

Discussion of

Neglected Peers in Merger Valuations

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What does this paper do?

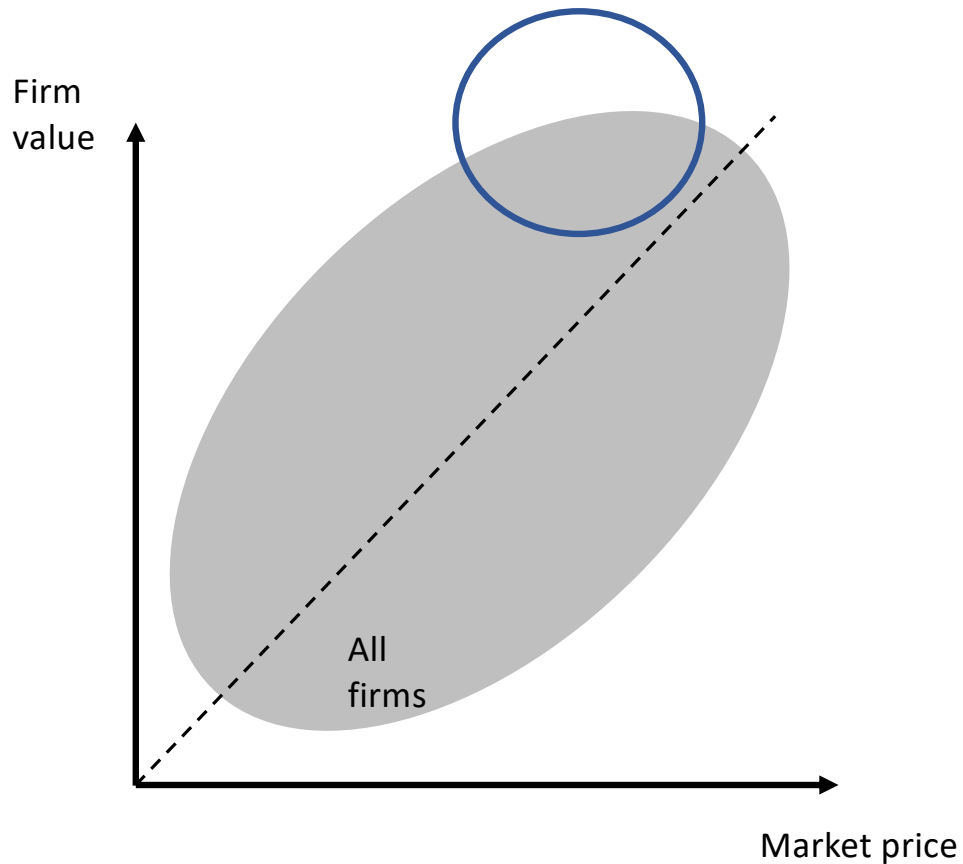
- 1) Peer firms of M&A targets listed in investment bank (IB) “fairness opinions” outperform matched firms in subsequent returns
- 2) Market prices are slow to respond to this information
- I fully believe 2). I’ll focus on 1) today.

My takeaway

- Empirically: very nice finding and lots of robustness checks
 - The authors have gone through immense pain collecting novel data
- Mechanism: still somewhat mysterious to me
 - Some channels are very intuitive, but they are not quantitatively large enough
 - Other channels are large but not intuitive (to me)

What is the mechanism?

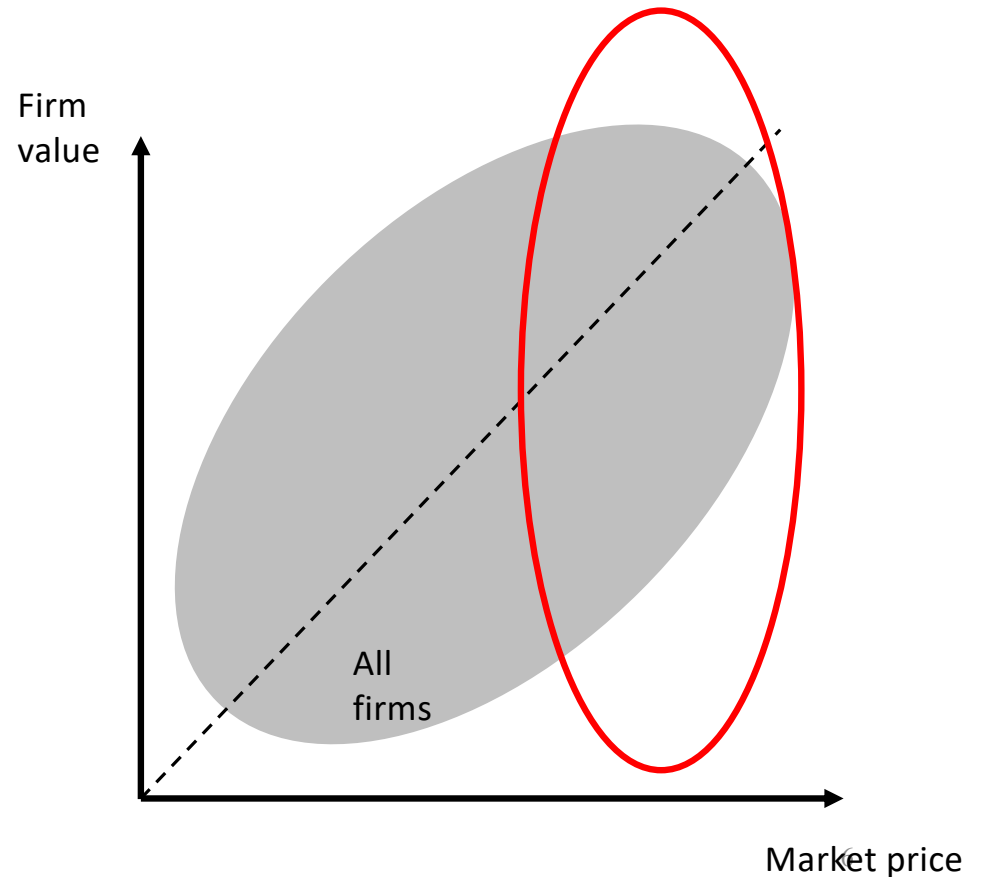
What do we need to arrive at the result?



- Consider an IB choosing peers from this space of possible firms
- To get the paper's result, IB needs to choose the blue area:
 - Valuation is high
 - But still undervalued

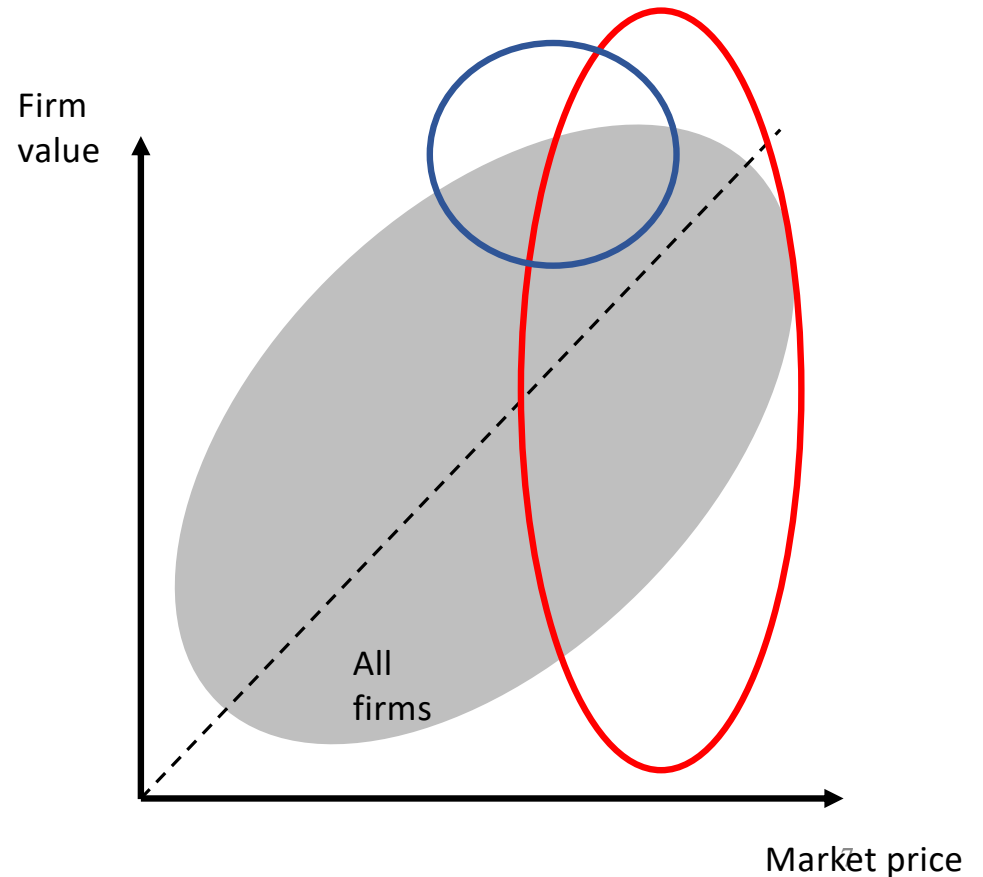
1) What if IBs just want a high valuation?

- If IBs *only* want to hype up the valuation to justify takeover premium...
 - Eaton-Guo-Liu-Officer (2021)
- Then they will choose the red ones
 - On average, this should lead to choosing *overvalued* firms that would *underperform*
- So this can't be the story



Suppose IBs know which firms are undervalued...

- That's plausible.
- But it is not clear why they would use that information.
- They are not asked to put together a “market-beating portfolio”!
 - They are just providing fairness opinions



2) What if IBs are good at identifying takeover targets?

- Very reasonable hypothesis.
 - IBs know a lot about the M&A process.
- The paper shows evidence for this!
 - Peers are *more likely to be acquired*: 8.30% vs. 3.69% (controls) in one year
- How big a return spread can this explain?
 - $(8.30\% - 3.69\%) \times (\text{takeover premium} \approx 30\%) \approx 1.4\%$
- However, peers outperform controls by around 5-6% in one year, so this channel explains around 1/4 to 1/3 of the outperformance

3) Takeover-induced demand effects

- When the target firm is acquired, its original investors need to *reinvest their money somewhere*.
 - They may just reinvest into peers!
 - Recent work shows that prices are inelastic, so this would push up peer prices
- Paper shows results consistent with this!
 - Peers experience 1.1% increase in institutional ownership relative to controls
 - Standard estimates of price elasticity to demand is $M \approx 1 - 2$
 - So this can justify 1.1 – 2.2% additional annual return

However, the evidence is more complex

- The takeover-induced demand effect is a one-time change

Panel A. Change in the institutional holding

	(1)	(2)	(3)
Dep. Var.	Change IOR_1Y	Change IOR_2Y	Change IOR_3Y
Peer	0.011*** (10.71)	0.021*** (15.90)	0.031*** (19.84)

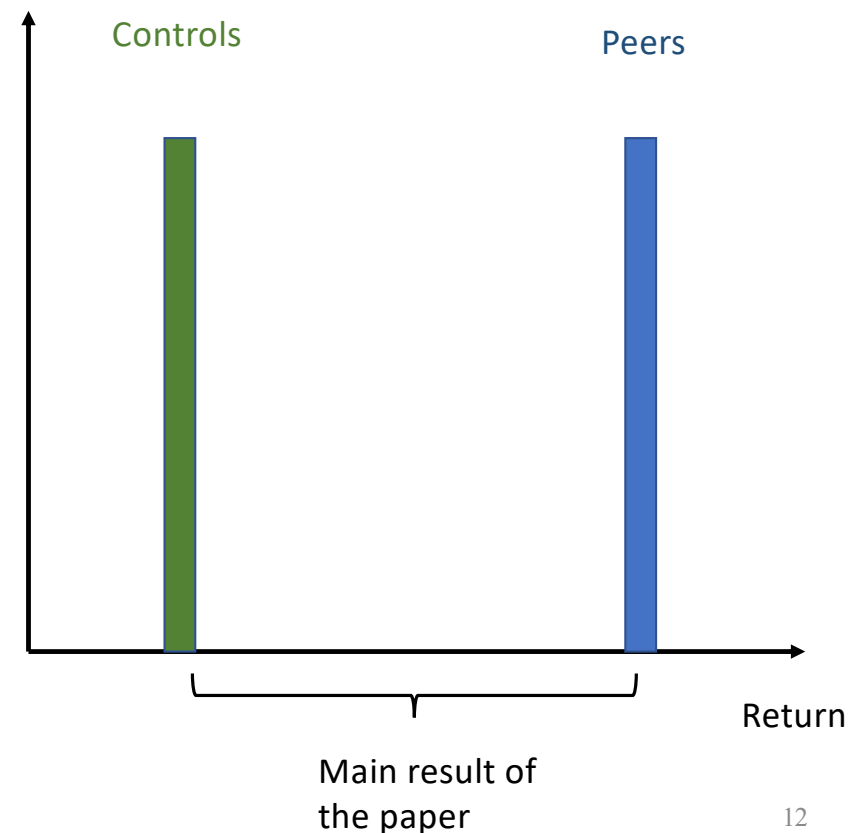
- Paper also shows that the peer firms also attract more analyst coverage later, etc, so they really just seem like “better firms”

To sum up the calculations

- What explains the 5-6% outperformance of IB chosen peers?
 - 1) IB picking undervalued firms (despite higher valuation)
 - 2) IBs know which ones will be acquired next
 - 3) Takeover-induced demand effects
- 2) has strongest evidence, can explain 1/4 to 1/3 of the effect
- 3) has weaker evidence, can explain 1/3 – 1/2 of the effect
- If we have to go to 1), it is still not clear to me why IBs would do so (even if they have superior information about firm value)

It is entirely okay if we can't 100% pin down the mechanism...

- ... if so, then perhaps the authors can show (even further) that the results are not sensitive to the controls
- Specifically: the current set of control firms are matched on N characteristics
 - What is the sampling distribution if you randomly leave one or two out?



Summary

- Very interesting paper, nice results
- I would suggest the authors try to further pin down the mechanism, or show extra robustness for the empirical finding
- I enjoy reading the paper and learned a lot in the process
- Returning back to sanity, I recommend the authors ignore what I said and focus on converting the paper in the publication process