NEW OUTSIDE BLOCKHOLDERS, PERFORMANCE AND GOVERNANCE IN GERMANY

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Abstract: In this paper we examine stock price reactions to announcements of large block purchases with German targets. We can show that the formation of new outside blocks leads to significant value creation for target shareholders, regardless the acquirer's intention. Splitting the sample by acquirer intention indicates that activist and strategic blocks entail significantly higher abnormal returns than purely financial blocks. The positive effect of activist block purchases still persists when we control for other block- and target-specific factors in cross-section. We do not find a significant relation between incumbent ownership structure and announcement effects, sustaining the recent evidence that existing large blockholders do not necessarily play a significant role in disciplining management.

Keywords: Large blockholders, block purchases, corporate governance, event study

1. Introduction

Many theoretical analyses argue that the involvement of large shareholders in monitoring or control activities has the potential to limit agency problems (Shleifer and Vishny (1986), Maug (1998), and Noe (2002)).[1] Empirical support for this argument has been provided by a number of studies. (e.g. Agrawal and Mandelker (1990), Hartzell and Starks (2003), Holderness (2003)). Results are, however, still ambiguous.

Most of the studies are static in nature, examining the impact of already *existing* large blockholders on firm performance or monitoring related variables like management turnover. In contrast, the body of empirical research on the dynamic effects of changes in ownership structure is considerably smaller. These studies investigate large block purchases and the corresponding market reactions to measure the wealth effect induced by large outside blockholders. Substantial empirical evidence shows that capital markets react positively to the formation of outside blockholders in anticipation of an increased takeover probability and enhanced monitoring (e.g. Choi (1991), Barclay and Holderness (1991)). Recent studies further document a strong influence of block- and target-specific characteristics on the realized wealth effects (e.g. Bethel, Liebeskind and Opler (1998), Park, Selvili and Song (2008)).

So far, the role of large blockholders appears fairly well explored, both statically and dynamically. However, the studies presented above focus entirely on the USA. In contrast, evidence on the role and effect of large blockholders in Europe is scare. Although a number of papers investigates the role of *existing* shareholders in this context (e.g. Franks and Mayer (2001), Dherment-Ferere, Köke and Renneboog (2004), Heiss and Köke (2004)), empirical evidence on the market reaction to new block formations is surprisingly sparse and inconsistent, especially with regard to Germany. We aim to fill this gap.

There are three specific characteristics of the German financial system that make us expect significantly lower abnormal returns to target shareholders than those observed in empirical studies that focus on the US market.

Firstly, the near absence of hostile takeovers and the low levels of merger activity in Germany relatively to the UK and the US suggest that there has been little or no market for corporate control in Germany. Although acquisitions of large block stakes may act as a substitute for the traditional market for corporate control (Franks and Mayer (2001), Köke

(2004)), this implies that one of the key explanations for the positive wealth effects of block purchases presented in US studies, namely the takeover anticipation hypothesis, is likely to play a substantially lower role in explaining market reactions to the formation of new blockholders. Hence, we would expect significantly lower abnormal returns than in the studies that focus on countries with active markets for corporate control.

Secondly, Germany in particular is characterized by a substantially higher ownership concentration than the US (La Porta, Lopez-de-Silanes and Shleifer (1999), Faccio and Lang (2002)). Becht and Boehmer (2003) document that over 80% of officially exchange listed German corporations have a minority blockholder controlling over 25% of the votes and that 65% are majority controlled. Hence, chances are high that block purchases in Germany take place in companies that already have at least one incumbent large shareholder. Conversely, this raises the question if the capital market also values *incremental* monitoring by an additional large blockholder, and whether this incremental benefit relates to block- and firm-specific characteristics. Thus, we expect lower abnormal returns than in countries that are characterized by a more diffused ownership structure such as the US or the UK.

Thirdly, private benefits of control are higher in Germany than in the US (Dyck and Zingales (2004)). Consequently, minority shareholders face a higher risk of expropriation by incumbent controlling shareholders. In turn, this may affect the distribution of wealth between the block acquirer and incumbent target blockholders. Theoretically, this should lead to lower abnormal returns to target shareholders than in countries with a low level of private benefits.

Given the above considerations, we will shed light on the economic implications of block purchases in Germany by studying a new set of data with 85 block purchases with German targets between 1997 and 2007. We focus on de-facto minority block purchases between 5% and 49.9% of target voting stock, since we want to detangle the wealth effects of implicit majority control transfers[2] from block- and target-specific effects such as acquirers' intention (e.g. activist investor) or target firms' incumbent ownership structure.

We make four key findings: First, block purchases in German companies lead to positive abnormal returns on average, regardless of the identity of the buyer. Second, block purchases by activist investors are accompanied with significantly higher abnormal returns than purely financial block purchases. This finding leads to the conclusion that activist acquirers either have superior monitoring or target selection abilities. Third, target characteristics that are frequently related to effective monitoring such as the presence of incumbent large shareholders have at most a marginal effect on the market reaction. Fourth, the share price reaction is negatively correlated to target firms' market capitalizations and valuation levels.

The remainder of the paper is structured as follows: Section 2 describes the empirical evidence on block purchases. In section 3 we discuss the sample selection procedure, relevant block- and firm-specific data and the econometric strategy. In section 4 we present univariate and multivariate analyses of share price announcement effects to minority block acquisition. Section 5 summarizes the findings and concludes.

2. Literature Review

Considering the US evidence, the majority of the early studies on the impact of block purchase on corporate performance find positive abnormal returns for the target upon the announcement of an accumulation of 5% or more of the common stock by an outside investor. In general, there are three main hypotheses that explain the source of value creation to target shareholders.

The "*anticipated takeover bid hypothesis"* is based on the notion that block purchases (or "toehold acquisitions") can start an inter-firm investment process, implying that the positive valuation effect is due to investors' perception of an increased probability of a subsequent takeover. Using a sample of 337 new large block formations during the period 1978-1980,

Mikkelson and Ruback (1985) examine the valuation effects of toehold acquisitions. They document that block purchases that are not followed by investment outcomes (e.g. takeovers, targeted repurchases) lead to significant negative abnormal returns for target shareholders in the post-toehold period. These results imply that the value increase at toehold acquisitions is an adjustment for the expected takeover premiums, and that the absence of takeovers makes investors revises downward the expected benefits of future takeover bids. Choi (1991) and Sudarsanam (1996) confirm these findings and further identify the increased probability of an external or internal control transfer as a potential source of value gains to target shareholders. Accordingly, the *"monitoring hypothesis" (or "control transfer hypothesis")* states that block purchases increase the probability of control transfers, which is expected to increase the target firm's management efficiency and thus future performance. Supporting the monitoring hypothesis, Holderness and Sheehan (1985) and Barclay and Holderness (1991) find that block purchases are typically followed by abnormal stock price appreciations and also increased management turnover for both purchases by "corporate raiders" and negotiated block trades, respectively.

Finally, the "*undervaluation hypothesis*" states that block purchases are generally attempted by investors, who either possess private information or superior security analysis skills, enabling them to ascertain that the target's shares are temporarily undervalued. There is, however, no robust empirical validation of this hypothesis, given the methodological problems to identify exactly a state of temporary undervaluation (Holderness and Sheehan (1985), Shome and Singh (1995)).

Since the mid 1990s, empirical evidence on the wealth effects of block purchases has focused increasingly on cross-sectional relationships between the observed share price reactions and block- or firm-specific characteristics. With regard to block-specific characteristics, especially the identity and intention of the acquirer has drawn attention. Shome and Singh (1995) document significantly higher abnormal returns to target shareholders if the acquirer of the block is either a corporation or an institutional investor. They attribute this finding to increased market power and future synergies and to efficient-monitoring, respectively. Distinguishing between activist, strategic and financial blocks, Bethel, Liebeskind and Opler (1998) document significant abnormal returns for target shareholders upon the announcement of block purchases by activist investors. In contrast, they only find marginally positive and slightly negative abnormal returns for financial and strategic blocks, respectively.

Recent studies also take into account the interaction between block- and target-specific characteristics. For example, Akhigbe, Madura and Spencer (2004) and Park, Selvili and Song (2008) document a significant impact of control related firm-specific characteristics. Basing their argumentation on the monitoring hypothesis, they state that the incremental benefit from an additional outside shareholder significantly depends on the target firms' existing internal and external monitoring mechanisms such as managerial ownership or leverage.

Whilst there has been considerable empirical support for positive wealth effects in the US, evidence on the impact of block purchases in European economies is sparse. Only few studies explicitly examine the capital market reaction to the announcement of block purchases in this context. Banerjee, Leleux and Vermaelen (1997) analyze the effects of non-controlling stake purchases for a sample of 122 French listed companies by holding and non-holding firms. Stake purchases by non-holding companies generate significant abnormal returns whereas similar operations by holding companies do not affect target value significantly. This result suggests that large blockholders *per se* do not guarantee effective monitoring, supporting the above US evidence on the influence of blockholder identity. Croci (2007) analyses 136 block purchases by 15 well-known corporate raiders (e.g. Guy Wyser-Pratte) in Europe between 1990 and 2001. He documents a positive market reaction to the first public announcement for

the entire European sample, supporting the US evidence on positive wealth effects from activist block formations. Although these findings do not contradict the US evidence, they do not explicitly account for cross-sectional block- and target-specific characteristics.

However, several studies provide German evidence on the link between *existing* large blockholders and firm performance. Analyzing 715 German takeovers during 1980 and 1995, Boehmer (2000) shows that neither the bidder's ownership structure nor the bidder's ownership identity have an impact on the economic value of the transactions. Given his initial hypothesis that effective monitoring by large blockholders should lead to value enhancing transactions, he concludes that high concentrated ownership per se only has a modest cross-sectional effect on German firms. Accordingly, Franks and Mayer (2001) show that *existing* large shareholdings are not important in explaining differences in management disciplining for a sample of poorly performing German firms. Dherment-Ferere, Köke and Renneboog (2004), who use large panels for Belgian, French, German and UK firms, confirm this result. Neither existing blockholders nor creditors play an active role in disciplining management in poorly performing German firms. However, block purchases, i.e. the formations of *new* large blockholders, may have a monitoring role in Germany.

To sum up, there is no consistent empirical evidence on capital market reaction on the announcement of block purchases in Germany or other comparable European governance systems. A clarification of the value consequences of block purchases in this context is needed.

3. Data and Methodology

3.1 Minority block purchases

Relevant block purchases were identified using the SDC/Thomson One Banker Deals database. The initial sample comprises all 12.328 completed M&A transactions with German targets from 1997-2007. We then use 9 criteria to further specify the sample: (1) The acquired block size is 5% to 49.9%; (2) The initial ownership of the block acquirer is 0%; (3) the target is no financial services firm; (4) the target is a public company and daily stock prices for the period t_{-220} to t_{+20} are available; (5) de-facto minority acquisition (no indirect formation of majority control blocks); (6) acquisition by outside investor; (7) identity of acquirer and specific size of acquired stake known (in % of voting stock); (8) accounting data and consistent ownership information available; (9) no material confounding news announcements within the 10 days around the announcement day t_0.

Following Choi (1991), we define outside minority blocks as investors who own more than 5% but less than 50% of the target's firm voting stock after the purchase (criterion (1)). As we are only interested in the formation of *new* outside blocks, we require the initial ownership to be 0% (criterion 2). We further exclude financial services firms (criterion (3)) to guarantee the comparability of accounting data across the sample companies. Using criterion (4), we only include companies with sufficient return data for the estimation of the market model parameters. Applying criteria (1) to (4), we derive 218 transactions. As we are only interested in de-facto

Table 1: Sample Selection

This table shows the total number of completed M&A transactions with German target over the 10 year period from 1997 to 2007 initially obtained from the SDC/Thomson One Banker Deals database and the number of transactions included after the application of defined selection criteria (1) to (9).

	Number	% of all reported transactions	% of initial minority block purchases
M&A transactions with German target (1997-2007)	12.328	100%	-
Screened after criteria (1) and (2)	1.252	10.2%	100.0%
Screened after criterion (3)	1.134	9.2%	90.6%
Screened after criterion (4)	218	1.8%	17.4%
Screened after criteria (5) , (6) and (7)	144	1.2%	11.5%
Screened after criterion (8)	100	0.8%	8.0%
Screened after criterion (9)	85	0.7%	6.8%

Minority block purchases by *outside* investors, we apply criteria (5) and (6) to control for minority purchases that lead to de-facto control blocks (e.g. if the acquirer was holding additional stock options prior to the reported minority block purchase) and for minority block purchases of insiders or affiliated companies. The control for the formation of de-facto control blocks is particularly important, since private benefits of control and thus the potential of minority shareholder expropriation are relatively high in Germany (Nenova (2003), Dyck and Zingales (2004)). The inclusion of acquisitions of de-facto majority control would probably lead to biased results. Hence, we use the Factiva news database and ownership information from Hoppenstedt Börsenführer[3] and the BaFin database on holdings of voting rights ("Stimmrechtsdatenbank") [4] to identify de-facto acquisitions of majority control as well as block purchases by insiders. Applying criterion (7), we only include those deals where the identity of the acquirer and the exact size of the acquired block is known.

The exact identity of the investor is important for the further cross-sectional analysis of abnormal returns. For the same reason, we are also interested in the exact size of the acquired stake by investor. Thus, we have to exclude most consortial block acquisitions, as the acquired stake size is generally reported as a total and not by acquiring party. Criterion (8) ensures that we can test hypotheses with regard to the firm-specific financial performance and ownership structure. We obtain accounting data from Thomson's Worldscope database and ownership information for the quarter before and after the block purchase from Hoppenstedt Börsenführer, BaFin Stimmrechtsdatenbank and the ownership module of Thomson One Banker. Combined, these sources offer a fairly precise picture of the target's ownership structure in the quarter prior to the transaction. Finally we control for material events such as M&A transactions or earnings surprises (criterion (9)) within the 10 days around the announcement of the block purchase at t_0 in order to isolate the economic effect of the transaction. Our final sample contains 85 transactions that fulfill all of the above criteria.

Block characteristics

When examining the wealth effect of new block formations for target shareholders, one has to take into account that the explanation of the effect could be a distribution of both, block characteristics and target specific factors. With regard to block characteristics, several studies show that there are significant differences between the various types outside blockholders, especially among institutional investors (e.g. Gaspara, Massa and Matos (2005), Cronqvist and Fahlenbrach (2007)). Hence, the use of a formal classification scheme for the type of outside investor does not seem appropriate to capture the effect of the underlying economic intention of the individual block purchase.5 For example, a non-financial company may on the one hand build up a minority position in another non-financial company with the intention to found or to further strengthen a strategic collaboration. On the other hand, the company may also regard the investment as purely financial and not even intend any business affiliation

with the target. Taking into account this differentiation, we follow Bethel, Liebeskind and Opler (1998) who distinguish between three types of outside block purchases according to their inherent intention: (1) activist blocks, (2) strategic blocks and (3) financial blocks. They define activist block purchases as those made by investors that are known for activist policies in the past and those with announced intention to influence corporate policy. Block acquisitions that are made by other companies and that are unopposed by management are considered strategic. Financial block purchases are those made by banks, pension funds, money managers, and individuals who do not act as an activist investor.

Following this definition, we require for a block to be considered as an activist that the acquirer explicitly states that he will attempt to actively influence the management of the firm in order to increase firm value or to be known for activist policies in the past.[6] We expect the wealth effect of activist blocks to be higher than that of financial blocks.

With regard to strategic block purchases, Chan et al. (1997) show a positive market reaction to announcements of both horizontal and non-horizontal strategic alliances, even when there is no equity participation. Allen and Phillips (2000) show that block purchases that are accompanied by strategic agreements and alliances result in significantly larger excess stock returns to target shareholders when compared to block purchases by companies that are not associated with strategic intentions. Hence, we further narrow our definition and consider only those blocks as strategic where either the acquirer or the target management explicitly states that the deal rational is strategic. In turn, the block purchases by corporations that do not have a strategic intent are classified as financial block purchases in our sample. In order to systematically classify the block purchases, we screen all news announcements around the block purchase in the Factiva database for relevant information and classify the transactions accordingly. Apart from the type of intention, the size of the acquired block is likely to affect potential monitoring activities by the partial acquirer. Blockholders owning large stakes are more likely to monitor management actions since they face a liquidity problem (Maug (1998)). Furthermore, the likelihood that the benefit of monitoring exceeds the cost increases with the size of the blockholding (Park, Selvili and Song (2008)). Consequently, we include into our sample the proportion of target voting stock acquired as a measure for block size. We further identify those block purchases made with stated takeover intention, since the observed wealth effect from these transactions might partially reflect an anticipated change in majority control. Finally, we also identify those block acquisitions that are made via private placements instead of an open market transaction or a block transfer. Several studies (e.g. Hertzel and Smith (1993), Hertzel et al. (2002), Barclay, Holderness and Sheehan (2007)) report a positive market reaction to most types of private placement announcements.[7] Hence, we control for this effect in order to correctly assess the economic impact of the corporate governance related block- and target-specific characteristics. Panel A of table 2 presents descriptive statistics on block characteristics. Financial blocks represent nearly half (48.2%) of the total transactions in our sample. Activist and strategic block purchases account for 21.2% and 30.6% of all transactions, respectively. The average size (% of voting stock) of the block purchase is 16.5%. Comparing the block parameters by block type, we find that strategic blocks are on average larger than activist and financial blocks. They also in here a takeover intention more frequently. Naturally, none of the purely financial blocks in our sample has a takeover intention.

3.3 Target characteristics

Apart from block-specific characteristics, we are interested in the ownership structure of the target company. The presence of large shareholders is generally regarded as beneficial, since their monitoring or control activities have the potential to limit agency problems. Conversely, this implies that if the target company already has one or more large blockholders

prior to the block purchase, the incremental monitoring-related benefit from an additional large blockholder is likely to diminish. Thus, we include three proxy variables into our sample to control for target ownership structure. We first count the number of ownership blocks holding at least 5% of voting stock in the quarter prior to the block purchase. We then measure ownership concentration as the total proportion of voting stock held by these large blocks. We also identify those targets that have at least one controlling shareholder holding over 25% of voting rights.[8] In this case, at least one incumbent shareholder holds a blocking minority (25-50%) or even majority control (>50%). We expect lower incremental benefits from a new large blockholder in the presence of incumbent large blockholders and thus a weaker capital market reaction. Second, we include additional financial information about the target companies that have a potential effect on the market reaction. We distinguish between factors affecting potential benefits through incremental monitoring and other factors. Considering factors that relate to the monitoring hypothesis, Helwege, Pirinsky and Stulz (2005) assume that the level of information asymmetries decreases with firm size. They argue that larger firms are more frequently monitored by analysts, institutional investors and regulators. We therefore measure the target's market capitalization prior to the block purchase (t_{-21}) as a proxy for firm size. Debt can be regarded as an external corporate governance device, since it can reduce the agency cost between management and owners (Jensen (1986)). The higher the target's level of debt prior to the block purchase, the lower we expect the incremental monitoring benefit from a new blockholder. Therefore, we include the debt ratio into our sample to proxy the extent of the monitoring effect of debt.
Unrelated to the monitoring hypothesis, stake purchases might also be perceived as a signal that the target company is undervalued (Banerjee, Leleux and Vermaelen (1997). We therefore include the market-to-book ratio to proxy target firms' valuation levels. Panel B of Table 2 summarizes target firm characteristics of the sample.

3.4 *Method of measuring abnormal returns*

To assess the value implication of the block purchase on the remaining shareholders, we use standard event study methodology. Expected returns are generated from the market model parameters, estimated with daily returns from 220 days before the block purchase announcement (t_{-220}) to 21 day before the announcement (t_{-21}). Adjusted prices (taking into account dividend payments and relevant changes to the capital structure) are used to calculate stock returns.

The CDAX9 is used as a proxy for the market returns. Abnormal returns (ARs) are calculated as the difference between actual returns and estimated returns from the market model in the event window. Following the suggestion by Harrington and Shrider (2007), we use the test statistic of Boehmer, Musumeci and Poulsen (1991) to test the significance of cumulated abnormal returns.

Table 2: Sample description of block characteristics

This table describes the data collected for the description of new block characteristics. The acquired block size is measured as the proportion of targets' common stock acquired. Takeover intention is a binary variable that takes on the value of 1 if the block purchase is made with an expressly stated takeover intention. Private placement is binary variable that takes on the value of 1 if the transaction is a private placement. The percentages for acquired block size, takeover intention and private placement represent the fraction of the total number transactions by block type (i.e. by column). Block concentration is measured as the sum of voting stock held by all blocks >5%. The number of ownership blocks represents the number of all ownership blocks >5%. Presence of controlling shareholder is a binary variable that takes on the value of 1 if the target firm has an incumbent large shareholder holding at least 25% of voting stock in the quarter prior to the transaction. Market-to-book ratio is defined as the market value of common equity to the book value of common equity at the end of the estimation period (t_{-21}). Debt ratio is defined as the as the book value of debt (Worldscope item 03255) divided by the firm value (Wordscope item 03255 + market value of equity at t_{-21}). Market value represents the market value of targets' common equity at t_{-21} .

Panel A: Sample description of block characteristics

	All blocks	Activist blocks	Strategic blocks	Financial blocks
Acquiring block type				
Number of observations	85	18	26	41
Percentage of total sample	100.0%	21.2%	30.6%	48.2%
Acquired block size by class				
5% - 15%	51.8%	61.1%	23.1%	65.9%
15% - 25%	18.8%	11.1%	19.2%	22.0%
25% - 50%	29.4%	27.8%	57.7%	12.2%
Acquired Block size (metric)				
Mean	16.5%	15.1%	23.0%	13.0%
Median	14.0%	10.0%	25.0%	10.0%
Stdev.	10.3%	10.7%	9.4%	8.7%
Takeover intention				
Number of blocks	6	2	4	0
Percentage of blocks by block type	7.1%	11.1%	15.4%	0.0%
Private placement				
Number of blocks	11	3	3	5
Percentage of blocks by block type	12.9%	16.7%	11.5%	12.2%

Panel B: Sample description of target characteristics by acquiring block type

	All blocks	Activist blocks	Strategic blocks	Financial blocks
Ownership characteristics				
Block concentration (>5% blocks)				
Mean	44.4%	42.3%	42.6%	46.5%
Median	44.3%	42.1%	38.6%	50.5%
Number of large blocks				
Mean	2.3	2.7	2.5	2.1
Median	2.0	2.5	2.0	2.0
Presence of controlling shareholder				
Number of blocks	50	9	15	26
Percentage of blocks by type	58.8%	50.0%	57.7%	63.4%
Financial characteristics				
Market-to-book ratio				
Mean	5.3	1.5	2.5	8.8
Median	1.5	1.3	1.8	1.5
Debt ratio				
Mean	36.1%	31.5%	40.5%	35.4%
Median	33.3%	23.8%	44.6%	33.3%
Market value [€ Mio.]				
Mean	797.8	332.8	118.8	1432.6
Median	86.7	212.2	52.5	112.7

4. Results

4.1 Announcement Effects

Table 3: Cumulative average abnormal target returns

This table shows the average cumulative abnormal returns for the total sample 85 minority block acquisitions and for the 3 sub-samples by acquirer category. Statistical significance at the 1%, 5%, and 10% level is denoted with ***, **, *. The statistical significance is tested using the test-statistic of Boehmer, Musumeci and Poulsen (1991) (z-statistics) and the standard t-test (t-statistics).

	Panel A: Total sample		(N=85)	Panel B: Activist blocks		(N=18)
Event time period	CAAR	t-statistics	z-statistics	CAAR	t-statistics	z-statistics
[-20;20]	10.7%	3.54***	4.42***	12.1%	2.73**	3.59***
[-10;10]	9.4%	5.59***	5.74***	11.5%	5.22***	5.81***
[-5;5]	8.7%	6.47***	6.49***	11.9%	5.94***	6.69***
[-2;2]	8.1%	6.61***	6.80***	11.2%	7.33***	6.23***
[-1;1]	8.0%	6.52***	7.56***	11.8%	6.16***	6.55***
[-1;0]	5.3%	5.54***	5.97***	6.2%	3.39***	3.18***
	Panel C: Strategic blocks		(N=26)	Panel D: Financial blocks		(N=41)
Event time period	CAAR	t-statistics	z-statistics	CAAR	t-statistics	z-statistics
[-20;20]	13.1%	2.39**	2.75**	8.6%	1.75*	1.94*
[-10;10]	15.7%	4.45***	5.21***	4.4%	1.95*	1.50
[-5;5]	12.7%	5.12***	5.79***	4.8%	2.40**	1.94*
[-2;2]	12.3%	4.34***	4.89***	4.2%	2.79***	2.63**
[-1;1]	11.3%	4.41***	5.43***	4.2%	2.63**	3.01***
[-1;0]	8.1%	3.69***	3.99***	3.2%	2.86***	3.33***

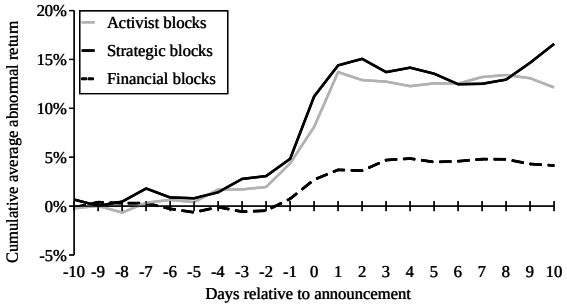

Figure 1: Cumulative average abnormal returns

Table 3 documents the average cumulative abnormal returns and test statistics for the total sample (panel A) and for the three sub samples by block type (panel B, C and D). The results from panel A suggests that purchases of minority blocks lead to a statistically significant positive market reactions. The average abnormal return amounts to 8.0% (z = 7.56) in the event window [-1, 1].

Panel B and C show that both activist and strategic block purchases lead to statistically positive announcement effects. Average cumulative abnormal returns in the event window [-1;1] amount to 11.8% (z = 6.55) for activist blocks. We also find strategic block purchases to create significant value to target shareholders. The average cumulative abnormal return of transactions with strategic intend is 11.3% (z = 5.43) in the event window [-1;1]. Panel D shows that the market also reacts positively to financial block purchases. However, the wealth

effect is significantly lower than for activist and strategic blocks. Figure I illustrates a dynamic view on the development of the cumulative abnormal returns in the [-10; 10] event window.[10] The results show that there is a run-up in stock prices before the event. here are two possible explanations for this observation. First, a large amount of the block purchases is carried out through open market purchases, and it can take months to accumulate a stake for which an official notification is required. As a consequence, the market may already react to increased buy-side pressure before an official announcement of a new block formation.

Second, there is a potential lag of 9 days between the actual block purchase and the mandatory public announcement.[11]

Hence, it cannot be ruled out that information on the transaction is already known to individual market participants prior to the official announcement date. Summing up, our approach to examine minority block purchase in Germany reveals a value creation to targets' shareholders for all minority block types. At the first glance, the univariate analysis also seems to confirm our initial hypothesis those activist blocks and strategic blocks hold more potential for value creation than financial blocks. However, the sample statistics presented in table 2 suggest systematic differences in block and target company characteristics. In order to

Table 5: Determinants of cumulative average abnormal target returns

This table shows estimation results for OLS-regression models with the cumulative abnormal return for the [-1;1] interval as the dependent variable. Activist block, strategic block, takeover intention, private placement and controlling shareholder are binary variables that take on the value 1 if the attribute is observable in the given transaction. t-values are in brackets. Statistical significance at the 1%, 5%, and the 10% level is denoted with ***, **, *. All test statistics are computed using a heteroskedasticity-consistent covariance matrix (White (1980)).

	Model 1	Model 2	Model 3	Model 4
Intercept	0.134	0.122	0.129	0.112
	(2.189)	(2.077)	(2.265)	(1.673)
Block characteristics				
Activist block		0.059	0.067	0.059
		(2.18)**	(2.513)**	(2.166)**
Strategic block		0.016	0.024	0.018
		(0.345)	(0.566)	(0.416)
Block size	0.003	0.002	0.002	0.002
	(1.971)*	(0.961)	(0.881)	(0.94)
Takeover intention		0.042	0.053	0.037
		(0.984)	(1.155)	(0.802)
Private placement	-0.034	-0.035	-0.027	-0.029
	(-1.001)	(-1.026)	(-0.796)	(-0.858)
Target ownership characteristics				
Concentration of existing block	-0.001	-0.001		
	(-1.986)*	(-1.572)		
Number of existing blocks			-0.012	
			(-1.795)*	
Presence of controlling shareholder				-0.023
				(-0.994)
Target financial characteristics				
Logarithm of market value	-0.016	-0.016	-0.017	-0.017
	(-1.932)*	(-1.914)*	(-1.969)*	(-1.885)*
Debt ratio	0.031	0.042	0.024	0.039
	(0.653)	(0.927)	(0.595)	(0.902)
Market-to-book ratio	-0.001	-0.001	-0.001	-0.001
	(-6.622)***	(-3.155)***	(-3.057)***	(-3.042)***
N	85	85	85	85
Adj. R^2	14.9%	17.5%	18.0%	16.4%
F-statistic	3.454***	2.974***	3.056***	2.831***

control for these factors, we conduct multivariate analyses in the following section.

4.2 Determinants of abnormal returns

We design four regression models to determine the drivers of the observed wealth effects to target shareholders. The abnormal return in the period [-1; 1] serves as dependent

variable.[12] Table 4 summarizes design and results for the four regression models. All test statistics are computed using White's heteroskedasticity-consistent covariance matrix (White (1980)).

The variables included into our model are structured following our initial hypotheses on the factors that potentially explain the observed wealth effect.

We include five variables to control for block-specific "takeover intention" and "private placement" is each dummy variables taking on the value 1 if the attribute is true. "Block size" is a metric variable that measures the size of the new block as the proportion of voting stock acquired. We also proxy target company characteristics via a predefined set of variables and distinguish between target ownership characteristics and target financial characteristics. A total of three variables is used to describe the ownership structure of the target prior to the acquisition. "Concentration of existing blocks" equals the combined share of voting rights of all blocks bigger than or equal to 5%. "Number of blocks" represents the number of all blocks larger than 5%. The dummy variable "presence of controlling shareholder" takes on the value of 1 if the target company has a controlling blockholder (>25% voting rights) in the quarter prior to the block purchase. With regard to the target's financial characteristics, we include three variables ("logarithm of market value", "debt ratio", and "market-to-book ratio").

In order to shed light on the drivers of the wealth effect to target shareholders, we first design a model that does not control for the intentions of the block acquirer. Hence, we omit the dummy variables "activist block", "strategic block" and "takeover intention" from the estimation model 1. We then include these variables again in models 2 to 4, where we explicitly control for the type of blockholder and takeover intention. Models 2 to 4 only differ in the variables used to control for the targets' ownership structure prior to the acquisition, since the underlying economic hypotheses for each variable differ from each other.

We refrain from jointly using the variables "concentration of existing blocks", "number of existing blocks" and "presence of controlling shareholder" in one model to avoid a multicollinearity problem. Comparing model 1 to the other models, we see that the inclusion of block intention significantly influences the regression results. The coefficients of the variables "block size" and "concentration of existing blocks" still have the expected sign, but are not statistically significant anymore. In contrast, the coefficient of the activist dummy is positive and highly significant for models 2, 3 and 4, suggesting that activist blocks have a greater monitoring potential than purely financial blocks.

This result supports the findings of Bethel, Liebeskind and Opler (1998) and Park, Selvili and Song (2008). However, it may also be the outcome of systematic differences in target selection, Cronqvist and Fahlenbrach (2007) provide evidence that block purchases by activists can be rather associated with influence on corporate policy and firm performance than with a selection explanation. In line with the US evidence we interpret our findings in a way that the positive abnormal returns around activist block purchases in our sample stem from positive capital market expectations with regard to beneficial monitoring activities.

Inconsistent with the univariate results, the regression models show that strategic blocks do not have a significant positive effect when abnormal returns are controlled for block and target characteristics. Block size and takeover intention both have a positive coefficient as expected, but are not statistically significant. Consistent with model 1, the dummy variable for private placement has a negative and insignificant coefficient.

Considering the ownership structure of the target prior to the block purchase, we find negative coefficients for all proxy variables as initially hypothesized. However, only the number of blocks in model 2 shows a statistical significance. If the capital market valued either ownership concentration or the presence of large blockholders, we would expect an immediate market reaction to an announcement of any substantial change affecting these factors. This result indirectly supports recent evidence by Beiner et al. (2006) who show that

neither the presence of a controlling shareholder nor large blockholders have a significant valuation impact. The finding is also consistent with Dherment-Ferere, Köke, and Renneboog (2004) who report that large shareholders do not play a significant role in disciplining underperforming management.

Regarding targets' financial characteristics, the debt ratio has no significant impact on the market reaction. Although we would have expected a negative correlation between leverage according our initial hypothesis, this result supports Dherment-Ferere, Köke, and Renneboog (2004) who cannot find robust evidence of creditor monitoring in German companies with high leverage. The coefficients for firm size and market-to-book ratio are negative and significant also when we control for block intention. With regard to firm size, this result suggests that the incremental benefit from new outside blockholders in large firms is likely to diminish, given the increased extend of external monitoring by analysts, regulatory authorities and other parties.

Our finding that abnormal returns to target firms' shareholders tend to be higher for companies with low valuation levels (reflected by a low market-to-book ratio) may be subject to two different effects. On the one hand, the capital market might perceive a block purchase in a target with a low market-to-book ratio as an undervaluation signal. On the other hand, one can interpret this result as an indication for decreasing incremental monitoring benefits from new large blockholders in the presence of high growth opportunities. As the discretion on the part of management may be higher in high growth companies (Helwege, Pirinsky and Stulz (2005)), external monitoring by large outside blockholders might become inefficient.

5. Conclusions and Outlook

In this study we investigate share price reactions to the formation of new minority outside blocks for a sample of 85 German block purchases between 1997 and 2007.

In the first part, we document a significant wealth creation for target companies, regardless of the economic intention of the acquirer. Most importantly, this finding is consistent with the US evidence, despite the structural differences initially discussed. Given the low takeover activity in Germany, we attribute the observed wealth creation to either the monitoring or the undervaluation hypothesis. We then analyze whether the market reacts differently to block purchases based on block and target characteristics. We can only confirm a significant positive relationship between activist block purchases and abnormal returns when we jointly control for other block- and target-specific characteristics. However, we cannot clearly distinguish if the driver of this effect is the market's perception of a superior monitoring ability by activist investors or rather superior stock picking skills. Considering target characteristics, our results also suggest that existing target ownership structure has at most a marginal impact on the amplitude of the market reaction. We interpret this finding as a dynamic (i.e. based on the observed capital market reaction) confirmation of the recent, mostly static (i.e. based on regression analysis of accounting measures) evidence that there is no significant relation between ownership concentration and large blockholders on the one hand and firm value (Beiner et al. (2006)) or effective monitoring (Dherment-Ferere, Köke and Renneboog (2004)) on the other hand.

Validations of this interpretation in further detail should be a fruitful topic for future research.

Footnotes

1. A large shareholder (blockholder) is generally defined as an entity that owns at least 5% of a firm's outstanding shares.
2. Faccio and Stolin (2006) show that bidding firms may use partial acquisitions (acquisitions of majority control but not of 100% control) to expropriate the target firms' minority shareholders.

Accordingly, Martynova and Renneboog (2006) document that the abnormal returns to the announcements of partial acquisitions to target shareholders are substantially lower than for full acquisitions.

3. The Hoppenstedt Börsenführer is a quartely stock guide that contains profiles and financial data for all listed German companies.
4. The German Federal Financial Supervisory Authority (BaFin) has drawn up a consolidated overview of the holdings of voting rights in German companies listed on the first segment of the German stock exchanges, given the publication requirements set out in the Securities Trading Act (WpHG). This database on holdings of voting rights is based exclusively on data gathered from the statutory publications made in supra-regional official stock exchange gazettes (e.g. Börsen-Zeitung). For the purpose of our study, the BaFin has kindly provided us with historical ownership information from this database.
5. We would regard as a formal classification scheme the economic sector based classification of the German Central Bank (based on the European System of Accounts (ESA 95)).
6. In our sample, this category includes individual activist investors (e.g. Guy Wyser-Pratte) as well as institutional activist investors.
7. There are three general hypotheses that explain the value effect of private placements: monitoring, value certification and management entrenchment. For a detailed theoretical description and empirical analysis see Barclay, Holderness and Sheehan (2007).
8. Although German law basically allows an investor owning more than 50% of all shares to appoint management, owning more than 25% of the voting stock grants the right to veto decisions.
9. The CDAX (or composite DAX) is a German all-share index introduced in 1993 that covers all German shares that are admitted to the Prime Standard and General Standard segments. Therefore, the index reflects the performance of the overall German equity market and is thus well suited for the purpose of this study.
10. We refrain from analyzing the development of cumulative abnormal returns for the [-20;20] event window, since we only controlled for interfering material events in the 10 days before and after the announcement. Hence, the development of cumulative average abnormal returns over the longer period is likely to be affected by unrelated corporate events.
11. §21 AktG (corporate law) requires that target management must be notified immediately if another corporation's engagement exceeds 25% or 50% of the target's voting rights. Since we do not want to address the complex process of voting rights disclosure in this context, we refer to Becht and Böhmer (2003) who discuss several transparency issues that arise from the current legal provisions covering the disclosure of control rights.
12. Using the abnormal return over the [-10; 10] event window as the dependent variable leads to the same qualitative results

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