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Do Financial Advisors Live Up to Their Reputation: The Case of Major Assets Restructurings of Chinese Listed Companies

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Abstract We investigate whether top-tier advisors provide superior services by examining the relationship between reputation (measured by whether it is a top-10 advisor ranked on deal value) of financial advisors on the bidder side and stock market-based/accounting-based performance of bidders. Using Chinese listed companies with major assets reorganizations (MARs, M&As with large-scale target), we find top-tier advisors are associated with higher excess returns (CARs), implying that reputation generates a verification effect on investors. But we find no significant relationship between the advisor reputation and bidders' accounting-based performance post-MARs. The findings indicate that although advisor reputation can attract M&A business and sends positive signal to the market, it does not lead to stronger financial performance in the long run. That is, the so-called top-tier financial advisors fail to live up to their reputation. We also find that payment premium is an intervening variable between advisor reputation and the long-term accounting-based performance of bidders, suggesting that top-tier advisors fail in their duties to help clients achieve greater share of synergy gains.

1 Introduction

After going through the phase of extensive growth, Chinese firms face many obstacles in continuous development, such as excess capacity and rising costs. In order to achieve transformation and gain core competitive advantages, firms need to effectively adjust their assets structures, capital structures, and business models. Such objectives are difficult to meet with the traditional mergers and acquisitions (M&As), major asset reorganizations (MARs) are thought to be more efficient means, which are usually associated with positive market response. Based on China Securities Regulatory Commission (the CSRC), an M&A is identified as an MAR if it meets one of the following three standards: assets being purchased or sold are no less than 50% of the bidder's assets, or relating to no less than 50% of the bidder's sales, or no less than 50% of the bidder's net assets listed in the audited consolidated financial statement of the most recent fiscal year. Due to the complexity of conducting MARs and strict requirements of timely information disclosure, the CSRC requires bidders to employ independent[1] financial advisors to enhance the effectiveness of information exchange in MARs.

Theoretically, top-tier advisors are more capable in promoting information exchange and reducing transaction cost (Golubov et al., 2012) [1], because reputation is a proxy for ability, suggested by the classical work of Klein and Leffler (1981)[2] and Shapiro (1983)[3], and their models are applicable to the case of investment banks' services (Chemmanur and Fulghieri, 1994[4]). But empirical results are mixed. While some find top-tier advisors perform superior services for their clients in return for premium fees (Golubov et al., 2012[1]), some report a negative or at best insignificant relationship between bidder reputation and bidder returns (Servaes and Zenner, 1996[5]; Rau, 2000[6]; Hunter and Jagtiani, 2003[7]; Ismail, 2010[8]).

While the current literature has extensively discussed M&As in China, very few focuses on the role of financial advisors in enhancing firm performance during MARs. Top-tier advisors can send signals to the stock market that both the bidder firms and M&As are of high quality, and top-tier advisors are more capable of selecting more premium targets and offering constructive advice. However, they take no responsibility for investors[2] and may fail to do their

[1] Financial advisors hired by bidders in MARs should have no benefit connection with the bidder or the seller.
[2] The disclaimer is written in the first few pages of an independent financial advisor report.

duties in due diligence, which is revealed by Chinese media[3]. These lead to our primary research questions: Does top-tier advisors lead to superior stock market-based performance? And are they behave as expected and generate strong accounting-based performance in the long run? Our results show that top-tier advisors are associated with better bidder[4] CARs but not better long-term accounting-based performance of bidders, it is consistent with the notion that financial advisors do not live up to their reputation. To explain above results, we find that top-tier advisors are associated with higher payment premium, resulting in wealth being transferred from bidders to sellers. We conclude that top-tier advisors care more about deal completion than helping clients negotiate favorable terms or achieve greater share of synergy gains.

Although China is not the only setting in which we can investigate reputation of financial advisors, the Chinese setting presents some advantages over that of developed countries. First, the bidder of an MAR must hire a financial advisor under the CSRC requirement. So by restricting our sample to MARs, we are able to remove samples of in-house acquisitions and avoid nonrandom sample selection. Besides, due to the larger scale of targets, financial advisors should play a more important role in MARs. Second, financial advisors are unlikely to focus on long-term interest in an unstable market, which is a reason that they do not live up to their reputation. Chinese M&A market is now under market reform, which provide a perfect setting to investigate what will financial advisors do to maximize short-run profit.

This study makes important contributions to the M&A and financial advisor literature. First, to our knowledge, this is the first study to investigate the outcomes of hiring a top-tier advisor in China. With the current M&A trend, many studies have investigated M&As in China's market. However, these studies ignore one crucial factor in enhancing M&A synergy, that is, the role of financial advisors in facilitating M&A process. We fill this gap by examining the effects of advisor reputation. Second, results show a mismatch between stock market-based and accounting-based performance of bidders. We argue that advisors' pursuit of deal completion and contingent fees can explain it. This paper extends the studies on the difference between short-run and long-term performance of bidders in M&As (Chi et al., 2011[9]; Dutta and Joginitial, 2009[10]). Third, payment premium is found to be an intervening variable between reputation and financial performance. It gives direct evidence that top-tier advisors fail in their duties and do not live up to their reputation.

We organize the rest of the paper as follows. Section 2 discusses the related literature and presents the hypotheses. Section 3 presents the data and methodology. Section 4 presents the empirical results, and Section 5 concludes the paper.

2 Related literature and hypotheses development

2.1 Stock market-based performance: expectation of the reputation

Professional firms play a role as rubber stamp and demonstrate themselves as reliable trustees of the management (Meyer, 1994[11]; Pfeffer, 1981[12]). In this section, we argue that hiring top-tier advisors has identification effect, because it sends signals that inform investors of at least two things: the quality of listed company and the quality of M&As.

First, it provides verification on quality of the bidder. If the bidder suffers from poor corporate governance or low information transparency, the M&A tends to have smaller chances of being approved by the regulatory parties (e.g. the CSRC). Besides, M&As by such bidders may very likely be driven by the management's or the board's pursuit of private interests. Consequently, such bidders are less likely to generate financial returns from M&A, which leads to reputation loss for the affiliated financial advisors, because reputation is strengthened by strong word-of-mouth. Top-tier investment banks are more cautious in choosing clients (Fang, 2005)[13], and they also have more experience in accessing conditions of clients. Thus, top-tier advisors prefer to provide service to firms of high quality.

Second, it provides verification on quality of the M&A. High reputation is accumulated from past experience, which can be proxy for high ability. Bao and Edmans (2011)[14] argue that, financial advisors share different levels of responsibility in M&As, depending on whether they initially propose the deal. If the financial advisor proposes the deal, top-tier advisors are more capable to select appropriate targets and increase completion possibility since they have accumulated more experience and network resources from past service. If financial advisors are merely involved in execution, top-tier advisors with more negotiation experience can play a better role to reduce transaction cost and negotiate favorable terms. Thus, regardless of what role they play, top-tier advisors help ensure better deal outcomes. Derrien and Dessaint (2014)[15] show that the quality of financial advisor's service is affected by its market share ranking, which is usually the proxy for reputation. Francis et al. (2014)[16] also find that financial advisors value their reputation in the local market, confirming that reputation can play a verification role.

In conclusion, investors will expect top-tier advisors to enhance MAR performance, which leads to our first hypothesis:

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[3] Securities Daily, March 27, 2015, the first C01 version. (in Chinese)

[4] Normally, only the bidders are listed companies and they acquire shares or assets from unlisted companies in China, which lead to the fact that relevant literature usually only investigates returns of bidders rather than both (Chi et al., 2011)[9].

H1: Higher reputation of financial advisors is associated with higher bidder CARs.

2.2 Accounting-based performance: truth of the reputation

Different from the stock market-based performance that reflects what investors expect from top-tier advisors, the accounting-based performance of bidders reflects the quality of service provided by top-tier advisors. So the former can be considered as the "expectation" of top-tier advisors' service and the latter "truth". We investigate the "truth" in this section.

In a market where reputation mechanism perfectly functions, top-tier advisors will live up to their reputation, because of the following two reasons. For one thing, they have more experience in selecting appropriate targets, negotiation, controlling deal risk and completing deals. So top-tier advisors can lead to better outcomes. For another, high reputation often attracts clients of higher quality. And advisors with a lot influence are more powerful in political lobbying, through which they can maximize their own interest. As a result, top-tier advisors are more cautious in selecting and carrying on deals, to avoid bad outcomes damaging reputation (Golubov et al., 2012)[1]. In conclusion, top-tier advisors are associated with better accounting-based performance of bidders.

However, when reputation mechanism does not perfectly function, the above scenario will not hold and reputation will not be proxy for ability. We offer three reasons that top-tier advisors may not provide superior service in China. First, political connections of Chinese companies can accelerate the pace of IPO activity (Piotroski and Zhang, 2014)[17]. It is reasonable to expect that if a financial advisor has political connections, it may also be more capable to guarantee or accelerate deal completion. So in order to attract clients, financial advisors may put more resources to build political connections than improve service quality. In such cases, financial advisors accumulate their reputation by political factors other than superior service or more experience.

Second, financial advisors will seek long-term development only if they have stable expectations in M&A market and relevant policies. However, China is in the middle of M&A market reform. In 2013, the CSRC released a quality appraisal system of financial advisors that will affect whether and how long should M&As of listed companies be authorized. There is a high probability that more laws or policies will be released in the near future. Uncertain expectation will drive advisors to pay little attention in building reputation by superior services or word of mouth. In order to maximize short-term profit, they care more about deal completion, because it determines advisory fees (Rau, 2000[6]; Kolasinski and Kothari, 2008[18]). Besides, by accelerating deal completion, financial advisors can increase their client base and future sales. In consequence, they might sacrifice due diligence and service quality to some extent. In such cases, financial advisors accumulate their reputation by expanding market share recklessly.

Third, long-term MAR performance is associated with a lot of complex influence factors, so performance lower than expected can not be easily attributed to the failure of advisory service, especially when deal completion is also the client's priority. It is quite possible in China because MARs are often drive by private interest of the controlling shareholders. They need a completed deal to transfer wealth. In such cases, financial advisors share less responsibility and caring less.

Based on the above argument, we hypothesize the following hypothesis:

H2: Higher reputation of financial advisors is not associated with higher long-term performance of bidders.

3 Data and methodology

We obtain the MARs data from the China Stock Market Trading Database (CSMAR), during the sample period ranging from 2006 to 2013. 2006 is when MARs started to be common, continuously taking place in every following year. In 2013, the CSRC released a quality appraisal system of financial advisors and the results were announced in 2014. It is a more direct proxy for advisors' ability, investor's cognition on top-tier advisors may be affected. We obtain the financial advisor data from each company's MAR announcement.

We download financial advisor league table from Mergermarket database. If a financial advisor is among the top-10 according to the value of deals on which they advised for a sample of M&A transactions by Chinese listed or unlisted companies during the period January 1, 1998 to December 31, 2012, it is a top-tier advisor[5]. Accumulation period for advisor reputation starts in 1998, because it is when Mergermarket database starts to disclosure league table and accumulation of reputation needs some time before having effects. The period ends in 2012, because in 2013 financial advisors' market share may be affected by the quality appraisal system.

Table 1 presents descriptive statistics. We employ the standard market model to calculate CAR. ***CAR*** is in the 3-day event window (-1, +1). The estimation period is (-150, -30). ***ΔROA*** is difference in ROA of year t+1 and t-1, t is the year of MAR announcement. ROA is adjusted by subtracting industry-year median. ***Premium*** is equal to difference between payment price and net asset of target divided by net asset of target. ***Rep*** is equal to 1 if a financial advisor is

5 Ten top-tier advisors are China International Capital Corporation Limited, CITIC Securities Co Ltd, Huatai United Securities Co Ltd, Haitong Securities Co Ltd, GF Securities Co Ltd, China Merchants Securities Co Ltd, Guotai Junan Securities Co Ltd, Southwest Securities Co Ltd, China Galaxy Securities Co Ltd, Bank of China International Holdings Limited. No foreign banks are included because they are not allowed to be the independent financial advisor in MARs.

among the top-tier, and 0 otherwise. ***Exp*** is equal to period expense of year t-1 divided by total asset at the end of year t-1. ***Sale*** is equal to natural log of sale of year t-1. ***Lev*** is financial leverage of year t-1. ***JR*** is equal to 1 if the president of the board is also the general manager, and 0 otherwise. ***JR*** controls how powerful the manager can be. ***Share*** is equal to percentage of controlling shareholder's share in year t-1. ***Exe_share*** is equal to 1 if the management hold shares in year t-1, and 0 otherwise. ***Soe*** is equal to 1 if the company is a SOE in year t-1, and 0 otherwise. ***Compare*** is book value of target divided by total asset at the end of year t-1. ***Bookvalue*** is equal to natural log of book value of target. ***Pay*** is equal to natural log of payment price.

Table 1 Descriptive Statistics

Variables	N	Mean	S.D.	Median	Minimum	Maximum
CAR3	300	0.24	0.88	0.14	-0.2	9.39
CAR5	300	0.28	0.88	0.19	-0.3	9.45
ΔROA	300	0.03	0.12	0.02	-0.4	0.39
Premium	300	2.24	3.68	1.07	-0.33	25.86
Rep	300	0.54	0.5	1	0	1
Exp	300	0.26	0.41	0.17	0.01	2.53
Sale	300	20.51	1.64	20.48	16.36	24.8
Lev	300	0.55	0.33	0.52	0.05	1.68[6]
JR	300	1.79	0.41	2	1	2
Share	300	35.85	14.67	34.44	8.93	75.19
Exe_share	300	0.91	0.29	1	0	1
Soe	300	0.59	0.49	1	0	1
Compare	300	1.96	9.11	0.34	0.01	141.33
Bookvalue	300	20.22	1.27	20.25	17.08	23.61
Pay	300	21.08	1.16	21.22	17.7	24.09

4 Empirical results

4.1 Outcomes of hiring top-tier advisors

We run the following model to test H1 and H2. *Performance* stands for ***CAR*** or ***ΔROA***.

$$Performance = Rep + ControlVariables + \xi \tag{1}$$

Panel A of Table 2 presents regression results. The second column shows that the coefficient of ***Rep*** is significantly positive, while the third and fourth columns show that the coefficients of ***Rep*** are both insignificantly. There results are consistent with H1 and H2. There exists mismatch between market-based and accounting-based performance of bidders associates with hiring top-tier advisors.

4.2 Discussion: Why not accounting-based performance?

A natural question that arises from above findings is why top-tier advisors can only enhance short-run bidder CARs but not accounting-based performance of bidders. Mismatch between short-run and long-term performance of bidders is also found by some literature (Dutta and Joginitial, 2009[10]; Chi et al., 2011[9]), arguing that investors are likely to be shortsighted at the beginning, due to lack of sufficient information (Delong and Deyoung, 2007)[20]. Such matters may be more pronounced in China, because Chinese investors are deficient in investment knowledge and skills (Wang et al., 2006)[21]. Being more immature and inexperienced than investors in developed countries, they are more likely to be misled by reputation, ignoring the “truth” that reputation may not be proxy for better advisory services.

We give further empirical evidence that reputation is not proxy for better service. As discussed earlier, top-tier advisors are more capable of negotiating favorable terms for bidders, among which payment price is a key term. For bidders, accepting a higher payment price leads to less share of synergy gains, which will destroy long-term financial performance. However, the sellers will accept deal terms more quickly given a higher payment price. Because top-tier advisors may care more about deal completion (Rau, 2000)[6] and contingent fees (if any) are positively related to payment price, we argue that top-tier advisors are associated with higher payment premium, which is negatively related to long-term accounting-based performance of bidders.

We run the following models to test mediating effect. *Performance* stands for ***ΔROA***.

$$Performance = Premium + ControlVariables + \xi \tag{2}$$

$$Premium = Rep + ControlVariables + \xi \tag{3}$$

Panel B of Table 2 presents the results. The first column shows that the coefficient of ***Premium*** is significantly negative. The second column shows that ***Rep*** is significantly and positively related to ***Premium***. Sobel test is significant

6 Samples with a leverage larger than 1 are not excluded because MARs are often motivated by serious financial risks.

at 10% level (z=-1.684). These results suggest that ***Premium*** is an intervening variable between ***Rep*** and ***ΔROA***[7]. Wealth is transferred from bidders to sellers through high payment price. Because MARs in China are often driven by private interest of the controlling shareholders, this result implies that top-tier advisors may accumulate their client base by supporting tunneling.

Table 2 Empirical Results

	Panel A: Main empirical results			Panel B: Mediating Effect	
	CAR	*ΔROA*	*ΔROA*	*ΔROA*	*Premium*
Rep	0.211**	0.018	0.020		0.622**
	(2.04)	(1.23)	(1.34)		(2.26)
Premium				-0.008**	
				(-2.30)	
Exp			-0.049**	-0.053**	-0.810*
			(-2.02)	(-2.19)	(-1.78)
Sale	-0.132***	-0.026***	-0.032***	-0.031***	-0.062
	(-3.55)	(-4.80)	(-5.18)	(-5.10)	(-0.54)
Lev	1.191***	0.035	0.051**	0.053**	0.165
	(7.08)	(1.44)	(2.02)	(2.11)	(0.35)
JR	0.089	0.021	0.022	0.016	-0.388
	(0.69)	(1.15)	(1.22)	(0.86)	(-1.14)
Share	0.001	0.000	0.000	0.000	0.001
	(0.30)	(0.26)	(0.44)	(0.45)	(0.10)
Exe_share	0.272	0.100***	0.093***	0.092***	-0.148
	(1.51)	(3.85)	(3.55)	(3.56)	(-0.31)
Soe	-0.048	0.030*	0.031*	0.030*	0.060
	(-0.41)	(1.81)	(1.89)	(1.80)	(0.19)
Compare	-0.020***	-0.004***	-0.003***	-0.003***	-0.006
	(-3.26)	(-4.02)	(-3.56)	(-3.59)	(-0.38)
Bookvalue	-0.051	-0.009	-0.010	-0.040**	-4.158***
	(-0.68)	(-0.81)	(-0.90)	(-2.32)	(-20.80)
Pay	0.051	0.029***	0.032***	0.064***	4.202***
	(0.66)	(2.62)	(2.90)	(3.65)	(20.44)
Constant	1.299	0.046	0.102	0.047	-1.741
	(0.93)	(0.23)	(0.50)	(0.24)	(-0.46)
Adj.R^2	0.151	0.113	0.123	0.135	0.659
F	2.521***	2.091***	2.170***	2.296***	17.047***
N	300	300	300	300	300

* Estimated significance at the 10% level, ** Estimated significance at the 5% level, *** Estimated significance at the 1% level.

4.3 Robustness tests

4.3.1 Two-stage Heckman procedure

We consider potential endogeneity of bidder-advisor matching. For example, top-tier advisors are more likely to be hired by large companies because of high advisory fees. OLS estimates are therefore biased. To address this concern, we adopt the two-stage Heckman (1979)[22] procedure. In the spirit of Golubov et al. (2012)[1], we construct a new variable ***Rep_before***, which is equal to 1 if in the 5 years prior to the deal, the bidder has employed a top-tier advisor at least once for an M&A, related party transaction, equity issue, or stock option incentive plan[8], and 0 otherwise. ***Rep_before*** effects the choice of financial advisor but not the M&A outcome. Unreported results show that in the first-stage equation, the coefficient of ***Rep_before*** is significantly positive, suggesting that if bidders have employed a top-tier advisor before, they are likely to hire a top-tier advisor again in MAR. From the first-stage equation, we construct an ***IMR*** (Inverse Mills Ratio) that reflects self-selection. After controlling ***IMR*** in the second-stage equation, the coefficient of ***Rep*** is still significantly positive in the ***CAR*** equation, and remains insignificant in the ***ΔROA*** equation.

4.3.2 Other sensitivity tests

We use two alternative event windows to calculate CAR, (-2,+2) and (-4.+4), the latter is the longest continuous period that CARs are significantly different from zero.

We also use an alternative definition of long-term financial performance. Starting from the first announcement, an M&A deal usually takes longer than a year to complete. So we replace ***ΔROA*** with difference in ROA one year before

[7] This kind of mediating effect is actually a "suppressing effect", where X is insignificantly associated with Y because two intermediary effects (X to M and M to Y) are of similar size but opposite in direction (Shrout and Bolger, 2002)[23].

[8] In any of these cases, a listed company should hire a financial advisor under the CSRC requirement.

and after *deal completion*, which is the date when an official permission paper is received by the bidder from the CSRC. None of these variations changes our results.

5 Conclusion

Using MARs of Chinese listed companies from 2006 to 2013, this paper investigates how financial advisors' reputation affects market-based/accounting-based performance of bidders. Contrary to prior literature that mainly focus on the U.S. advisory market, we find reputation has verification effect on Chinese investors, but there is no evidence that higher reputation of financial advisors is associated with better accounting-based performance of bidders. It suggests that investors are misled by the reputation of top-tier advisors, although it is not proxy for better advisory services. In addition, we discuss why financial advisors do not live up to their reputation. Investors may be shortsighted and payment premium is found to be an intervening variable between advisors' reputation and long-term accounting-based performance. These results suggest that reputation mechanism needs improvement in Chinese M&A market. While hiring a financial advisor, firms should pay more attention to the quality of advisory services rather than the ranking of market share.

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