Journal of Global Business and Social Entrepreneurship (GBSE)
Vol. 1: no. 1 (2015) page 9–14 | gbse.com.my | eISSN 24621714|

THE ROLE OF FINANCIAL ADVISORS IN ACQUISITIONS

Norhamiza Ishak[1]
Kamarun Nisham Taufil Mohd[2]
Hanita Kadir Shahar [3]

Abstract

This paper aims to identify current state of studies, and in turn highlight gaps that exist in academic literatures on the role, reputation and implication of financial advisors to the wealth of acquirer in M& A deals. Numerous articles from 1996 to 2013 have documented empirical evidence on this research area. The existing literature is classified into two parts that include research on reputation ranks and market structure. It is found that there are limited literatures on role of acquirer's financial advisor in Malaysian companies. Although the requirement to hire financial advisor are stipulated in laws and regulations on Malaysian code on Take-overs and Mergers 2010, their role and effectiveness in wealth creation to acquirers are debatable. To date, many studies used event study methodology to measure wealth creation caused by hiring financial advisors. Particularly, the wealth-creation depends on how reputable financial advisors are in assisting acquirers during M&A deals. This study would be beneficial to investors, acquiring and target companies. The information would assists them into having better insight in understanding and evaluating potential financial advisor in order to ensure the success of deal and wealth creation .

Keywords: *Financial Advisor, Reputation, Market Structure*

2015 GBSEGlobal

Introduction

Mergers and acquisitions (M&As) are among the largest and most readily observable forms of corporate investments (Masulis, Wang & Xei, 2007). Even though the term mergers and acquisitions are used interchangeably, they are different in terms of implementations. Mergers refer to the process of consolidation where the two combined firms would become a new entity. On the other hand, acquisitions refer to the process of taking over target firms by bidding firms where the target firms become a part of the bidding firms. There are three types

[1] School of Economics, Finance and Banking, Northern University of Malaysia, 06010 Sintok, Kedah, Tel: 0139123885, E-mail: s95160@student.uum.edu.my
[2] Associate Professor School of Economics, Finance and Banking, Northern University of Malaysia, 06010 Sintok, Kedah, Tel: 04-9286873, E-mail: kamarun@uum.edu.my
[3] Senior Lecturer School of Economics, Finance and Banking, Northern University of Malaysia, 06010 Sintok, Kedah, Tel: 04-928684, E-mail: hanita@uum.edu.my

of M&As, which are horizontal, vertical, and conglomerate. In horizontal M&As, bidders and targets operate in the same industry. Vertical M&As refers to M&As where bidders try to diversify their businesses by venturing into upstream or downstream activities. Finally, conglomerate M&As refer to M&As between two firms in unrelated industries.

There are several studies that reviewed the role of financial advisor including Kale, Kini, and Rya (2003), Chahine and Ismail (2009), Schiereck, Griib, and Unverhau (2009) and Song, Wei, and Zhou (2013). Kale et al. (2003) state in their paper about two roles of financial advisor. First, investment bank could identify and/or structuring better merger with higher expected synergistic gain. Second, to provide better merger, investment banks could design offers document to ensure takeover would succeed with the lowest possible price to target firm. Chahine and Ismail (2009) however claimed that investment banks could access private information beyond the reach of would be-acquirer or would-be targets through their underwriting service and experience Financial advisor could access private information[4] of target firms through their role as information producers or middlemen whose function is to certify the value of security (Kale et al. 2003). Meanwhile, Schiereck et al. (2009) give general perspective on role of financial advisor whereby investment bank acts as an agent that provide liquidity to increase in efficiency on the market for corporate control. Given the important role recognized in the previous studies, there is a study that document the implication of inefficient role played by financial advisors that could lead to greater loss to their reputational capital (Golubov, Petmezas & Travlos, 2012).

Financial Advisor based on Reputation Ranks

Almost all researchers have proposed several different ranks for reputation of financial advisor. Different ranks of financial advisor could lead to different outcome to acquirer's wealth. For example, Kale et al. (2003) argue that higher quality advisors are able to consult acquirer firms to withdraw from a potentially unprofitable acquisition. Financial advisors are found not only influence acquisition decision making, but also affect stock return by using different types of payment. For example, Walter, Yawson, and Yeung (2008) claim that higher quality advisor could deliver greater returns in stock deals. Meanwhile, Golubov et al. (2012) and Chahine and Ismail (2009) state that higher fees to quality advisor determine greater return. Finally, Song et al. (2013) find contradiction with prior result whereby low quality financial advisor which is referred as "boutique" financial advisor are more likely to be chosen although the completion period is time consuming. The result shows that acquirers gain positive impact due to reduced premium. Meanwhile, Rau and Rodgers (2002) find significant negative abnormal return when higher quality advisors are used. Other studies find that the choice of financial advisory is not related to the returns to acquirer firms (Servaes & Zenner, 1996; Schiereck et al. 2009; Ismail, 2010; Bao & Edmans, 2011). In short, prior studies show inconclusive results. This is summarized in **Table 1.** Not only the financial advisor could play an important role in M&As deals, market structure is also found to be as

[4] In case of capital rising, issuing firms have private information regarding the value of the security that they plan to issue. The value of security is then certified by financial advisor come to the market repeatedly. Thus, they have the incentive to build reputation as providers of more accurate valuation information.

imperative factors to ensure the successfulness of deals. This is discussed in the following section.

Table 1:
Studies on ranking of financial advisor

Author	Market/Sample period	ranking	Result	Data sources	Method
Servaes & Zenner (1996)	US Sample (1981-1992)	First-tier = five investment banks are classified: Boston, Goldman Sacha, Merrill Lynch, Mogan Stanley and Solomon Brothers. In house deals include transaction with no financial advisor involved	Insignificant returns whether an investment banks is used.	Based on market share financial advisor in league table	Market model
Rau & Rodgers (2002)	US Sample (1980-1994)	First-tier: top five banks Second-tier: next 15 Third-tier: remaining banks	Top-tier banks are hired by bidders with large boards of directors, less concentrated equity ownership and less insider ownership. Negative significant returns in short and long terms. Finally, the deals are more likely to be completed.	Investment bank ever year on the basis of the value of transactions advised during the year.	Adjusted-market model Logistic regression.
Kale, Kini, & Ryan (2003)	US Sample (1981-1994)	Group 1- consist top 10 reputation advisor Group 2- next 10	Higher reputation advisor are more likely to be involved with a bidder who withdraws from a potentially unprofitable acquisition	Constructed as the ratio of the bidder advisor reputation to that of the target advisor	Dollar-denominated abnormal wealth gains over CARs OLS regression and inverse mills ratio (IMR) analyzed advisor reputation.
Walter, Yawson,& Yeung (2008)	US Sample (1980-2003)	First tier: Top 1 to 5 Second tier: Top 6 to 20 Third tier: other bank	Higher quality investment banks deliver greater returns to acquirers by used stock-payment in deals.	The rank advisers based on contemporaneous market share in a rolling window period of three years allowing adviser quality.	Market model
Chahine & Ismail (2009)	US Sample (1985-2002)	First tier: Top 1 to 20 Second tier: for the rest bank	Acquirer firms that hired first tier advisor could lead returns but could charge higher advisor fees and higher premium.	Based on market shares on market share in league table	Market model 2LS

Schiereck, Griib, & Unverhau (2009)	European Sample (1997-2002)	Top-tier : Top 5 advisor Second-tier : others bank	Financial Advisor service could lead to insignificant returns.	3-year rolling average of the rank values of the financial advisors.	Abnormal percentage returns with market capitalization of the relevant firms.
Author	**Market/Sample period**	**ranking**	**Result**	**Data sources**	**Method**
Ismail (2010)	US Sample (1985-2004)	Tier-one: Top ten advisors with largest market share Tier-two: all other advisors that are ranked higher than tenth.	Insignificant returns between the acquirer advisor tier and the acquirer wealth gain.	The selection of investment banks must be based on the advisors' track record in generating gains to clients in prior acquisitions	Market capitalization 2 months prior to the announcement of the merger multiplied by the cumulative abnormal return in the (-2, 2) window.
Bao & Edmans (2011)	US Sample (1980-2007)	Top-quintile: based on 2 year performance by number deals in the period over which post performance.	Insignificant returns in M&As transaction.	Market share based on number of deals or prestige of the bank's name.	Market model
Golubov, Petmezas, & Travlos (2012)	US Sample (1996-2009)	Top-tier: Top 8 investments by values of deals advised. Non-top-tier In house deals include transaction with no financial advisor involved	Top-tier advisors are associated with better services and higher advisory fees in public. Therefore deliver higher bidder returns.	Based on market share financial advisor in league table	Market model Dollar-denominated return (synergy)
Song, Wei, & Zhou (2013)	US Sample (1995-2006)	Boutique or full-service advisors. (track the total number and value deals advised by each bank)	Boutique advisors are more chosen in more complicated deals and significant positive effect to reduce premium cost.	Boutique- advisor has expertise in M&A advisory or specializes in a certain industry but does not have full-spectrum or diversified business lines.	Multi-logit regression

Table 1: *continued*

Financial advisor based on Market Structure

Based on studies by Servaes and Zenner (1996) and Golubov et al. (2012) in the US market, the services of financial advisor are optional to acquirering firms. Servaes and Zenner (1996) claimed that acquirers, who face complicated M&A transaction and stock payment in their dealing, could hire financial advisor. Meanwhile, according to Golubov et al. (2012), financial advisor service is not necessary in firms where their board of directors have past successful experience in M&A deals. This situation is different from Malaysia, whereby financial advisor hiring is required by Malaysian M&A regulation to provide 'fair and reasonable' deal to both parties (Malaysian Code on Take-Overs and Mergers 2010). These prior studies are summarized in **Table 2.**

Table 2:
Studies on financial advisors based on market structure

Author	Year	Market	Ranks	Result
Servaes& Zenner	1996 (1981-1992)	**US-**	**First-tier:** five investment banks are classified: Boston, Goldman Sacha, Merrill Lynch, Mogan Stanley and Solomon Brothers. **In house**: deals include transaction with no financial advisor involved	The choice of investment banks depends on the complicated of the transaction, method of payment, acquisition experience and degree of diversification. However, the return to acquirer is significantly lower but do not depend on whether an investment bank is used.
Golubov, Petmezas, & Travlos	2012 (1996-2009)	**US**	**Top-tier:** Top 8 investments by values of deals advised. **Non-top-tier** **In house**: deals include transaction with no financial advisor involved	Top-tier advisors associated with better services and higher advisory fees in public. Therefore deliver higher bidder returns. Bidding firms do not hire financial advisor when their in-house M&A expertise is high.

Conceptual Overview

From the extensive literature searching process, almost all studies have been done in the US market where the demand for financial advisors is voluntary among the acquirers (Servaes and Zenner, 1996; Golubov, Petmezas and Travlos, 2012) . The studies in the market span from year 1996 to 2013. The scopes of this search are the quality of financial advisors hired by acquirer firms and the returns effect on shareholders wealth. However, different ranks of quality of financial advisor could lead to inconclusive outcomes to the acquiring firms as discussed in previous section. To sum, Kale, Kini, & Ryan (2003), Walter, Yawson and Yeung (2008), Golubov, Petmezas and Travlos (2012), Chahine and Ismail (2009) find that higher quality of financial advisor service could lead to significant returns to acquirer firms. On the other hand, Song, Wei and Zhou (2013) find lower quality financial advisor give more benefit to shareholders wealth by reduced amount of premium deals paid to target firms.

Conclusion and Limitation

The literature review find variety of measurements and methods are employed in past studies, thus it lead to inconclusive research outcome. The result by using high and lower quality of financial advisor could create or destroy value to acquirer firms. As mentioned in previous section, ranking of financial advisor is important to firms in order to create wealth. Higher quality financial advisor are more chosen than bear risky by hired low quality advisor. Firms have opportunity to choose financial advisor based on ranking because the requirement of third party is optional. In contrast, regardless of reputation of investment banks, financial

advisor service is mandatory in M&A deals (Malaysian Code on Take-Overs and Mergers 2010). This regulation indicates not only firm could create wealth through M&As activity but the wealth created is fair and reasonable for both parties (bidder and target firms). Thus, the third party which is the financial advisor is necessary in M&As transaction. Furthermore, to measure quality of financial advisor, researchers rely on league tables that provide the list of investment bank and rank based on market shares or deal services. The used of league table are subject to discretion by researchers in determining the ranking of financial advisor. To identify whether financial advisor affect stock returns, method employed in the study is a key point in which market model is widely employed in most studies. Since this paper is limited to cover a review of past studies on financial advisors in developed markets, further investigation is urgently needed to explore the effect of financial advisors in Malaysian M&As deals.

Reference

Dutta, S., MacAulay, K., & Saadi, S. (2011). CEO power, M&A decisions, and market reactions. Bao, J., & Edmans, a. (2011). Do Investment Banks Matter for M&A Returns? *Review of Financial Studies*, *24*(7), 2286–2315.

Chanine, S., & Ismail, A. (2009). Premium, Merger Fees and The choice of Investment banks: A Simultaneous Analysis. *The Quartly Review of Economics and Finance,* 49, 159-177. *Journal of Multinational Financial Management*, 21(5), 257–278.

Golubov, A., Petmezas, D., & Travlos, N. G. (2012). When it pays to pay your investment banker: New evidence on the role of financial advisors in M&As. *Journal of Finance*, *67*(1), 271–312.

Ismail, A. (2010). Are good financial advisors really good? The performance of investment banks in the M&A market. *Review of Quantitative Finance and Accounting*, *35*(4), 411–429.

Kale, J. R., Kini, O., & Ryan, H. E. (2003). Financial Advisors and Shareholder Wealth Gains in Corporate Takeovers. *The Journal of Financial and Quantitative Analysis*, *38*(3), 475.

Malaysian Code on Take-Overs and Mergers 2010 (http://www.sc.com.my/legislation-guidelines/take-overs-code/).

Masulis, R. W., Wang, C., & Xie, F. (2007). Corporate governance and acquirer returns. *The Journal of Finance,* 62(4).

Rau, P. R., & Rodgers, K. J. (2002). Do Bidders Hire Top-Tier Investment Banks to Certify Value? *SSRN Electronic Journal*, (October).

Song, W., Wei, J., & Zhou, L. (2013). The value of "boutique" financial advisors in mergers and acquisitions. *Journal of Corporate Finance*, *20*(1), 94–114.

Servaes, H., & Zenner, M. (1996). The Role of Investment Banks in Acquisitions. *The Review of Financial Studies*, 9(3), 787-815.

Schiereck, D., Griib, C. S.,& Unverhau, J. (2009). Investment Bank Reputation and Shareholder Wealth Effects in Mergers and Acquisitions. *International Business and Finance*, 23, 257-273.

Walter, T. S., Yawson, A., & Yeung, C. P. W. (2008). The Role of Investment banks in M&A TransactionS: Fees and Services. *Pacific-Basin Financial Journal*, 16, 341-369.

Zhao, J. (2013). Entrenchment or incentive? CEO employment contracts and acquisition decisions. *Journal of Corporate Finance*, 22(1), 124–152.