Lecture 2: Takeovers and corporate governance

In this lecture we examine aspects of corporate governance which are of key relevance to investment, namely the reasons why governance is important to performance, the issues in takeovers and the role of institutional investors in generating change both in the US and in traditionally bank dominated countries.

What are the key issues in corporate governance?

Agency costs and equity finance – link to information asymmetries and incomplete contracts between shareholders and managers
Evidence for agency costs

- share prices of bidder firms fall when acquisition announced (Roll)
- manager resistance to takeovers threatening position (Walkling and Long)
- premium to shares with voting rights (Zingales)

Equity holders vulnerability compared to other stakeholders – need control mechanisms but also remaining distinct from management
If not resolved equity finance costly/unavailable

Legal protection for shareholders

Right to vote in meetings
Appoint non executive directors
Managers' duty to serve shareholders, legally enforceable

But boards captured by managers (Jensen) or passive in all but extreme circumstances (Kreps)
Hence need for large investors with leverage to complement legal rights

- overcome free rider problems for shareholders
- but beyond 5% may exploit minorities

Paradigms of corporate governance

Direct control via debt

- relationship banking – banks maintain corporate control via credit, also as equity holders/representatives sitting on boards
- cross shareholdings among companies
- low liquidity of equity markets
- low public information disclosure
- voting restrictions and discrimination against minorities

Market control via equity

- Anglo Saxon shareholder capitalism
- Voting rights enforced and minorities protected
- High public information disclosure
- Importance of liquidity
- Agency problem resolved by takeovers

Debate on which system is superior (Allen and Gale) – Anglo Saxon cross sectional risk sharing, equity funds flow to new sectors, cope with uncertainty – Continental better for mature industries, risk well known, credit finance

Mergers and takeovers

Mergers exist in all countries but till recently hostile takeovers unique to Anglo Saxon countries
Aim improved resource utilization by bidders or by existing managers under threat
Pattern of waves

Reasons for rise in merger activity since 1980

- less presumption mergers anti competitive
- deregulation and availability of finance
- international trade growth

Arguments for individual mergers

Synergy – combined firm more efficient
Free cash flow – reduced ability to squander resources, especially if leverage increases in takeover
Monitoring costs may decline if merged firm more stable
Accounting – market may apply bidders P/E to combined firm
Under valuation – assumes inefficient market, insider information or analytical skills of raider
Managerial Motives – if agency costs uncontrolled – remuneration tied to firm size

Characteristics of acquired firms – small size, less profitable, low gearing, high retentions

Predicting mergers – financial profile of targets

“Market control via debt”

New paradigm emerged in 1980s
View retention policy key to agency conflict (“free cash flow”)
Debt issue reduces as cash flow pre-empted
Managers given equity stakes to perform well
Capital market inspects new investment
Debt availability prerequisite
Higher leverage raises creditor/shareholder conflict

What are the benefits and costs of takeovers

Performance of mergers – capital market

- use event study and focus on share price (Jensen/Ruback, Firth)
- UK more pessimistic results for bidder firm

Performance of mergers – profitability – little evidence that it is boosted (Scherer)

Benefit to shareholders, if exists, may link to reallocation of wealth from others such as customers/workers

Table 8.5 Significance tests for average monthly portfolio

Period	Targets taken over	Targets not taken over	Acquirers complete
1. m−48	−0.014	−0.018	0.018
to m−13	(−0.083)	(−0.251)	(0.197)
2. m−12	0.021	0.029	−0.003
to m−2	(0.910)	(0.726)	(−0.082)
3. m−1	0.065	0.084	−0.001
	(5.423)	(6.171)	(−0.041)
4. m 0	0.281	0.312	−0.063
	(31.070)	(31.866)	(−5.971)
5. m+1	0.010*	0.040	0.005
to m+12	(0.011)	(1.015)	(0.051)
6. m+13	N/A	−0.015	−0.004
to m+36		(−0.344)	(−0.069)

Notes: The first figures give the cumulative average residual for the portfolio holdi
brackets relate to the portfolio *t* statistic; * = months +1, +2, +3 only.
Source: Firth, 1980, Table V, p. 248.

How have institutional investors reacted?

Perceived shortcomings of takeovers

- cost
- takeover defences
- variation in credit availability
- overbidding

Specific features of the US

- institutional framework
- dominance of institutional investors
- regulatory aspects
- indexation

Direct control via equity - the “corporate governance” movement

Board representation supplemented by direct contacts at other times
Challenge excessive executive compensation, takeover defences, combined chairman/CEO, remove under performing managers, appoint more non executive
Codes of conduct for firms
Mechanism of shareholder initiative

Motivations
- indexation and need to improve performance directly
- active managers and large stakes (illiquidity)
- collapse of takeover wave
- role of public pension funds

Regulatory preconditions

- collaboration permitted (required with 5% stakes)
- fiduciary obligation to vote
- rules on disclosure of executive remuneration

HOLDERS OF CORPORATE EQUITIES BY SECTOR (%), 2000

	UK	US	Germany	Japan	Canada	France	Italy
Households	20	35	17	18	41	21	35
Companies	4	14	31	24	25	35	28
Public sector	0	1	3	2	3	3	6
Foreign	37	9	16	18	6	20	14
Financial	39	41	33	38	25	21	17
Banks	2	2	12	12	3	12	8
Life/pension	27	23	8	17	12	4	4
Mutual funds	9	16	13	3	8	5	6

How effective is institutional activism?

Results

- successful in changing management structures
- mixed evidence on increased returns

- may link to political focus of public pension funds
- private relationship investors (Warren Buffett) better at getting results over long term

How are institutions themselves governed?

Developments in the UK – Cadbury and Greenbury reports, codes of good practice

Corporate governance and European financial systems

Recent developments:

- US institutions seek to improve corporate governance
- Firms seek access to international capital markets
- Cross holdings begin to unwind (tax reform, legal changes)
- Beginning of takeovers (e.g. Mannesmann)
- Banks seek to reduce relationship links/sell equity and become investment banks, as profitability of traditional lending declines

Barriers to Change

- need to reform laws and company statutes
- shareholder blocs slow to change (including cross-holders)

EMU and Corporate Governance

- EMU likely to speed development of capital markets
- Companies' desire to issue equity, hence satisfy institutions' requirements (dividends etc.)
- Euro corporate bond market facilitates LBOs
- Also international diversification of institutions
- Hence decline of relationship banking
- Future pension reform will increase pressure

Risks in the transition

- need to reduce leverage
- shareholders may free ride
- bond markets' difficulties in restructuring

Empirical work on institutions and corporate performance (Davis 2002)

Estimated impact of the changing share of domestic and foreign institutions in equity holding

In “Anglo-Saxon” countries, long term institutions boost dividends, mutual funds restrain. Institutions restrain investment; domestic institutions boost total factor productivity (TFP). Unclear implications for “short termism” critique (Lecture 8)

In Europe and Japan, weaker effects in a similar direction for dividends; only domestic institutions restrain investment, while foreign boost it; for TFP, domestic institutions boost while foreign restrain.