DOES COMMON OWNERSHIP INCREASE INCENTIVES FOR MERGERS AND ACQUISITIONS?

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I. INTRODUCTION

There is a growing awareness of the rise of common ownership of publicly traded firms due to portfolio diversification. In the words of FTC Commissioner Noah Phillips, "common ownership is a reality of today's economy."[2] Recent theoretical and empirical work has explored the implications of this phenomenon for both market competition and innovation. In this article, we would like to point to another implication of common ownership: its effect on the incentives for firms to engage in mergers and acquisitions.

Previous studies have found empirical evidence that the market, on average, reacts negatively when a public firm announces an acquisition of another public firm, destroying the acquirer's shareholder value. The impulses behind such value-destroying acquisitions have been attributed to CEO empire-building, overconfidence, and the lack of shareholder monitoring.[3] Still, a puzzle arises as to why acquirer shareholders approve these bad deals despite losing wealth.[4] While the lack of incentives and power to monitor due to short investment horizons could be an explanation,[5] Matvos and Ostrovsky shed light on this puzzle with a new perspective by showing that acquirer shareholders can benefit even from a bad deal when they also hold stakes in the target company, which usually gains value due to the takeover premium. However, Harford et al. argue that cross-ownership at the individual shareholder level is too small to compensate for the loss from acquirer stakes.[6]

Both of these papers looked only at the implications of common ownership of the target and ignored common ownership of rival firms. The latter is potentially more impactful, given that non-merging rivals are often much larger than merging partners, and the competitive effects of the merger could affect their valuation significantly. There is also empirical evidence that non-merging rival firms gain on average after a merger between two firms in their industry.[7]

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2 Noah J. Phillips, 2018, "Taking Stock: Assessing Common Ownership," The Global Antitrust Economics Conference, New York, NY. https://www.ftc.gov/system/files/documents/public_statements/1382461/phillips_-_taking_stock_6-1-18_0.pdf.

3 See, for example, Malmendier & Tate, "Who makes acquisitions? CEO overconfidence and the market's reaction," 89(1) Journal of Financial Economics 20-43 (2008).

4 The announcement return is the market's best estimate of the value of the deal, which has been shown to only underestimate the magnitude of value destruction in the long run.

5 See Gaspar, Massa & Matos, "Shareholder investment horizons and the market for corporate control," 76(1) Journal of Financial Economics 135-165 (2015).

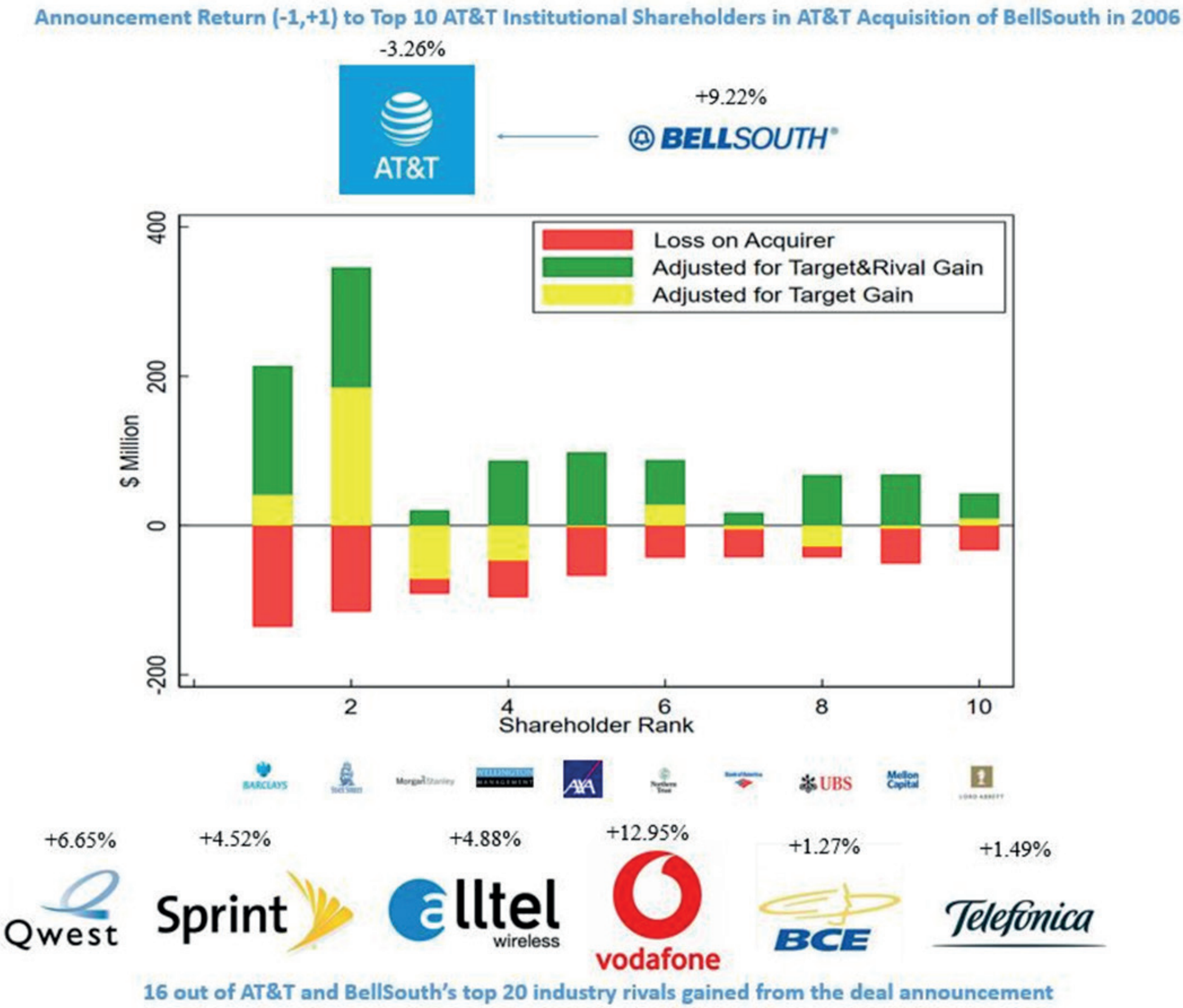
6 Matvos & Ostrovsky, "Cross-ownership, returns, and voting in mergers," 89(3) Journal of Financial Economics 391-403 (2008); Harford, Jenter & Li, "Institutional cross-holdings and their effect on acquisition decisions," 99(1) Journal of Financial Economics 27-39 (2011).

7 Song & Walkling, "Abnormal returns to rivals of acquisition targets: A test of the acquisition probability hypothesis," 55(2) Journal of Financial Economics 143-171 (2000); Salant, Switzer & Reynolds, "Losses from horizontal merger: the effects of an exogenous change in industry structure on Cournot-Nash equilibrium," 98 (2) The Quarterly Journal of Economics 185–199 (1983).

In a recent empirical paper, we look into this hypothesis and find that, indeed, if we account for acquirer shareholders' ownership in both the target and non-merging industry rivals when measuring their profits from a value-destroying acquisition, we can rationalize the approval of a large portion of "bad deals" that reduce the valuation of the acquiring firm.[8] While target ownership indeed only matters to a small subset of acquirer shareholders, a significantly larger amount of diversified acquirer shareholders end up with a gain in a bad deal at the industry portfolio level through their ownership of non-merging rival firms.

II. AN EXAMPLE – AT&T'S ACQUISITION OF BELLSOUTH

Figure 1: Announcement Returns to Top 10 AT&T Shareholders



Source: Antón, Azar, Gine, and Lin (2019)

AT&T's US $73 billion acquisition of BellSouth in 2006 was the second largest M&A deal in the U.S. during the 2000s. The deal was not well received by the market, and led to a 3.26 percent abnormal loss for AT&T shareholders during the 3-day announcement window. As presented in Figure 1, the top ten largest institutional shareholders of AT&T stock all suffered substantial losses from the announcement of this deal.

8 Anton, Azar, Gine & Lin, "Beyond the Target: M&A Decisions and Rival Ownership," available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3226390.

Unsurprisingly, the target BellSouth experienced a 9.22 percent abnormal gain during the same time period. Ownership in BellSouth does offset the loss from AT&T for four of the top ten shareholders mentioned above.

Meanwhile, sixteen out of AT&T's top twenty industry rivals experienced abnormal gains during the deal's announcement window. After accounting for both target and rival ownership by AT&T shareholders, as suggested by Anton et al., all of AT&T's top ten shareholders end up with a positive abnormal gain during the announcement of the deal. This example illustrates the idea that it can be rational for diversified acquirer shareholders to approve value-destroying acquisitions when they focus on portfolio value maximization, instead of firm value maximization.

III. A BROADER LOOK AT SHAREHOLDER RETURNS AROUND M&A ANNOUNCEMENTS

There has been extensive theoretical and empirical evidence showing that non-merging industry rivals gain at the expense of the merging firms, both during and after the merger. In the short run, rival stocks experience positive cumulative abnormal returns during the M&A announcement window. In the long run, rivals can gain at the expense of efficiency losses by the merged firm. In a world of increased portfolio diversification, it is almost inescapable to factor in the effect of rival performance when evaluating the incentive of a diversified shareholder for getting involved in a firm's M&A decisions.

Our paper shows that, on average, each acquirer shareholder (especially among the acquirer's top 10 largest shareholders) holds rival shares that provide positive returns during the announcement window of an M&A deal. The cumulative abnormal return is no longer negative for an average acquirer shareholder after accounting for ownership in both the target and non-merging rivals. This effect is particularly pronounced in value-destroying deals, with target and rival gains jointly mitigating 72 percent of the loss from acquirer stake for an average acquirer shareholder, while target gain alone can only lead to an average of 24 percent loss reduction.

Close to a third of the sample of acquirer shareholders in value-destroying acquisitions end up with a net gain after accounting for common ownership (target+rivals). The paper further argues that diversified acquirer shareholders can also benefit from their stakes in non-merging rivals in the long run by showing a negative association between M&A deal synergies and the market/operating performance of non-merging rivals in the two years following deal completion.

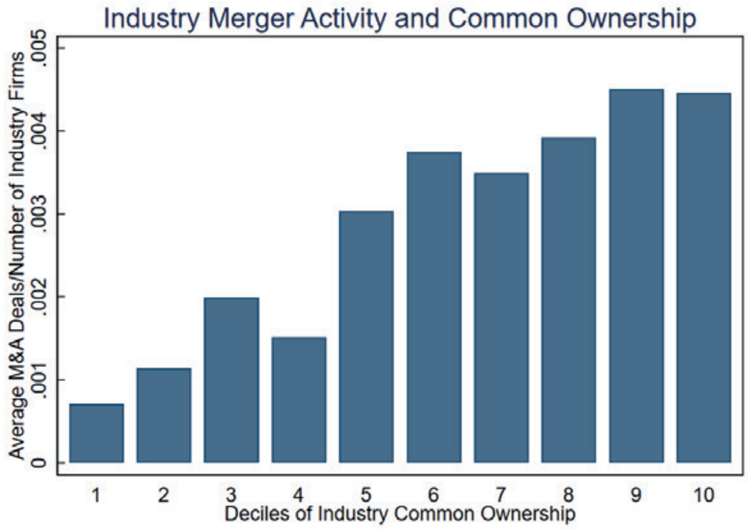
IV. COMMON OWNERSHIP AND M&A ACTIVITY

The evidence presented in the paper suggests a positive correlation between the level of common ownership and M&A frequency within the industry. Based on Figure 2 (taken from the paper), M&A frequency indeed appears to be higher in industries with higher common ownership. The paper conduct further analyses to examine the relationship between the level of common ownership and M&A deal characteristics.

The results indicate that the announcement returns to acquirer shareholders and the synergy level of the merger are lower when acquirer shareholders have high rival ownership, while having high target ownership does not have a significant effect. Such results support the notion that diversified acquirer shareholders require less return and synergies from the merged firm to approve the acquisition since they can benefit from gains by non-merging rivals and increase their overall industry portfolio value.

Furthermore, another set of analyses show that value-destroying acquisitions are also more likely to be completed when acquirer shareholders have higher rival ownership. This suggests that, since acquirer shareholders with high rival ownership are already benefiting from the deals through their rival stakes, they tend to have less incentive to exert scrutiny on the proceedings of bad deals.

Figure 2: Common Ownership Level and M&A Frequency



Source: Antón, Azar, Gine, and Lin (2019)

V. CONCLUSION

Finance scholars have wondered for a long time why value-destroying acquisitions get approved. Are shareholders irrational, or unable to effectively monitor empire-building or overconfident managers? That could be part of the explanation. However, we find that the amount of irrationality needed to understand merger activity is reduced drastically when we take common ownership into account. The value of the target firm and, more importantly, of non-merging rivals increases on average around these so-called "bad deals," and the shareholders of the acquiring firm often have substantial stakes in all these firms. When taking this ownership structure into account, many of these deals become rational (or close to rational) for the majority of the acquiring firm's shareholders.

Common ownership can potentially affect firm behavior in a way that reduces the level of competition in an industry. That is not, however, the whole story. The evidence we presented in this article shows how common ownership can operate at a more basic level, by changing the incentives for firms to merge and thus changing the industry's structure itself. Moreover, because merging firm shareholders internalize some of the spillovers that the merger generates on rival firms, the level of efficiencies that is necessary for the merger to be rational is lower than in the absence of common ownership.

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