The Dark Role of Investment Banks in the Market for Corporate Control

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What Does This Paper Do?

- ## Combines two literatures

  - Large literature on return patterns surrounding M&As

  - Growing literature on agency conflicts involving financial intermediaries

- ## Sheds new light on role of the advisor in M&As

  - Agency conflict between advisors and acquirers contributes to negative acquirer returns

  - "Our results also cast some doubt on the corporate governance role played by the M&A market"

Anatomy of an Agency Conflict

Consider the following relationships:

- **AAA** has a business relationship with **BBB**

- **BBB** has a business relationship with **CCC**

  *where relationship **AAA-BBB** is "stronger" than relationship **BBB-CCC***

Agency Conflict ⇒

BBB takes actions that benefit **AAA**…

… at the expense of **CCC**

Potential Agency Conflicts

Ex 1. Mutual fund **AAA** pays commissions to trading desk of investment bank **BBB**, which underwrites the IPO of firm **CCC** $\Rightarrow$ **Potential for BBB to benefit AAA at expense of CCC** *(by setting low price per share for CCC and allocating underpriced shares to AAA)*

Ex 2. Author **AAA** writes papers with author **BBB**, who is asked to discuss another of **AAA**'s papers for the benefit of audience **CCC** $\Rightarrow$ **Potential for BBB to benefit AAA at expense of CCC** *(if BBB refuses to publicly trash a bad paper)*

Potential Agency Conflict Between Advisors and Acquirers

The Setting

- Fund **AAA** is related to investment bank **BBB**

- Investment bank **BBB** is retained by acquirer **CCC** to advise on potential M&A targets

Two "Dark" Outcomes of Interest

1. **AAA** receives and trades on inside information about the target (*Inside Information Hypothesis = **IIH***) $\Rightarrow$ **Illegal but not necessarily harmful to acquirer**

2. **BBB** "sacrifices interests of acquirer" when selecting target and determining level of the bid (*Conditioning Hypothesis = **CH***) $\Rightarrow$ **True agency conflict**

Empirical Strategy

- Aggregate 13F holdings to "brand" level
  - In 2005, AXA brand = AXA Advisors + Sanford C. Bernstein + AXA Equitable Life + AllianceBernstein + MONY

- Determine if advisor to acquirer holds shares in target
  - On June 30, 2000, Merrill Lynch brand held 51,674 shares of Fort James Corp. On July 17, 2000, Georgia Pacific made a friendly bid for Fort James Corp. Merrill was GP's advisor.

- Regress y on measure of the advisor's holdings of the target (in quarter before the announcement) and controls
  - Advisor holdings measures as $, % common shares outstanding, and dummy indicating when holdings are positive
  - Coefficient on *Ownership by Advisor* used to test **IIH** and **CH**

Summary of Evidence (1)

- **T1:** In acquisitions that destroy the most value, advisor is most likely to own shares in the target
  - 49.6% with positive holdings vs. 28.7% in other deals
  - Consistent with **CH**
  - However, evidence much stronger for $ returns than % returns
  - If banks that advise on largest deals most likely to have asset management arms, correlation could be spurious

- **T4:** Firm is more likely to be target when advisor has (recent) ownership stake ($, %, or dummy) in the target
  - Consistent with both **IIH** and **CH**
  - Unclear how specification is estimated. Given one observation per potential target per advisor/M&A event, correct specification is (probably) fixed effects logit.

Limits to Empirical Strategy

- Don't distinguish between direct and indirect holdings
  - Does the aggregation add additional power to the tests?
  - Do legal restrictions, etc., lead us to expect weaker results when focused only on directly holdings?

- Don't distinguish between active and passive holdings
  - Since Merrill Lynch offers index funds, it will have positive holdings of most potential targets…
  - Want to focus on time-series variation in Merrill Lynch's active holdings, *perhaps measured as % of Merrill's equity portfolio rather than as % of target's shares outstanding*
  - Controlling for lagged holdings is a good start but the control seems to missing from Table 4
  - Why not include advisor fixed effects?

Limits to Empirical Strategy (2)

- Control for % equity held by all 13F filers, but I'd like to see more controls for institutional ownership

  - Since *Ownership by Advisor* is not always measured the same way as *Institutional Ownership*, I would simultaneously control for institutional holdings measured as $, %, and dummy

  - As a falsification test, for each acquirer-target pair, construct an ownership variable based on ownership by those brands most active in the M&A advisory over the prior year *excluding the advisor to the acquirer* and use these measure in place of *Ownership by Advisor*.

    - Similar, in spirit, to "matched sample" return analysis in T7; more intuitive than the *Change in Arb. Capital* measure

Summary of Evidence (2)

- **T5:** Takeover premium is higher when adviser has ownership stake in the target ($, %, or dummy)
  - Consistent with both **IIH** and **CH**
  - However, one specification suggests result is limited to inexperienced acquirers (which had no IPO, SEO, debt issue, M&A deal, or repurchase in prior 3 years)
  - One interpretation: Banks take advantage of first time acquirers in the same way they take advantage of first time issuers (IPOs)

- **T6&7:** Knowledge of advisor ownership stakes generates profitable long-short trading strategy
  - Consistent with both **IIH** and **CH**
  - Results hold up across numerous specifications, including matched sample analysis in T7

Summary of Evidence (3)

- **T8:** Mergers more likely to succeed when adviser has ownership stake in the target (81.9% vs. 76.2%)
  - Only consistent with **CH**… unless **IIH** $\Rightarrow$ marginal proxy vote
  - Why? Table 9 provides evidence on increased use of Target Termination Fees (Officer (2003))

- **T10:** Merged entities exhibit lower ROE, ROA, and Profit Margins during next fiscal year when adviser has ownership stake in the target
  - If increased Pr(success) is not a benefit $\Rightarrow$ consistent with **CH**
  - However, increased Pr(success) *may* imply optimal marginal acquisition has lower NPV, implying lower ROE, etc.
  - How do you deal with serial acquirers? Are results stronger if the sample is restricted to inexperienced acquirers?

Things I'd Still Like to Know

- What happens when the advisor has ownership stakes in both the acquirer and the target? If results are driven by agency conflict, we'd expect them to be weakest when advisor's stake in the acquirer is largest. Do they dump holdings of the acquirer prior to the announcement?

- Are advisors to the acquirer more likely to recommend potential targets that they took public (or otherwise underwrote for)? This is a direct proxy for advisor's knowledge of the firm.

- What role do advisors to the targets play? Do they dump holdings of the acquirer prior to the announcement?

Conclusions

- Should you read this paper? **Yes.** It asks an intriguing question and conducts sensible tests along numerous dimensions.

- That said, I'd like to see the authors really beat up their initial (and necessary) result that advisor ownership stakes help predict M&A targets

- The obvious remaining question is this:

  How do we weigh the costs that advisors impose upon (inexperienced) acquirers against the benefits that we might expect them to generate?