Long-term consequences of Short-term Incentives

A Edmans, V Fang, A Huang

Mireia Gine
IESE Business School

How serious is short-termism?

Ho: deliver immediate returns to shareholders while underinvesting in

innovation

skilled workforces

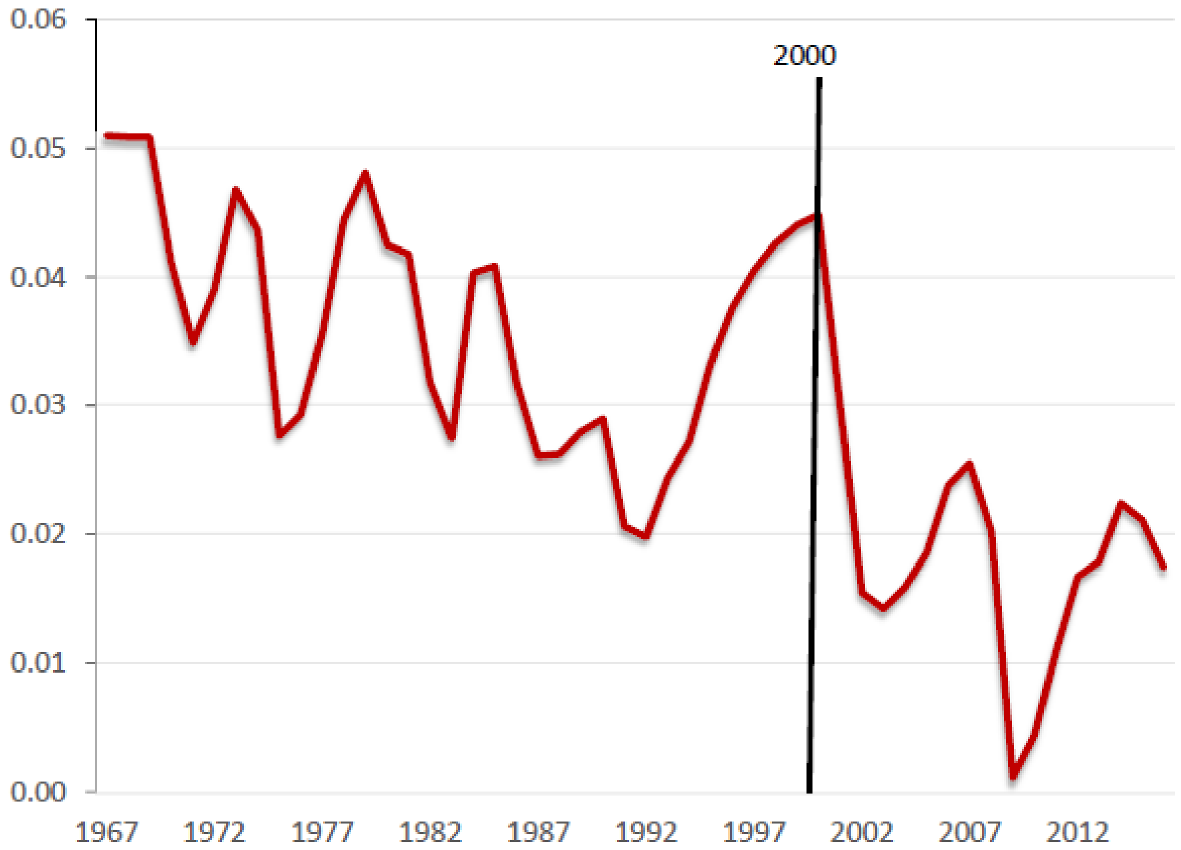
capital expenditures necessary to sustain long-term growth

Are there strong incentives or pressure to succumb to short-termism?

Are corporations not investing enough for the long term precisely because of it?

A Macro Trend: Decline in Capital Formation

Net Investment to Capital Stock Ratio



Investment-less Growth, Gutierrez and Philippon 2016

Explanations of Investment Gap

Investment-less growth, Gutierrez and Philippon 2016, 2017

1. Decrease in Competition
2. Increase in Intangibles
3. Governance & Short-termism

Short-term pressure

- Meeting Earnings forecast
  - Managers willing to trade off investments and employment for repurchases that allow them to meet analyst EPS forecast (Almeida, Fos, Kronlund 2016)
- Investor Horizon
  - Positive relation between the presence of ST investors and the use of share buybacks (Gaspar et. al. 2004)
  - Activist Hedge Funds (Brav, Jiang, Bebchuk, 2017, 2018)
  - Firms with more short-term investors adapt better to the new competitive environment (Giannetti and You 2018)
- Vesting options in compensation contracts
  - Vesting quarter associated w/ reduced investment (Edmans et. al. 2017)
  - Change in regulation accelerated vesting under FAS123R induces reduction in investment, increase in equity sales (Ladika & Saunter 2016)

Where are the long-term studies?

Very few due to double challenge of Identification beyond the ST and measuring long-term

- Hedge Fund activism has positive productivity effects using plant-level information (Brav, Jiang, Kim 2015)
- EPS-driven repurchases lead to a reduction in long-term productivity (Almeida, Ersahin, Fos, Irani, Kronlund 2019)

- Growth model based on firm-level decisions to meet short-term profit targets, estimate how much ST lowers growth considerably. (Terry 2017 R&R Econometrica)

Overview

Solve the two main challenges

- Vesting is used a main proxy for short-term incentives
  - Vesting is exogenous i.e independent of cashflows
- Focus on two corporate actions that are **useful to measure effects** in the long term using BHAR
  - Vesting-driven repurchases
  - Vesting-driven M&A announcements

Key Results

- **R1:** A one standard deviation increase in vesting equity
  - 1.2% increase in a firm's likelihood to repurchase shares
  - 0.61% higher return over Q1&2; then negative BHAR
- **R2:** A one standard deviation increase in vesting equity
  - 0.6% increase in a firm's likelihood to announce M&A
  - 1.47% higher return over Q1&Q2; then negative BHAR
- **R3:** Vesting equity is associated with M&A goodwill impairment
- **R4:** CEOs concentrate their equity sales in a short window after announcing repurchases and immediately after an M&A announcement. → this is very important for the story

Comment 1: What is BHAR capturing?

- Happy about the ST: Quarter Vesting-driven Repurchases

What is BHAR capturing?

- Vesting is associated with reduced investment, changes in analysts forecast, positive guidance, product market reputation, M&A activity.

- Could the BHAR not only capture myopic repurchase but other actions beyond the repurchase decision as well?
- Interpretation behind the negative returns
  - If vesting modifies investments this could be first order
    - account for Investment story in BHAR

Comment II: M&A deals

- Large literature on announcement effects of M&A and there is a wealth of papers on the negative CARs for Acquirer

- M&A is a major decision. How are these deals? Selection or purely timing
  - How are they structured? Paying with cash; Smaller deals? Privately owned firms? Within the same industry, easier to justify synergies?
  - How are the target premiums to the target

Comment II: Bad deals

- With Vesting, am I doing better or worse M&A deals?
  - The data shows that deals are perceived as good in the ST but later on are revealed as value destroying. The market is fooled. The company needs to do an impairment loss adjustment.

  - Alt: With Vesting I should be inclined to do good M&A to ensure that the market reaction is positive.
  - And then the long term effect is capture by other actions, again investment, poor quality products …
  - Investment decrease but M&A increases

- Big challenge to measure the long-term effects from M&A decision only Malmendier, Moretti and Peters 2016

Comment III: Board quality

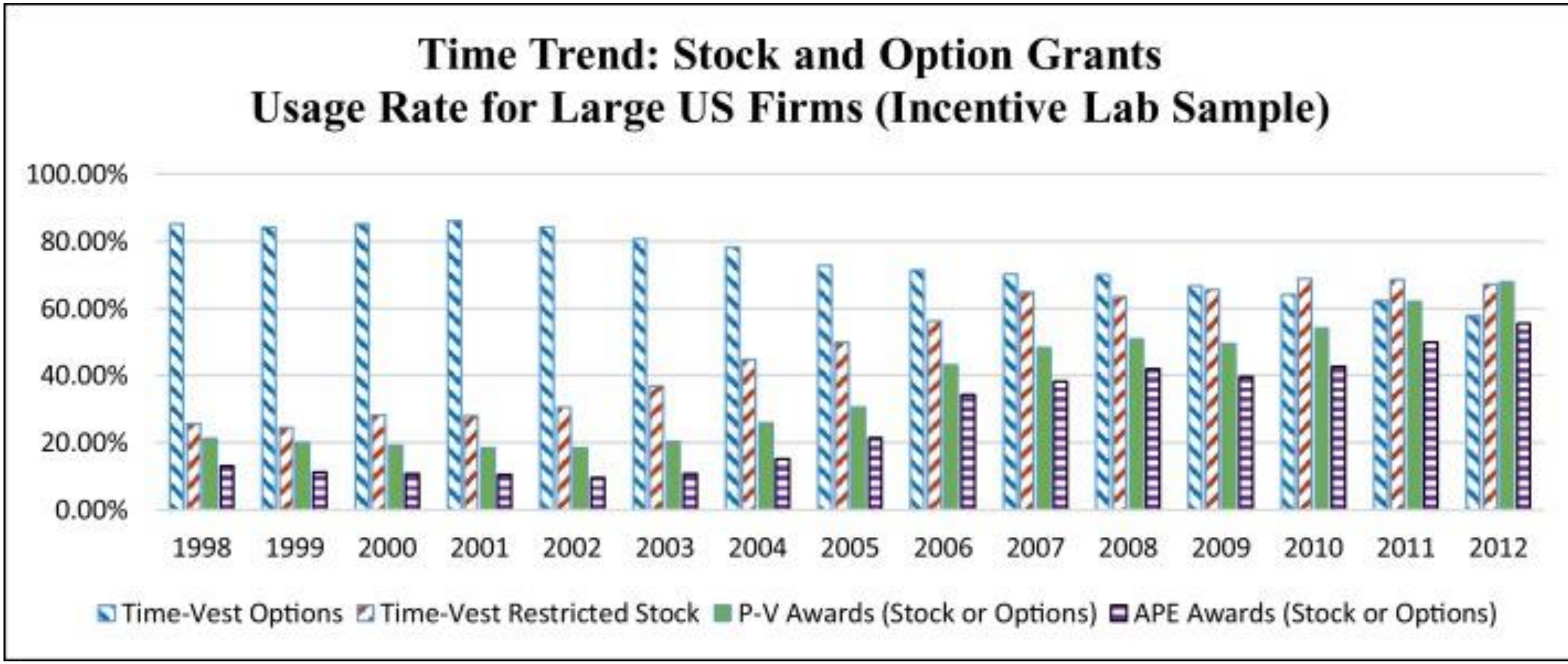
- Address how can the board miss this
  - Why wouldn´t the board anticipate it?
  - Could you control for Governance quality?
  - Does this happens with an independent and attentive board / weak board.

Comment IV: Ceo impact

- Impact on the CEO wealth of this short-term behaviour.
- Is the CEO hurting himself? In the long term the CEO still has a lot to loose.
- Two types of time-vesting schedule:
  - Cliff vesting – vesting in one period, executive must stay entire for entire period.
  - Graded vesting – in increments over the vesting period, annually. Allows for longer vesting periods since executives receive a portion. 78% of equity awards are graded, Equilar

- Incorporate a short discussion on the validity of Vesting
  - Why there is no endogeneity: design contracts where the vesting mimics the cashflow of projects?

Comment V: Time-vesting vs Performace-vesting



Conclusions

Important & challenging question

1. What does BHAR capture? Vesting effect not on myopic repurchases but efficient repuchases with other corporate policies adjustment due to Vesting.
2. Investments declines but M&A increases → so maybe capex are decreasing even more than documented before…
3. How is the board missing this?
4. Could this specific form of short-termism be on its way to being solved via performace based options?