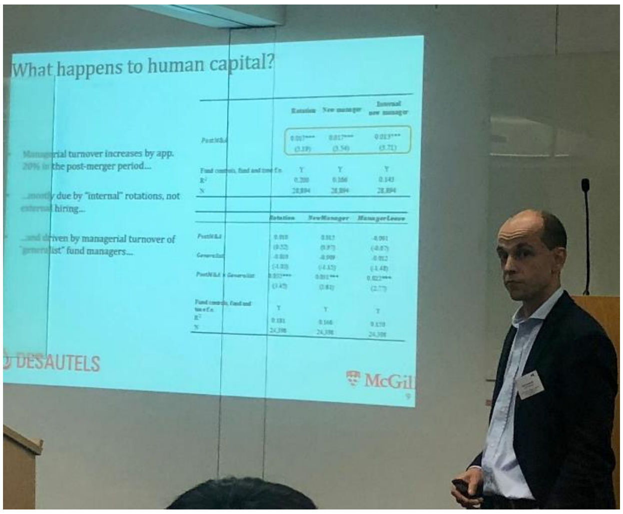
In previous M&A literature, financial stakeholder's behaviour is well researched. Little is known however about rank-and-file employee's behaviour. **Ashwini Agrawal** presented a paper which adopts proprietary data from a job search website to reveal how employees search for new jobs around M&A events. The paper documents several new empirical facts. Firstly, there is increased job search activity around five months before an M&A announcement while abnormal stock returns for target companies materialise usually one month before the event. Secondly, employees in these targets seek lower outside wages when they search for new jobs. Finally, there is heterogeneity in the timing of searches across work. There are three potential explanations: 1) Information related to M&A is dispersed across the organisation; 2) Poor firm performance drives both employee job searches and the M&A event; 3) There is reverse causality (workers leaving makes the firm a cheaper target). The results support the first explanation and offer no evidence for the rest.

In his discussion, **Andrey Golubov** stated that clarification about the data regarding the job seeker and M&A are necessary. For example, is the data for a particular worker or panel data? If so, what is the unconditional probability of being a job seeker? Further, what is the source of the M&A data? What about hostile/unsolicited bids? He then pointed out that the definition of the control group should be clearer. Matching would be desired as the data observations are rich. He also questioned the empirical specification as the firm is the analytical unit for the number of seekers analysis, while the worker is the unit for wage analysis. The audience made a point regarding middle-level managers: since they have a higher probability of getting fired, they are more likely to post their resume on a website and thus there will be a selection bias.

Hao Liang: *"Cross-Border Acquisitions and Employee Relations"* (With **Luc Renneboog and Cara Vansteenkiste**)

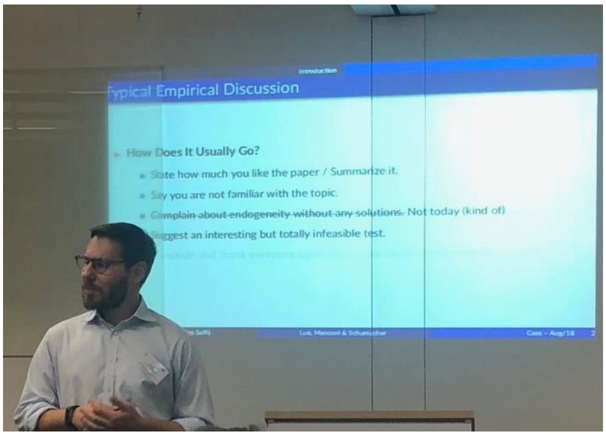
Hao Liang presented a paper examining the relationship between employee relations and M&A takeover. The paper hypotheses that acquirer shareholders view treating employees well favourably but they dislike such generous employment benefits in cross-border acquisitions. The empirical results show shareholders react positively to an acquirer's provision of employee-friendly policies around domestic acquisitions, but negatively in cross-border acquisitions. The channel relies on incentives and uncertainties. The effects mostly come from monetary incentives, rather than job security. The negative effect in cross-border deals is weaker when uncertainties about employee integration and employment policy consistency are reduced. Deal completion and long-run operating performance are consistent with short-run cumulative abnormal returns.

The discussant, **Paolo Volpin**, made comments from three perspectives: interpretation of the findings, measurement issues and endogeneity concerns. Firstly, employment quality is a composite index and measures many dimensions. It cannot be interpreted in the same way as employment protection. Employment quality is more about stakeholder rights than employment protection. He questioned whether this quality is more valuable in some sectors than in others. Also, he suggested that environmental factors and governance factors should be considered. In addition, he questioned why the paper picks up the fact that firms with more productive workers are making better acquisitions. The instrumental variable adopted in this paper may not address the endogeneity concern. The audience asked if cultural difference instead of employment quality would be the concern when the firm makes cross-border acquisitions.



David Schumacher: *"The Value of Human Capital Synergies in M&A: Evidence from Global Asset Management"* (with **Mancy Luo** and **Alberto Manconi**)

Many papers examine the relationship between mutual fund size and performance while less attention is paid in understanding potential economies of scale at firm level. **David Schumacher** presented a paper which uses mergers in the global asset management industry as a laboratory and researches economies of scale at firm level. The paper performs a micro-level analysis of merger-related operating changes in mutual funds and focuses on the role of human capital. The paper documents significant changes in managerial turnover, portfolio differentiation and fund performance in the post-merger period. The re-allocation of human capital following a merger creates \$4.2 million additional value per year per fund. The synergies are prevalent in mergers that increase the size and complementarity of human capital expertise and this leads to a better matching of human to investment capital.



In his discussion, **Pedro Saffi** tried to understand the mechanism behind the relationship between size and performance. What are the driving factors for consolidation in the industry? Could they be: lower cost, spreading fixed cost over larger asset under management or expansion into a new area? He then questioned the variable definition. The paper uses the change in the number of managers as the measurement for human capital and he questioned why the increase in human capital is simply the change in manager team size. Also, he suggested a clearer the definition of core and non-core investment areas. Finally, he pointed out that a large proportion of funds are sub-advisor and performance does not change much when firms hire/fire a sub-advisor. There are flows when poor performers are fired. In this sense, he questioned why the same people incapable of picking good managers can do so during a merger.