. THE IMPACT OF SUCCESSOR CHARACTERISTIC ON STOCK RETURNS

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Abstract

To find out effects of top managers' turnover on stock returns, this study utilizes the market model to analyze the wealth effects of top executive turnover in Taiwanese listed electronic companies. Results in this study show that in the case of insider successor condition, it supports the ritual scapegoating theory for top executives (R&D Managers and CEOs). The results of chairmans are more consistent with vicious cycle hypothesis. On the other hand, the case of outsider successor condition shows that the ritual scapegoating theory is more suitable for CEOs and chairmans. The common sense theory is more valid when the new outsider successors are R&D Managers. The results of this study show that selecting the chairman of board is a critical decision when new successors of chairman of board are insider. The results also show the turnovers of R&D managers have positive stock reactions when new successors are outsiders.

Keywords: Top executive turnover, Stock returns, Market model, Successor characteristic

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1. Introduction

Managers in corporate top hierarchies are specifically related to the firm's performance. When the performance is not accepted by the firm's board of directors and shareholders, management turnover will take place. It will further have the impact on the firm's performance.

Previous researches focus on the turnover of the chairman and CEO. However, R&D is an important key factor for the firms in the high-tech industry. R&D manager is related to develop and hold key technology. Therefore, R&D manager turnover will have significant impact on the firm's performance. In this study, we focus on the impact of manager turnover, especially including R&D manager, and contribute further understanding to the literature about manager turnover.

Firms often encourage morale and improve performance by the turnover of employee. The top managers are more important than any other employee. Our study investigates whether the market reactions and the content of information are different between new manager from inside and from outside.

2. Literature review

2.1 Management turnover and market reaction

Management is the core of a firm's operation. Their decision-making quality is shown in market performance. However, in the prior literature, the market reactions are mixed. Worrell et al. (1997) find that, when three top executives simultaneously change, the market reaction is negative. They also find that the degree of market reaction is positively related to the level of institutional shareholdings, and that new manager from outside can improve their market performance. Huson et al. (2001) and Parrino et al. (2002) find that the turnover of board and manager, the ownership change, and new manager coming from outside are related to the firm value. Moreover, the performance of the firms in the high competitive industry is significantly related to management turnover (DeFond and Park, 1999).

When the performance prior to management turnover is not good, market will expect that new manager will improve the firm's performance and give them positive reaction. Contrarily, when the performance prior to management turnover is good,

investor cannot confirm the persistence of the good performance and give the firm negative reaction (Friedman and Singh, 1989；Bendeck and Waller, 1999). Prior researches find that new manager coming from outside will revise more strategies and market reaction is better (Wiersema, 1992).

Mahajan and Lummer (1993) and Jens and Soren (2000) find that, when the reason of management turnover is that prior manager leave the firm or is recruited by other firm, the market reaction is negative. Miller and Chen (1994) and Reinganum (1985) find that large firms have lower possibility of management turnover than small firms, and the impact is also lower on large firms than on small firms. Harrison et al. (1988) find that larger firms have lower information asymmetry and the impact of management turnover is less significant. Hambrick and Fukutomi (1991) find that management turnover can improve the firm's market performance.

The impact of management turnover can be summed up to three hypotheses. First is *common sense hypothesis*. Based on this hypothsis, when a firm's performance is poor, the board will select manager with higher talent to replace prior manager. The firm's performance is thus improved and the stock performance rises (Guest, 1962; Davidson et al., 1990; Murphy and Zimmerman, 1993; Denis and Denis, 1995; Huson et al., 2004). Davidson et al. (1990) examine the successor coming from outside or inside and find that the firms with new manager from inside have positive abnormal returns but firms with new manager from outside do not.

Second is *vicious cycle hypothesis*. Based this hypothesis, management turnover can not only improve firm's performance but also have negative market reaction. When a firm has poor performance, management turnover will induce inside conflict and further hurt the firm (Grusky, 1963; Beatty and Zajac, 1987; Bendeck and Waller, 1999; Lausten, 2002). Beatty and Zajac (1987) find that, no matter what new manager is insider, management turnover result in negative market reaction.

Third is *ritual scapegoating hypothesis*. This hypothesis states that management turnover will not result in any market reaction. The dismissed manager is just a scapegoat (Brown, 1982; Reingaum, 1985; Kesner and Sebora, 1994; Worrell *et al.*, 1997; Nelson, 2005). Reingaum (1985) find that the announcements of manage turnover have more abnormal returns when new managers are outsiders than when new managers are insiders.

2.2 Inside successors and outside successors

Prior researches find that management turnover has different impact between inside and outside successors. Wiersema (1992) examines 146 firms and finds that outsider successors revise firms' future strategies. Pfeffer and Leblebici (1973) investigate whether the successors are from the same industry or not. Helmich and Brown (1972) investigate whether the successors are from the same cliques or not. Grusky (1963) find that the possibility of reducing performance by inside successors is lower than that by outside successors. Contrarily, ）Helmich (1974) and Helmich and Brown (1972) find that outside successors have more possibility to give firm growth. Davidson and Worrell (1990) find that management turnover by outside successors obtain positive market performance. Chung et al. (1987) find that the successors frim outside also obtain positive market performance. Beatty and Zajac (1987) find that, no matter where the successors from inside or outside, the firms' value decline.

Shen and Cannella (2003) investigate the market reaction of management turnover based on 400 large firms from Compustat in 1988. The management includes firms' presidents and CEOs, who come from inside and outside. The result shows that the inside successors have negative market reaction, but outside CEOs have positive reaction. Weisbach (1987) examines 367 publicly traded non-financial firms and find that there are negative relationship between the market reactions of management turnover and the board controlled by outsiders. Peng (2004) investigates the relationship between the outside successors of directors and ROE of China. The 1,211 sample firms are listed in the Shenzhen Stock Exchange and the Shanghai Stock Exchange between 1992 and 1996. His results are consistent with Dalton et al. (1998), i.e., outside successors and the performances of accounting and market are not significantly related. His results also show that larger and older firms employing outside managers have negative performance. It is consistent with the findings of Claessens and Djankov (1999), Hingorani, Lehn, and Makhija (1997), and Tian and Lau (2001).

Bailey and Helfat (2003) examines the firms with outside successors between 1978 and 1987 and find that outside successors are more possible to have transferable skill from the same or similar industry. ROA of firms with outside successors does not improve significantly, but the volatility of ROA is smaller. They also find that the ratio of managers with poorer performance and forced to leave is 25%, higher than Cannella and Lubatkin's (1993) 14.5% and Friedman and Signh's (1989) 11%.

Prior researches find that firms with poorer performance will employ outside managers (Friedman and Singh, 1989; Pfeffer and Salancik, 1978). Harris and Helfat (1997) suggest that outside successors are likely not to understand the operation of the firms and induce the firms' performance decline or distress. Hambrick and Finkelstein (1995) suggest that, when firms use outside successors, they should confirm that these successors have the skill benefit to these firms. Therefore, Vancil (1987) suggest that outsiders are likely to experience four to ten years when they are top executives. Some researches find that smaller firms are more likely to employ outside managers because insiders are lack of the suitable candidates (Reinganum, 1985) or outsiders can extend firms' size and transfer more skill and know-how (Harris and Helfat, 1997).

3. Data and Methodology

3.1 Data

Our sample of management turnover is drawn from the publicly traded firms of the electronic industry in the Taiwan Stock Exchange from 1997 to 2009. The management turnover includes the turnovers of chairman of board, CEO, and R&D manager. The turnover events are discloused in the Market Observation Post System of the Taiwan Stock Exchange. The sample includes 189 chairman turnover firms, 296 CEO turnover firms, and 142 R&D manager turnover firms. The outside chairman, CEO and R&D manager successors are 53, 62, and 19 firms respectively.

3.2 Event study

Event study is often used in financial and accounting literature (Ball and Brown, 1968; Fama et al., 1969; Mark et al., 2004; David and Timothy, 2000; Jo et al., 2001; Chung and Chung, 2005). Most empirical studies of event study examine whether some corporate event have abnormal stock returns.

In this study, the event date is the announcing date of management turnover. The observation period is from day -105 to day +15 of the turnover announcement, which is shown in Figure 1. The estimation period is from day -105 to day -16 of the turnover announcement and the event period is from day -15 to day +15 of the turnover announcement.

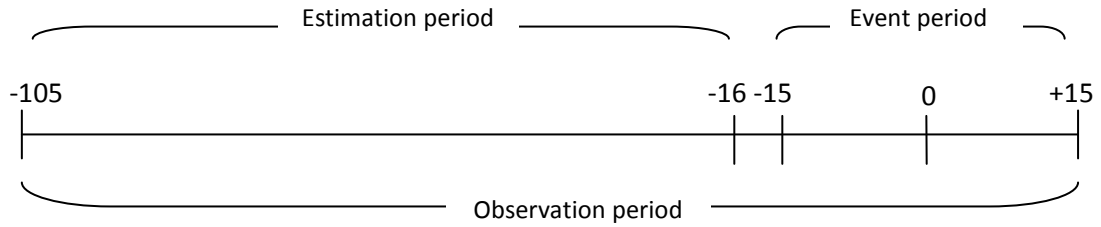


Figure 1 The observation period of event study

3.3 Market model

Brown and Wanrner (1985) find that market model is suitable to empirical study of corporate event. This study uses market model to estimate average abnormal returns and cumulative average abnormal returns and tests them by ordinary cross sectional method. Market model assumes that there is a linear relationship between a firm's stock return and market return, as follow:

$$R_{it} = \alpha_i + \beta_i R_{mt} + \varepsilon_{it} \qquad (1)$$

where R_{it} is the stock return of firm i in day t of the management turnover announcement, R_{mt} is the market return in day t, α_i is the intercept, β_i is the beta coefficiency, and ε_{it} is the disburtance item. When the two estimators, $\hat{\alpha}_i$ and $\hat{\beta}_i$ are estimated by market model, we can use them to estimate the abnormal return (AR_{it}) of firm i in day t, as follow:

$$AR_{it} = R_{it} - \hat{\alpha}_i - \hat{\beta}_i R_{mt} \qquad (2)$$

To divide the sum of all days' *AR*s for firm i in the event period, we can obtain its *AAR*. The abnormal return of sample firms in day t is calculated as follow:

$$\overline{AR}_t = \frac{1}{n}\sum_{i=1}^{n} AR_{it} \qquad (3)$$

where n is the number of sample firms.

To sum up the average abnormal returns from day τ_1 to day τ_2 can obtain cumulating abnormal returns (CARs), which is as follow:

$$CAR_i(\tau) = \frac{1}{N}\sum_{t=\tau_1}^{\tau_2}\sum_{i=1}^{N} AR_{it} \quad (4)$$

where $\tau = \tau_2 - \tau_1$, N is the number of sample, and i represents the stock of firm i. Event study is used to examine whether corporate event has impact on the firm's stock return. It thus needs to test whether the average abnormal return and/or cumulating abnormal return significantly equal to zero. According to the Central Limit Theorem, when the cross-sectional abnormal returns are independent and identical distribution, large sample size can approximate the distribution of average abnormal return to normal distribution. The traditional parametric test can produce robust power. Our study use ordinary cross-sectional method and t_{OCSM}^{AR} is obtained as follow:

$$t_{OCSM}^{AR} = \frac{AR_E}{\sqrt{\frac{1}{N(N-1)}\sum_{i=1}^{N}(AR_{i,E} - \sum_{i=1}^{N}\frac{AR_{i,E}}{N})^2}} \quad (5)$$

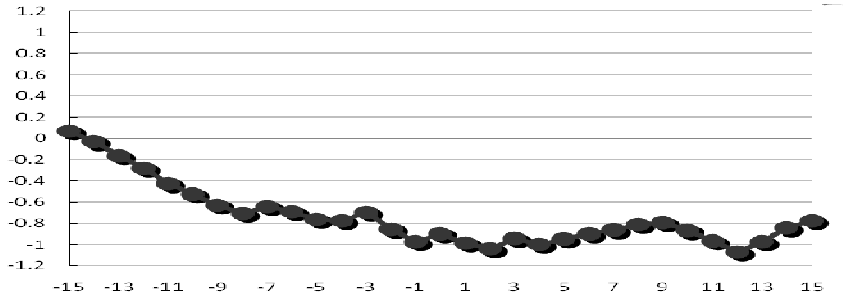
where $AR_{iE} = \frac{1}{N} = \sum_{i=1}^{N} AR_{iE}$.

4. Empirical results

4.1 Inside successors

Chairman of board

The CARs and the trend of the chairman turnover are shown in Table 1 and Figure 2. The CAR(-15,*t*) is cumulated from day -15 to day *t* of management turnover announcement. The results show that the CARs are significantly negative between day -10 to day +5 around turnover announcements. The CARs also show the negative trend and resprent negative market reaction to chairman turnover. These are more consistent with *vicious cycle hypothesis*.

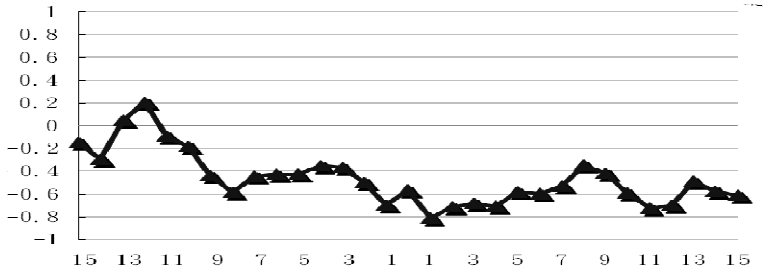


Event period

Figure 2. The CARs(%) of inside chairman sucessors

CEO

The CARs and the trend of the CEO turnover are shown in Table 1 and Figure 3. Table 1 shows that the CARs are not significantly negative or positive around turnover announcements. It is more consistent with *ritual scapegoating hypothesis.*



Event period

Figure 3. The CARs(%) of inside CEO successors

R&D manager

The CARs and the trend of the R&D manager turnover are shown in Table 1 and Figure 4. Table 1 and Figure 4 show that the CARs are not significantly negative or positive around turnover announcements. It is more consistent with *ritual scapegoating hypothesis.*

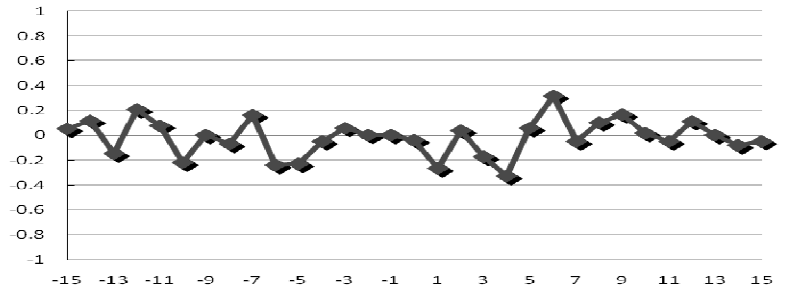


Figure 4. The CARs(%) of inside R&D mamager successors

Table 1. The CARs for new inside successors of management

Event period	Chairman of board		CEO		R&D mamager	
	CAR(%)	p-value	CAR(%)	p-value	CAR(%)	p-value
-15	0.0712	0.2795	-0.1469	0.3391	0.0533	0.7834
-14	-0.0285	0.7985	-0.2971	0.2325	0.1185	0.6143
-13	-0.1617	0.2526	0.0474	0.8765	-0.1455	0.4670
-12	-0.2824*	0.0834	0.2056	0.5440	0.2090	0.2853
-11	-0.4258**	0.0184	-0.0909	0.7979	0.0758	0.6842
-10	-0.5232**	0.0109	-0.1813	0.6267	-0.2196	0.300
-9	-0.6275***	0.0074	-0.4396	0.2886	-0.5313**	0.010
-8	-0.7070***	0.0061	-0.5880	0.2024	-0.0713	0.7525
-7	-0.6434**	0.0218	-0.4439	0.3916	0.1643	0.5030
-6	-0.6891**	0.0267	-0.4284	0.4475	-0.2380	0.3226
-5	-0.7656**	0.0210	-0.4257	0.4607	-0.2272	0.3135
-4	-0.7777**	0.0276	-0.3500	0.5627	-0.0483	0.8149
-3	-0.6998*	0.0691	-0.3663	0.5580	0.0592	0.7872
-2	-0.857**	0.0367	-0.4981	0.4474	0.0032	0.9890
-1	-0.9697**	0.0194	-0.6963	0.3073	0.3900*	0.0782
0	-0.8981**	0.0376	-0.5655	0.4282	-0.0418	0.8508
1	-0.9841**	0.0335	-0.8114	0.2922	-0.2636	0.2846
2	-1.0404**	0.0334	-0.7157	0.3818	0.0367	0.8767
3	-0.9425*	0.0675	-0.6853	0.4267	-0.1743	0.4679
4	-0.9988*	0.0686	-0.7081	0.4316	-0.3260	0.1691
5	-0.9462*	0.0887	-0.5823	0.5254	0.0570	0.7783
6	-0.8998	0.1077	-0.594	0.5308	0.3159	0.1273
7	-0.8635	0.1261	-0.5274	0.5864	-0.0498	0.8274
8	-0.8133	0.1504	-0.3458	0.7280	0.1036	0.6645
9	-0.7959	0.1621	-0.4172	0.6827	0.1707	0.4519
10	-0.8673	0.1380	-0.5901	0.5675	0.0167	0.9425
11	-0.9634	0.1064	-0.7236	0.4902	-0.0486	0.8164
12	-1.0699*	0.0788	-0.7006	0.5031	0.1136	0.6137
13	-0.9721	0.1188	-0.4895	0.6433	0.0002	0.9992
14	-0.8429	0.1832	-0.5757	0.5876	-0.0813	0.725
15	-0.7752	0.2301	-0.6138	0.5766	-0.0470	0.7913

Note: CARs are estimated by market model. The symbols *, **, and *** denote the significance at the 10%, 5%, and 1% levels, respectively.

4.2 Outside successors

Chairman of board

The CARs and the trend of the R&D manager turnover are shown in Table 2 and Figure 5. Table 2 shows that the CARs are not significantly negative or positive around turnover announcements. It is more consistent with *ritual scapegoating hypothesis*.

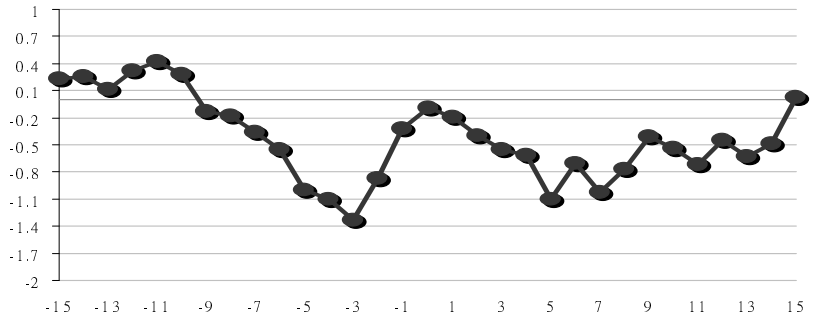


Figure 5. The CARs(%) of outside chairman sucessors

CEO

The CARs and the trend of the CEO turnover are shown in Table 2 and Figure 6. Table 2 shows that the CARs are not significantly positive around turnover announcements. It is more consistent with *ritual scapegoating hypothesis*.

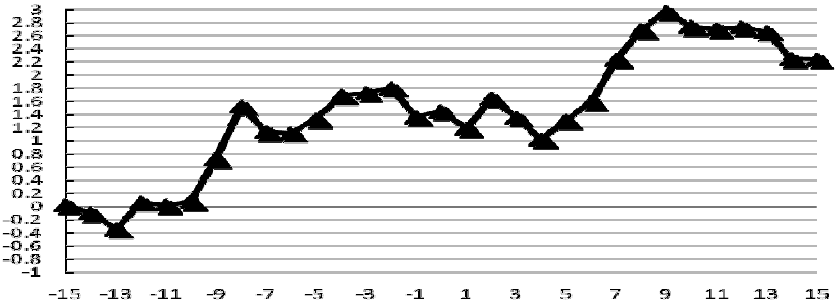


Figure 6. The CARs(%) of outside CEO successors

R&D manager

The CARs and the trend of the R&D manager turnover are shown in Table 2 and Figure 7. Table 2 and Figure 7 show that the CARs are significantly positive after turnover announcements. It is more consistent with *common sense hypothesis.*

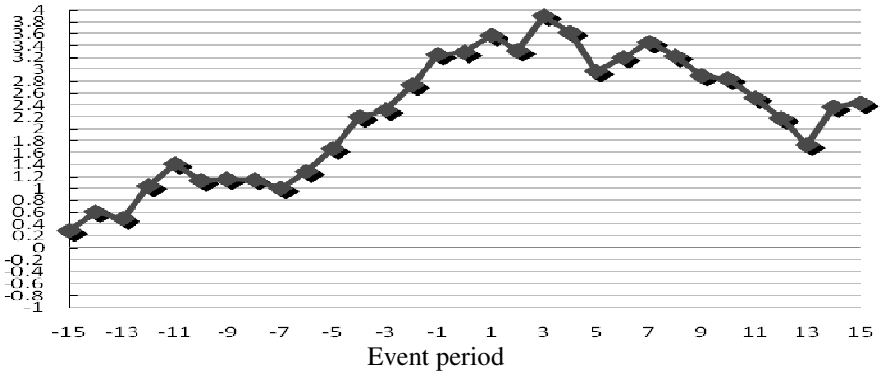


Figure 7. The CARs(%) of outside R&D mamager successors

Table 2. The CARs for new outside successors of management

Event period	Chairman of board		CEO		R&D manager	
	CAR(%)	p-value	CAR(%)	p-value	CAR(%)	p-value
-15	0.2341	0.3963	0.0218	0.9478	0.2915	0.3423
-14	0.2627	0.5349	-0.1037	0.7356	0.6068	0.2312
-13	0.1129	0.8378	-0.3418	0.399	0.4903	0.4492
-12	0.3222	0.6147	0.0676	0.2581	1.0452	0.2141
-11	0.4269	0.5284	0.0238	0.8895	1.4165	0.1027
-10	0.2829	0.7025	0.0687	0.8846	1.1323	0.2114
-9	-0.1329	0.8691	0.7152**	0.0365	1.1635	0.2599
-8	-0.182	0.8261	1.5238**	0.0475	1.1508	0.2697
-7	-0.3648	0.6894	1.1371	0.2848	1.0094	0.3860
-6	-0.5454	0.5936	1.1188	0.9590	1.2848	0.2897
-5	-1.0015	0.3694	1.3259	0.5906	1.6646	0.1988
-4	-1.1074	0.351	1.7715	0.3213	2.2092	0.1117
-3	-1.3332	0.2928	1.8411	0.8755	2.3146	0.1250
-2	-0.8773	0.5049	1.8432	0.9961	2.7422	0.1167
-1	-0.3176	0.8174	1.4034	0.2959	3.2590	0.0888
0	-0.0884	0.9511	1.4884	0.8466	3.2901*	0.0855
1	-0.1924	0.8954	1.1404	0.4004	3.5739**	0.0493
2	-0.3916	0.7897	1.5994	0.2781	3.3218*	0.0551
3	-0.5497	0.7211	1.3957	0.6285	3.9083**	0.0213
4	-0.6215	0.7022	1.5585	0.7322	3.6218**	0.039
5	-1.1015	0.5076	1.8387	0.4529	2.9709*	0.0814
6	-0.6999	0.6801	2.1294	0.4484	3.2063*	0.0547
7	-1.0228	0.5545	2.7727	0.1118	3.4596**	0.0375
8	-0.7706	0.6697	3.2231	0.2941	3.2294*	0.0773
9	-0.4064	0.8257	3.4933	0.5141	2.8994	0.1099
10	-0.534	0.7742	3.2729	0.5372	2.8475	0.1217
11	-0.7116	0.7101	3.2273	0.9051	2.5215	0.1938
12	-0.4448	0.8115	3.2608	0.9282	2.1787	0.2574
13	-0.6239	0.7352	3.1953	0.8592	1.7351	0.3693
14	-0.4837	0.8017	2.7779	0.2555	2.3664	0.2284
15	0.0311	0.9873	2.6495	0.7642	2.4390	0.2249

Note: CARs are estimated by market model. The symbols *, **, and *** denote the significance at the 10%, 5%, and 1% levels, respectively. ◦

Table 3 is the results summary for market impact of management turnover by inside and outside successors.

Table 3. The hypotheses for management turnover

Inside or outside	Chairman of board	CEO	R&D manager
Inside	*vicious cycle hypothesis*	*ritual scapegoating hypothesis*	*ritual scapegoating hypothesis*
Outside	*ritual scapegoating hypothesis*	*ritual scapegoating hypothesis*	*common sense hypothesis*

5. Conclusions

This study examines whether management turnovers have impact on stock returns. The sample is drawn from the publicly traded firms of electronic industry in the Taiwan Stock Exchange. The management includes chairman of board, CEO, and R&D manager. We compare the two subsample partitioned by new successors from inside or outside.

The results show that, when new successors of chairman of board are insider, the stock reactions are negative. The turnovers of CEOs and R&D managers do not have significant impact on stock returns. When new successors are outsiders, the turnovers of R&D managers have positive stock reactions but the turnovers of chairman of boards and CEOs do not.

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