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The role of investment banks in M&A transactions: Fees and services ☆

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Abstract

We examine the pricing and performance of advisers in M&A transactions. We determine adviser quality on the basis of a contemporaneous market share measure and show that high quality advisers receive higher M&A advisory fees. High quality advisers also complete deals faster, but their superiority is not reflected in increasing the likelihood of deal completion or delivering greater abnormal equity returns to their clients. It is well known that stock bids are received more negatively than cash bids, so we further partition the sample of acquirers by consideration type and examine the abnormal returns of each partition. We find that high quality investment banks are able to differentiate themselves by delivering greater abnormal returns to their acquirer clients in deals involving stock.

JEL classification: G34
Keywords: Investment banks; Quality premium; Advisory fees; Stock bids

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1. Introduction

The fees that investment banks receive from providing merger and acquisition (M&A) advisory services are large.[1] According to the SDC Platinum database, M&A transactions completed in the U.S. during 2003 alone totalled more than $435 billion. Of these, investment banks acted as advisers on deals worth a combined value of $386 billion. The total amount of advisory fees that advisers earned exceeded $596 million, suggesting that investment banks derive a significant amount of income for providing M&A advice. Although advisory fees are of such substantial size, there has been very little research into the factors that determine the level of advisory fees paid. In this paper, we examine the factors that determine the level of fees charged in M&A transactions and further evaluate the performance of M&A advisers.

Prior research indicates that fees paid in advisory work may be related to the quality of the advisor. High quality advisers may signal their superiority by charging higher fees in providing M&A advice. Bowers and Miller (1990, p.36) suggest that for investment banks with greater prestige, "the enhanced reputation will differentiate that banker in the marketplace, thereby allowing superior bankers to charge higher fees". Consequently, this paper evaluates the determinants of M&A advisory fees and further investigates whether high quality advisers receive a premium in providing M&A services.

Given that investment banks possess different levels of reputation, we determine whether the performance of advisers differ systematically across different levels of advisers. Here, we focus on the performance of advisers on two key fronts. Consistent with Rau (2000) and Hunter and Jagtiani (2003), we compare advisers of different levels of quality on the basis of their deal completion rates and the time taken to complete deals. High quality advisers should be able to work more effectively than low quality advisers, leading to a successful outcome for deals that have been announced. In addition, deal completion should be faster when a high quality adviser is used because of the adviser's expertise and experience in handling M&A transactions. We further examine the abnormal returns delivered by advisers of different quality to their clients. In theory, any project, including M&A transactions, should only be undertaken if it adds value to the firm. Bowers and Miller (1990, p. 34) posit that "managers should use the same decision criterion in choosing an investment banker as in all other corporate decisions: by evaluating the impact on shareholder wealth". This makes the stock returns of an adviser's client an important measure of the adviser's performance. As a result, we expect high quality advisers to be able to deliver higher value to their clients.

There have only been a few studies investigating the level of advisory fees paid, and the results from these studies have been inconsistent. McLaughlin (1992) provides evidence that, depending on the fee contract type between the adviser and the client in a transaction, lower quality advisers may receive a greater amount of advisory fees than higher quality advisers. However, more recent studies find the opposite result, with the research by Rau (2000) and Hunter and Jagtiani (2003) reporting higher level of fees received by high quality advisers in M&A transactions. Furthermore, earlier studies report that wealth gains are greater in deals involving high quality advisers (Bowers and Miller, 1990). While this result is theoretically sound, the empirical evidence produced by later studies does not support this. McLaughlin (1992) finds that the abnormal returns to acquirers are lower when the acquirer uses a high quality adviser, and Rau (2000) finds no support for the hypothesis that high quality advisers deliver greater abnormal

[1] In this paper, the terms 'investment banks' and 'advisers' are used interchangeably.