Evidence Of Investors' Responses To Managerial Investment Decision-Making

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Abstract

This paper investigates the stock price reaction of some pre-management buyout (MBO) investment decisions of managers. This paper finds that managers who engage in non-acquisition type investment expenditures (like plant expansions) in the pre-MBO period could lower the firm's stock price. In addition, managers whose companies buy the assets or a stake in another firm give their company a positive stock price movement. Lastly, there is a statistically significant difference in stock price reaction depending on whether the investment expenditure is non-acquisition or acquisition.

Introduction

This study examines the investor reactions to investment announcements by 32 large firms in a three-year period before a management buyout (MBO). This study is motivated by the belief that managers may want to decrease the price of their company' stock if they anticipate making an MBO in the near future, and that a firm's stock price might decline upon the announcement by managers of additional investment projects.

A number of studies identify situations in which incentives exist for managers to artificially increase earnings (Healy, 1985, Liberty and Zimmerman, 1986, McNichols and Wilson, 1988, Cahan, 1992, and Guenther, 1994). Most of these studies hypothesize that managers attempt to positively manage accruals and earnings either to their firm's benefit (to meet bond covenant agreements) or their own personal benefit (through compensation agreements such as stock options).

By investigating pre-management buyout activity, this study is unique to those studies since managers in the pre-buyout period may wish to artificially decrease, rather than increase, the price of the firm's stock. When negotiations for the MBO begin, managers could pay less for each outstanding share of stock. One study, DeAngelo (1986), specifically tests the hypothesis that managers attempt to depress earnings in the pre-buyout period of an MBO in order to lower the actual buyout price paid by the managers. She finds no conclusive evidence that managers manipulate accruals to lower the net income of the company.

Instead of examining managers' manipulation of earnings, this study examines the stock price reaction to the announcement of in-

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vestment activity. Jensen and Meckling (1976) argue that many MBO firms were investing in unprofitable projects in the pre-buyout period. They conclude that the firm's value would increase after an MBO since the company's increased debt burden would mean less free cash flow to invest in unprofitable projects.

Denis and Denis (1993) follow this line of reasoning by examining the stock price reactions around the announcements of increased investment of firms that would undergo a leveraged recapitalization within five years. They find that most of the firms' stock prices react negatively to investment announcements. They conclude that investors feel that these firms were investing in projects with a negative net present value in the pre-recapitalization period.

Taking the results of these studies together, it is possible that managers in the pre-MBO may announce a firm's investment projects instead of negatively manipulating earnings. Such announcements might decrease the firm's stock price.

Sample selection

A list of firms that underwent an MBO was compiled using the following four point criteria. First, *The Wall Street Journal* contains an announcement that the company proposed to go private and at least one member of the incumbent management team would have an equity interest in the newly-private firm. This restriction means that at least one member of the management team will remain in place and could have gained from a decreased buyout price. Second, the newly-private firm is an independent entity, not a former subsidiary of a still public company. This limitation is imposed since it would have been difficult, if not impossible, to segregate the investment activities and the stock market reaction of parent and subsidiary. Third, the firm has assets of at least $500 million. This limitation means investment decisions will be more fully disclosed to stock investors. Fourth, the effective date of the MBO was between January 1, 1983 and December 31, 1989. This restriction means that the investment decisions were made both in a recessionary and expansionary economy before and after the Tax Reform Act of 1986.

There were 32 firms that met these criteria and their characteristics are shown in Table 1.

Table 1
Number of Firms and Total Purchase Price per Year

Buyout Year	Number of Firms	Total Purchase Price
1984	3	$2,539,300,000
1985	2	2,162,000,000
1986	8	22,046,000,000
1987	5	18,344,300,000
1988	9	13,431,200,000
1989	5	39,860,500,000

To find pre-buyout investments of these MBO firms, *The Wall Street Journal Index* was searched for each MBO company's name for the three years preceding the year the buyout negotiations first became publicly known. Consistent with Denis and Denis (1993), all announcements for which there was an expenditure of resources for a purpose other than a payment to creditors of the firm were noted. This search resulted in a total of 29 announced investment decisions, 20 of the acquisition type (purchase of another company or some of the assets on an unrelated firm) and 9 of the non-acquisition type (general capital expenditures, research and development, and plant, property and equipment). Table 2 shows each year of investment announcements and the number of announcements in that year.

Discussion of Results

The results, presented in Table 3, show

Table 2
Investment Announcements by Year

Year of Announcement	Number of Announcements
1980	1
1981	2
1982	4
1983	3
1984	2
1985	6
1986	1
1987	6
1988	4

that managers, when merely announcing an acquisition or non-acquisition type of investment activity, do affect the price of their company's stock (around a -5, +1 window) but not at a high level of statistical significance (where p is less than .10 or .05).

Interestingly, though, the investment announcement has a positive stock price reaction if the firm is announcing an investment expenditure for the acquisition of another company or some of the assets of another company and a negative stock price reaction when the company is announcing a non-acquisition type investment. When the stock price responses to the acquisition versus non-acquisition type investments are compared, there is a highly statistically significant difference.

This finding may be consistent with the theory that managers in a pre-MBO period are investing in negative net present value projects if those projects are an extension of the already existing business. It would appear that the investing community feels that investments in new operations (like the purchase of another firm or another firm's assets), as opposed to extension of old operations, will make the firm more profitable. However, future research is this area is needed.

Table 3
Cumulative Returns Associated with the Announcement of Investment Decisions

(a) Abnormal Returns	Sample Firm	NYSE Composite
Type of Investment	(-5,+1)	(-5,+1)
Acquisition	+1.0%*	-3.9%
Non Acquisition	-1.7%**	+0.8%
(b) Difference in responses		
Acquisition versus non acquisition	7.4% ***	

"*" and "**" notes statistically significant at the .15 and .30 levels.
"***" notes statistically significant at the .10 level.

These results are different from those found by Denis and Denis (1993). Using the same -5, +1 window, they find highly statistically significant negative effects for both acquisition and non-acquisition type investments in the pre-recapitalization period.

Conclusion

This study is unique in two ways. First, this study investigates a situation where managers may wish to decrease, rather than increase their firm's stock price. Second, this study examines investors' reactions to decisions made by

managers beyond the realm of accrual adjustments - making investments either in plant expansion (an acquisition type investment) or in the purchase of another company or some of the assets of another company (a non-acquisition type investment).

This paper finds that managers who engage in non-acquisition type investment expenditures (like plant expansions) in the pre-MBO period could lower the firm's stock price. In addition, managers whose companies buy the assets or a stake in another firm give their company a positive stock price movement. However, neither of these stock price movements could be shown to be highly statistically significant. Lastly, there is a highly statistically significant reaction when comparing the stock price movement from a non-acquisition versus acquisition type investment.

Suggestions For Future Research

Statistical significance in this type of study may have been proven if more observations had been obtained. A future study may wish to use more firms, or more years before a buyout to create a larger pool of observations. It is important to note, however, that as the number of years before a buyout increases, the linkage from management manipulation of its company's stock price through announcing investing activity becoming more tenuous. It is also possible that smaller firms will be less likely to announce investment decisions that are reported by the media.

Another possible avenue of research would be to correlate the stock price reactions of investment decisions with the net cash flows of the firms. It might be that pre-MBO firms with high levels of cash flows who make non-acquisition type investments would be treated differently by the investing public than low cash flow pre-MBO firms that make an acquisition type investments. 🕮

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