Aspects of Acquirer Behaviour in Australian Mergers and Acquisitions

Nigel Garrow

Macquarie Graduate School of Management, Macquarie University, NSW, Australia

Email: nigel.garrow@mgsm.edu.au

Professor Thomas Valentine

Macquarie Graduate School of Management, Macquarie University, NSW, Australia

Email: tom.v@bigpond.net.au

Aspects of Acquirer Behaviour in Australian Mergers and Acquisitions

Nigel Garrow

Macquarie Graduate School of Management, Macquarie University, NSW, Australia

Email: nigel.garrow@mgsm.edu.au

Professor Thomas Valentine

Macquarie Graduate School of Management, Macquarie University, NSW, Australia

Email: tom.v@bigpond.net.au

ABSTRACT

Mergers and acquisitions continue to be value destroying for many acquiring firm shareholders. The consequences of this value destruction can be far reaching for stakeholders such as pension funds. The assumption of a rational and efficient market does not explain some aspects of an acquirer's offer. This paper examines acquisitions in Australia between 1990 and 2006.The behavioural characteristics of the acquirer such as animal spirits, hubris, and narcissism may provide an explanation for an acquirer's offer, and hence M&A value destruction. Good corporate governance practice including greater transparency to stakeholders can help in addressing these behavioural factors.

Keywords: agency, stakeholders, board effectiveness, corporate governance

It is frequently argued in discussions of mergers and acquisitions (M&A) that acquisitions tend to reduce the wealth of shareholders in the acquirer (Agrawal, Jaffe & Mandelker 1992; Gregory 1997; Tuch & O'Sullivan 2007). The consequences of this value destruction can be far reaching in the economy, affecting pension funds, employees, government tax revenue, and banks. This paper considers two aspects of the acquisition decision—the premium paid to shareholders in the acquired firm and the size of the consideration paid (as a percentage of the acquirer's net assets). These characteristics of the acquisition decision are likely to be influenced by similar variables to those considered relevant to the success of an acquisition.

The research questions being addressed are: What role do behavioural characteristics of the senior executives in the acquiring firm play in influencing M&A outcomes? In the event that behavioural characteristics are important in M&A outcomes, what improvements can boards adopt in their corporate governance practice to mitigate some of the adverse consequences of these behaviours?

The theories identifying the explanatory variables used in this analysis are outlined in the second section of this paper. The sample and data are discussed in the third section which includes a listing of the empirical variables used as proxies to test the theories. The fourth section of the paper presents the results and is followed by a discussion of the conclusions.

THEORIES OF THE BEHAVIOUR OF ACQUIRERS

Earlier Australian research found that acquired firms earn a positive abnormal return during the 3 – 6 months prior to the acquisition (Dodd 1976, McDougall et al 1986, Bishop et al 1987, (Bugeja & Walter 1995) and these returns are likely to be higher than those of the acquirer over this period (McDougall et al (1986)). Acquirers earn better returns than non-acquirers during the period prior to an acquisition (Bishop, Dodd & Officer 1987; Dodd 1976; McDougall et al. 1986; Sharma & Ho 2002). These outcomes must arise from the decisions of the acquiring firm so it will be useful to consider the factors determining these decisions.

Some leading theories describing the behaviour of acquirers are:

- principal-agent problems;
- animal spirits
- hubris (or narcissism?)

Agency problems arise when agents (company executives) act in their own interests rather an in those of their principals (shareholders) (Jensen & Meckling 1976). Berkovitch and Narayanan (1993) and Seth *et al.*(2000) argued that agency problems, not hubris, seem to be the major reason for the existence of value-reducing acquisitions. They based this on the view that management are motivated by self-interest in acquisitions, that they are rent seeking, and that there is a negative correlation between acquirer returns and acquired firm returns.

In order to test whether agency problems affect the outcome of acquisitions for shareholders, the increase in the income of the CEO of the acquiring firm following the acquisition has been tested as a possible explanatory variable of the return earned by shareholders.

"Animal spirits" have also been included as a possible explanation of the outcome of an acquisition. This concept was developed by Keynes (1936) and has recently been reinterpreted by Akerlof and Shiller (2009). They focus on confidence as a key component of animal spirits (Akerlof and Shiller (2009, p.13)). The relevance of this influence has been tested by including various measures of movements in market returns because a boom in the market is likely to reflect a high level of confidence.

"Hubris" is often cited as an explanation of behaviour in mergers and acquisitions (Gregory 1997; Sharma & Ho 2002). A distinction between hubris and animal spirits is that hubris is a personal characteristic whereas animal spirits is a market condition. The hubris concept was introduced by Roll (1986) who argues that if acquirers pay too much for their targets, they must be acting on the self-belief that they can value targets better than the market consensus. Roll (1986) argues that if there are no gains in takeovers, hubris is necessary to explain why managers do not abandon these bids since reflection would suggest that such bids are likely to represent positive errors in valuation. .

Tichy (2001) argued that hubris is fuelled by business or stock market cycles and the optimism that they generate. Even when managers are aware of the probability of failure, their advisors, who typically earn fees based upon success in consummating an acquisition, will persuade managers to pursue and complete an acquisition. He observed that managers tend to overestimate savings which can be earned from an acquisition and to underestimate revenue losses, a process which is made worse by the failure of 'outside control'.

The problem with hubris is that it is difficult to measure (Sirower 1997, p.12; Tichy 2001). Hayward and Hambrick (1997) use media citations as an empirical measure of hubris, but it is not clear why such a relationship should exist. Moreover, the hubris hypothesis is used as a catch-all explanation of the variations in the outcome of acquisitions which cannot be explained by other variables (Gregory 1997; Sharma & Ho 2002). As such, it is a theory which cannot be tested or refuted. That is, it cannot be acceptable as an adequate explanation of acquisition behaviour.

Bruner (2004, p.76) raised concerns about the potential for ambiguity with the hubris hypothesis, commenting that the "hubris hypothesis for M & A activity says too much and too little. It says too much in the sense that hubris could be used to explain most business failures. It says too little in that one wishes it has more prescriptive content".

Narcissism is an alternative to hubris as a psychological explanation of managerial behaviour. Unlike hubris, narcissism is well recognised in the psychological literature. A narcissistic personality disorder can be defined as an exaggerated sense of self-importance, a tendency to overvalue one's accomplishments, an exhibitionist desire for attention and admiration and preoccupation with fantasies of success, wealth, power and esteem. It is a form of emotional self-investment. When normal it leads to self-regard and mature aspirations. When pathological, it is accompanied by inordinate demands upon oneself, excessive dependence on acclaim from others and a deteriorated capacity for interpersonal relations. Narcissism has recently been explained within the context of leadership by Higgs (2009), Kets de Vries and Miller (1993) and Chatterjee and Hambrick (2007).

The negative aspects of narcissism are reflected in organizational consequences (Higgs 2009) such as creation of a blame culture, unethical behaviour, abuse of power and often organizational collapse. Higgs commented on the potential for positive outcomes from narcissism, citing Finkelstein and Hambrick (1996) and Chatterjee and Hambrick (2007). Higgs concluded that, whilst not all 'bad' leadership is caused by narcissism, narcissistic leadership is damaging to an organization internally (e.g. culture) which ultimately leads to longer term deterioration in organizational performance.

Chatterjee and Hambrick (2007) argue that "narcissism is a more ingrained trait than hubris" and that a narcissistic personality stirs hubris. They argue that acquisition activity is particularly suited to narcissists with their attention seeking nature and attraction to bold attention seeking activity. The empirical measures they adopt to represent narcissism involve media citations. Previously such measures were used to proxy for hubris, but they seem to be more suitable as representatives of narcissism.

THE DATA SET

Merger and acquisition studies adopt one of two time frames for their analysis (Tuch & O'Sullivan 2007, p.143) — an examination of the announcement effect for both target and acquirer shares (a short event window) or the effect on the longer term performance of the shares of the acquirer, usually across a 2 – 5 year period, following the acquisition (a long event window). Sudarsanam (2010, p.114) notes that short-horizon event studies assume that share prices react almost instantly to new information in the market, but he argues that a growing body of literature argues that share prices adjust slowly over longer time periods (typically 3 – 5 years). Gregory and McCorriston (2005) observe that recent finance research suggests that announcement period returns do not fully reflect the wealth effect of an event. The emphasis of this study is not on the possibility of earning short-term trading profits, but rather on longer-term impacts on shareholder wealth and, therefore, the economy. The approach adopted in this paper is a long event window (Bruner 2004, p.33).

The sample comprises 47 acquisitions in Australia between 1990 and 2006 and the analysis covers a period of up to three years prior to the completion of the acquisition and three years after completion. Both the acquiring and acquired firms were ASX listed companies with one exception, Landmark, which was acquired by AWB from Wesfarmers. Landmark was included in the sample because the data required for the analysis could be obtained for both the acquirer (AWB) and the acquired firm (Landmark). The sample covered 10 industry sectors but omitted 'materials' or mining and related activities; this is consistent with earlier studies in Australia by Sharma and Ho (2002), McDougall *et al.* (1986) and Kiel and Nicholson (2003), which also excluded the 'materials' sector. The minimum size of the consideration paid was AUD$50 million.
The acquisitions were obtained from Thomson Reuter's "Thomson One" database. Additional data sources were the annual reports of the acquirer and the acquired firm, Datastream, Aspect Huntley, the Australian Financial Review, the Reserve Bank of Australia (RBA) and the Australian Stock Exchange (ASX) for the S&P/ASX200 Accumulation Index.

The sectors from which the 47 acquisitions were drawn are described in Table 1.

Table 1: Here

The dependent variables used in the statistical analysis are:

TGTCAR:

Target firm cumulative return from six months prior to completion to completion, adjusted by the ASX Accumulation Index, resulting in the cumulative abnormal return. This variable reflects the premium paid by the acquiring firm.

CONSA:

The consideration paid by the acquirer as a percentage of the acquirer's net assets in the year prior to completion. It gives an indication of the potential risk to the acquirer if the acquisition is unsuccessful.

The independent variables related to the theories discussed in this paper and tested in the statistical analysis are:

Indicator of agency problems

- BD which is the number of board directors in the acquiring company. Alternative directors and the Company Secretary are not included in the measure.

Indicator of "animal spirits"

- CAR which is the cumulative abnormal return for the acquirer in the year prior to completion minus the average cumulative abnormal return during years two and three prior to completion.

Indicator of hubris (narcissism)

- MEDIA which is the sum of chairman and CEO mentions in the media during the period one year after completion. The data were obtained using the Factiva database (on 25 August 2010).

Some other potentially relevant explanatory variables have been included in the equations to ensure that the results are not affected by spurious correlation. These variables will be described following the equations in which they occur.

EMPIRICAL RESULTS

The equations reported in this section were estimated on the EVIEWS package. R^2 is the coefficient of determination and the figures under the coefficients are t-statistics. Asterisks indicate the degree of significance of the coefficient. One asterisk indicates significance at the five percent level and two asterisks indicate significance at the one percent level. The standard deviations of the coefficients have been calculated using the White heteroscedasticity consistent covariance.

The first equation is for TGTCAR:

$$\mathbf{TGTCAR = 42.16 + 0.616CAR - 3.090BD - 0.398DIV}$$
$$\mathbf{(4.06^{**})\ (4.21^{**})\quad (2.58^{*})\quad (2.39^{*})}$$
$$\mathbf{+\ 0.337EPS \qquad R^2 = 0.597}$$
$$\mathbf{(5.05^{**})}$$

The equation indicates that the premium earned by shareholders in the acquired firm increases with CAR which indicates that animal spirits (confidence) play a role in the premium paid. The number of directors has a negative impact on the benefit received by the acquired firm's shareholders. This result has some implications for corporate governance—larger boards are less likely to make over-generous offers to target firms. The hubris (narcissism) variable (MEDIA) is insignificant when added to the equation.

DIV is the dividend per share. It has a significant negative coefficient suggesting that a high dividend payment leads to a reduction in the offer made to the target. This relationship arises because a high dividend payment means that a greater proportion of the offer has to be financed by borrowing. EPS (earnings per share) has a highly significant positive coefficient—high earnings allow the company to more easily fund the offer.

The second equation is for CONSA:

$$\mathbf{CONSA = 133.5 + 126.1NAR - 13.93BD - 64.66SPT}$$
$$\mathbf{(2.49^{*})\ (7.40^{**})\quad (3.12^{**})\quad (30.32^{**})}$$
$$\mathbf{+\ 0.0884MEDIA + 0.540\ EPS \qquad R^2 = 0.723}$$
$$\mathbf{(2.97^{**})\qquad (2.53^{*})}$$

It indicates that the consideration paid relative to the acquirer's assets is affected negatively by BD whose coefficient is highly significant. Again this suggests that it is advantageous from a corporate governance viewpoint to have a larger rather than a smaller number of directors on the board.

The MEDIA variable is highly significant providing some support for the hubris (narcissism) hypothesis. There is no evidence of an impact of animal spirits.

NAT is the net assets of the target divided by the net assets of the acquirer. It is highly significant which could also be taken as an indication of hubris (narcissism). Acquirers are willing to offer higher amounts for relatively large targets.

SPT is the change in the target's share price in the six months prior to completion. It has a highly significant negative coefficient indicating that acquirers are likely to offer less for a firm whose price is appreciating rapidly. EPS has a significantly positive coefficient for the reasons discussed earlier.

The two equations arise out of the same decision and this suggests that they should be estimated as a system using the Seemingly Unrelated Regression estimator (Greene 2008, p.304-305) which produces more efficient estimates by taking account of the correlations of the errors in different equations. Unfortunately, in this case use of the systems estimator makes little difference because the equation errors actually have a very low level of correlation.

CONCLUSIONS

The results reported in this note suggest that two aspects of an acquirer's offer—the return earned by the acquired firm's shareholders and the amount offered relative to the net assets of the acquirer—are affected by variables which are not explicable under the assumption of a rational and efficient market. First, there is evidence that acquirers' behaviour is affected by the number of directors on the acquirer's board which has implications for corporate governance. Secondly, there is evidence that the acquirer's decisions are influenced by animal spirits (i.e. market conditions). Thirdly, this study found some support for the hubris, or as it is more usefully interpreted, the narcissism hypothesis. Also, it was found that a high earnings per share for the acquirer encouraged more aggressive bidding for the target.

There are implications from this paper for corporate governance. Evidence of agency problems suggests that remuneration committees may need to examine reward schemes which more effectively align shareholder interests and returns with those of the acquiring firm's managers when an acquisition has been completed. Evidence of animal spirits suggests that CEO remuneration could be more closely aligned with the previous three years' performance of the firm and not as closely correlated with the previous year.

In 2009 the Australian Government requested that the Productivity Commission undertake a review of the regulatory framework around remuneration of directors and executives, in part in response to concerns that there may be a lack of alignment between their remuneration and returns to other stakeholders and that existing governance and regulatory frameworks may be ineffective in this matter (Productivity Commission 2009). Evidence in this study supports the contention that there is a basis, through behavioural characteristics, for the view that stakeholder interests are not aligned.

The findings in this study support several of the 15 recommendations of the Productivity Commission (2009); in particular this study adds significant support to three of the dimensions of remuneration policy and reporting (2009, p.xlii), recommended by the Commission, which require a clearer explanation of the decision-making processes to shareholders and can be pursued by the remuneration and nomination committees:

1. How the remuneration policy aligns with the company's strategic directions, its desired risk profile and with shareholder interests.

2. How incentive pay arrangements were subjected to sensitivity analysis to determine the impact of unexpected changes (for example, in the share price) and how any deferral principles and forfeiture conditions would operate.

3. Whether post-remuneration evaluations have been conducted to assess outcomes, their relationship to the remuneration policy and the integrity of any initial sensitivity analysis.

Adopting these reporting guidelines would provide greater transparency to shareholders in relation to the strategic framework within which remuneration policy is formulated and how executive performance is being assessed, particularly in M&A and when the firm's outcome has been deleterious to shareholders.

Animal spirits, hubris, and agency problems can be addressed through improved corporate governance practice.

This study has some limitations. The sample size was quite small at 47. The study encompassed two wave merger periods (wave 5 from 1993 to 2001 and wave 6 from 2003); the timing of the acquisitions may have affected the outcomes and therefore a more detailed analysis and comparison within each wave period may provide new insights.

References

Agrawal, A, Jaffe, JF & Mandelker, G 1992, 'The Post Merger Performance of Acquiring Firms', *Journal of Finance*, vol. 47, pp. 1605-21.

Akerlof, GA & Shiller, RJ 2009, *Animal Spirits. How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism.*, Princeton University Press, Princeton.

Berkovitch, E & Narayanan, MP 1993, 'Motives for Takeovers: An Empirical Investigation', *Journal of Financial & Quantitative Analysis*, vol. 28, no. 3, pp. 347-62.

Bishop, S, Dodd, P & Officer, RR 1987, *Australian Takeovers: The Evidence 1972-1985*, St. Leonards, April 1987.

Bruner, RF 2004, *Applied Mergers & Acquisitions*, John Wiley & Sons, Inc., Hoboken, New Jersey.

Bugeja, M & Walter, T 1995, 'An Empirical Analysis of Some Determinants of the Target Shareholder Premium in Takeovers', *Accounting and Finance*, vol. 35, no. 2, pp. 33-60.

Chatterjee, A & Hambrick, DC 2007, 'It's All about Me: Narcissistic Chief Executive Officers and Their Effects on Company Strategy and Performance', *Administrative Science Quarterly*, vol. 52, pp. 351-86.

Commission, P 2009, *Executive Remuneration in Australia, Report No. 49, Final Inquiry Report*, Melbourne, 49.

Dodd, P 1976, 'Company Takeovers and the Australian Equity Market', *Australian Journal of Management*, vol. 1, no. 2, pp. 15-35.

Finkelstein, S & Hambrick, DC 1996, *Strategic Leadership: Top Executives and Their Effects on Organization*, West Publishing, New York.

Greene, WH 2008, *Econometric Analysis*, Sixth edn, Pearson Prentice Hall, Upper Saddle River, New Jersey.

Gregory, A 1997, 'An Examination of the Long-Run Performance of UK Acquiring Firms', *Journal of Business Finance & Accounting*, vol. 24, no. 7 & 8, pp. 971-1002.

Gregory, A & McCorriston, S 2005, 'Foreign Acquisitions by UK Limited Companies: Short- and Long-Run Performance', *Journal of Empirical Finance*, vol. 12, pp. 99-125.

Hayward, MLA & Hambrick, DC 1997, 'Explaining the Premiums Paid for Large Acquisitions: Evidence of CEO Hubris.', *Administrative Science Quarterly*, vol. 42, pp. 103-27.

Higgs, M 2009, 'The Good, the Bad, and the Ugly: Leadership and Narcissism', *Journal of Change Management*, vol. 9, no. 2, pp. 165-78.

Jensen, MC & Meckling, WH 1976, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure', *Journal of Financial Economics*, vol. 3, pp. 305-60.

Kets de Vries, MFR 1993, *Leaders, Fools, and Imposters: Essays on the Psychology of Leadership*, Jossey-Bass, San Francisco.

Keynes, JM 1936, *The General Theory of Employment, Interest, and Money*, Macmillan and Co. Ltd, London.

Kiel, GC & Nicholson, GJ 2003, 'Board Composition and Corporate Performance: How the Australian Experience Informs Contrasting Theories of Corporate Governance', *Board Composition and Corporate Performance*, vol. 11, no. 3, pp. 189-205.

McDougall, FM, Round, DK, Crouch, AGD & Wirth, A 1986, in *The Effects of Mergers and Takeovers in Australia*, vol. Australian Institute of Management - Victoria Research Report No. 3, p. 207.

Productivity Commission 2009, 2009, *Executive Remuneration in Australia, Final Enquiry Report*, Melbourne, 49.

Roll, R 1986, 'The Hubris Hypothesis of Corporate Takeovers', *Journal of Business* vol. 59, pp. 197-216.

Seth, A, Song, KP & Pettit, R 2000, 'Synergy, Managerialism or Hubris? An Empirical Examination of Motives for Foreign Acquisitions of US Firms.', *Journal of International Business Studies*, vol. 31, no. 3, pp. 387-405.

Sharma, DS & Ho, J 2002, 'The Impact of Acquisitions on Operating Performance: Some Australian Evidence', *Journal of Business Finance & Accounting*, vol. 29, no. 1&2, pp. 155-200.

Sirower, ML 1997, *The Synergy Trap*, The Free Press, a Division of Simon & Schuster, New York.

Sudarsanam, S 2010, *Creating Value from Mergers and Acquisitions*, Second edn, Pearson Education Limited, Harlow, Essex, England.

Tichy, G 2001, 'What Do We Know about Success and Failure of Mergers?', *Journal of Industry, Competition and Trade*, vol. 1, no. 4, pp. 347-94.

Tuch, C & O'Sullivan, N 2007, 'The Impact of Acquisitions on Firm Performance: A Review of the Evidence', *International Journal of Management Reviews*, vol. 9, no. 2, pp. 141-70.

Table 1: Sectors

Category	**Number of Acquisitions**
Health Care	5
Media & Entertainment	8
consumer Staples	10
Industrials	8
Real Estate	4

High Technology	1
Retail	1
Financials	8
Energy & Power	1
Consumer Products & Services	1