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The sources of value destruction in acquisitions by entrenched managers ☆

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ABSTRACT

Prior work has established that entrenched managers make value-decreasing acquisitions. In this study, we determine how they destroy that value. Overall, we find that value destruction by entrenched managers comes from a combination of factors. First, they disproportionately avoid private targets, which have been shown to be generally associated with value creation. Second, when they do buy private targets or public targets with blockholders, they tend not to use all-equity offers, which has the effect of avoiding the transfer of a valuable blockholder to the bidder. We further test whether entrenched managers simply overpay for good targets or choose targets with lower synergies. We find that while they overpay, they also choose low synergy targets in the first place, as shown by combined announcement returns and post-merger operating performance.

1. Introduction

One particularly costly manifestation of the agency conflict between shareholders and managers is a bad acquisition (see, for example, Jensen, 1986). Masulis, Wang, and Xie (2007) present evidence that acquisitions that destroy the most bidder value are made by managers who can be considered partly entrenched. In this paper, we ask how partly entrenched managers destroy value in their acquisitions. Specifically, we study the types of acquisitions they make with respect to the target's attributes, the method of payment, and the synergies created.

We find that a significant portion of value destruction comes from entrenched managers' avoidance of private targets, and from their attempts to preserve their position of entrenchment. Prior research, such as Chang (1998) and Fuller, Netter, and Stegemoller (2002), has shown that acquisitions of private targets are generally value-increasing,

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and those of public targets are more likely to be value-decreasing. Most evidence points to the capture of the illiquidity discount (see Officer, 2007) and to the creation of a monitoring blockholder in an equity-based transaction, as discussed in Chang (1998) and Fuller, Netter, and Stegemoller (2002). In addition, an equity offer for a private company is effectively a large private placement and carries similar scrutiny and certification effects (Moeller, Schlingemann, and Stulz, 2007). We find that when entrenched managers do target private companies, they are more likely to use cash. While we can never perfectly assign motivation, paying cash has the effect of avoiding both scrutiny and the potential creation of a blockholder. We also find that entrenched managers prefer not to use stock when acquiring public firms with large blockholders. Nonetheless, even controlling for the form of the target, entrenched managers make worse acquisitions, so target form is not the whole explanation.

We next examine synergies and overpayment across acquisitions. All value destruction involves overpayment. The question we ask is whether entrenched managers select low synergy targets in the first place or whether they select high or normal synergy targets but simply pay too much for them. The post-merger operating performance for acquisitions by entrenched managers is worse than for others, suggesting that poor target selection, as opposed to simply overpaying for good targets, explains the value destruction.

We also examine premiums paid by entrenched and nonentrenched managers. Notably, on average entrenched managers pay lower premiums than nonentrenched managers. Thus, the net effect of paying somewhat lower premiums for much worse targets is value destruction. Some evidence suggests that the higher premiums paid by nonentrenched managers are justified by greater synergy creation.

We conduct a variety of robustness checks. We use the Bebchuk, Cohen, and Ferrell (2009) Entrenchment Index instead of the GIM (Gompers, Ishii, and Metrick, 2003) index. We also confirm that poor governance is not simply picking up older, mature, low-growth firms. Finally, we address endogeneity concerns. Our results remain robust and our inferences are unchanged.

The paper contributes to the literature in several ways. First, we show that entrenched managers select targets and methods of payments differently from nonentrenched managers in ways that are consistent with trying to preserve their entrenchment. Specifically, they are less likely to pay stock for private targets or for public targets that have significant blockholders, implying an attempt to preserve entrenchment. Second, we show some collateral support for the idea that stock acquisitions of private targets create a monitoring blockholder. Specifically, we show that the benefits of stock acquisitions of private targets increase with deal size (and, thus, increase with the potential size and power of the monitoring blockholder). Third, we establish that the source of value destruction goes beyond simply overpaying for good targets. That is, entrenched managers also select targets that yield low synergies.

The paper proceeds as follows. In the next section we develop the hypotheses. We follow with a description of the sample in Section 3. Section 4 presents the empirical results, and Section 5 describes some robustness tests. Section 6 concludes.

2. Hypotheses development

Acquisitions are a well-established point of potential agency conflict between managers and shareholders. The potential for value destruction is greater when the agency conflict is not well controlled. In keeping with this, early work by Byrd and Hickman (1992) shows that firms with outsider-dominated boards make better acquisitions than those with insider-dominated boards. Recently, the GIM index has been proposed as a direct measure of managerial entrenchment because it aggregates antitakeover provisions. Further, even ignoring a direct entrenching effect of the provisions, a preponderance of these provisions at a firm likely indicates a generally self-serving approach by management and an accommodating board (see e.g., Davila and Penalva, 2006). As such, the GIM index serves as an indicator of firms in which agency problems are most severe. Masulis, Wang, and Xie (2007) provide evidence consistent with the hypothesis that high GIM index firms (so-called dictators) engage in value-destroying acquisitions on average, even controlling for a wide variety of firm and event characteristics. Our goal is to explore the source of this value destruction. In doing so, we test the following hypotheses.

2.1. Target selection

There is a continuum of entrenchment. Even if a manager is relatively entrenched, that does not mean that he or she could take no action that would weaken his or her position. On the contrary, such a manager actively seeks to maintain his or her level of entrenchment. Thus, entrenched managers could promote investments that increase (or at least do not decrease) their level of entrenchment. Target selection is one way to do this.

Avoiding private targets helps entrenched managers to preserve their entrenchment and avoid further internal scrutiny. When a bidder buys a private target with stock, particularly one that is nontrivial in terms of relative size, it creates a large shareholder because the ownership of the private firm is concentrated. This large shareholder then has the ability and motivation to monitor bidding management going forward. Chang (1998) and Fuller, Netter, and Stegemoller (2002) find evidence consistent with this, showing that, in contrast to the case of public targets, bidders using equity to buy private targets receive higher announcement returns on average. Entrenched managers prefer to avoid any additional monitoring and so would not acquire a private firm using equity. A solution is to effect the acquisition with cash. However, if they do not have sufficient cash on hand, they would need to turn to external capital markets for financing, at which point they would be subject to similar monitoring or scrutiny. The net effect would be fewer private targets overall, with a preference for cash payment when private firms are targeted.

Another, complementary hypothesis regarding private targets comes from the certification effect that a company

receives when an informed investor accepts a large placement of the company's shares. This certification effect is similar to that in the private placement literature by Hertzel and Smith (1993) and is confirmed in the case of acquisitions by Moeller, Schlingemann, and Stulz (2007). Specifically, in the case of a private target, the target accepts bidder shares only if the chief executive officer (CEO) in the target has access to private information and is comfortable with the bidder's economic situation and with changes in the float. Such scrutiny would not be welcome by a dictator bidder, and the resulting certification would be less valuable as well.

Under-targeting private firms has negative consequences for bidder shareholders as extant evidence shows that acquisitions of private targets are value-creating and those of public targets are value-destroying, on average (e.g., Chang, 1998; Fuller, Netter, and Stegemoller, 2002). Officer (2007) shows that premiums for private targets are significantly lower than those for similar public firms, owing to the value of providing liquidity to the private target's owners. Specifically, acquisitions of unlisted targets involve an illiquidity discount. Here, the acquirer pays a lower acquisition premium to compensate for the illiquidity of the asset, to compensate for the opacity of the target, and because the unlisted target takes liquidity as a form of nonpecuniary payment (following Capron and Shen, 2007; Faccio, McConnell, and Stolin, 2006). Thus, under-targeting private companies would explain part of the average value destruction by entrenched bidders.

Avoiding public targets that have blockholders can also reinforce entrenchment. Prior literature suggests that large blockholders monitor managers through actions such as voting at shareholder meetings (Agrawal and Mandelker, 1990; Chen, Harford, and Li, 2007; Aggarwal, Saffi, and Sturgess, 2011). If managers use stock to acquire a target that has a large blockholder, then they could risk importing a large blockholder to the merged firm. Thus, entrenched managers would avoid using stock to acquire a target that has a large monitoring blockholder.

2.2. Pure overpayment

Entrenched managers are more interested in completing the deal than in maximizing bidding shareholder value. Whether it is due to empire-building incentives or defensive acquisition incentives such as those described in Gorton, Kahl, and Rosen (2009), entrenched managers interested in preserving and extending their private benefits of control would be willing to overpay for target assets. This leads to the overpayment hypothesis: Entrenched managers overpay for their targets (which could otherwise be similar to targets of unentrenched managers), thus destroying value.

2.3. Low synergies

A related hypothesis is that entrenched managers choose targets with which their firm has low (or no) synergies. This is still overpayment in the sense that any premium for a no-synergy target is overpayment, but it specifically focuses on the lack of synergies, as opposed to overpayment for a firm with an average amount of synergies. The lack of synergies could be due to a poor match because entrenched managers are more interested in empire-building than value creation. Alternatively, or in combination, it could be that entrenched managers lack the skill to exploit potential synergies that do exist.

3. Sample

The initial sample contains 3,935 takeovers made by US acquirers of public, private, and subsidiary targets from 1990 to 2005. The sample includes 27 cross-border deals. The takeover sample is from SDC Platinum's Mergers and Acquisitions database. We follow Masulis, Wang, and Xie (2007) by imposing the following sample requirements:

1. The acquisition must be completed.
2. The bidder must own less than 50% of the target before the acquisition and 100% after.
3. Transaction value must exceed $1 million and at least 1% of the bidder's market capitalization 11 day before the announcement.
4. The bidder must have accounting data on Compustat and stock data on, Center for Research in Security Prices (CRSP) for 210 trading days before the announcement.
5. The bidder must have Investor Responsibility Research Center (IRRC) governance data.

The IRRC database (now part of RiskMetrics) primarily contains large Standard & Poor's (S&P) 500 firms that constitute over 70% of US stock market capitalization (Bebchuk, Cohen, and Ferrell 2009). However, post-1998 IRRC publications include smaller firms. The IRRC has published data in 1990, 1993, 1995, 1998, 2000, 2002, and 2004. We assume that firms maintain the previous publication's provisions in between publication dates (following Gompers, Ishii, and Metrick, 2003; Masulis, Wang, and Xie, 2007).[1]

Because of our focus on the paths to value destruction for entrenched managers, we categorize our acquirers into democracy or dictator categories based on their GIM index (whereby a firm with ≥ 10 antitakeover provisions is a dictator). For robustness, we categorize democracy and dictator based on the extremes of the GIM index and find our inferences are unchanged (see Section 5). We also impose the condition that a firm must have a nonclassified board to be considered a democracy. We also separately consider simply using the presence of a classified board to proxy for entrenchment and self-interest. While the classified board is a simple measure, it is also a blunt proxy for agency problems as it is present in approximately 63% of firms and protects against only one type of disciplinary action, a proxy fight. Nonetheless,

[1] The results are qualitatively similar if we use the subsequent publication's data to backfill the governance indices. The results also hold if we constrain our sample to include only larger firms for the full sample period, i.e., those that belong to the S&P 500 index.

we want to see how well a very simple, easily calculated measure would perform compared with the more complex GIM index. Using this simple, blunt measure produces results that are largely consistent with those reported in the paper, as well as usually significant, but they are also weaker (not tabulated). Table 1 presents the time series of mergers, broken out by democracy and dictator acquirers.

Table 1 shows a gradual increase in activity during the early to mid-1990s, with significant increases in both the number of transactions and the size of the acquiring firms in the late 1990s. The mean and median relative transaction size does not decrease as the acquirer size increases, indicative of the large deals seen at the end of the 1990s. Notably, the large differences in mean and median values reflect the existence of some very large bidders and deals. While initially dictator bidders are larger on average than democracy bidders, the relation begins to reverse in 1994. Democracy firms were slower to join the 1990s merger wave than were dictator firms. The announcement returns for dictator bids turn negative earlier and are more consistently negative than for democracy bidders. However, the results for the 1999 to 2001 period do confirm conclusions from other studies such as (Moeller, Schlingemann, and Stulz, 2005, Table 1) that many bids made then were value-destructive.

4. Results

Table 2 presents summary statistics for the sample split according to the entrenched status of the acquirer. Panel A shows that dictators are more likely to have a classic free cash flow problem, showing higher free cash flow coupled with lower Tobin's q. They are older firms as

Table 1
Sample construction by announcement year and dictator or democracy groups.
Number of takeovers of publically listed targets completed between 1990 and 2005 by acquirer market capitalization, relative deal size, and 5-day cumulative abnormal returns (CARs). In this table, dictators are firms with a GIM (Gompers, Ishii, and Metrick, 2003) index 10. Democracies are firms with a GIM index <10 and a non-classified board (CBRD=0). Median values are reported in parentheses.

Year	Dictator (GIM index ≥ 10)				Democracy (GIM index <10 and CBRD=0)			
	Number of deals	Market capitalization millions of dollars	Relative deal size	Five-day CAR percent	Number of deals	Market capitalization (millions of dollars)	Relative deal size	5-day CAR (percent)
1990	59	2,177	0.092	0.903	37	829	0.134	2.074
		(699)	(0.042)	(1.167)		(486)	(0.076)	(1.710)
1991	49	1,701	0.160	1.453	35	2,407	0.150	0.535
		(899)	(0.052)	(−0.201)		(960)	(0.075)	(0.658)
1992	56	2,094	0.112	−0.896	34	1,394	0.091	2.286
		(1,237)	(0.044)	(−1.111)		(733)	(0.066)	(1.655)
1993	109	2,646	0.105	0.182	53	2,042	0.090	2.283
		(1,538)	(0.041)	(−0.271)		(1,007)	(0.052)	(0.708)
1994	123	2,886	0.102	0.323	53	3,526	0.137	0.744
		(1,743)	(0.044)	(−0.369)		(1,647)	(0.041)	(−0.395)
1995	110	3,508	0.159	−0.280	61	4,002	0.125	0.822
		(1,741)	(0.086)	(−0.251)		(1,312)	(0.064)	(−0.364)
1996	125	4,061	0.171	0.798	64	5,134	0.123	2.470
		(2,366)	(0.074)	(0.691)		(2,074)	(0.057)	(1.700)
1997	141	5,104	0.152	−0.014	59	9,258	0.112	0.412
		(2,828)	(0.070)	(−0.495)		(2,695)	(0.052)	(0.094)
1998	166	6,116	0.140	−0.725	130	9,952	0.137	1.117
		(3,279)	(0.067)	(−0.792)		(2,680)	(0.054)	(1.120)
1999	162	8,205	0.137	−0.319	90	16,591	0.172	−0.238
		(2,522)	(0.059)	(−1.034)		(2,081)	(0.068)	(−0.348)
2000	124	9,580	0.188	−1.505	89	24,913	0.128	0.797
		(3,001)	(0.079)	(−0.542)		(4,653)	(0.051)	(1.512)
2001	113	8,578	0.124	−0.794	88	10,908	0.116	−0.373
		(3,282)	(0.053)	(−0.787)		(2,381)	(0.051)	(−0.436)
2002	140	6,780	0.100	1.174	109	8,085	0.118	0.767
		(1,629)	(0.054)	(0.673)		(996)	(0.057)	(−0.307)
2003	131	3,862	0.136	−0.723	85	9,909	0.085	−0.976
		(1,993)	(0.066)	(−0.779)		(1,054)	(0.053)	(−0.512)
2004	152	5,317	0.149	0.837	88	5,323	0.154	1.156
		(2,141)	(0.060)	(0.675)		(1,424)	(0.070)	(1.002)
2005	145	9,929	0.136	−0.120	60	14,105	0.121	1.995
		(3,421)	(0.057)	(−0.145)		(1,535)	(0.057)	(0.936)
Overall	1,905	5,664	0.137	−0.036	1,135	9,320	0.126	0.837
		(2,199)	(0.059)	(−0.197)		(1,655)	(0.057)	(0.628)
Subsample analysis for different time periods								
1990–1993	273	2,155	0.117	0.411	159	1,668	0.116	1.795
1994–1997	499	3,890	0.146	0.207	237	5,480	0.124	1.112
1998–2001	565	8,120	0.147	−0.836	397	15,591	0.138	0.326
2002–2005	568	6,472	0.13	0.292	342	9,356	0.12	0.736

well. We control for age in our subsequent analysis and specifically examine older, low-growth versus younger, high-growth acquirers in our robustness section. Dictators are also more likely to have one person undertaking the dual role of CEO and chairperson and to have larger boards, lower CEO pay sensitivity, lower CEO equity ownership, and lower equity-based pay. Taken together, the results are certainly consistent with the proposition that a preponderance of antitakeover provisions (ATPs) is a reasonable proxy for managerial entrenchment

Table 2
Acquirer, target, and deal characteristics.

Descriptive statistics for acquirer, target, and deal characteristics as defined in Appendix A sorted by dictator or democracy portfolios. Dictators are defined as firms with a GIM (Gompers, Ishii, and Metrick) index ≥ 10. Democracies are defined as firms with a GIM index < 10 and a nonclassified board (CBRD $= 0$). Median values are denoted in parentheses. ***, **, and * denote a statistically significant difference between dictator and democracy acquirers, using a two-tailed test at the 1%, 5%, and 10% level, respectively.

Variable	All	Dictator GIM index ≥ 10	Democracy GIM index < 10 and CBRD $= 0$
Panel A: Acquirer characteristics			
Market value equity (millions of dollars)	6,924	5,664***	9,320
	(1,845)	(2,199)	(1,655)
Total assets (millions of)	12,154	11,996	15,477
	(2,323)	(3,520)***	(1,550)
Tobin's q	1.793	1.635***	2.021
	(1.415)	(1.354)***	(1.601)
Free cash flow	0.017	0.020***	0.016
	(0.022)	(0.023)**	(0.021)
Leverage	0.166	0.179***	0.142
	(0.143)	(0.157)***	(0.105)
Stock run-up	0.071	0.047***	0.078
	(0.018)	(0.009)*	(0.001)
Industry M&A	0.022	0.021***	0.025
	(0.015)	(0.014)***	(0.017)
Relative size	0.134	0.137	0.126
	(0.059)	(0.059)	(0.057)
Volume	0.072	0.083	0.123
	(−0.045)	(−0.033)	(−0.030)
PRIV	2.137	1.840***	2.432
	(1.566)	(1.469)***	(1.696)
Age (in years)	22.392	26.841***	19.475
	(19)	(24)***	(13)
CEO Chair	0.808	0.836***	0.780
Board size	9.924	10.642***	8.953
Prop. independent directors	0.741	0.735*	0.757
Largest block holder (percent)	11.421	11.151	11.727
CEO wealth sensitivity	0.118	0.062***	0.182
CEO equity ownership	0.030	0.022***	0.035
CEO equity-based pay	0.441	0.411***	0.491
Panel B: Target characteristics			
Total assets (millions of dollars)	4,343	3,214***	8,378
	(660)	(1,046)***	(540)
Market value (millions of dollars)	2,468	2,379	3,171
	(297)	(389)	(354)
Tobin's q	2.076	1.910	2.404
	(1.339)	(1.231)*	(1.576)
Leverage	0.121	0.130	0.104
	(0.082)	(0.091)	(0.034)
PRIV	1.791	1.574	2.017
	(1.133)	(1.000)	(1.410)
Panel C: Deal characteristics			
Tech dummy	0.209	0.134***	0.307
Conglomerate	0.369	0.399**	0.358
Competed	0.020	0.022	0.017
Crossborder	0.007	0.002***	0.016
Friendly	0.989	0.987	0.989
Serial 3	0.688	0.735***	0.653
Serial 4	0.532	0.585***	0.470
Serial 5	0.425	0.469***	0.350
Premium (3-day)	0.512	0.498	0.539
	0.399	(0.385)*	(0.444)
Premium (11-day)	0.584	0.564	0.616
	0.464	(0.426)**	(0.500)
Premium (35-day)	0.671	0.645**	0.725
	0.549	(0.513)**	(0.631)

(Goyal and Park, 2002; Yermack, 1996; Datta, Iskandar-Datta, and Raman, 2001; Core and Guay, 2002).

Panel C of Table 2 presents the deal characteristics, revealing several differences between dictator and democracy deals. Dictator deals are less likely to be high-tech, but they are more likely to be diversified or conglomerate in nature. Dictator managers are also much more likely to be serial acquirers. Nonetheless, the data on premiums show that dictator firms pay lower premiums on average than do democracies.

Table 3 provides some initial insight into the roots of dictator bidder value destruction. In the first row, we confirm the general result, found in Masulis, Wang, and Xie (2007), that announcement cumulative abnormal returns (CARs) are lower for dictator firms. Broken out by target form, the data reveal several important facts. Compared with democracy firms, dictator firms earn positive, but smaller CARs on private and subsidiary targets. They earn negative, but similar CARs on public targets. While these findings might not provide

Table 3
Acquirer cumulative abnormal returns by organizational status, method of payment, and interactions.

Descriptive statistics for acquirer characteristics as defined in Appendix A sorted by dictator or democracy portfolios. Dictators are defined as firms with a GIM (Gompers, Ishii, and Metrick, 2003) index ≥ 10. Democracies are defined as firms with a GIM index < 10 and a nonclassified board (CBRD=0). Median values are denoted in parentheses, followed by frequencies, in brackets. ***, **, and * denote a statistically significant difference between dictator and democracy acquirers, using a two-tailed test at the 1%, 5%, and 10% level, respectively. Frequency differences are tested with a Chi-square test.

Variable	All	Dictator GIM index ≥ 10	Democracy GIM index < 10 and CBRD=0
All deals	0.301	−0.036***	0.837
	(0.118)	(−0.197)***	(0.628)
Public targets	−1.457	−1.531	−1.259
	(−1.328)	(−1.360)	(−0.965)
	[0.316]	[0.342]**	[0.307]
Private targets	0.771	0.484**	1.438
	(0.597)	(0.304)***	(1.456)
	[0.364]	[0.316]***	[0.393]
Subsidiary targets	1.493	0.940***	2.192
	(0.840)	(0.544)	(1.278)
	[0.319]	[0.337]**	[0.294]
All cash	0.960	0.498***	1.562
	(0.612)	(0.309)**	(1.171)
	[0.553]	[0.578]***	[0.518]
All stock	−1.188	−1.156	−0.864
	(−0.900)	(−1.026)	(−0.364)
	[0.230]	[0.214]**	[0.251]
Mixed	0.199	−0.368**	1.060
	(−0.044)	(−0.734)**	(0.659)
	[0.218]	[0.208]	[0.231]
Public * All cash	0.297	0.145	0.443
	(−0.022)	(−0.204)	(−0.635)
	[0.094]	[0.103]	[0.093]
Public * All stock	−2.340	−1.931	−2.823
	(−1.885)	(−1.672)	(−2.737)
	[0.136]	[0.141]***	[0.135]
Public * Mixed	−1.975	−2.724***	−0.603
	(−1.498)	(−2.263)***	(−0.175)
	[0.086]	[0.098]***	[0.079]
Private * All cash	0.753	0.280**	1.526
	(0.485)	(0.315)*	(1.483)
	[0.191]	[0.182]	[0.190]
Private * All stock	0.506	0.345**	1.808
	(0.338)	(−0.199)***	(2.379)
	[0.081]	[0.061]***	[0.098]
Private * Mixed	1.041	1.109	0.933
	(0.838)	(0.605)	(1.001)
	[0.086]	[0.098]***	[0.079]
Subsidiary * All cash	1.327	0.716***	2.046
	(0.811)	(0.439)*	(1.562)
	[0.266]	[0.290]***	[0.231]
Subsidiary * All stock	0.051	0.023	−1.313
	(−0.907)	(0.608)	(−1.169)
	[0.011]	[0.011]	[0.017]
Subsidiary * Mixed	3.095	3.045	4.173
	(1.779)	(2.086)	(2.885)
	[0.038]	[0.036]	[0.047]

convincing support for the monitoring or certification hypotheses, because arguably one might expect dictators to generate larger returns when they buy private targets, particularly with stock, univariate statistics tend to obscure underlying relations with other characteristics. For example, the target's size relative to the bidder is important in conveying additional monitoring benefits. Many untabulated differences exist in the characteristics of dictator and democracy targets, including the fact that the average private target of a dictator is smaller than that of a democracy bidder. While multivariate CAR regressions are the appropriate place to sort out these differences, we can confirm that returns to dictator private deals financed with stock increase in relative size. For example, increasing relative size from the first quartile to the fourth quartile increases CARs to dictators from –0.74% to 6.68% (untabulated). For democracies, the relevant increase is 1.74% to 4.52%. We show later in our multivariate CAR regressions that, after controlling for other factors, dictators generate significantly higher CARs when they undertake larger private deals paid for with stock. The economic magnitude is also large, so while monitoring benefits are not the whole story, the market's reaction is consistent with its importance.

The frequencies denoted in brackets also reveal that the targets of dictator firms are less likely to be private than are the targets of democracy firms (32% versus 39%) and more likely to be public (34% versus 31%). Thus, the general result that dictator firms destroy value on average is due to a combination of choosing generally value-decreasing public targets more often and to creating less value when choosing private and subsidiary targets.

We can gain more insight by comparing the frequencies broken out by target form and method of payment. One notable finding is that dictator firms are more likely to use stock for public targets but are less likely to use stock for private targets. Fuller, Netter, and Stegemoller (2002) hypothesize that the generally higher returns for acquisitions of private targets with stock are due at least partly to the creation of a blockholder. Dictator bidders' preference for cash is consistent with entrenched management's desire to avoid creating a new monitor (but is not conclusive). It is also consistent with avoiding or not valuing the scrutiny and certification of what is effectively a large private placement. In later multivariate analysis, we further explore the facts that, compared with democracy firms, dictator firms show a preference for public targets and are much less likely to use stock when paying for private targets. We further examine whether they show a preference for avoiding blockholders in general.

Univariate results are at best suggestive, identifying characteristics that must be included in the multivariate analysis to come. The picture that emerges is that dictator acquirers tend to be more mature, with lower q's, higher leverage, and higher free cash flows. Combined with their high antitakeover index and board and compensation characteristics, the potential for significant agency problems exist. Table 1 shows that dictator acquirers are more active in general, and Table 2 shows that they disproportionately under-target private firms. When they do target private firms, they are less likely than democracy acquirers to use all stock as consideration. This has the effect, intended or not, of avoiding scrutiny or the creation of a blockholder through the transaction.

4.1. Likelihood of bidding

The univariate results in Table 3 suggest that the targets of dictator bidders are shifted toward public, not private, status. Here we examine target choice in a multivariate setting to explore that observation further. Specifically, we estimate a double-sided tobit (censored at zero and one) to explain the proportion of future targets that are public (or private or subsidiary) for a given bidder at a given time. We control for bidder characteristics that should influence the decision as well as the public status of the bidder's prior targets. We estimate the tobit as the second step of a two-step Heckman procedure that controls for the selection inherent in a bidder choosing to bid again at some point in the future.[2] The results are presented in Table 4.

Column 1 shows that the observation from the univariate results does carry over to the multivariate setting, Dictator firms have a significantly lower fraction of private targets, all else equal. Columns 4 and 5 shed some light on this result. The proportion of private targets paid for with cash is not abnormally low for dictator bidders, but the proportion paid for with stock is. While we cannot conclusively determine the motivations of dictator bidders, this set of results is consistent with the conjecture that entrenched managers are less likely to pay stock for a private target so as to avoid creating blockholders or undergoing scrutiny from the target owners. The results remain significant if we use higher values of the GIM index to identify dictator firms.

To further examine whether entrenched managers behave as if they wish to avoid blockholder monitoring, in Panel B we examine public targets with existing blockholders. Even though the ownership of some of these blockholders could drop below the blockholder level after the acquisition, their willingness to become a blockholder reveals that they are more likely than other shareholders to be activist (see Aggarwal, Saffi, and Sturgess, 2011), something an entrenched manager would prefer to avoid. In our tests in Panel B we estimate the likelihood of targeting a firm with a blockholder. The interaction variable for dictator paying with stock is negative and significant, indicating that entrenched managers are less likely to use a stock swap to acquire a target with a blockholder. Likewise, the interaction for dictator and all cash payment is positive and significant. Again, while assigning motivation is impossible, we note that the results for method of payment in private targets and for

[2] The selection equation controls for the dictator dummy (that the GIM index exceeds 10); the bidder's industry concentration (Herfindahl–Hirschman Index); cash holdings scaled by total assets; the number of previous deals; the natural log of the firm's market value of assets; book leverage; whether the prior deal was friendly; the bidder price-to-residual-income value and the Officer (2007) proxy premium paid for the prior acquisition.

Table 4
Predicting the target type.

Panel A examines the types of acquisitions made by acquirers who make more than one acquisition. The dependent variable in Column 1 is the proportion of all deals after the first deal that are for private targets. Similarly, the dependent variables in Columns 2–5 are the proportion of deals that are for public targets, subsidiary targets, private targets paid for using cash, and private targets paid for using stock. All models use a Heckman procedure to control for self-selection into making more than one bid. Dictator is a dummy variable taking a value of one if GIM (Gompers, Ishii, and Metrick, 2003) index ≥ 10, and zero otherwise. PRIV, leverage, free cash flow, and Tobin's q are defined in Appendix A. Panel B examines the likelihood using logit regressions that an acquirer bids for a public target with a blockholder. The dependent variable in Columns 1–3 (4–6) is equal to one if the target has a blockholder with holdings of 5% or more (greater than the median blockholdings level). The independent variables are defined in Appendix A. Standard errors denoted in parentheses are adjusted for heteroskedasticity and acquirer clustering. Regressions control for year fixed effects (unreported). ***, **, and * denote significance at 1%, 5%, and 10%, respectively.

Variable	Private (1)	Public (2)	Subsidiary (3)	Private cash (4)	Private stock (5)
Panel A: Acquisition type					
Dictator dummy	−0.094*	0.005	0.044	−0.027	−0.284***
	(0.057)	(0.062)	(0.062)	(0.086)	(0.083)
Log market value	−0.224***	0.264***	−0.053**	−0.248***	−0.139***
	(0.024)	(0.028)	(0.024)	(0.034)	(0.031)
Tobin's q	−0.039	0.014	0.008	0.023	−0.088**
	(0.028)	(0.031)	(0.029)	(0.041)	(0.037)
Free cash flow	0.415	1.578	−1.502	2.383**	−1.784
	(0.675)	(1.086)	(0.996)	(1.099)	(1.207)
Leverage	−0.470*	−0.698**	1.256***	−0.246	−0.679*
	(0.257)	(0.278)	(0.251)	(0.408)	(0.349)
PRIV	0.007	−0.004	0.001	0.002	0.017*
	(0.005)	(0.007)	(0.005)	(0.006)	(0.010)
Log firm age	−0.061	0.016	0.044	−0.039	−0.097
	(0.044)	(0.050)	(0.051)	(0.057)	(0.060)
Inv Mills	−0.806***	−0.222	0.608**	−0.25	−1.128***
	(0.210)	(0.233)	(0.248)	(0.290)	(0.292)
Constant	4.338***	−2.722***	−1.033*	3.016***	3.414***
	(0.515)	(0.590)	(0.584)	(0.664)	(0.657)
Number of observations	2,299	2,299	2,299	2,299	2,299
F-statistic	5.66***	9.23***	3.5***	4.47***	3.43***
Pseudo-R^2	7.50%	12.20%	4.10%	7.80%	5.10%

	Target blockholdings $\geq$ 5%			Target blockholdings $\geq$ median blockholdings		
	(1)	(2)	(3)	(4)	(5)	(6)
Panel B: Likelihood of targeting a firm with a blockholder						
Dictator dummy	−0.082	0.139	−0.236	−0.124	0.128	−0.280*
	(0.164)	(0.181)	(0.177)	(0.146)	(0.163)	(0.161)
Dictator * All stock		−0.524***			−0.605***	
		(0.185)			(0.180)	
Dictator * All cash			0.521***			0.521***
			(0.201)			(0.191)
Log market value	0.136**	0.155***	0.150***	0.115**	0.136***	0.129***
	(0.054)	(0.054)	(0.054)	(0.050)	(0.050)	(0.050)
Tobin's q	0.367***	0.360***	0.359***	0.204***	0.204***	0.201***
	(0.089)	(0.084)	(0.085)	(0.063)	(0.061)	(0.062)
Free cash flow	0.066	−0.303	−0.353	−1.006	−1.478	−1.488
	(2.321)	(2.335)	(2.324)	(2.236)	(2.241)	(2.232)
Leverage	0.661	0.521	0.614	0.086	−0.064	0.046
	(0.631)	(0.632)	(0.631)	(0.604)	(0.605)	(0.605)
Stock run-up	−0.283*	−0.257	−0.269	−0.144	−0.119	−0.131
	(0.168)	(0.165)	(0.167)	(0.153)	(0.151)	(0.152)
PRIV	0.001	0.002	0.002	0.003	0.003	0.003
	(0.011)	(0.011)	(0.011)	(0.008)	(0.008)	(0.008)
Log firm age	0.107	0.094	0.099	0.059	0.042	0.05
	(0.091)	(0.091)	(0.092)	(0.092)	(0.091)	(0.093)
Constant	−1.045*	−1.201*	−1.124*	−0.747	−0.941*	−0.838
	(0.612)	(0.616)	(0.617)	(0.550)	(0.553)	(0.553)
Number of observations	1,245	1,245	1,245	1,245	1,245	1,245
Wald statistic	54.43***	65.26***	61.19***	53.42***	63.07***	60.28***
Pseudo-R^2	4.34%	4.89%	4.80%	3.22%	3.97%	3.70%

public targets with blockholders is consistent with blockholder-avoidance. These results are broadly consistent with the Bertrand and Mullainathan (2003) quiet-life hypothesis, characterizing part of the agency problem as a desire by entrenched managers to maintain their position of freedom from interference.

4.2. Announcement returns

We move to an analysis of the value creation or destruction by different types of bidders by estimating a specification to explain the bidder's stock price reaction to the acquisition announcement. We use five CARs measured from days -2 to $+2$, where $t=0$ is the takeover announcement day. The CARs are measured as the return in excess of that predicted by a market model. Similar to Masulis, Wang, and Xie (2007), we estimate the market model over days -210 to -11.[3] The announcement return specification includes an indicator variable for bidders we classify as dictators. Models 1 to 3 test the target selection hypothesis, and Models 4 and 5 test the overpayment hypothesis. Model 1 is the base model, which includes no interactions. Model 2 includes interactions to capture target organizational status and method of payment (Private * All stock), and larger private-all stock deals (Private * All stock * Relative size). The latter interaction is included to account for the fact that monitoring potential is related to the relative size of the private target to that of the acquirer. Model 3 then includes interactions with our dictator dummy to specifically test if coefficient values differ across dictator and democracy acquirers. We also include a number of control variables that are standard to the literature; (see, e.g., Fuller, Netter, and Stegemoller, 2002; Humphery-Jenner and Powell, 2011; Moeller, Schlingemann, and Stulz, 2004, 2005; Moeller and Schlingemann, 2005; Moeller et al., 2005; Masulis, Wang, and Xie, 2007; Travlos, 1987). Specifically, we include prior-year stock return (stock run-up), size, firm age, q, free cash flow, leverage, a measure of industry merger and acquisition activity (Industry M&A), relative size of the target, abnormal trading volume, and indicator variables for deals in high technology industries, conglomerate deals, all cash, all stock, target organizational status (i.e., private or subsidiary), competed deals, friendly deals, cross-border deals, and acquirers involved in serial deals. Jensen (2005) proposes that the existence of overvalued or highly valued equity could give rise to value-destroying acquisitions. Following the approach in Dong, Richardson, and Teoh (2006), which is similar to that used by Rhodes-Kropf, Robinson, and Viswanathan (2005) and Lee, Myers, and Swaminathan. (1999), we also include a measure of overvalued equity, price-to-residual-income value (PRIV).[4]

The results in Table 5 show that dictators have lower announcement returns, consistent with the results in Masulis, Wang, and Xie (2007). In untabulated results, we also find that the dictator dummy is negatively significant in the public-only and non-public samples. As in prior literature, we also show in Model 2 that the announcement returns for private acquisitions are higher when the bidder uses stock, consistent with a positive effect from a potential increase in monitoring from a new blockholder. Model 3 shows, however, that, for dictators, the market perceives target size as an important factor in delivering monitoring or certification benefits, with only stock bids for larger private targets generating higher returns. This impact of relative deal size is economically significant. For dictatorship firms acquiring an unlisted target with stock, a 1 standard deviation increase in relative deal size doubles CARs (holding all else constant). The calculation is

$$\begin{aligned}&\beta(\textit{Relative Deal Size})\\&\times(\textit{Relative Deal Size})+\beta(\textit{Private}\times\textit{Stock})\\&+\beta(\textit{Private}\times\textit{Stock}\times\textit{Relative Deal Size})\\&\times(\textit{Relative Deal Size})+\beta(\textit{Dictator}\times\textit{Private}\times\textit{Stock})\\&+\beta(\textit{Dictator}\times\textit{Private}\times\textit{Stock}\times\textit{Relative Deal Size})\\&\times(\textit{Relative Deal Size}),\end{aligned}$$

where a $\beta(.)$ term represents a regression coefficient from Column 3 of Table 6 and Relative Deal Size represents the relative deal size for acquisitions by dictators. The average Relative Deal Size is 0.137, and the standard deviation is 0.200. Thus, the CAR for the average relative deal size (ignoring all other coefficients) is 2.518%. Increasing the Relative Deal Size by 1 standard deviation to 0.337 induces a CAR of 5.172%.[5] So, holding all else constant, increasing the relative deal size by 1 standard deviation doubles CARs for dictatorships that make acquisitions of private targets with stock.

Consistent with extant findings on public samples, the results also show that higher bidder q, higher bidder leverage, and bids by smaller firms are greeted more positively by the market, while public and friendly bids and those with overvalued equity (PRIV) are more value destructive.

One concern with using announcement returns is that they incorporate the stock market's assessment of more than just the value of the acquisition to the acquirer. For example, they also include a reassessment of the stand-alone value of the bidder, possibly reflecting the implication that internal growth opportunities are not as valuable as had previously been believed. We take two approaches to mitigate this inference problem. First, we repeat the analysis excluding the first acquisition made by a given bidder. Although we try to control for the fact that high GIM index firms also tend to be maturing firms, our controls could be incomplete. Under the assumption that most of the information about the state of the bidder's internal growth opportunities is revealed at the announcement of its first bid, dropping the first bid from the sample provides a cleaner measure of the bid's effect

[3] The results are robust to different event windows (e.g., $-3,+3$, $-1,+1$). Further, the results are robust to alternative models of expected return, including a market-adjusted model with alpha equal to zero and beta equal to one, and GARCH (generalized autoregressive conditional heteroskedasticity) or EGARCH (exponential generalized autoregressive conditional heteroskedasticity) estimations.

[4] For a detailed description of the computation of PRIV, see Lee, Myers, and Swaminathan (1999) and Dong, Hirshleifer, Richardson, and Teoh (2006).

[5] This CAR is consistent with the high relative size quartile CARs reported during discussion of Table 3. The magnitude could create a concern that some of these large relative size deals are reverse takeovers in which the private firm is effectively going public by buying a public company, paying a premium, but the public company survives as the official buyer. We examine the sample carefully in subsection 5.2 and rule this out.

Table 5
Acquirer announcement return regressions.

The regressions are estimated using a sample of completed acquisitions from 1990 to 2005. The five-day ordinary least squares market model cumulated abnormal return (in percentages) is the dependent variable. Model 1 is estimated on the full sample without any method of payment or target firm organizational status interaction variables. Dictator is a dummy variable taking a value of one if GIM (Gompers, Ishii, and Metrick, 2003) index ≥ 10, and zero otherwise. Regressions 2 and 3 include interactions between target organizational status (private), method of payment (all stock), and relative size to test the target selection hypothesis. Regression 3 specifically tests whether the coefficient estimates on the interactions are significantly different between dictators and democracies. Regressions 4 and 5 include Officer's (2007) proxy premium measure to test the overpayment hypothesis. Regression 5 includes the interaction between the dictator dummy and proxy premium to specifically test if the coefficients are significantly different between dictators and democracies. Other variable definitions are defined in Appendix A. Standard errors denoted in parentheses are adjusted for heteroskedasticity and acquirer clustering. ***, **, and * denote significance at 1%, 5%, and 10%, respectively. All regressions control for year fixed effects (not reported).

Variable	Hypotheses and models				
	Target selection			Overpayment	
	(1)	(2)	(3)	(4)	(5)
Dictator dummy	−0.524**	−0.518**	−0.542**	−0.635***	−0.341
	(0.210)	(0.210)	(0.219)	(0.219)	(0.300)
Subsidiary	2.059***	1.862***	1.857***	1.933***	1.766***
	(0.327)	(0.339)	(0.339)	(0.326)	(0.336)
Private	1.495***	1.131***	1.127***	1.340***	1.007***
	(0.278)	(0.340)	(0.340)	(0.281)	(0.339)
All cash	0.313	0.341	0.342	0.31	0.34
	(0.310)	(0.310)	(0.310)	(0.314)	(0.314)
All stock	−0.813**	−1.244***	−1.244***	−0.928***	−1.345***
	(0.345)	(0.386)	(0.386)	(0.348)	(0.382)
Private ∗ All stock		1.248**	1.423*		1.284*
		(0.623)	(0.732)		(0.772)
Private ∗ All stock ∗ Relative size		−2.081	−7.079		−7.187
		(8.442)	(8.785)		(9.144)
Dictator ∗ Private ∗ All stock			−0.717		−0.345
			(0.798)		(0.849)
Dictator ∗ Private ∗ All stock ∗ Relative size			20.184*		19.448*
			(10.951)		(11.129)
Proxy premium				−0.314**	−0.139
				(0.142)	(0.191)
Dictator ∗ Proxy premium					−0.423*
					(0.251)
Log firm age	−0.016	−0.014	−0.021	0.02	0.014
	(0.152)	(0.152)	(0.151)	(0.156)	(0.155)
Stock run-up	0.977***	0.966***	0.973***	1.014***	0.996***
	(0.340)	(0.341)	(0.342)	(0.348)	(0.349)
PRIV	−0.085***	−0.085***	−0.084***	−0.086***	−0.084***
	(0.019)	(0.019)	(0.019)	(0.020)	(0.020)
Log market value	−0.318***	−0.327***	−0.324***	−0.319***	−0.325***
	(0.083)	(0.083)	(0.083)	(0.091)	(0.091)
Tobin's q	0.292**	0.290**	0.287**	0.355***	0.351***
	(0.117)	(0.118)	(0.119)	(0.125)	(0.128)
Free cash flow	6.625*	6.677*	7.015*	7.310*	7.856*
	(3.892)	(3.890)	(3.865)	(4.083)	(4.040)
Leverage	3.187***	3.218***	3.253***	3.844***	3.941***
	(1.041)	(1.032)	(1.034)	(1.078)	(1.068)
Industry M&A	−0.156	−0.304	−0.526	0.136	−0.591
	(6.130)	(6.137)	(6.124)	(6.170)	(6.160)
Relative size	0.146	0.157	0.163	0.053	0.112
	(0.793)	(0.792)	(0.791)	(0.857)	(0.850)
Tech	0.314	0.309	0.289	0.29	0.243
	(0.248)	(0.249)	(0.248)	(0.255)	(0.255)
Conglomerate	0.038	0.027	0.028	0.042	0.02
	(0.227)	(0.227)	(0.227)	(0.236)	(0.237)
Competed	−0.948	−1.047	−1.155	−0.712	−0.96
	(0.701)	(0.705)	(0.709)	(0.673)	(0.676)
Volume	0.124	0.117	0.114	0.161	0.154
	(0.098)	(0.098)	(0.098)	(0.101)	(0.102)
Cross-border	2.964**	2.916**	2.880**	2.880**	2.774**
	(1.160)	(1.178)	(1.188)	(1.241)	(1.273)
Friendly	−2.786***	−2.774***	−2.798***	−3.021***	−3.140***
	(0.870)	(0.866)	(0.866)	(0.933)	(0.940)
Serial_3	0.092	0.095	0.114	−0.024	0.001
	(0.274)	(0.273)	(0.273)	(0.287)	(0.286)

Table 5 (*continued*)

Variable	Hypotheses and models				
	Target selection			Overpayment	
	(1)	(2)	(3)	(4)	(5)
Constant	3.626***	3.916***	3.965***	3.954***	4.250***
	(1.269)	(1.273)	(1.275)	(1.348)	(1.369)
Number of observations	3,934	3,934	3,934	3,718	3,718
F-statistic	8.31***	8.26***	7.97***	8.22***	7.97***
Adjusted R^2	7.30%	7.40%	7.50%	8.10%	8.40%

Table 6
Performance of mergers.

Panel A in the table reports the combined acquirer and target five-day cumulative abnormal returns (CARs), where relative market values are used as weights, adjusted for toeholds held by the bidder. Panel B reports the industry-adjusted operating performance (IAOP) of merging firms from fiscal years −3 to +3. Operating performance is calculated as return on assets (ROA), defined as operating income before depreciation (Compustat data item 13) scaled by total assets. The operating performance before the merger is a weighted average of the acquirer and target, with the weights being their relative total assets measured at the beginning of the fiscal year. Dictator acquirers are defined as those with a value of GIM (Gompers, Ishii, and Metrick 2003) index ≥ 10. Democracy acquirers are defined as those acquirers with a value of GIM index < 10 and a non-classified board (CBRD=0). ***, **, and * denotes statistical significance at 1%, 5% and 10%, respectively.

	All	Dictator or Democracy
Panel A: Combined acquirer and target CARs		
Mean CAR	0.86%**	
Median CAR	(0.37%)	
Dictator		0.11%
		(−0.25%)
Democracy		1.68%***
		(2.23%)
Mean difference		−1.57%**
Median difference		(−2.48%)***

Year relative to takeover	All	Democracy	Dictator	Difference
Panel B: Industry-adjusted operating performance				
T-3	5.66%	6.16%	5.25%	0.91%
T-2	5.78%	6.23%	5.42%	0.81%
T-1	5.60%	6.28%	5.05%	1.24%
T=0 (announcement year)	5.58%	6.44%	4.88%	1.57%***
Pre-IAOP mean	5.48%	6.26%	4.83%	1.43%
T+1	5.20%	6.45%	4.17%	2.28%***
T+2	4.61%	5.88%	3.56%	2.32%***
T+3	3.96%	5.11%	3.01%	2.10%***
Post IAOP 3-year mean	4.59%	5.81%	3.58%	2.23%***
Post 3-year IAOP mean less Pre-IAOP, T-1	−1.02%***	−0.49%	−1.47%***	0.97%
Post 3-year IAOP mean less Pre-IAOP mean	−0.89%***	−0.49%	−1.25%***	0.76%

on the bidder's value. When we do so, the inferences are unchanged.

The second approach we take is to examine the post-acquisition performance directly. This performance should be more specifically related to the advisability of the deal. We discuss those results, presented in Table 6, in Section 4.3.

In additional specifications (Models 4 and 5) reported in Table 5, we include a measure of the premium using the method developed in Officer (2007), allowing us to include all targets, whether public or not. If we could completely control for potential synergies in our regressions, then a higher premium would always be bad for the acquirer, as it would unambiguously represent less value captured. However, assuming that we cannot perfectly control for synergies, then, in the cross section, higher premiums could also be associated with higher total synergies. In that case, the coefficient on premium would capture the net effect of two opposing forces: a larger synergy pie to be divided and a smaller piece for the acquirer. If we find a uniformly negative coefficient on premium, then the synergy effect is either not present or too small. Alternatively, if we find that the coefficient on premium is negative for dictator firms and not for democracy firms, then it suggests that the effect is there in general, but that higher premiums are more often associated with loss of value for dictator bidders on net than they are for democracy bidders on net.

The coefficient on premium in Model 4 is significantly negative, indicating that the market views higher premiums by managers as overpayment. In Model 5, we

include an interaction between the dictator dummy and the premium. The coefficient on the interaction is significantly negative, but the coefficient on premium alone is insignificant. Thus, the market views higher premiums paid by dictators (the interaction term) as overpayment, but higher premiums paid by democracy managers (the base premium term) as appropriate compensation for higher synergies. Although problems arise with using the actual premium in announcement return regressions, we repeat the test with actual premium (instead of proxy premium) and our inferences are unchanged (untabulated). The negative relation between premiums and announcement returns is consistent with both the pure overpayment and low synergy hypotheses. To distinguish between the two hypotheses, we examine post-merger operating performance in the next section.

4.3. Synergies

In Table 6, we continue to examine the hypothesis that, despite paying lower premiums on average, dictator firms are still overpaying because they have low synergies with their targets. In Panel A, we examine combined bidder and target announcement returns to assess total synergies (value creation) in the mergers. The results show that on average the public deals in our sample do create value in that they have net positive synergies: The mean combined CAR is 0.9% and the median is 0.4%.[6] When these are broken out by whether bidder management was entrenched or not, combined CARs for dictator firms are much lower than those for democracy firms. In fact, the median point estimate is negative for the dictator firms. Conversely, democracy bidder combined CARs are positive and greater than 1%. The differences between the market's assessment of the total synergies (combined CARs) for democracy bidder-led deals and dictator bidder-led deals are also significant. Again, if we drop the first acquisition by a bidder from the sample, the inferences are unchanged.

The announcement return results should in part reflect an unbiased assessment of the merger's effect on the future operating performance of the combined firm. Post-merger operating performance tests have inherently low power because the counterfactual (the bidder's performance had it not completed the merger) is hard to proxy for. We follow extant literature and use industry performance as the counterfactual. Consequently, Panel B presents industry-adjusted changes in operating performance around the merger. The panel reveals generally worse performance for dictator firms in the first place along with a worsening of performance after the merger.

Due to the preexisting difference in performance between democracy and dictator firms, in Table 7 (Panel A) we control for pre-merger performance in a regression setting similar to Healy, Palepu, and Ruback (1992). In Panel B we include controls for the size and book-to-market of the acquirer, as well as the method of payment, attitude of the deal, and whether the target and acquirer are in related industries. In this type of regression, the constant captures the abnormal performance change from before to after the merger. The democracy firms show a significant increase in performance following the merger. The performance of dictators is insignificantly different from that prior to the merger. When we nest the samples so that we can test for differences in post-merger performance in democracy versus dictator firms, we find that the coefficient on the democracy indicator is significantly positive. Panel B reports the models with pre-merger industry-adjusted performance and other controls. Here the results indicate that dictator bidders significantly under-perform post-merger, but democracies do not.

While dictator firms overpay for their targets, the findings are also consistent with the low synergies hypothesis; that is, dictator firms choose targets with below average synergies but do not pay a low enough premium for them. Both the announcement returns and post-merger operating performance reflect this. These results are also consistent with those found for overvalued stock acquisitions by Fu, Lin, and Officer (2010). Specifically, they find that when the bidder's stock is potentially overvalued, the post-merger performance is poor, leading them to conclude that these acquisitions are characterized by a lack of synergies.

5. Robustness

In this section we report the results of additional tests that examine whether our findings are robust to the use of alternative definitions of entrenchment, different subsamples based on growth characteristics, backdoor listings, and endogeneity concerns.

5.1. Is a governance effect being picked up?

We repeat our analysis substituting different measures in place of the dictator dummy variable: the continuous GIM index, the continuous Entrenchment Index from Bebchuk, Cohen, and Ferrell (2009), and dummy variables set to one when the GIM index is greater than or equal to 11, 12, 13, and 14, the Entrenchment Index is greater or equal to 3, 4, and 5, or the firm has a poison pill. In all cases, the inferences remain the same. We also attempt to control further for the concern that entrenchment simply proxies for low growth in the announcement return models by splitting the sample using quartile and median Tobin's q, market-to-book, and firm age. We find that the negative relation between entrenched management and acquirer returns is not simply a low-growth effect.

5.2. Are the results robust to backdoor listings?

A backdoor listing occurs when a takeover deal is structured in such a way that the true acquirer in a private equity deal is the private target and not the observed

[6] These figures are slightly smaller than those reported in Moeller, Schlingemann, and Stulz (2004), who find a combined CAR of 1.352%. An explanation is that our acquirers must have IRRC data and so are larger on average than acquirers in their sample. Supporting this, they report a combined CAR of 0.70% when they restrict their sample to bidders whose market capitalization is in the top 75% of NYSE firms.

Table 7
Operating performance regressions.

The table reports the result of the Healy, Palepu, and Ruback's (1992) regressions for measuring the operating gains to mergers, where the mean industry-adjusted return on assets (ROA) over the three-year post-period is regressed on the combined acquirer-target industry-adjusted ROA for the fiscal year before the takeover (T−1). The regression intercept is an estimate of the operating gains to mergers. Dictator acquirers are defined as those acquirers with a value of GIM (Gompers, Ishii, and Metrick, 2003) index ≥ 10. Democracy acquirers are defined as those acquirers with a value of GIM index < 10 and a non-classified board (CBRD=0). Panel B reports the regression models with additional controls for acquirer size, book-to-market, a cash payment dummy (=1 for cash), a friendly dummy (=1 for friendly), and a related dummy (=1 if the acquirer and target are in the same Fama and French industry). Standard errors denoted in parentheses are adjusted for heteroskedasticity and acquirer clustering. ***, **, and * denote significance at 1%, 5%, and 10%, respectively. IAOP is industry-adjusted operating performance.

Model	All (1)	Dictator (2)	Democracy (3)	All+dummy (4)
Panel A: Healy, Palepu, and Ruback (1992) regressions				
Pre-IAOP, T-1	0.670***	0.577***	0.761***	0.666***
	(0.064)	(0.098)	(0.067)	(0.064)
Democracy dummy				0.014**
				(0.007)
Constant	0.82%*	0.67%	1.01%*	0.22%
	(0.004)	(0.005)	(0.006)	(0.005)
No. of observations	531	239	194	531
F-statistic	110.92***	34.98***	129.67***	58.4***
Adjusted R^2	56.15%	46.39%	66.56%	56.70%
Panel B: Healy, Palepu, and Ruback (1992) regressions with controls				
Pre-IAOP, T-1	0.600***	0.555***	0.569***	0.592***
	(0.071)	(0.098)	(0.089)	(0.071)
Democracy dummy				0.017***
				(0.006)
Log market value	0.002	0.003	0.000	0.002
	(0.002)	(0.002)	(0.004)	(0.002)
Log book-to-market	−0.017**	−0.004	−0.042***	−0.018**
	(0.009)	(0.008)	(0.012)	(0.008)
Related	0.009	0.017*	0.004	0.010*
	(0.006)	(0.009)	(0.007)	(0.006)
All cash	0.010	0.007	0.012	0.009
	(0.007)	(0.009)	(0.008)	(0.007)
Friendly	0.002	0.011*	−0.003	0.003
	(0.005)	(0.007)	(0.008)	(0.005)
Constant	−3.44%**	−4.79%**	−2.26%	−4.72%***
	(0.017)	(0.023)	(0.027)	(0.018)
Number of observations	524	237	190	524
F-statistic	34.14***	6.75***	64.96***	31.97***
Adjusted R^2	59.23%	48.94%	72.52%	60.01%

public bidder. The objective in such deals is to secure a public listing without dealing with the formalities and expense required for a formal listing. It is not clear whether such deals exist in our sample, but if they do, it might explain why private deals generate higher CARs. Specifically, private target firms that are truly the bidding firms would be effectively paying a listing premium to the officially listed bidder. If dictators do more of these deals, it might also explain why they generate higher CARs for larger private stock swap deals, as reported in Table 5. It is likely that private firms undertaking these deals would be larger, so one way to control for this effect would be to exclude large relative size deals. The maximum relative size deal in our sample is 1.15, and only 57 deals have a relative size of greater than 1. Of these 57 deals, dictators account for 26, however only 3 of these are private deals, with none involving a stock swap. If we reduce the relative size requirement to 0.5 or 50%, this increases the dictator private deals sample from 3 to 20, however, only 2 of these are financed by stock.

5.3. Endogeneity concerns

One concern with using proxy or actual premiums in our announcement returns analysis is that premiums could be endogenous with respect to announcement returns and other variables in the regression model, including firm size, multiple bidders, and method of payment. Also, collinearity problems could arise when premium is included in the model given that it is positively correlated with other variables, including firm size, relative size, Tobin's q, and overvaluation (PRIV). To address these concerns we employ instrumental variables using a generalized method of moments (GMM) regression approach (see Hansen, 1982). The results from the GMM regression models are consistent with those reported in Table 5. Specification tests related to over-identifying restrictions (Hansen's *J*) and the validity of the instruments used (Stock–Wright *S*-statistic) indicate that these are not significant concerns for our GMM models.

We also examine endogeneity concerns related to possible omitted variables in our acquirer announcement returns regression models. Endogeneity arising from omitted variables could be a problem if an omitted variable explains the correlations between premium and acquirer returns. Masulis, Wang, and Xie (2007) examine the impact of managerial quality on their findings, because conceivably the observed correlation between ATPs and returns could be driven by low-quality CEOs, who adopt ATPs to entrench themselves. If low-quality CEOs also overpay for acquisitions, this could explain the correlation between takeover premium and acquirer returns. For completeness, we reestimate our models reported in Table 5, including a proxy for CEO quality, measured as industry-adjusted operating income growth over the three years prior to takeover announcement. In untabulated results we find a highly significant and positive correlation between CEO quality and acquirer returns, supporting the contention that quality CEOs make more profitable acquisitions (Morck, Shleifer, and Vishny, 1990). The GIM index dictator dummy remains negative and significant as reported in Table 5. Further, premium remains significantly negative for dictators only, indicating that CEO quality does not appear to drive the correlation between premium and acquirer returns. The other variables also remain largely unchanged to those reported previously.

6. Discussion and conclusion

We explain why acquisitions by entrenched managers destroy value. Masulis, Wang, and Xie (2007) show that the market reacts negatively to takeovers by entrenched managers. We examine the drivers of this negative reaction and find several.

Dictators prefer to avoid acquisitions that risk reducing their level of entrenchment. Thus, they are less likely to acquire private targets using stock (thereby avoiding scrutiny and the creation of a monitoring blockholder). Further, when dictators acquire public targets they are less likely to pay stock for targets that have a significant blockholder, thereby avoiding the imposition of a monitoring institutional shareholder. Both results suggest attempts by dictators to reinforce their entrenchment and avoid additional monitoring.

Dictators also tend to overpay and select low synergy targets. Post-takeover operating performance is lower for dictators' acquisitions, implying that dictators select targets that are less synergistic. Further, the market reacts negatively to the takeover premiums that dictators pay, implying that the premiums reflect overpayment for low synergy targets.

These results highlight the avenues of value destruction in acquisitions by entrenched managers. Entrenched managers avoid acquiring firms that could reduce their level of entrenchment, fail to capture value-creating illiquidity discounts, make acquisitions that are less synergistic, and tend to overpay. We emphasize the importance of examining not just if but also why and how entrenched managers destroy value.

Appendix A

See Table A1.

Table A1
Variable definitions.

Variable	Definition
Abnormal returns and antitakeover provisions	
CARs	5-day cumulative abnormal returns (%), calculated using the market model. The paper estimates market model parameters over days $(-210,-11)$ using an ordinary least squares model.
GIM	Gompers, Ishii, and Metnick (2003) governance index; aggregates 24 antitakeover provisions.
Bidder characteristics	
Firm size measures	Log of total assets (item 6); Log of market value (number of shares outstanding x price 11 day prior to announcement); log of sales (item 12)
Firm age	Log of one plus the number of years a firm is listed on the Center for Research in Security Prices (CRSP) database prior to current bid.
Leverage	Book value of debt (item 34+item 9) over total assets (item 6)
Free cash flow	Operating income before depreciation (item 13) – interest expense (item 15) – income taxes (item 16) – capital expenditures (item 128) over book value of total assets (item 6): (item 13 – item 15 – item 16 – item 128)/ item 6
Tobin's q	Market value of assets over book value of assets: (item 6 – item 60 +item 25 x item 199)/item 6
Price-to-residual-income value (PRIV)	Price 35 day before announcement over residual income valuation.
Stock run-up	Bidder buy-and-hold-abnormal return over days $(-210,-11)$ using the CRSP value-weighted index as the market return
Volume	Abnormal volume over days $(-30,-11)$.
CEO-Chair	Dummy: one if chief executive officer is also the board's chairman, zero otherwise
Board size	Number of directors on bidder's board
Prop. independent directors	Dummy: one if over 50% of directors are independent, zero otherwise
Largest blockholder	Percentage holding of largest blockholder that holds more than 5% of the bidder
CEO wealth sensitivity	Change in value of CEO's compensation per 1% change in stock price; utilizes the Core and Guay (2002) methodology
CEO equity ownership	Bidder CEO's percentage ownership of the bidder (includes stock and option holdings)
CEO equity-based pay	Proportion of bidder CEO's pay that is equity-based. Equity-based compensation includes stock options and restricted stock grants.

Table A1 (*continued*)

Variable	Definition
Deal characteristics	
Transaction value	Dollar value of deal reported by SDC Platinum.
Public	Dummy: one for public targets, zero otherwise
Private	Dummy: one for private targets, zero otherwise
Subsidiary	Dummy: one for subsidiary targets, zero otherwise
All cash	Dummy: one for deals financed with cash only, zero otherwise
All stock	Dummy: one for deals financed with stock only, zero otherwise
Mixed	Dummy: one for deals financed with a mix of cash and stock, zero otherwise
Conglomerate	Dummy: one where bidder and target are in a different Fama and French industry, zero otherwise
Relative size	Transaction value over bidder's market capitalization 11 day before the announcement date.
Industry M&A	Aggregate value of corporate control transactions over the aggregate book value of assets (item 6) for each prior year and Fama and French industry
Friendly	Dummy: one for friendly deals, zero otherwise
Serial 3, Serial 4, Serial 5	Dummy: one for acquirers involved in three, four or five or more deals over the sample period
Competed	Dummy: one for competed deals, zero otherwise
Cross-border	Dummy: one for crossborder deals
Premium	Payment exceeding target's price three, 11 or 35 day before the takeover announcement. The calculation is: (Payment)/(Target Market Value) – 1. The payment data are from SDC Platinum. The target's market value is the market value 3, 11, or 35 day before the acquisition as obtained from CRSP by multiplying the share price and the number of shares outstanding.
Tech	Dummy: one for high-tech acquisitions, zero otherwise. An acquisition is high-tech if both the bidder and target are technology firms. Following Loughran and Ritter (2004), Faccio and Masulis (2005), and Masulis, Wang, and Xie (2007), tech firms involve computer hardware (Standard Industrial Classification codes 3571, 3572, 3575, 3577, 3578), communications equipment (3661, 3663, 3669), electronics (3671, 3672, 3674, 3675, 3677, 3678, 3679), navigation equipment (3812), measuring and controlling devices (3823, 3825, 3826, 3827, 3829), medical instruments (4812, 4813),telephone equipment (4899), and software (7371, 7372, 7373, 7374, 7375, 7378, 7379).

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