

Governance Provisions and Firm Performance during Merger Wave

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ABSTRACT: I examine the impact of takeover defences on acquirer performance during merger wave. Previous literature reports poor acquisition performance associated with governance provisions. Using a sample of 4,545 completed deals, I find that the negative relation between takeover defenses and acquisition returns exists only when mergers occur during the period of merger wave. The result in the paper shows that the adverse impact of takeover defenses is conditional on the time period. The finding suggests that the capital market does not fully anticipate the behavior of acquirers during the merger wave driven by the technological and regulatory shocks.

KEYWORDS: Corporate governance; takeover defenses; mergers and acquisitions; abnormal returns

I. INTRODUCTION

Using the governance index that counts the number of takeover defenses adopted by a firm, Gompers, Ishii, and Metrick (2003) document that the trading strategy based on a corporate governance index generates a positive abnormal return. Chi (2005) finds that investors did not fully anticipate the difference in firm performance between firms with strong versus weak shareholder protection.

Agency theory indicates that poorly monitored CEOs may initiate the value-destructive acquisitions at the cost of shareholder's interests (Morck, Shleifer, and Vishny, 1990; Lang, Stulz, and Walkling., 1991). Masulis, Wang, and Xie (2007) show that acquirers under weak governance structures are more likely to engage in value-destroying acquisitions. The result implies that an unaware capital market fails to recognize the importance of governance structures that protect shareholders' rights.

In addition, previous literature indicates that the adverse impact of takeover defenses is exacerbated during merger waves. Cremers and Ferrell (2012) argue that the corporate governance-based trading strategy yields a higher abnormal return during merger waves when many firms do M&As in the same period. This suggests that the association between the takeover defenses and acquirer returns co-varies with M&A waves. The adverse impact of takeover defenses becomes more pronounced when other firms undergo merger waves at the same time.

In theory, takeover defenses may enhance firm value by increasing takeover premium or destroy it if they entrench potential target managers. On the positive side, takeover defenses deter acquirers' incentives to engage in value-destroying M&As by increasing the target premium. However, when many firms engage in M&As at the same time, managers of acquirers with a weak monitoring structure are more likely to pay the takeover premium.

Shleifer & Vishney (2003) argue that unanticipated shocks in valuation drive merger waves. Andrade, Mitchell, and Stafford (2001) claim that the capital market fails to fully price in the value of takeover defenses because the external shocks that drive merger waves are unpredictable. When mergers are not anticipated by the market during merger waves, the market will be negatively surprised by the announcement of unanticipated poor acquisitions. This merger wave hypothesis predicts that the impact of takeover defenses on acquirer returns worsens during merger waves. The result shows that the takeover defenses are associated with negative abnormal announcement returns for acquirers only when mergers occur in waves.

The finding contributes to the existing literature in a significant way. Previous literature reports poor acquisition performance associated with governance provisions. The results in the paper extend the findings by showing that the adverse impact of takeover defenses is relevant only during merger waves.

The paper is organized as follows. Section 2 describes the sample selection procedure. Section 3 is the empirical results. Section 4 concludes the paper.

II. SAMPLE DATA SELECTION

The merger sample is collected from the Securities Data Corporation's U.S. Mergers and Acquisitions database. To be included in the sample, the acquirer is an U.S. company that controls less than 50% of the target's shares prior to the announcement and owns 100% of the target shares after the transaction, and the deal value shall be greater than \$1 million. The sample merger data is matched with other financial and deal-related data. The sample is also matched with announcement return data. Dual-class firms and real estate investment trusts (REITs) are excluded. Finally, the takeover defenses data from RiskMetrics is

matched to the sample. The measure of takeover defenses is the entrenchment index developed by Bebchuk, Cohen, and Ferrell (2009). The takeover defenses are indexed by counting six takeover defenses that include classified boards, limits to amend the charter, limits to amend bylaws, supermajority rule, blank check preferred stock, and poison pill.

From table 1, the final sample consists of 4,329 acquisitions between 1990 and 2006. There are more merger activities from the year 1998 than before. The increase is due to the expansion of IRRC coverage. Following Cremers and Ferrell (2012), the merger wave is defined to the period from year 1996 to 2000. Other years are “non” merger wave period. There are 1,530 mergers during the merger wave period and 2,799 mergers during the “non” merge wave period.

III. TEST RESULTS

The merger announcement period returns are measured. The expected returns are computed with the market model residuals with the CRSP value-weighted index as the benchmark market index. Market model parameters are estimated over a (-210, -11) day window before the merger announcement date. Table 2 reports the cumulative abnormal return (CAR) around the five-day announcement date. CAR is significantly lower during the period of merger wave, compared to that of the non-merger wave period. The mean CAR is -0.35% in the merger wave and it is 0.05% in the non-merger wave period. The finding suggests that acquirers make poorer acquisition decisions during the merger wave period.

Next, I examine the relation between takeover defenses and merger performance during the merger wave period compared to the non-merger wave period. After controlling for the deal and firm characteristics, and industry fixed effect, the result shows that takeover defenses are more harmful to acquirers' performance during the merger wave period.

In Table 3, I regress the takeover defenses on the CAR controlling for deal characteristics, acquirer characteristics, and industry fixed effect. Deal characteristics include private status of targets, hostility of the deal, cash deal, tender offer, an indicator variable indicating whether acquirers or targets belong to high-tech industries, a dummy variable indicating that acquirers and targets are in the same industries, and relative deal size. Acquirer firm characteristics are free cash flow, firm size, market-to-book ratio, and leverage.

Table 3 shows that the coefficient on the takeover defenses is negative, but statistically insignificant. While Masulis et al. (2007) find a significant negative coefficient on the takeover defenses; the discrepancy is likely due to our inclusion of merger wave variable. The coefficient on the interaction of the takeover defenses and merger wave is

significantly negative, -0.521. The coefficient on merger wave is positive, but insignificant. Thus, the takeover defenses hurt acquirer performance specifically during the merger wave period. The finding is consistent with the view that weak monitoring on acquirer CEOs leads to poor acquisition decisions during the merger wave.

Further, the capital market did not anticipate the merger wave driven by technology and regulation changes, and the implications of the governance structure caused by takeover defenses. This suggests that rational markets cannot fully explain the the negative association during the merger wave.

IV. CONCLUSION

Takeover defenses restrict shareholder rights. While the impact of takeover defenses on firm value is inconclusive. Masulis et al. (2007) argue that an acquirer with many takeover defenses weakens the monitoring efficacy, and thus leads to poorer acquisition performance. It appears, however, that the adverse impact of takeover defenses exists only when the capital market is not aware of the merger wave driven by sudden technological and regulatory changes. The wealth effect of takeover defenses is not always negative. Takeover defenses are more detrimental to acquirers during the merger waves. The result suggests that takeover defenses are value-destructive for some firms under certain circumstances.

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Table 1. Annual distribution of mergers

Year	Number of Acquisitions	Year	Number of Acquisitions
1990	136	1999	327
1991	115	2000	294
1992	124	2001	238
1993	176	2002	327
1994	185	2003	304
1995	252	2004	345
1996	244	2005	322
1997	241	2006	275
1998	424	2007	216
Total			4,545

Table 2. Announcement period abnormal returns

	Merger Wave	Non-Merger Wave	Tests for Difference
CAR	-0.35* [-0.43]	0.05 [0.07]	2.1** [2.3]**

***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.

Table 3. Merger wave and the takeover defenses

Intercept	1.613* (1.82)
Takeover defenses	-0.039 (-0.48)
Takeover defenses × Merger wave	-0.521** (-2.45)
Merger wave	0.061 (0.55)
<i>Controls:</i>	
Deal characteristics	Yes
Firm characteristics	Yes
Industry fixed effect	Yes
Year dummy	Yes
Adj. R ²	0.06
N	4,328

***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.