Why CEOs May Want You Talking About Takeover Attempts

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Theory and common sense suggest that the marketplace imposes discipline on corporate managers. If top leadership performs poorly, the stock price will suffer. Then things could get worse -- the company could become a takeover target and the executives could lose their jobs. That should be a strong incentive to perform well.

But it has been hard to find solid evidence that falling share prices really do trigger takeover activity. If the theory is false, the supposed market discipline may not exist, making it easier for managers to put their own interests ahead of the firm's.

Why is the stock price-takeover trigger so hard to see? Possibly because another force is masking the effect, says Wharton finance professor Itay Goldstein. Since people believe poorly-run firms are ripe for takeovers, and because takeover battles can drive share prices up, investors might be eager to buy stock in a troubled company, causing the price to rebound.

"You have sort of a dual relationship between market price and takeover activity," Goldstein says. "It could well be that [low] market price is a great motivation for a takeover, but we can't see this very clearly in the data."

In fact, various studies have failed to find much evidence that low prices do trigger takeover attempts, adds Wharton finance professor Alex Edmans. "The very firms that are likely to be taken over because they have bad managers are more likely to have their prices inflated." If so, the market may not be imposing the discipline -- giving bad managers an incentive to do better -- that many have long assumed.

Edmans, Goldstein and Wei Jiang, a finance professor at Columbia Business School, studied 6,555 mergers and acquisitions from 1980 through 2007 for better evidence of how the two forces governing share prices interact. They looked at which firms received takeover bids in any given year and discuss their findings in a recent paper titled, "Takeover Activity and Target Valuations: Feedback Loops in Financial markets."

The traditional view, they write, "is that a firm's low valuation relative to its peers suggests internal managerial problems. An acquirer can then take over the firm, correct its problems and earn a profit by restoring the firm's value." Investors and firms that mount takeover attempts typically use factors like low price-to-earnings ratios to uncover troubled firms. Company managers "strive to maintain high market valuation to prevent a hostile takeover." In this way, the marketplace supposedly imposes discipline on managers, prompting them to do the best they can.

But, the authors note: "Despite this logic, empirical studies on takeovers fail to systematically uncover a meaningful relationship between market valuations and takeover probabilities." The problem, Edmans, Goldstein and Jiang say, is that a "feedback loop" may be obscuring the view, as investors anticipating a takeover drive the stock price up, offsetting the decline from the market's perception of poor management.

The study's main challenge was to disentangle the two-way relationship between prices and takeover likelihood. The authors' approach was to find an outside variable that shocks the system, and thus allow them to break it apart. "What you want to do," says Edmans, "is find something that affects the price but does not affect takeover likelihood other than through its effect on price." A company's stock price may fall, for example, if a large mutual fund sells a sizeable block of shares to raise cash for investors who are

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reducing their fund holdings. The falling share price would not, in this case, reflect poor management performance, and should not increase the likelihood of a takeover attempt.

"An investor's decision to accumulate or divest mutual fund shares is not driven by [his or] her views on the takeover likelihood of individual stocks held by the fund," the authors write. "However, her actions induce the fund to expand or contract its existing positions, generating price pressure on the stocks held that is uncorrelated with their takeover likelihood."

Becoming a Takeover Target

For each firm studied, Edmans, Goldstein and Jiang set a "potential" stock value by using other firms in the industry as a benchmark. That made it possible to determine whether the stock was trading at a discount attributable to poor management. Then they looked at movements of the firm's share price and whether the company had been the target of a takeover attempt.

This allowed the researchers to extricate the two forces thought to be at work: the "trigger effect," in which low price attracted takeover attempts, and the "anticipation effect," in which the market's expectation of a takeover battle drove the price back up. To measure the anticipation effect, the study looked at whether a firm's shares traded above the discount that otherwise would be expected.

"I think they basically happen more or less at the same time," Goldstein says of the two effects. "This is why it is so hard to disentangle it just by looking at the correlation" between share price and takeover attempts.

On average, a firm has a 6% chance of becoming a takeover target in any given year, according to Goldstein. "We found that a reasonable drop in price will increase the probability of takeover by about 7 percentage points on average." This is a much larger effect than previous researchers have found, the authors write.

But, Goldstein notes, the anticipation effect typically drives the price up, reducing the takeover prospect by 6 percentage points. The net result: A firm seen as poorly managed has a 7% chance of becoming a takeover target, rather than 6%.

Because the anticipation effect wipes out most of the trigger effect, stock price becomes a poor indicator of whether the market believes a firm has "agency problems" -- i.e, that it is poorly managed. "While researchers typically use valuation measures as a proxy for management performance, a firm's stock price may not reveal the full extent of its agency problems, as it may incorporate the expected correction of these problems," the authors state. "By breaking the correlation between market valuations and takeover activity into trigger and anticipation effects, our analysis enables us to ascertain the extent to which future expected takeovers are priced in."

Directors who rely on share prices to assess the quality of their managers could be deceiving themselves, the authors suggest. "It's really tempting for the board of directors to be lazy and to just look at the stock price," Edmans says. "There's some view that boards of directors don't really perform their role as monitors."

Finally, the "feedback loop" -- or the anticipation effects offsetting most of the trigger effect on share price -- discourages takeovers. While managers clearly don't like takeovers because they stand to lose their jobs, anyone who wants market forces to encourage the best possible management practices might find the study's findings disappointing. The feedback loop, the authors write, "may both deter value-enhancing takeovers of firms that are already underperforming, and allow managers to shirk in the first place, since they are less fearful of disciplinary acquisitions."

The anticipation effect may explain why previous studies have shown that acquiring firms find it far less profitable to take over publicly traded companies than private ones: There is no anticipation effect with private firms because their shares are not publicly traded. The study may also explain why merger and acquisition activity tends to come in waves, the authors write. "If a recent spate of mergers leads the market to predict future acquisitions, this [anticipation effect] causes valuations to rise ... dissuading further acquisition attempts."

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The research shows why corporate managers often seem willing, even eager, to publically complain that their firms may be takeover targets, even though that would seem to raise questions about their own management. The authors note that "these concerns inflate the price, which in turn deters the takeover from occurring. Indeed, conversations with industry practitioners suggest that this is an occasional practice among likely takeover targets."

Finally, the authors' findings raise questions about whether efficiency in the financial markets really makes companies operate better, as is generally assumed. In fact, they say, the share price increases from the anticipation effect "may deter the very actions that they anticipate."

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