THE EFFECT OF MANAGERIAL MISCALIBRATION ON INVESTMENT AND OVERPAYMENT IN MERGERS AND ACQUISITIONS

Omar Camara, Department of Accounting and Finance, King Fahd University of Petroleum and Minerals (KFUPM), Saudi Arabia

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ABSTRACT

Using a panel data, I examined the effect of optimism bias and strategic misrepresentation on investment and overpayment in mergers and acquisitions (hereafter M&A) of S&P 500 companies from 2009 - 2019. Informed by investment, agency and prospect theories, the paper at first stage examined the relationship between strategic misrepresentation and underinvestment problem, and a relationship between optimism bias and asset substitution; at a second stage, the paper investigated a direct impact of managerial miscalibration (i.e. optimism bias and strategic misrepresentation collectively) on overpayment in M&A; and to substantiate the adverse or nonpositive impact of managerial miscalibration on the widely referenced expected synergy variables, the third stage of the paper assessed differential financial outcomes (i.e., expected synergy variables) by comparing firms with M&A activities against firms without any prior incidence of M&A effort. The empirical findings of the paper show that optimism bias proxied by the interaction of corporate cash holdings or cashflows from operations and US economy has at 1% statistical significance, a positive impact on asset substitution. Similarly, strategic misrepresentation has at 1% statistical significance, a reinforcing impact on underinvestment problem. Further direct testing revealed that at 1% statistical significance, both optimism bias and strategic misrepresentation increases overpayment (goodwill) in M&A transactions. Consequentially, the results show no statistically significant differential financial outcome between firms with M&A activities and firms without M&A activity. Robustness tests using an alternative proxy for optimism bias and strategic misrepresentation shows consistent findings. Finally, for corporate finance policy considerations, the paper found that a deliberately-induced debt overhang can be a mitigating factor for both strategic misrepresentation and optimism bias.

Keywords: *optimism bias, strategic misrepresentation, asset substitution, underinvestment problem, M&A, goodwill, synergies*

1. INTRODUCTION

In their Harvard Business Review article, Christensen et.al. (2011) divulged that firms in aggregate and globally spend more than $2 trillion on M&A annually, yet studies consistently put the failure rate of M&As somewhere between 70% to 90%. The paper refers to failure in M&A activity in instances where enterprise value is not positively impacted (i.e., equity value hasn't improved and expected synergies were not realized over time).Traditionally, research in M&A has been focused on financial, strategic, cross-cultural and operational dimensions (Schoenberg & Cartwright, 2006) without providing any consensus on why M&As are failing at an alarming rate (Hitt et al., 2009, Uzelac et al., 2016, Angwin, 2007). Subsequent conflation of economics and psychology in early 20th century drew attention to research conducted by Flyvbjerg, Garbuio, and Lovallo (2009) and Kahneman and Lovallo (2003) in which high failure rate of major infrastructure projects were attributed to optimism bias and strategic misrepresentation, with optimism bias contextualized as when managers make decisions based on delusional optimism rather than on a rational weighting of gains, losses, and probabilities, and in such decision making process, managers overestimate benefits and underestimate costs. On the other hand, strategic misrepresentation is a type of flawed planning and decision-making due to political pressures and agency issues (Flyvbjerg, Garbuio and Lovallo 2009, Buehler, Griffin, and Ross 1994).

As strategic misrepresentation and optimism bias can be theoretically traced to agency and prospect theories respectively, the two theories are also intuitively intertwined with the value proposition of