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Investment bank reputation and shareholder wealth effects in mergers and acquisitions

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ABSTRACT

This paper investigates the relationship between the reputation of investment banks employed in mergers and acquisitions transactions and the resulting wealth effects. Two hypotheses are tested: the superior deal hypothesis, stating that high reputation advisors suggest deals with higher overall transaction gains; and the bargaining advantage hypothesis, stating that the larger share of transaction benefits is attributed to the party employing a highly reputed advisor. Evidence from 285 European M&A-transactions announced between 1997 and 2002 does not support any of these hypotheses. On average, wealth effects are not significantly different for transactions advised by different advisor tiers.

1. Introduction

Most market participants would agree that investment banks play an important role in advising their clients in the mergers and acquisitions process. McLaughlin (1990), among others, summarizes three core activities that M&A-advisors perform for their clients: (i) identifying potential bidders and targets, (ii) working to complete offers, seeking higher bids, defending against hostile offers, and negotiating, (iii) advising on bidding strategy, on the offer price, on the accept/reject decision, and evaluating the potential for competitive bids. In addition, practitioners emphasize the role of investment banks in providing liquidity and therefore an increase in efficiency on the market for corporate control.

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The role of investment banks advising clients in corporate finance transactions has been subject to a large body of research since the early 1970s. Whereas the vast majority of the existing research focuses on the underwriting business (e.g., Chalmers et al., 2002; Garner and Kale, 2001; Hansen, 2001; Dunbar, 2000; Krigman et al., 2000), the role of investment banks in mergers and acquisitions is less well covered. Almost all studies that focus on mergers and acquisitions examine only M&A transactions in the United States. As the US market is very mature and M&A activity rather high it is not always possible for a client within this market environment to take the advice of his most preferred investment bank because this advisor might have some conflicts of interest which prohibit the mandate. In less mature markets with less M&A activity the probability of conflicts of interests should be significantly lower and potential influence of the investment banks on M&A outcome should be less biased.

The main objective of this paper is to investigate the shareholder wealth effects of investment banks in a sample of European M&A transactions during a period of still developing markets. Until a few years ago the relative share of M&A transactions accompanied by investment banks was by far smaller in the European market than in the US. For the US, Kale et al. (2003) and Allen et al. (2004) document that 88%, respectively 84%, of all transactions are performed under the guidance of an investment bank for the acquiring company. Based on reports of Thomson Financial this ratio is only 12% in Germany in 2000. We expect to find more extreme differences in stock market returns between high quality and medium quality investment banks in Europe.

The paper is organized as follows. First, the existing body of literature relating to shareholder wealth effects of employing M&A-advisors is introduced. Next, the research hypotheses are derived and the data set and the methodology are described. In the subsequent section the empirical results are presented. The last section concludes and discusses the implications of the results for companies planning to involve in an M&A-transaction.

2. Literature

There is mixed evidence on the shareholder wealth effects of investment banks acting as M&A-advisors. For acquiring firms, Servaes and Zenner (1996) find no impact of investment banks on the returns earned by the acquiring firms' shareholders. Allen et al. (2004), who compare transactions advised by commercial banks against those advised by investment banks, show that returns are higher for acquirers that employ no advisor at all. Looking at different types of investment banks, Bowers and Miller (1990), Servaes and Zenner (1996), Kale et al. (2003), Rau (2000), Hunter and Jagtiani (2003) or Rau and Rodgers (2002) come to a similar conclusion: first-tier investment banks are not better in providing superior shareholder wealth effects compared to lower tier investment banks. Similar evidence for Swiss acquirers is documented by Lowinski et al. (2004). Da Silva Rosa et al. (2004) and Walter et al. (2008) also fail to find support for a positive association between stock returns and the quality of investment banks.

Concentrating on target firm shareholders, Kale et al. (2003) find that cumulative abnormal returns are lower only if the target firm chooses external M&A-advice. In contrast, target firm shareholders benefit if either the bidder or the target firm is advised by a first-tier rather than a lower-tier investment bank. Bowers and Miller (1990) show similar results. Hunter and Walker (1990) compare combined abnormal dollar returns and combined fee payments. They arrive at an average cumulated abnormal dollar return of USD 85 m in comparison to a combined average fee payment of USD 5 m. Bowers and Miller (1990), who concentrate on first-tier versus lower-tier investment banks, find that combined wealth effects are higher if the target, the bidder or both are advised by a high-quality investment bank. Kale et al. (2003) come to similar conclusions.

Investigating the premiums paid by acquiring firms, Hunter and Walker (1990) find no impact of investment bank participation. Instead, acquirers pay higher premiums if the cash/asset-ratio of target firms is high. Concentrating on the reputation of investment banks, Michel et al. (1991), McLaughlin (1992) or Rau (2000), show that acquiring firms pay a higher premium if they are advised by a first-tier M&A-advisor. In the transaction sample of Rau (2000), acquirers with first-tier investment banks pay an acquisition premium (median) of 56.3%. The premium paid by acquirers with third-tier banks equals 38.1%. McLaughlin (1990, 1992, 1996), Kesner et al. (1994), Rau (2000), Saunders and Srinivasan (2001), Walter et al. (2008) or Chahine and Ismail (2005) analyze fee payments. The results convey a posi-