Equities

Do Appearances Matter?

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Corporate mergers and other major investment decisions are often conditioned on their being accretive to a firm's future earnings-per-share ("EPS"). This is based on a widespread assumption by corporate managers that transactions that result in changes in EPS have real effects on stock prices, whether or not these changes reflect differences in future cash flows.

This paper addresses this notion by reviewing a sample of 224 mergers and acquisitions completed between 1975 and 1994 to see whether there is any relation between EPS accretion and both announcement and long-term abnormal returns for acquiring firms. Using a measure of EPS accretion designed to exclude the real effects of any potential synergies from the acquisition, the data suggest that EPS accretion has statistically significant positive effect, both at announcement and for the period up to 18 months following completion of the deal.

This effect is robust across different measures of abnormal performance, and after controlling for other factors known to affect the long-term performance of acquiring firms. However, the estimated effect is one order of magnitude smaller than implied by practitioners' views, suggesting that the concerns expressed by managers are largely exaggerated. Also, the magnitude of the effect is lower for firms with a larger base of institutional investors, suggesting that less-sophisticated investors are more likely to be misled by cosmetic EPS effects. In particular, the evidence suggests that, except for the most dilutive transactions, it makes little sense for managers to expend time, effort and resources in structuring deals to improve their effect on reported EPS.

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