



Show Me the Money: Aura of Top M&A Banks Often Obscures Low Returns for Clients

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Reputation matters. Companies with the best reputations are often assumed to offer the greatest value to their clients. That's the conventional wisdom, and on Wall Street, that kind of thinking helped make Goldman Sachs and Morgan Stanley the investment banks with the largest market shares in the mergers and acquisition advisory business. Goldman is even lionized in a newly published book -- *The Partnership*, by Charles Ellis -- as the best managed company in American finance.

But [Alex Edmans](#), a Wharton finance professor, has found that the conventional wisdom may be wrong. In merger-and-acquisition advice, at least, market share doesn't seem to equate with value delivered to clients. In a paper titled, "[How Should Acquirers Select Advisors? Persistence in Investment Bank Performance](#)," Edmans and Jack Bao, a graduate student at the Massachusetts Institute of Technology, find that market share does not necessarily translate to the best returns for a bank's clients.

Edmans and Bao examined nearly 30 years of returns to shareholders from mergers and acquisitions, and found a strong negative correlation between a bank's market share and the returns of its acquirer clients. In other words, the more market share a bank has, the less value it is likely to deliver. "Practitioners appear to be using market share as a measure of quality without having verified that it is actually correlated with superior performance," the two scholars write. "Our results suggest that it is a poor proxy." Instead, Edmans and Bao found that the best predictor of the return from a bank's deals is the return from its prior deals: Banks that yesterday could identify the most promising merger partners and negotiate the best terms should also be able to do so today.

But past performance doesn't appear to be the criterion that companies use in picking their advisers. Instead, they seem to give credence to industry "league tables" -- the most cited ones are published by Thomson Financial -- that track the total number and value of deals advised by each bank but not their returns. "There are no league tables based on performance," Edmans says. "The entire industry seems to equate market share with quality, without stopping to check whether market share is actually positively related to performance."

Edmans stresses that nothing in his results suggests misdeeds on the part of investment bankers or corporate managers who select them for advice on transactions. "I don't see this as being a scandal," he says. "Nobody's breaking any contracts. It's just the way the industry is set up."

Banks are simply responding sensibly to industry practices. "Since clients ignore the very measures that do predict future performance [i.e. past performance] and instead focus on market share, it is entirely logical for banks to maximize their league table position -- in particular, by accepting even value-destructive mandates," he and Bao write. "Not only will the mandate boost fee income today, but it



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will also increase market share and the ability to generate income in the future."

Once market share becomes entrenched as the standard for evaluation and thus a signal of reputation, it can undermine efforts by corporate managers to use other measures. "Remember the old saying, 'No one gets fired for buying IBM,'" Edmans says. "Goldman Sachs is often number one in the league tables and it's the same with them. No one gets fired for choosing Goldman Sachs as their investment banker."

A corporate financial manager might decide to hire a smaller bank with strong past performance as her company's adviser on a merger. But she then has to sell that selection to the rest of the executive team, including the CFO and CEO who have been hearing for years that Goldman is the best bank, bar none. (In some areas and by some measures, that may be true. Edmans and Bao limited their analysis to the financial return on M&A.)

"Even if one person in a company did the analyses that we did, that person doesn't decide alone which bank to hire," Edmans points out. "They must convince all of the others who have to buy into the decision." What's worse, the staffer might succeed in convincing her bosses of the soundness of her arguments only to see them ignore her advice. "Even if managers are aware that market share is negatively correlated with acquirer returns, they may select the largest banks for legitimacy reasons, since boards or shareholders may equate league table position with superior advice," Edmans and Bao write.

The 25th Red Sweater

Edmans and Bao point out that a bank's low average return may not necessarily imply poor negotiating ability. Many deals are not initiated by banks, but by the clients themselves. An adviser therefore might blame a low average return on being handed bad deals to execute. But Edmans argues that investment banks have a duty to advise clients against such transactions. After all, they typically claim to be trusted advisers who are acting in their clients' interests, not just maximizing their fee income. Indeed, the researchers write, persistently low average returns on deals may stem not from poor negotiating skills but from a bank failing to advise against bad transactions. Regardless of the cause, high market share may be a signal that a bank isn't advising against bad deals.

Edmans and Bao add that, in some cases, a bank may have little ability to sway a client bent on a bad deal. Even if it warns against a transaction, the client may be fixated on it for a host of reasons that have nothing to do with shareholder return. Maybe a CEO will receive an ego boost from running a bigger company. Maybe he realizes an executive's paycheck tends to grow with the size of his company. Or maybe he gets a thrill out of seeing his firm on the front pages of *The New York Times* and *The Wall Street Journal* and being interviewed on CNBC. Regardless of the reason, a fixated CEO will not be swayed. "A bank may indeed caution that returns will be negative, but the client demands that [the deal] be undertaken anyway," the two scholars write. The banker's role then becomes more like that of a retailer. The consumer has decided what he wants. If the banker doesn't provide it, someone else will, so the bank can't be blamed for doing so. A clothier doesn't tell the customer that she already has too many red sweaters. It sells her the 25th sweater.

Similarly, a bank shouldn't be held responsible for a deal pushed by a fixated CEO. After all, it's possible that the bank helped the CEO's shareholders by making a bad deal better. The bankers might not dissuade the executive, but at least they could ensure that the transaction cost shareholders less.

In their analysis, Edmans and Bao tried to tease out mergers undertaken by fixated CEOs by using a list of firm characteristics that may indicate a value-destructive client. After controlling for these variables, performance remained significantly persistent. Still, Edmans stresses that their proxies are, necessarily, indirect and imperfect. "I'd love to be able to directly observe who the fixated clients are," he says. "That would make the analysis much cleaner. But no CEO will simply admit that he or she is an empire builder."

Edmans and Bao didn't set out to chide Goldman, Morgan Stanley or anyone else. If anything, Edmans retains strong affection for Morgan Stanley, where he worked in both investment banking and fixed-income sales and trading before entering academia. But his stint in banking did highlight for him the fact that many clients seemed to use questionable criteria in choosing their banks.

"We would take it for granted that, if we acted as a trusted adviser and turned down bad deals, clients would notice and reward us with future business," he recalls. "But the good guys didn't always seem to win." He therefore wanted to rigorously test whether superior performance persisted and whether clients rewarded it with repeat business and thus greater market share.

Tyranny of the Tables

Edmans' time on Wall Street also underscored for him bankers' obsession with league tables and got him wondering whether it might swamp any attention paid to actual quality. "At Morgan Stanley, there were people whose primary job was making sure we got credit for our deals in the league tables," he recalls. What's more, when pitching for business, banks would include the league that show they were number one in a particular segment of the market as well as tombstone ads to trumpet their largest recent deals.

League tables also mattered greatly in the evaluation of individual bankers. "If you're a banker, you need to bring in the business," Edmans notes. "If there was a big deal you weren't on, you'd have to explain the missed business. It would be very difficult to say that we had deliberately missed a deal because we thought it was bad for the client, and we told them so. When it comes to the evaluation at the end of the year, it's more tangible to say something like, 'I brought in this deal that brought in \$5 million,' than it is to say, 'I created client value by advising them against this deal.'"

Of course, one could argue that bonus-hungry bankers don't have an obligation to save companies from themselves. They are just pursuing their self-interest, as people are wont to do. Instead, it's the corporate financial managers who are erring and should be held accountable. After all, they have a duty to protect their shareholders. But Edmans sympathizes with the difficulties that managers face in picking bankers. "Market share league tables are ready-made and at a client's fingertips," he notes. "And doing what Jack and I did -- calculating an average performance measure for all banks and controlling for fixation proxies -- is a lot of work. So it's tempting just to assume that the largest bank is the highest quality."

The researchers therefore suggest that policymakers should promote the dissemination of league tables based on average return to clients. Not only will this help acquirers with their selection decisions, but it could also strengthen banks' resolve in turning down bad deals.

In other words, Edmans sees no problem in using reputation as a shortcut in decision-making. He just thinks that people need to make sure they consider what that reputation is based on. As he and Bao write: "Reputation *does* improve future M&A performance, if reputation is measured on the basis of past performance rather than market share or prestige."

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