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Why Double Exit Firms Switch Investment Banks in Mergers and Acquisitions?

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This paper asks the question why double exit firms switch away from their IPO lead underwriter in the subsequent merger and acquisition transactions. We find that consistent with underwriting literature, firms are more likely to switch investment bank service when their IPO lead underwriter is not a top investment bank, when the elapsed time between IPO and merger increases, and when the firm has relatively low market to book ratio. Market actually punishes the switchers as the switchers earn lower announcement period return.

Field of Research: Investment Banking, IPO underwriter, Merger and Acquisition

1. Introduction

Literature has referred to the newly public firms that are acquired within three years after their IPOs as double exit firms or double tracking firms. For double exit firms, such as Paypal, which got acquired by Ebay only a few months after it had launched its IPO, going public and getting acquired are the two most important corporate events. While no firm will reveal that their actual motivation behind IPO is to be bought by another company, undoubtedly considerable business revenues are generated for the investment banking industry from both underwriting and advising merger and acquisition (M&A) activities, especially within such a short time frame.

For 361 double exit firms from 1992 to 2007, about 60% of the firms use a different M&A advisor other than their lead IPO underwriters. In this paper, we ask the important question: Why do the double exit firms switch investment banks?

There are multiple reasons why we focus on double exit firms. First, IPO underwriting represents one of the most significant events in the double exit firm's life cycle, and will most likely result in a strong business tie with the firm. Second, the set of underwriters and M&A advisors largely overlap with each other, with most of the top underwriters serving also as top merger advisors. Third, we concentrate on target firms for the very reason that we are not concerned by the contamination of possible future long-term relationships with the investment banks. Once the target firm is acquired, its relationship with the investment bank ceases.

Using a sample of 361 double exit firms from 1992 to 2007, we provide evidence that double exit firms' decisions to switch from their IPO lead underwriters is more likely to

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happen when the IPO lead underwriter is not a prestigious investment bank, when the time between IPO and M&A deal announcement is longer, and when the firm has a smaller market to book value. We also find that the cumulative abnormal return (CAR) for the double exit firms is lower when they switch, especially when they switch to a top tier investment bank.

The rest of the paper proceeds as follows. Section 2 reviews the recent literature. Section 3 describes empirical methodology. Section 4 details and analyzes the results. Section 5 discusses the implications of the findings and presents our conclusions.

2. Literature Review

2.1 The Choice of Advisors in M&A

Most papers examine why there is an advisor. For example, Servaes and Zenner (1996) find that when transaction is more complex and the information asymmetry is more severe between the target and the bidder, acquirer firms are more likely to hire an advisor. Forte, Iannotta, and Navone (2010) examine 473 European M&A transactions, and conclude that complexity of the deal also positively affect target firm's decision to hire an advisor. There are also adequate literature shows that financial advisors help to identify the acquisition counterparties to create better synergy gains, and advise firms on strategic moves. (McLaughlin, 1990, 1992; Bowers and Miller, 1990; Kale, Kini, and Ryan, 2003).

2.2 The Effect of Previous Banking Relationships

The effects of prior bank-client relationships on the likelihood of winning subsequent business with the same firm are well documented. Ljungquvist, Marston, and Wilhelm (2006), (2009) examine U.S. debt and equity offerings between 1993 and 2002 and conclude that underwriters are more likely to be retained if the investment banks have served as lead-manager or co-manager in previous underwriting services. Ellis, Michaely, and O'Hara (2006) also provide supporting result suggesting that if firms have used the banks in prior debt underwriting or lending, they tend to use the same bank in equity offerings.

2.3 The Switching of Banks

There are only limited empirical evidences in M&A literature with regard to why firms switch investment bank services. Saunders and Srinivasan (2001) find that firms tend to switch to investment banks with higher reputation. Hunter and Jagtiani (2003) contend that switching may be fee driven because when acquirers switch advisors either within the same tier or to an upper tier, the fee decreases.

However, the theoretical and empirical work on the decision to switch book-runners from firms' IPO to SEO is more developed in underwriting literature. Betty and Ritter (1986) and Dunbar (2000) both show that short-run mispricing will cost IPO underwriters market share over time. James (1992) finds that the longer the time between IPO and SEO, the more likely a firm is to switch underwriters as the degree of information asymmetry is alleviated.

Furthermore, Krigman, Shaw, and Womack (2001) provides evidence that it is a strategic move for firms to switch lead underwriter in an SEO within three yeas of their IPOs, which results in additional and star analyst coverage from the new lead underwriters.

2.4 The Market Reaction

Saunders and Srinivasan (2001) find that there is no significant difference between average announcement returns of non-switchers and switchers. Krigman, Shaw, and Womack (2001) show that market reacts more positively upon the announcement when firms switch to investment banks with star-analyst coverage. Forte, Iannotta, and Navone (2010) provides more evidence to support the certification hypothesis which states that the abnormal returns of target companies increased with the intensity of the previous banking relationship.

An investment bank's reputation also plays an important role in the M&A transaction's outcome. Kale, Kini, and Ryan (2003) documents that the absolute wealth gain accruing to the bidder increases as the bidder advisor's reputation increases relative to that of the target. Hunter and Jagtiani (2003) find that top tier advisors are more likely to complete deals, and do so in less time than lower tiers; however, acquirer gain decreases when top advisors are used. Their findings are consistent with Rau (2000), who find that top tier advisors tend to advise the buying side to offer larger premiums.

Our paper is more closely related to Krigman, Shaw, and Womack (2001) and Saunders and Srinivasan (2001). This paper attempts to explain why a newly public firm switch away from its main relationship banks, the IPO lead underwriters, when it becomes the target at the M&A market.

3. The Methodology

3.1 Sample Selection

We obtain the data used in this study from several databases. Our IPO sample comes from the Securities Data Company (SDC) databases on U.S. Global New Issues. It covers all U.S. IPOs issued from 1992 to 2005[1]. We apply the common standards used in many other research on IPOs, by excluding unit offering, closed-end funds, real estate investment trust (REIT), spin-offs limited partnerships, and previous leverage buyouts. We also eliminated financial institutions (SIC codes between 6000 and 6999) and very small issues with an offer price under $5.

The sample of acquisitions is collected from SDC U.S. Mergers and Acquisitions database. We only include 100% acquisitions by U.S. public firms from 1992 to 2007. Using a 6-digit CUSIPs to match the IPO sample with acquisition sample, we identified 455 double exit firms, firms that are acquired within three years of their IPO issuance.

Moreover, the IPO firm must be available on the Compustat annual industrial database for the fiscal year prior to the M&A transaction to ensure that the necessary accounting information is available to study firms' characteristics prior to merger. To get data on stock

prices, returns, and shares outstanding, we also require the firm to be on the University of Chicago Center for Research in Security Prices (CRSP) database during the 6 calendar months before the acquisition. This leaves us with 374 firms.

Of the 374 deals, we delete 13 that were completed in-house (i.e., no target advisors were used). Our final sample includes 361 observations. Due to the long time period covered by the study, we convert all nominal dollar values into real values for the year of 2007.

3.2 Investment Bank Reputation and the Switching of Banks

For the investment banks' prestige rankings, we use the Carter and Manaster's metric of underwriter "pecking order" from 1992 to 2007. Investment banks are categorized into two tiers. *Top Underwriter* is a dummy variable, equal to 1 respectively, if the IPO underwriter has a ranking greater than 9.0 and 0 otherwise. *Top MA advisor* is another dummy variable, equal to 1 if the target has hired at least one M&A advisor that has a ranking greater than 9.0 and 0 otherwise.

A firm is said to have switched if it chooses a merger advisor who is NOT its IPO lead underwriter. *Switch* is a dummy variable, equal to 1 if the firm has switched, and 0 otherwise. To further explore the heterogeneity in switching, following Saunders and Srinivasan (2001), we classify firms that switch in three categories: (1) those that switch to a top tiered bank (Switch Up), (2) those that switch to a lower tiered bank (Switch Down), and (3) those that switch to a bank that has the same tier as their IPO lead underwriter (Switch Same Tier).

3.3 Empirical Design

3.3.1 Why Firms Switch?

We examine the factors that are important in determining firms' decision to switch. First, following Betty and Ritter (1986), Michaely and Shaw (1994), Dunbar (2000), and Krigman (2001), we use two measures to proxy for IPO lead underwriter competence: *Underpricing* is the difference between first trading day close price and offer price in IPO, scaled by the offer price. *Gross Spread* is the percentage fee of IPO principal proceeds that underwriters receive.

***Hypothesis 1*:** Mispricing of IPO. Firms will tend to switch investment banks for M&A if their IPO lead underwriter leaves too much money on the table.

Second, Krigman et al (2001) shows that firms do not necessarily change their underwriters in response to poor IPO performance. Rather, the firm chooses a more prestigious investment bank to signal its high quality. In addition, top investment banks have proven their superior expertise as opposed to lower tiered counterparts.

***Hypothesis 2*:** Certification Effect. Firms will tend to switch investment banks for M&A if their IPO lead underwriter is NOT a *Top Underwriter*.

Third, as more time passes after the firm becomes public, the value of its firm specific information decays (James, 1992). In addition, the strength with the IPO lead underwriter weakens over time, and the possibility of having business relationships with other banks increases. We follow Krigman et al (2001) to construct a proxy for this graduation effect: *Time between IPO and MA* is the number of months between firms' IPO issue date and acquisition announcement date.

***Hypothesis 3*:** Graduation Effect. Firms will tend to switch investment banks for M&A as the *Time between IPO and MA* gets longer.

A multivariate probit regression analysis is utilized in our study of why firms switch. The results are given in Table 2 and will be discussed in the next section.

3.4 Control Variables

We also incorporate a number of control variables to capture deal-specific and firm-specific information, which have been analyzed by prior research. *Ln_Deal* is the natural log of the dollar value of the merger transaction. *Pct_Cash* is the percentage of the acquisition financed with cash. *Same_Ind* is a dummy variable, equal to 1 if both target and acquired have the same 2-digit SIC code, 0 otherwise. *Relative_Size* is the log of ratio of total assets between target and acquirer. *Market to Book* is the ratio of the target firm's market value of equity to total assets. *ROA* is the operating income of the target firm, scaled by total assets. All accounting variables are lagged by a year, and all continuous variables are winsorized at 1% level to eliminate the effect of outliers.

4. The Empirical Results

4.1 Summary Statistics

Table 1 presents the summary statistics and provides several interesting and significant patterns across the variables used in this research. First, the average first-day return for the sample of IPOs is 30.3% for non switchers versus 24.4% for switchers. The firms staying with their lead IPO underwriters are more severely underpriced at the IPO, but statistically this is not significant. However, like James (1992), Nanda and Warther (1998), and Krigman et al (2001), we find that the gross spreads at the IPO are lower for firms that do not switch. Thus, a first tentative conclusion is that firms may switch due to excessive fees paid at the IPO. Second, prestigious underwriters underwrote 56% of the firms that subsequently chose not to switch at the time of IPO, as opposed to 37% of the switching firms, consistent with the findings of Krigman et al., (2001), and Saunders and Srivnivasan (2001) that the switchers had been firms underwritten by lower reputation underwriters. Third, on average, non-switching firms are acquired 19.7 months after they become public, and switching firms 22.5 months. This evidence lends initial support to the graduation effect. Finally, the non-switching firms are typically larger in size with higher merger and acquisition transaction value.

4.2 A Multivariate Probit Analysis

The univariate comparison of non-switching firms and switching firms is potentially misleading if the variables examined are highly correlated. We provide probit regressions in Table 2 to address the robustness of the results in a multivariate setting. The probit regression models the probability that a firm will switch investment banks in M&A transactions. We first construct three specifications to test the individual hypotheses, and then one comprehensive model to test the variables jointly.

Table 1: Summary Statistics

	Non Switching				Switching				Statistical Comparison	
	N	Mean	Median	St. Dev.	N	Mean	Median	St. Dev.	Difference in mean	Difference in median
Underpricing	157	0.303	0.123	0.492	204	0.244	0.125	0.344	0.059	0.123
Gross Spread (%)	157	6.811	7.00	0.475	204	6.964	7.00	0.371	-0.153***	0***
Top Underwriter	157	0.560	1	0.497	204	0.372	0	0.484	0.188***	1***
Time from IPO to MA	157	19.738	19	8.547	204	22.588	24	8.120	-2.85***	-5***
Ln_Deal	157	6.092	6.073	1.453	204	5.547	5.425	1.461	0.545***	0.648***
Pct_Cash (%)	157	25.045	0	39.442	204	26.444	0	41.052	-1.399	0
Same_Ind	157	0.643	1	0.480	204	0.553	1	0.498	0.09*	0*
Relative_Size	157	1.793	1.551	1.727	204	2.105	1.788	1.840	-0.312	-0.237
Size	157	5.235	4.925	1.298	204	4.768	4.693	1.131	0.467***	0.232***
Market to Book	157	5.414	2.789	9.064	204	3.765	2.549	6.233	1.649**	0.240
ROA	157	0.016	0.085	0.241	204	-0.040	0.061	0.315	0.056**	0.024
CAR	157	0.241	0.219	0.275	204	0.223	0.169	0.264	0.018	0.05

Notes: Panel A of Table 1 reports the summary statistics and univariate test between the non-switching and switching firms. The mean difference is tested by t-test, and the median difference is tested by Wilcoxon-Mann-Whitney test. All variables are defined in Section 3. ***, **, * indicate the mean/median of non-switching firms is greater than that of the switching firms at 1%, 5%, and 10% levels, respectively

The first specification considers the IPO performance. The coefficient on *Underpricing* is negative and significant at 10% level. The greater the level of underpricing, the less likely a firm is to switch. This runs counter to previous literature, which states that leaving too much money on the table is a bad thing. Also significant in this estimation is the *Gross Spread*. The higher the percentage of fees paid to investment bank at the time of IPO, the more likely that a change in investment bank will be made. This is contrary to the common view that underwriting fees are clustered at 7% and usually given low priority in the decision to switch (Chen and Ritter, 2000; Krigman et al, 2001)

The second specification includes the variable related to underwriter reputation. The coefficient on *Top Underwriter* is negative and significant at a 1% level. Firms are more likely to switch investment banks if they went public with a less reputable underwriter. This confirms our conclusion from the univariate test.

The third specification addresses the graduation effect. The coefficient on *Time from IPO to MA* is positive and significant at 1% level. Consistent with James (1992) and Krigman et al (2001), we find that the length of time between IPO and MA is an important factor in explaining why firms switch.

Finally, we simultaneously test the three hypotheses. The comprehensive model reveals that for double exit firms, both the reputation of underwriter, as represented by *Top Underwriter*, and graduation, as represented by *Time from IPO to MA*, are important to the decision to change investment banks for subsequent merger activity. In addition, we find double exit firms' market to book ratio is significant in all specifications. Firms with lower market to book ratio are more likely to switch. We do not have sufficient evidence to support that the firms switch because they are "burned" at IPO.

4.3 Market Reaction

In what follows, we concentrate on whether the market recognizes the value of the decision to switch investment banks.

In Table 3, we regress the determinants of the *CAR* cross-sectionally to test whether market values the switch decision. In the models, we control of several deal features and firm characteristics. Deals with higher percent of cash offer have higher CAR, *Pct_Cash* (positive). When a double exit firm is acquired by a bigger acquiring firm, its CAR also increases, *Relative_Size* (positive). Smaller target firms get higher announcement return, *Size* (negative).

Table 2: Determinants of Switching

	IPO Performance		Reputation		Graduation		Comprehensive	
	Estimate	p-value	Estimate	p-value	Estimate	p-value	Estimate	p-value
IPO performance :								
Underpricing	-0.363	(0.056)*					-0.308	(0.110)
Gross Spread	0.407	(0.056)*					0.386	(0.090)*
Certification:								
Top Underwriter			-0.454	(0.005)***			-0.448	(0.007)***
Graduation:								
Time from IPO to MA					0.036	(0.000)***	0.037	(0.000)***
Deal Characteristics:								
Ln_Deal	0.047	(0.593)	0.032	(0.717)	0.031	(0.723)	0.071	(0.442)
Same_Ind	-0.223	(0.151)	-0.225	(0.153)	-0.227	(0.152)	-0.275	(0.086)*
Pct_Cash	-0.009	(0.963)	-0.006	(0.975)	0.002	(0.989)	-0.025	(0.901)
Relative_Size	0.021	(0.654)	0.031	(0.498)	0.032	(0.487)	0.039	(0.401)
Firm Characteristics:								
Size	-0.174	(0.096)**	-0.160	(0.110)	-0.290	(0.004)***	-0.168	(0.147)
Market to Book	-0.025	(0.019)**	-0.025	(0.021)**	-0.025	(0.019)**	-0.023	(0.026)**
ROA	-0.058	(0.846)	-0.096	(0.757)	0.015	(0.959)	-0.113	(0.728)
Observations	361		361		361		361	
Pseudo R^2	8.23%		8.54%		10.31%		13.05%	

Notes: This table reports the coefficients from the multivariate probit regressions of firm's decision to switch on a set of variables defined in Section 3. Intercept and coefficients of the year dummies are not reported here. Robust p-value, corrected for heteroscedasticity, is reported in the brackets. ***,**, and * indicate significance at 1%, 5%, and 10%, respectively.

Table 3: Effect of Switching on the Announcement CAR

	Model 1		Model 2	
	Estimate	p-value	Estimate	p-value
Switch dummy	-0.072	(0.023)**		
Switch Up			-0.092	(0.016)**
Switch Down			-0.087	(0.136)
Switch Same Tier			-0.055	(0.142)
Certification:				
Top Advisor	-0.030	(0.286)	-0.024	(0.495)
Graduation:				
Time from IPO to MA	0.002	(0.077)*	0.002	(0.080)*
Deal Characteristics:				
Ln_Deal	0.011	(0.473)	0.010	(0.515)
Pct_Cash	0.144	(0.000)***	0.147	(0.000)***
Same_Ind	0.008	(0.780)	0.008	(0.795)
Relative_Size	0.021	(0.018)**	0.021	(0.017)**
Target Characteristics:				
Size	-0.045	(0.015)**	-0.043	(0.023)**
Market to Book	-0.002	(0.135)	-0.002	(0.147)
ROA	0.104	(0.157)	0.103	(0.161)
Observations	361		361	
Adjusted R^2	16.65%		19.32%	

Notes: This table reports the coefficients from the multivariate OLS regressions of firm's announcement CAR on a set of variables defined in Section 4. Intercept and coefficients of the year dummies are not reported here. Robust p-value, corrected for heteroscedasticity, is reported in the brackets. ***,**, and * indicate significance at 1%, 5%, and 10%, respectively.

In model 1, the variable of interest is *Switch*. This measure is intended to capture whether the market punishes or rewards double exit firms for switching away from their lead IPO underwriters. The coefficient on *Switch* is negative and significant at 5% level. The switchers earn lower announcement period return compared to non switchers. The result is consistent with some of the previous empirical work on the value attributable to the perceived certification by banking relationships (Allen et al.,2004; Forte, Iannotta, and Navone,2010).

To further explore this result, we then replace the single dummy with three switch dummies – *Switch Up*, *Switch Down*, and *Switch Same Tier.* The result in model 2 of Table 3

indicates that the firms that switch up to a top tier investment bank appear to get the significantly lower announcement CAR. So market penalizes those double exit firms that went public with a lower tiered underwriter but sought merger advises from a prestigious bank.

5. Conclusion

Double exit firms are an interesting phenomenon -- newly public firms that get acquired within three years after their IPOs. For double exit firms, their lead IPO underwriters play a very important role because the investment banks help them to establish a market price and boost firm visibility in the capital market.

This paper examines double exit firms from 1992 to 2007. The sample includes 361 deals, with 60% of the firms switching investment banks services. Why do double exit firms switch away from their lead IPO underwriter in subsequent mergers and acquisitions? First, switching is not primarily driven by investment banks' performance at the time of IPO, measured by IPO first-day return, and the gross spread. This is consistent with Krigman et al (2001)'s finding that a firm's decision to switch underwriters from IPO to SEO is not influenced by IPO mispricing. Second, double exit firms trade up to a higher-reputation investment banks for merger advices. Like Krigman et al (2001), and Saunders and Srinivasan (2001), our findings support the story that firms switch to gain the service and prestige of top tier investment banks. The third finding is that double exit firms are more likely to switch when the time between IPO and merger is longer. Again, this is highly consistent with Krigman et al (2001)'s graduation effect.

Our research not only extends the current literature on M&A advisor choice for target firms, but also connects investment banks' service at both the IPO and the M&A markets together. Future research in this area looks promising.

Endnote

1. We choose the sample from 1992-2005 to be consistent with the Carter and Manaster underwriter rankings

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