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Working for the enemy? The impact of investment banker job changes on deal flow

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ABSTRACT

This paper examines the impact of job changes by prominent investment bankers on the M&A and equity market shares of investment banks. Using a hand-collected sample of job changes between 1998 and 2006, we find that after controlling for deal and bank-level characteristics, hiring a banker from an investment bank with a more prominent industry presence has a positive impact on both equity and M&A market share for the gaining bank and a negative impact on the losing bank's M&A market share. After the banker switches firms, we find a significant amount of business following the banker from the losing bank to the gaining bank, particularly when the relationship is strong between the client firm and the banker. Abnormal returns around the announcement of a banker changing employers are positive and significant for the gaining bank, suggesting that the market views banker additions as value increasing. Overall, our results suggest human capital is a critical component of investment banking deal flow.

> "Merrill Lynch & Co. spent decades building one of Wall Street's premier investment banks. Undoing that work has taken just months. Merrill has lost at least 18 veteran investment bankers since the firm agreed to sell itself to Bank of America Corp. In a business where human capital is often a firm's most valuable asset, such an exodus can prove fatal."—*Wall Street Journal*, July 8th, 2009

1. Introduction

There is a wide body of academic evidence suggesting that the investment banking industry is driven by relationships. Anand and Galetovic (2000) suggest that long-term relationships between firms and investment banks are the norm in the United States and in much of the developed world. Yasuda (2005) finds that bank relationships are important in determining a firm's underwriter choice in the corporate bond market. Fernando et al. (2010) highlight the value of investment banking relationships by showing that equity underwriting clients of Lehman Brothers experienced a −5% abnormal return around Lehman's bankruptcy.

The extent to which relationships are embodied within the key personnel of a bank has received much less attention. Anecdotally, the above quote suggests that the loss of a key banker can have a profound impact on a bank's market share. Similarly, Morrison and Wilhelm (2007) suggest that the high degree of labor mobility observed in the investment banking sector has the potential to create significant problems for client–bank relationships.

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Currently, there is little direct evidence as to whether the addition or loss of a key banker has the potential to create a relationship shock. In the context of the IPO market, Dunbar (2000) finds that for established banks, an increase in the quality of the bank's analysts has a positive impact on an investment bank's share of new issues. More directly, Clarke et al. (2007) investigate the impact of *Institutional Investor* all-star analyst job switches on market share and investment banking deal flow. They find that the bank gaining the all-star analyst increases its market share for equity transactions, but find no such evidence for M&A or bond transactions. Finally, Ljungqvist et al. (2006) control for the arrival and departure of investment bankers in their analysis of investment banking mandates. They find mixed evidence as to whether the movement of key bankers has an impact on the probability of winning a mandate.

In this paper, we focus on the relationship shock caused when a prominent banker defects from his or her current employer to work for a rival bank. We compile a hand-collected dataset of 339 investment banker job changes over the August 1998 to December 2006 period and adopt an approach similar to Clarke et al. (2007). We examine market share changes to the investment banks affected by the switch. We then examine if client firms switch their business to the banker's new employer. Finally, we examine the market reaction to news of the switch to determine if these events are economically meaningful.

We document three main empirical findings. First, we find that, on average, the bank gaining the banker experiences an insignificant increase in its industry-level market share. The losing bank however, experiences an economically and statistically significant decrease in its industry-level market share of approximately −0.63%. This loss is driven primarily by a decline in M&A business. In cross-sectional regressions, we find evidence that the ability to hire an investment banker from a rival bank that has a greater industry presence than the hiring firm is positively related to the gaining bank's market share and negatively related to the losing bank's market share. For instance, depending on the model specification and type of transaction (equity or M&A), hiring a prominent rival increases industry market share anywhere from 1% to 2%. It corresponds to an approximately 3% decline in the industry M&A market share for the bank losing the investment banker. This effect is distinct from the overall reputation of the investment bank.

Second, and perhaps more importantly, we find evidence that a significant amount of business follows the investment banker from their old bank to their new bank. This result holds for both equity and M&A transactions. Further, we examine the likelihood of a firm following the banker to her new employer and find that it is positively related to the strength of their past relationships.

Finally, we find significant wealth effects upon the announcement of banker job switches. The difference in market-adjusted returns between the gaining bank and the losing bank is greater than 1%, which is both statistically and economically meaningful, indicating the market reacts to news of investment banker job changes. Collectively, our evidence indicates that human capital is a vital component of an investment banks' ability to generate business.

These results complement and expand on those presented in Ljungqvist et al. (2006) in several important dimensions. First, unlike Ljungqvist et al. (2006), we examine the role of investment bankers in M&A deals, as well as, equity transactions. This is important because relationships between investment bankers and client firms are critical in the M&A market because acquirers typically engage in a large number of deals. For instance, Netter et al. (2010) examine all CRSP-listed firms from 1992 to 2009 and find that 91% are involved in at least one type of acquisition with the average firm engaged in 16 acquisitions over this time period. Thus, it is not surprising that most of our results are found for M&A deals. Second, we incorporate banker specific variables like experience into our analysis. Third, we examine the industry market share impact to investment banks that lose or gain bankers. Fourth, we track individual deal flow from the gaining to losing banks and vice versa. Finally, we examine the stock price reaction to the departure and arrival of key bankers for our sample of publicly traded investment banks, which is an exogenous way to examine the market's perception of the switch.

The rest of this paper proceeds as follows. Section 2 provides the motivation of this paper and a discussion of the related literature. Section 3 explains the data and empirical methods, while Section 4 reports our empirical results. Finally, Section 5 concludes.

2. Motivation

There is substantial evidence indicating that investment banking is characterized by on-going relationships rather than arms-length transactions. For example, Corwin and Schultz (2005) note that approximately 70% of firms stay with their initial underwriters from their IPO to their subsequent equity offers. Additionally, Burch et al. (2005) examine underwriting fees for repeat issuers of new securities to determine the relation between loyalty to an underwriting bank and the fees charged. For equity offerings, they find that loyalty is associated with lower fees for common stock offers, which is consistent with valuable relationship capital being built.

While relationships are assumed to be important for investment banking, there is little direct evidence examining the extent to which individual bankers are the gate keepers to clients. To the best of our knowledge, Ljungqvist et al. (2006) is the only paper to address this important issue. They note that the high frequency with which investment bankers switch employers has the potential to create relationship shocks. While the focus of their paper is on the relation between aggressive analyst recommendations and the likelihood of winning investment banking business, they do control for investment banker job changes in their models. Their empirical evidence is mixed. In the absence of analyst coverage, they find gaining bankers increased and losing bankers decreased the chances of winning an equity mandate. However, in the presence of analyst coverage, movements of key bankers had little effect on the likelihood of winning an equity mandate. For debt mandates, movements of key bankers had a substantial impact. The chances of a bank winning a mandate were lower when it had lost key members of its debt team and higher when it had recently hired debt professionals from other banks.