INFORMATION SOURCES FOR INVESTORS' VALUATION OF STRATEGIC ALLIANCES

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BASIC RESEARCH QUESTION

What information sources are useful for investors' valuation of strategic alliances?

KEY PAPER(S)

Chan, S. H., Kensinger, J. W., Keown, A. J., & Martin, J. D. (1997). Do strategic Alliances create value? *Journal of Financial Economics*, 46, 199-221.

Adams, R.B. (2000). The dual role of corporate boards as advisors and monitors of management: theory and evidence. Working paper, Federal Reserve Bank of New York.

MOTIVATION/ PUZZLE

The availability of information to evaluate the probability of future net benefits from strategic alliance investments is a fundamental issue for investors, particularly given alliances are intrinsic to a firm's competitive strategy. Despite the prevalence of alliances and their promising value creation prospects, alliances are vulnerable to poor performance and failure. However, there is limited availability of information for investors' valuation of alliances since there is not and cannot be (due to the lack of history) a lot of financial reporting on alliances at their inception. Evidence from previous studies suggests that information regarding various firm level and alliance specific factors may be useful for investors to assess the value creation prospects of alliances. In addition, directors' capability and incentives in advising and monitoring the investment in strategic alliances may be critical to the success of strategic alliances as with all the other investments undertaken by firms. Hence, even if some alliances may not be successful, do investors see the potential value of alliances in some announcement contexts and if so when?

THREE CORE ASPECTS OF ANY EMPIRICAL RESEARCH PROJECT

THE IDEA

It is expected that investors' valuation of alliances is associated with a combination of firm-level and alliance specific factors. Specifically, firm level factors such as the firm's alliance experience as well as active growth life cycle stage may signal the firm's capability to extract value from strategic alliances. In addition, alliance specific factors such as the type of activity and governance form may help investors to assess the value creation prospects of strategic alliances.

Investors' valuation of alliances is also expected to vary with the different demand for the board's advisory and monitoring expertise to support different forms of alliances. Specifically, market reactions to the alliance announcements may vary with the form of the alliance relative to the independence of the board of directors and the busyness of the directors, as reflections of the different demand for monitoring versus specific advisory expertise across different alliances. Specific advisory expertise relating to accounting, law, and technological knowledge is also expected to be more important for particular types of alliances compared to other types of alliances.

This study also takes into account the firm's pre-announcement information environment that may improve the efficiency of investors' valuation of alliances.

THE DATA

1. Country/setting: US setting because it provides a large sample of alliance announcements and good coverage across a range of industries.
2. Sample: US listed firms with alliance announcements.
3. Sample period: 2003-2013. The Sarbanes-Oxley Act (SOX) which came into operation in 2002 has significantly affected firms' risk-taking and disclosure behaviour and was therefore in force over the entire sample period.
4. Data structure: unbalanced panel data.
5. Data Sources: Securities Data Corporation Platinum (SDC) database for alliance data, the Center for Research in Security Prices (CRSP) database for stock return information, Compustat and the Institutional Brokers Estimate System (IBES) databases for firms' financial information and analyst forecast data, BoardEx for board of directors data.

THE TOOLS

The event study methodology and regression analysis is employed to test the hypotheses relating to the stock market reaction to the alliance announcements. The baseline event window includes the three days before and the three days after the event day to allow for leakage of information before the announcement or for a slow market response to the announcement. Alternative event windows are also employed comprising three days (day -1 to +1) and five days (day -2 to +2). The seven-day (days -3 to +3) abnormal return for each security is measured using the deviation of the security's realised return over the seven-day period from the expected return generated by the market model (Fama et al., 1969). Market model parameters are estimated over a period from 180 to 10 days before the announcement. The Standard & Poor's 500 index (S&P 500) is used to measure the market return.

TWO KEY QUESTIONS

WHAT'S NEW

The main aspect of novelty to this study as compared to previous studies is the data. Previous studies mainly focus on shared equity alliances undertaking specific type of activities namely technology development or manufacturing activities in the late 1980s and early 1990s but strategic alliances have become more common with more complex structure. This study substantially extends the range of alliance governance structure and type of activities analysed compared to prior studies. Moreover, this study also utilises state of the art statistical modelling to ensure high quality results.

SO WHAT

There is some concern about an adverse selection problem in the capital market due to information asymmetry relating to the firm's strategy (Myers and Majluf, 1984; Benner and Zenger, 2015). Well-intentioned managers make strategic choices they believe will increase firm value; however, they face difficulties informing investors about the value of their choices. Potentially valuable strategies may be more complex or long term and, hence, more difficult for investors to evaluate, consequently putting pressure on managers to adopt strategies that are more familiar to capital market participants, but perhaps less valuable for the firm. Thus, understanding key information sources and underlying factors for investors' valuation of alliances may shed light on the role of mandatory and voluntary disclosures in reducing information asymmetry relating to the firm's strategy.

ONE BOTTOM LINE

THE CONTRIBUTION

The primary expected contribution is to understand key information sources and the underlying factors that inform investors' valuation of alliances at the formation stage, and use these insights to further our knowledge of the role that mandatory and voluntary external reporting disclosure might play in information efficiency around these events.

OTHER CONSIDERATIONS

"Risk" assessment: "No result" risk: low; "Competitor" risk: moderate; "Obsolescence" risk: low.