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Citation: Vitkova, V. & Rosenberg, M. (2018). Playing the long game: Do certain financial advisors in the UK bring longer term value to the M&A table?. (MARC Working Paper Series 2018).

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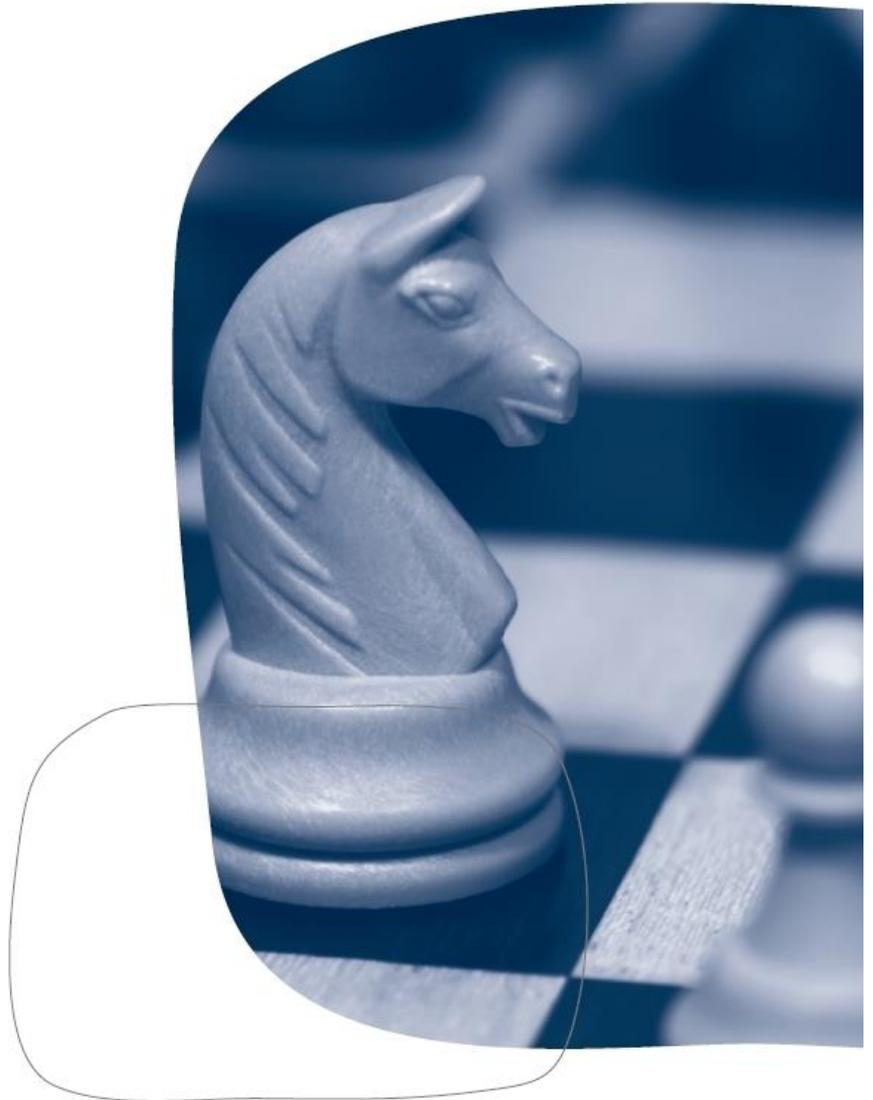


Playing the long game:

Do certain financial advisors in the UK bring longer term value to the M&A table?

M&A Research Centre – MARC

September 2018



MARC – Mergers & Acquisitions Research Centre

MARC is the Mergers and Acquisitions Research Centre at Cass Business School, City, University of London – the first research centre at a major business school to pursue focussed leading-edge research into the global mergers and acquisitions industry.

MARC blends the expertise of M&A accountants, bankers, lawyers, consultants and other key market participants with the academic excellence of Cass to provide fresh insights into the world of deal-making.

Corporations, regulators, professional services firms, exchanges and universities use MARC for swift access to research and practical ideas. From deal origination to closing, from financing to integration, from the hottest emerging markets to the board rooms of the biggest corporations, MARC researches the wide spectrum of mergers, acquisitions and corporate restructurings.

Overview

It is too early to tell how Coca-Cola's bid to buy Costa Coffee from Whitbread will play out commercially but analysts calculate that Coca-Cola's offer of £3.9b represents a remarkable premium of around 70 per cent on the coffee chain's estimated value. Whitbread's share price jumped 19 per cent on news of the deal. However, the longer-term value of this strategic deal for the world's biggest beverage giant – its biggest in eight years – are yet to play out.

This paper is an attempt to investigate if certain financial advisors (FAs) – notably, top-tier investment banks and/or accounting firms – are better equipped in delivering long-term value to UK acquisitions. It is a key question for analysts, investors, shareholders, governments and company executives. Produced by the M&A Research Centre (MARC) at Cass Business School, our report seeks to add new insights into the UK M&A market – both before and since the financial crash of 2007/8 – by better understanding the UK market for financial advisors who help close acquisition deals in one of the biggest economies in the world.

A crowded and competitive pitch...

More and more firms have entered the UK advisory services market which has been influenced by policy responses to global financial events including Enron in 2001 and the financial crisis of 2008. It can be loosely segmented into the following players: top-tier investment banks; universal banks; boutique M&A investment banks and, increasingly, accounting firms. Thompson Reuters, Bloomberg and others publish to advisor league tables encouraging advisors duke it out to rank as high as possible in the hope of winning a competitive advantage in client pitches.

...so how to value and choose the best financial advice for your deal?

Most academic analyses of the M&A market have found that bidders experience negative or insignificant abnormal returns in both the short-term window (up to ten days before and after an acquisition) and over the longer-term, up to three years after an acquisition, causing critics to question the core purpose of the M&A in driving 'value creation'. However, such concerns have far from stopped the M&A juggernaut: In the first half of 2018 alone, worldwide deal-making totalled \$2.5 trillion, up 64 per cent compared to the same period in 2017 and surpassing the previous \$2.3 trillion historic high for the comparable period of 2007.

Is anyone playing the long game?

Past studies have questioned whether certain financial advisors are better positioned to ensure better returns to the bidder. Many have failed to show a relationship between the financial advisor and bidder returns. The two papers that did identify more significant linkages¹ both didn't research if this reaction is a short-term effect only signalling investors' confidence, or if these advisors are really better at finding deals with more synergies. If so, the bidder should be able to demonstrate better results in the long-term – as well as the short-term – after the deal is implemented.

Picking a financial advisor to unlock longer-term value

Are top-tier investment banks and/or accounting firms really better than other advisors in finding M&A targets that have a long-lasting positive effect on the bidder or do both outlier papers reveal only a short-lived sign of confidence by investors? This MARC paper to finds an answer to this question.

¹ Golubov, A., Petmezas, D. and Travlos, N., The Journal of Finance, 2012 and Bilinski, P. and Yim, A., SSRN, 2016.

Background (and what we knew)

Previous academic literature studied the effect financial advisors have on the CAR share return of the bidder around the announcement date. Our study considers the long-term effect accounting firms and top-tier investment banks have on M&A deals when acting as the financial advisor of the acquiror or bidder.

This paper sought to test if investors' perception is correct and holds for the long-term after implementing the deal by looking at the three-year buy-and-hold accumulate returns (BHAR) to research acquirors' actual post-merger performance.

M&A advisory plays a large part in the world of investment banking and competition is fierce. In 2016, over 46 per cent of Goldman Sachs' investment banking division's total revenue came from M&A advisory services and it also contributed the biggest share of revenue in Credit Suisse's and JP Morgan's investment bank divisions.

Ranking banking

League tables ranking advisors based on fees earned or total deal value are published by firms like Thomson Reuters and Bloomberg. Banks are keen to perform well as a firm's higher ranking will positively affect future M&A activity, especially with inexperienced M&A clients.² High rankings confer prestige and gives banks a competitive edge when pitching. The importance of those league tables has gone so far that banks allegedly manipulate their M&A reports to achieve a better league position, sparking a FCA clampdown in 2016.³

What league tables tell us (and what they don't)

Other academics have in the past struggled to make sense of league tables and their findings imply rankings that can be misleading at times and do not always tell the whole story⁴. Despite leading to further work for the investment bank, as noted above, few links between acquiror gains and a bank's ranking in league tables have been found, supporting what researchers call the "deal completion hypothesis", i.e. that banks are more concerned about deal completion than value gained for the acquiror.

Do banks strike better deals for bidders?

One study in 2012⁵ studied the bidder-advisor matching and concluded that top-tier investment banks are able to strike better deals for a bidder by being better at identifying strategic synergies and driving a hard bargain on price – what they describe as 'better merger' and 'skilled negotiation' advantages.

Both that study and another in 2011⁶, conclude that top-tier investment banks add more value to acquisitions compared to non-top-tier advisors in the short-term around the announcement day. As with accounting firms, this paper tested these results to establish if they also held in the long-term. If banks are better at identifying synergies and negotiating, we might reasonably expect acquirors they advise to outperform the market in the long-run.

² Derrien, F. and Dessaint, O., SSRN, 2016

³ Binham, C., Ft.com, 2018

⁴ Hunter, W. and Jagtiani, J., Review of Financial Economics, 2003, Raghavendra Rau, P., Journal of

Financial Economics, 2000 and Ismail, A., Review of Quantitative Finance and Accounting, 2009.

⁵ Golubov, A., Petmezas, D. and Travlos, N., ibid.

⁶ Bao, J. and Edmans, A., Review of Financial Studies, 2011.

Our approach

Buy-and-hold abnormal returns (BHAR) were used to build a model testing the above hypotheses whether top-tier investment banks and accounting firms add value in the three-year window after an acquisition. We took a sample 774 M&As from within the UK market between the beginning of January 2000 and end of December 2014 (our list of deals ends in 2014 in order to be able to test performance three years after the deal completion). Key variables were added to our model to ensure results were apportioned and captured correctly. Key hypotheses we tested are summarized here:

What impact did the financial crisis have on deal value post-2008

Tighter financial and bank regulations followed the collapse of Lehman Brothers and the 2008 financial crisis it sparked, including the Dodd-Frank act in the U.S. and Basel III for banks. Low or even negative interest rates have become the norm, bank regulations have tightened enormously and, crucially for M&A, investors have become more risk averse. Generally, banks have become more limited and restricted in their dealings and much more prudent. Our paper therefore distinguishes between the performance of advisors before and after the 2007/8 financial crisis.

Testing bias in deal and accounting characteristics

Researchers have found certain deal and accounting characteristics to influence the bidder's stock-return upon announcement of an acquisition. To properly research the long-term performance of acquirors and the financial advisor-effect, some of those variables need to be included so to apportion the returns correctly these fall into two categories discussed here: characteristics unique to each deal and performance / accounting characteristics of the bidder.

Deal characteristics

Our paper tested for key deal characteristics where market bias had been identified by previous research including: payment methods, public versus private targets, family ownership, cross-border acquisitions and disclosure quality. For example, previous studies have shown the following:

- Cash financed bids send a more favourable signal to investors than share payments. Negative returns are reported post-announcement when offer includes a "stock-offer".
- Acquisitions of a public target create negative returns for the bidder, whereas acquisitions of a private or subsidiary target will give significant positive returns.
- Acquisitions of targets with significant family ownership will have a negative effect on post-M&A returns.
- Cross-border acquisitions return lower or negative returns in comparison to domestic ones for a variety of reasons, including different tax and accounting regimes.
- Targets from countries with lower disclosure regulations will perform worse in the long-term as firms are likely to overpay for the available synergies.

Accounting characteristics

Based on leading research in this area, our paper adopts the following hypotheses relating to accounting characteristics:

- Higher leverage of the bidder will positively impact post-acquisition returns.
- The bidder's 'Tobin's q' or 'market-to-book' ratio and post-acquisition performance are inversely correlated.
- Pre-acquisition profitability positively influences post-acquisition performance.
- Liquidity of the bidder negatively affects post-acquisition performance.
- A relatively bigger deal (higher ratio to the bidder's market value) is expected to have a negative effect on post-takeover performance of the acquiror.

Our findings

There were eight key findings related to these deals and their advisors.

Deals advised by top-tier investment banks produce better short- and long-term value

Our findings are consistent with previous studies noted earlier that top-tier investment banks bring a positive improvement in the cumulative abnormal returns in the short-term window after an M&A announcement, but only when the target is public. However, our paper suggests that the buy-and-hold returns over 36 months would be much higher than previously found, a positive gain to the acquirer / newly-merged firm by over 19 per cent – a significantly stronger link than previous research has identified. It implies that the initial positive market reaction of an M&A advised by top-tier investment banks is justified as, over the long-term, these deals really do produce better value.

...because proper deal implementation trumps deal price?

We offer two explanations of these results: First, top-tier investment banks charge significantly higher fees than other advisors such as accounting firms, hence an aura of prestige and reputation around them exists. Paying the right price for the target is the first step for ensuring long-term profitability of an acquisition, but proper implementation of the deal is what ultimately counts. Given the high fees bidders pay to top-tier banks, they are more likely to adhere to the suggested structures of deal implementation. When paying less to advisors or hiring less prestigious advisors, bidders might be less likely to adhere to the suggested advice, hence a worse long-term performance. Secondly, most top-tier investment banks have a long legacy in the M&A advisory market, comparatively to accounting firms and other boutique advisors. They therefore might have a better knowledge in ensuring the deal is also properly implemented. This might explain why deals

advised by top-tier investment firms see better long-term performance than deals advised by accounting firms or other investment banks.

Initial positive investor reaction to accounting firms advising M&A does not last

It is often claimed that accounting firms should be better placed to value the possible synergies and the target more fairly ensuring no overpayment of the premium. Whilst previous research found that investors react more positively at the announcement date when accounting firms are named as the advisor, our analysis shows that the effect does not seem to last.

The financial crisis strongly impacted long-term deal performance in the EU post-2008

Supporting previous research, this paper's findings would imply that acquisitions after the crisis on average also destroyed value in comparison to pre-crisis deals. Our findings imply that the phenomenon is not only statistically significant but also very strong. As 76 per cent of deals in our sample were within Europe, the strong effect the crisis had on Europe might explain why deals post-2008 show as performing worse.

Public acquisitions are more challenging in both the short and long term

Our findings uphold the general hypothesis that acquisitions of a public target create negative returns for the bidder in the short term compared to acquisitions of a private or subsidiary target which give more positive returns. Moreover, we find that such negative returns are also sustained over the longer term.

Poor disclosure and cross-border targets challenge long-term deal performance

Our results confirm that the quality of disclosure at the target's jurisdiction has an impact on the long-term performance post-acquisition. Nevertheless, this seems to only make a difference when acquiring a private firm. The logical explanation for this might be that publicly-listed companies have more compliance requirements and private companies have more accounting choices. Discrepancies between the acquiror's and target's reporting can make it harder for firms to merge successfully. Our results on cross-border deals with targets outside the UK, finds the majority of deals perform worse. This reinforces both findings as a majority of countries have a lower disclosure index than the UK. Studies have also found that cross-border deals have additional challenges with post-closing integration.

Market-to-book value may positively influence long-term returns for subsidiary targets deals

Market-to-book, or Tobin's q, coefficient is very low at 1.35% but highly significant. This result only holds for subsidiary deals. It would prove that a target's market-to-book value positively influences long-term returns. It would imply that 'glamour' firms (higher q-ratio) perform better than 'value' firms (lower q-ratio). This is contrary to the findings of previous studies⁷ and may result from our small sub-sample.

Past profitability is a guide to future profitability for public targets

Our results strongly support previous research that post-acquisition RoE (return on equity) is dependent on pre-acquisition RoE. It is no surprise then that the buy-and-hold returns of the company are also dependent on it. Nevertheless, this is only found to be significant if the target was a public firm.

Other variables

All other variables in our model are found to be insignificant. This is a common sight in studies that not all variables will receive statistically significant results. To ensure the robustness of these novel findings, various robustness tests were carried out with no discernable adverse findings.

⁷ See, for example, Raghavendra Rau, P. and Vermaelen, T., Journal of Financial Economics, 1998.

Conclusions

M &A is finally back, but what price advice?

The worldwide M&A market has seen the strongest year-to-date growth in the first half of 2018 since records began. Our paper shows that bidders looking to capitalize on today's cheap money and unprecedented resurgence in M&A activity should think carefully about their choice of financial advisor to maximise long-term shareholder value.

Which advisors are playing the long game in M&A value creation?

Our research builds on previous research into short-term returns. We found bidders who hire top-tier investment banks as their advisor, especially for bigger deals, stand a better chance of seeing their new acquisition give higher returns (even in the long-run) than M&A deals advised by non-top-tier advisory firms. In conclusion:

1. Top-tier investment banks justify their high fees by unlocking better long-term value: Our paper supports past research arguing that investment banks are able to strike better deals for a bidder by being better at identifying strategic synergies and driving a hard bargain on price. Top-tier banks may also be better placed to ensure the deal is also properly implemented. Our research shows deals advised by top-tier investment banks show better short- and long-term performance than any other advisor category, justifying the high fees charged and the importance of publishing advisory league tables.
2. Accounting firms have yet to demonstrate their full value: Many bidders turn to financial advisors to help them in valuing their target, but we found no evidence that accounting firms were better equipped to do this. Despite early positive investor perceptions, we found no evidence to show that accounting firms bring additional

value to the long-term deal performance. Despite accounting firms being more strongly represented when the deal or target is smaller or private, this new breed of M&A adviser has yet to demonstrate their full value to grow their current market share. Contrary to our initial belief, we could not observe any gain in market share in the six years after the 2008 crisis for accounting firms.

Despite identified limitations in our research (see Appendix), the findings of this paper are a significant stepping stone in understanding M&A deal performance. We show that the right choice of financial advisor can turn mergers and acquisitions into a long-lasting success for the acquirer and investors alike either by inspiring investor confidence or by striking better deals. Paying high fees to top-tier investment banks might indeed be a worthy investment for the future as returns will be higher.

Time will tell if the fizz surrounding Coca-Cola's acquisition of Costa will go flat over the next three years. Alison Brittain, chief executive of seller Whitbread said: "They are giving us a lot of the value that they are going to create [in Costa's future growth] in the price they are willing to pay."

However, bid advisor Akeel Sachak of Rothschild (a bank ranked just outside the top-tier of our 2000-14 research), hints of the strategic synergies and long-term value still to be tapped: "The strategic importance goes beyond what its scale might imply... I suspect this deal will wrongfoot those who still see Coca-Cola as the business it was five or 10 years ago, when it was seen as being about selling as much Coca-Cola as possible."

If our research is correct and Rothschild are competing for the top-tier, this is good news for long-term shareholders.

Appendix

Data and methodology

Data of mergers and acquisitions are taken from the SDC Platinum platform. The time period for the sample is between 01.01.2000 and 31.12.2014 and only includes M&As' where a majority interest was gained. As the proposed analysis for long-term performance requires stock performance data and completed deals only this paper requires bidder firms to be:

- based in the UK;
- bidder is publicly traded; and
- deals that were announced and completed prior to 31.12.2014.

This leaves us with an initial sample of 3,163 mergers. Since financial firms have a lot of insider knowledge in the M&A industry, this paper follows Allen, Jagitani, Peristiani, and Saunders (2002) and excludes all deals that involve financial firms as either target or acquiror. Available SIC codes (6000-6999) are used to exclude the above-mentioned.

Further, the sample is restricted to include only deals where information on the financial advisor exists and where only a single firm acted as sole advisor. The sample size is further reduced manually to exclude deals where accounting firms and investment banks are listed together as one advisor. The latter restriction is due to the fact that if more than one advisor exists, it hampers the ability to properly evaluate the influence each advisor itself had on the merger. Three more deals are removed as their advisor name is given as 'no investment bank retained'. This leaves the final sample to include a total of 774 mergers.

Descriptive statistics of the sample

The final sample size contains 11 accounting firms, eight top-tier investment banks, and 140 non-top-tier banks were noted acting as financial advisors for the bidder who advised on 112, 130 and 532 deals respectively.

Our methodology

This section will discuss the methodology used to gain answers for our hypotheses.

Rather than using the CAR method, our paper chooses to study the influence of advisors on an M&A looking at the long-term buy-and-hold abnormal returns (BHAR) after 3 years (36 months) advocated by Barber and Lyon (1997). The post-event period starts from the date the deal was announced. This should allow to capture actual long-term performance of acquirors after their M&A rather than just investors' expectations of an M&A and the "announcement effect". The BHAR is calculated from the difference in the long-term return for a sample firm i and the return of a buy-and-hold investment asset/portfolio such as the UK MSCI-All index.

How we measured advisors

To ensure financial advisors are grouped and captured correctly, top-tier investment bank advisors need to be defined. Following previous studies, the top-8 investment banks by value of deals advised are classified as top-tier. All other advisors are considered as non-top tier. The advisor league-table for the UK during the sample-period is downloaded from Thompson Reuters with ranking as follows:

Table 1 – Top 20 financial advisors in the UK between 2000-2014

This table was created using Thomson Financial SDC Platinum. It ranks the top-20 M&A advisors according to value of deals they advised on for all deals in the UK between 01.01.2000 and 31.12.2014. Credit was allocated fully to both bidder and target firm advisor and to every eligible advisor in the case of multiple advisors.

Rank	Name	Deal Value (\$Mil)	# of deals
<i>Top-tier</i>			
1	Goldman Sachs & Co	1,053,312.40	489
2	Morgan Stanley	951,014.80	402
3	JP Morgan	925,011.30	553
4	Citi	889,781.20	455
5	UBS	876,210.80	526
6	Bank of America Merrill Lynch	743,867.50	373
7	Credit Suisse	720,449.50	390
8	Deutsche Bank	715,312.70	417
<i>Non-top tier (shown from top-9th to top 20th)</i>			
9	Rothschild & Co	657,382.20	924
10	Lazard	513,635.80	404
11	Nomura	407,803.20	193
12	Barclays	333,510.50	142
13	RBS	280,439.60	233
14	HSBC Holdings PLC	240,162.30	270
15	Commerzbank AG	198,084.50	244
16	BNP Paribas SA	180,943.10	124
17	Greenhill & Co, LLC	139,061.40	102
18	PricewaterhouseCoopers	135,405.90	1020
19	Cazenove & Co	119,751.10	119
20	RBC Capital Markets	107,078.00	89

M&A between advisory firms or name changes are tracked to ensure all advisors are captured correctly.

Recommendations for future research:

Limitations we identified in our research included:

- The definition of which investment bank qualifies to be in the top-tier bracket is consistent with previous studies but remains arbitrary; the findings of this paper have showed to be sensitive to this definition.
- The BHAR model is criticised for it having its biases⁸, especially through cross-correlation. More could be done to enhance our findings by adopting remedies like bootstrapping⁹ or a correction procedure to adjust for cross-sectional bias.¹⁰
- Future research could introduce additional controls to account for bias in a bidder's choice of advisor, which is not completely random.

⁸ Brav, A. Journal of Finance, 2000; Mitchell, M. and Stafford, E., The Journal of Business, 2000

⁹ Ikenberry, D., Lakonishok, J., and Vermaelen, T., Journal of Financial Economics, 1995

¹⁰ Dutta, S. and Jog, V., Journal of Banking and Finance, 2009; Mitchell, M. and Stafford, E., ibid.

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Cass Business School

In 2002, City University's Business School was renamed Sir John Cass Business School following a generous donation towards the development of its new building in Bunhill Row. The School's name is usually abbreviated to Cass Business School.

Sir John Cass's Foundation

Sir John Cass's Foundation has supported education in London since the 18th century and takes its name from its founder, Sir John Cass, who established a school in Aldgate in 1710. Born in the City of London in 1661, Sir John served as an MP for the City and was knighted in 1713.