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Takeovers and Stockholders: Winners and Losers

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This booklet is one in a series designed to enhance the understanding of the private enterprise system and the key forces affecting it. The series provides a forum for considering vital current issues in public policy and for communicating these views to a wide audience in the business, government, and academic communities. Publications include papers and speeches, conference proceedings, and other research results of the Center for the Study of American Business.

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Introduction

> The directors of such [joint-stock] companies, however, being the manager rather of other people's money than their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartner frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honor, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.
>
> Adam Smith, *The Wealth of Nations*

The literature on corporate takeovers has focused primarily on shortcomings of the managements of target companies—who supposedly care more for their own interests than those of the shareholders—as the motivation for corporate acquisition; the accompanying run-up in the price of the target's stock is viewed as confirming evidence of the benefits to shareholders that will arise from efficiencies introduced by new management.[1] We believe that this analysis is incomplete and that misleading conclusions may be drawn from it.

The prevailing literature downplays the fact that the same potentials for conflicts of interest between target shareholders and their managements exist between acquiring firm shareholders and their managements. To the extent that manager remuneration, prestige, and general perquisites are a positive function of firm size, takeovers represent means by which management may act on this conflict of interest. Hence, management self-interest in the acquiring firms is an alternative motivation for corporate acquisition. Contrary to prevailing theory, the market for corporate control may not provide effective policing of manager abuses, especially in the short run. The empirical evidence on this point is quite clear, as we will see.

In our view, the issue of the justifiability of merger activity is misplaced. Negative wealth effects to acquiring firm shareholders can

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occur even in a properly functioning market for corporate control. Winners and losers exist and the data are specific as to who they are. This highlights the fact that simply advocating a free market for corporate control is not sufficient to protect the interests of shareholders. What is required is a stronger set of internal checks on the agency relationship governing the responsibility of management. In particular, corporate boards that are more responsive to the concerns of the shareholders are needed to serve as healthy counterweights to the actions of management.

Background

Implicit in most academic studies of changes in corporate control is the notion that internal monitoring of management is ineffective in protecting the interests of the shareholders. Because of the difficulties involved in day-to-day oversight, firms have the incentive to devote part of their resources to enhance management prerogatives rather than profit maximization. Hence, they will not be operating efficiently. This situation will be reflected in a low evaluation of the company's stock in the market for securities.

Under such circumstances, it has been suggested that the market for corporate control can act as an external check on management.[2] Undervalued shares invite takeover attempts as outsiders realize the gains to be made by expelling inefficient, entrenched management. Replacing those managers with executives more willing to seek a profit-maximizing strategy will presumably improve the valuation of the firm's shares in the market. In this view, corporate takeovers provide economic gains. In efficient capital markets, the resultant increased profitability implies enhanced shareholder wealth. Indeed, a large number of "event" studies confirm the usual pattern of increases in stock market evaluations of firms that are targeted for takeover.[3]

Typically, the shareholder gains from an acquisition are estimated by comparing the "abnormal" returns to the shareholder arising from the acquisition and the normal returns from ownership of the stock. A fairly standard and sophisticated methodology has been developed for this purpose (based on the well-known capital asset pricing model). We do not quarrel with that approach for the purposes of this study. In fact, we rely upon it in the section that follows. However, we do need to acknowledge the presence of a few studies that report contrary results; that is, they show that frequently companies and their stock values perform more poorly after takeovers.[4]

The Returns to Acquiring Firms

As noted earlier, the empirical studies of corporate takeovers focus on the benefits to the shareholders of the target companies. Nevertheless, a substantial body of data exists on the effects of takeovers on the shareholders of the acquiring firms. In fact, both sets of data typically are taken from the same studies, using the same methodology. However, the data on the acquiring firms provide some interesting variation from the dominant theme in the literature which finds takeovers generally improving the performance of the business sector.

Table 1 presents a survey of ten takeover studies which report cumulative average abnormal returns to acquiring firm shareholders over three separate event periods. Virtually all studies report positive abnormal returns to acquiring firms in the weeks or months prior to the actual announcement of the merger. This is the factual basis from which the prevailing literature concludes that shareholders of the acquiring firm benefit from mergers.

But that is not the end of the story. Only two of the studies show significantly positive returns around the date of the announcement; four report insignificant gains or losses during that limited time period, and three report significant decreases in the returns to bidding companies. Of even greater interest is the fact that nine of the ten studies go on to report losses in shareholder returns during the period following the announcement of the merger.

Using the same theoretical framework as the prevailing literature employs for analyzing the effects on target firms, we are led to the conclusion that the significant negative cumulative abnormal returns due to acquisition indicate that the acquisitions are, on average, a poor investment for acquiring firms. Parallel to the concern about the shortcomings of target managements, the negative returns indicate the ability of managements of the acquiring firms to act in their own behalf and not in the shareholders' best interests.[5]

Of course, these results have puzzled those sympathetic to the view that takeovers create wealth. Inevitably, the statistical methodology has been challenged. Specifically, the notion of measuring cumulative abnormal returns around the event date has been criticized because returns will be influenced by the size of the firm involved in the acquisition. Since most acquisitions involve a larger firm acquiring a smaller one, the measured returns to the bidding firm will be biased downward simply due to the size factor. This concern can be

Table 1. Average Abnormal Returns to Acquiring Firms
[Periods are reported relative to announcement date (0)]

Study		Cumulative Average Abnormal Returns (in percent)
Asquith (1983)	Preannouncement period (−480 to −20 days)	14.3%*
	Announcement date (0 days)	0.2
	Post-announcement period (1 to 240 days)	−7.2*
Asquith et. al. (1983)	Preannouncement period (−20 to 0 days)	2.8*
	Announcement date (0 days)	0.9*
	Post-announcement period (1 to 20 days)	−0.2
Dodd (1980)[1]	Preannouncement period (−40 to 0 days)	5.37*
	Announcment date (0 days)	−0.62*
	Post-announcement period (0 to 40 days)	−0.2
Dodd and Ruback (1977)	Preannouncement period (−12 to −1 months)	11.66*
	Announcement date (−1 to 1 month)	2.83*
	Post-announcement period (1 to 12 months)	−1.32
Eger (1983)	Preannouncement period	n.a.
	Announcement date (−5 to 10 days)	−4.0*
	Post-announcement period (0 to 20 days)	−3.1*
Firth (1980)[2]	Preannouncement period (−12 to −2 months)	−0.3
	(−1 month)	−0.1
	Announcement date (0 months)	−6.3*
	Post-announcement period (1 to 12 months)	0.5
Langetieg (1978)[3]	Preannouncement period (−6 to −1 months)	−2.25*
	Announcement date (0 months)	n.a.
	Post-announcement period (1 to 12 months)	−6.25*
Malatesta (1983)	Preannouncement period (−60 to 0 months)	4.3*
	Announcement date (0 months)	0.9*
	Post-announcement period (1 to 6 months)	−5.4*
	(7 to 12 months)	−2.2*
Mandelker (1974)	Preannouncement period (−40 to 1 months)	4.9*
	Announcement date (−1 to 0 months)	0.18
	Post-announcement period (0 to 40 months)	−1.5
Mueller and Magenheim (1984)	Preannouncement period	n.a.
	Announcement date (0 months)	0.28
	Post-announcement period (−3 to 36 months)	−42.2*

[1]Dodd also reports returns around first public announcement of subsequently completed mergers. The are −1.09%, −.29%, and −7.22% for the preannouncement, announcement, and post-announcement dates respectively.

[2]Covers U.K. firms.

[3]Presents results from four different performance measures. Results reported here reflect an average of all four measures.

*Indicates statistically significant results.

Source: See Bibliography

remedied by estimated abnormal dollar returns rather than abnormal returns per share. Table 2 presents the studies that have been prepared on this aggregate basis.

The results are not very different. Only one study shows evidence of positive dollar gains to shareholders of acquiring firms, while the other four have negative returns. Several writers have attempted to explain away the negative findings. Some suggest that the tendency for the lack of positive changes in acquiring firm stock value is related to the fact that the market capitalizes the gains to acquiring firms at the time they announce a takeover program.[6] Hence individual acquisition announcements have little stock market effect because they have already been discounted. Other explanations, such as inefficiencies in the market itself, are quickly dismissed.[7] As for the statistical methods used, whatever shortcomings they possess are nevertheless enthusiastically embraced when they show gains to target shareholders.

Net Wealth Effects of Corporate Acquisitions

Evidence of negative returns to acquiring firm shareholders raises the question of the direction of aggregate wealth effects in the takeover process. From a policy perspective, the combined gain or loss to shareholders of target and acquiring firms is the relevant number on which to focus. The net return identifies if takeovers, on average, create or reduce social (aggregate) wealth while abstracting from distributional effects of the process.

A difficulty that arises in the determination of the overall wealth effects of corporate acquisitions (i.e., returns to acquiring firm shareholders plus returns to target firms) is that most studies use average abnormal "rates of return" of the respective firms in question. Comparing returns to acquiring firms and target firms is meaningless since such a comparison says nothing about the aggregated wealth effects of the merger. For example, a target firm may incur a positive abnormal return of 20% and the acquiring firm only a 5% negative abnormal return. Yet, if the acquiring firm is sufficiently large (i.e., has a much larger amount of outstanding shares), the total dollar return of the transaction may be negative.

It is interesting to note that while this aggregate dollar return is the key number with which policy makers are concerned, very few studies report it and instead concentrate on the "rate of return"

Table 2. Average Abnormal Dollar Returns to Acquiring Firms

Study		In Millions
Bradley Desai and Kim (1982)[1] (162 tender offers)	Period (−20 to 5 days)	−$17
Bradley Desai and Kim (1983)[1] (698 tender offers)	Period (−20 to 5 days)	+$6
Firth (1980) (434 takeovers)	Period (−1 to 0 months)	−$1,140
Malatesta (1983) (256 mergers)	Period (−60 to 0 months)	−$111
Varaiya (1985)[1]	Period (−60 to 60 days)	−$129

[1]See Richard Roll, "The Hubris Hypothesis of Corporate Takeovers," *Journal of Business,* Vol. 59, No. 2 (April 1986): 203.

Source: See Bibliography.

approach. We have found only six studies that report total wealth effects of corporate takeovers. These are reported in Table 3.

The results are mixed. One study (Firth, 1980) presents evidence of aggregate wealth losses.[8] Another (Halpern, 1973) suggests aggregate wealth gains, while the remainder do not differ statistically from zero.[9] From this limited evidence, it appears that the total wealth effects to society are approximately zero. Clearly, the data do not support the notion that owners of acquiring firms generally benefit from takeovers. The available evidence of aggregate returns further suggests that acquiring firm losses on average are large enough to completely offset the gains made by owners of target firms.

The next section introduces an alternative view of corporate acquisitions. We suggest that, in a market for corporate control where transactions costs are present, the managements of the acquiring firms can pursue acquisition strategies that satisfy their individual interests at the expense of their shareholders.

Table 3. Average Aggregate Abnormal Dollar Returns
(Acquiring Firm Plus Target Firm Dollar Returns)

Study		In Millions
Bradley Desai and Kim (1982)[1]	Period (−20 to 5 days)	−$17.0
Bradley Desai and Kim (1983)[1]	Period (−20 to 5 days)	+$33.9
Firth (1980)	Period (−1 to 0 months)	−$36.6*
Halpern (1973)	Period (−7 to 0 months)	+$27.35*
Malatesta (1983)	Period (−60 to 0 months)	+$0.29
Varaiya (1985)[1]	Period (−60 to 60 days)	+$60.7

[1]See Richard Roll, "The Hubris Hypothesis of Corporate Takeovers," *Journal of Business,* Vol. 59, No. 2 (April 1986): 203.

*Indicates statistical significance.

Source: See Bibliography.

Management Self-Interest as an Incentive for Acquisition

The existence of negative returns to shareholders of acquiring firms suggests that acquisitions do not reflect a profit maximization strategy on the part of the managements of the acquiring firms. If shareholder interest (i.e. profit maximization) is not the motivating factor for takeovers, then it must be the case that management self-interest is. The same incentive differentials which encourage managers to appropriate the firm's resources for their own benefit can also be the driving force behind corporate acquisitions.

Through takeovers, acquiring firm managers can create new potentials for exploiting the manager-shareholder relationship. By creating larger, more diverse corporations, managers increase the shareholders' cost and complexity of monitoring. Furthermore, if the managers' proportion of equity in the new, larger firm falls, that lowers the cost to management of deviating from a profit-maximizing strategy. The result of acquisition is that management can extract more of the firm's resources for itself.

The ability of managers to pursue their own self-interest results from the nature of the corporate structure (that is a variation of the point made by Adam Smith in the opening quotation). Managers have two key roles within the firm. First, they have been hired (with compensation) by the shareholders to apply their particular skills toward managing the firm's assets. Secondly, managers are often shareholders and like other owners are concerned with the value of their shares. Managers who own only small fractions of the outstanding equity and reduce that fraction further through acquisition can appropriate more of the corporate resources in the form of "rents" without paying the full cost of doing so.

One team of researchers has confirmed this hypothesis with regard to acquisitions. A study of 191 acquiring companies during the period 1963-1981 found a positive relationship between abnormal stock returns from mergers and the percentage of the acquiring firm's shares held by management.[10] This positive relationship supports the hypothesis that the lower the percentage of share ownership by the manager, the greater the incentive to undertake acquisitions that may not be in the shareholders' best interest.

The market for corporate control can correct this inefficient use of resources through counter-acquisition. Assuming no market imperfections, another firm (or individual) can acquire the management-dominated firm, pursue the appropriate profit-maximizing strategy, and reap the benefits of increased value. The gain in doing this must be distributed between management and the shareholders of both the acquiring and target firms.

Alternatively, if imperfections such as significant transaction costs of acquisitions are present, the cost of counter-acquisition may outweigh its payoffs, and the market provides no effective incentive to correct the situation. One researcher showed that transaction costs limited tender offers until share values fell at least 13 percent.[11] This finding supports the possibility of negative returns to acquiring firm shareholders. While the potential for pursuit of management self-interest exists, the next section considers the actuality of it occurring.

The Incentives to Acquire

The "rents" received by management can be broadly classified into two groups. The first has been called nonpecuniary benefits. These are the somewhat intangible and difficult to measure benefits derived from controlling a larger group of corporate assets. Examples of these were mentioned earlier: increased economic or political

power and prestige, greater job satisfaction, etc.

The second type of rent is the pecuniary remuneration received as a result of managing larger amounts of corporate assets. These more easily measured rents come in the form of salaries, bonuses, restricted stock plans, and stock option plans.

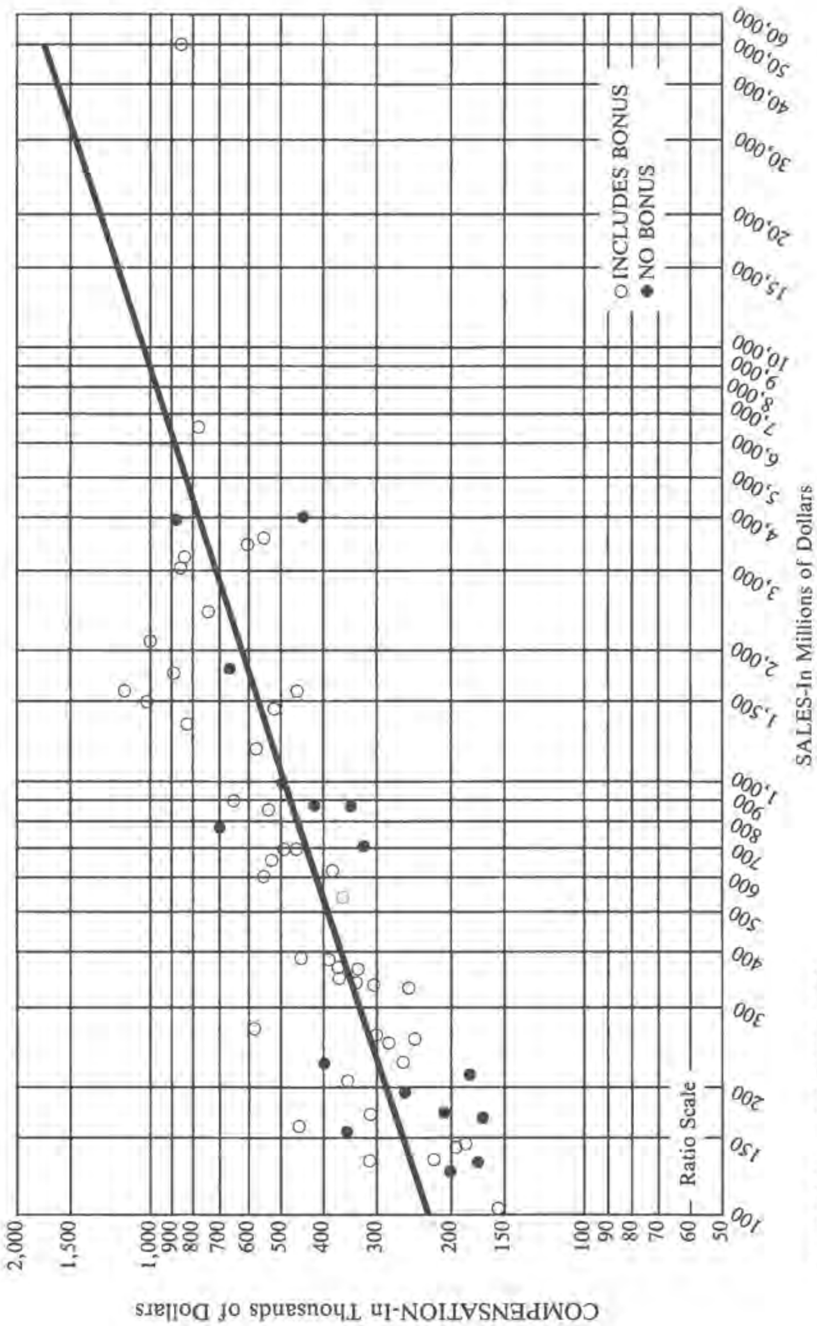
Trying to measure nonpecuniary rents is problematic since no real standard of measurement exists. Consequently, casual observation presents the only alternative. Certainly, the common perception is that larger and better perquisites are available to those who control a greater amount of corporate assets. If one is willing to accept this presumption as true—and substantial anecdotal evidence is available—corporate acquisition is an effective method of increasing the quantity of corporate assets over which management has discretion.

One particular form of nonpecuniary rent studied in the literature views corporate acquisition as a method of diversifying managers' "employment risk" (i.e., the risk of losing their jobs, professional reputations, and employment perquisites).[12] Since manager remuneration and other perquisites are tied to firm activity, the manager's employment risk is closely related to the firm's risk. While shareholders can diversify their portion of firm risk by holding a broad portfolio of capital assets, managers heavily endowed in firm-specific (i.e., non-tradeable) human capital are not able to do so. If managers are risk averse, they will attempt to diversify by some other means. One such method is to undertake corporate acquisition to broaden the firm's market and stabilize its income stream. Mergers having these characteristics may be viewed as a particular form of management perquisite intended to decrease the risk associated with the manager's human capital.

This hypothesis suggests that firms more heavily controlled by managers are more likely to be involved in acquisitions as managers seek to impose their risk-reducing preferences on the corporate structure. The data appear to bear this point out. A study of acquisitions between 1961 and 1970 found that, on average, firms with weak owner control made twice as many acquisitions as those with strong owner control.[13]

Measuring monetary compensation is considerably easier. A variety of scholars has suggested that managerial compensation is directly proportional to firm size.[14] Maximizing the growth of the firm becomes the dominant strategy of the self-interested manager. The data contained in a recent study by the Conference Board support this suggestion. Using the Board's data, Figure 1 shows the rela-

Figure 1. Compensation of the Chief Executive Officer, by Company Sales



Source: Conference Board, 1986.

tionship between total compensation of Chief Executive Officers and total sales as a proxy for company size.[15] The chart clearly indicates that managerial remuneration rises with firm size. While other factors contribute to a CEO's salary and bonuses, the Conference Board reports that approximately half of the variation in CEO pay is statistically explained by variations in company size.

The Conference Board also notes that, among industries providing sufficient data to analyze (namely, manufacturing, banks, insurance companies, and retailers), bonus awards tend to be a larger percentage of salary the larger the size of the company.[16] The results reported by the Conference Board are hardly an aberration. The fact that managers generally benefit from increased firm size has been well documented in earlier academic studies.[17]

One scholar has directly examined the hypothesis that corporate acquisition is an effective means of increasing managerial compensation. A study of 355 successful United Kingdom takeovers found the average increase in managerial remuneration from acquisition to be 33 percent. The average increase for managers of firms not involved in acquisitions during the same period was approximately 20 percent. This indicates that, at least in that large sample of changes in corporate control, acquisitions benefited acquiring firm managers substantially. Meanwhile, the shareholders of these firms were losing over 1 billion pounds sterling.[18]

The evidence appears clear. The normal operation of the market for corporate control allows potential for pursuit of self-interest on the part of acquiring firm management. Furthermore, the benefits to managers from increases in firm size do exist. Finally, management is indeed acting on the incentives provided.

The Need for Stronger Internal Monitoring

Shareholders have an alternative method of controlling manager behavior. Regardless of the limited ability of the market for corporate control to police manager activity, shareholders can always reject a reduction in wealth by voting as a group to disapprove the merger.

Several explanations have been put forth as to why shareholders may approve actions that are detrimental to their interests.[19] The most compelling is that information and transaction costs required to reject the action may at times be sufficiently large to rule out effective opposition.

Managers may also have an advantage in a merger situation. Even though share prices had fallen upon announcement, they may convince shareholders either explicitly or implicitly that they have special information that the market has not taken into account. To the extent that shareholders trust management, they will be more likely to rubber stamp the decision.

This serves to highlight the role of the corporate board of directors. The board has a fiduciary responsibility to act in the best interest of the shareholders they represent. Since transaction costs in the market for corporate control and high information costs to shareholders limit the extent to which they can monitor management activities, the board of directors assumes the responsibility of doing so.

Conclusions and Policy Suggestions

We conclude that, based on historical data, negative returns to shareholders from acquisitions are more prevalent than the prevailing folklore on the subject admits. Clearly, there are winners and losers in the takeover game. Most studies confirm that, in general, target firm shareholders are winners. The evidence presented here indicates that, on average, acquiring firm shareholders are not as fortunate. At best, these shareholders are no worse off, but often they lose during acquisitions.

Furthermore, while the acquiring firm shareholders are losing overall, the individuals they have hired to manage their assets are benefiting from their loss. Takeover promoters are not the champions of the small shareholder, as so often claimed. Rather, it is intriguing to note that they promote the interests of a select group of shareholders to which they have no obligation, at the same time neglecting those whom they were hired to serve.

Despite this rather gloomy reexamination of the takeover process, we refrain from suggesting additional government regulation as a solution to managerial abuses. The history of government regulation of business in the United States hardly supports the case for expanding the role of the public sector in private sector decision making. The market for takeovers is too complex to permit a regulatory body or statute to effectively sort out acquisitions that produce only wealth gains. Moreover, a free market for corporate control is necessary for the maintenance of an efficient and dynamic corporate sector. Yet, such a market is not free from imperfections.

The appropriate response to corporate acquisition requires stronger internal checks on the management of acquiring firms. There are many ways to accomplish this objective. One involves tying manager remuneration more closely to share price performance (e.g., stock option plans and larger managerial share holdings). Other approaches include increasing the accuracy and clarity of financial reporting, and generally strengthening shareholders ability to oversee large investment decisions. More fundamental is the responsibility for oversight of management which is lodged in the corporate board of directors. A more assertive board willing to take a stand against actions not in the best interest of the shareholders they represent will also ensure stronger internal checks on management.

The increasing frequency of legal challenges to board decisions makes it more likely that board members, especially independent outside directors, will change their customary approach of supporting the management's proposals for investments and acquisitions, as well as other matters. Rather than automatically deferring to management (which at times may subject them to expensive shareholder suits), board members in the future may be focusing more attention on the desires of the owners of the firm, whom they legally represent.

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