



The Role of Managerial ability on Operational Performance and Stock Return moderated by CEO Overconfidence

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Abstract

Purpose: This study aims to determine the effect of the acquisition company's managerial ability on the company's performance after mergers and acquisitions. CEO overconfidence was added as a moderating effect in this study. The sample data of this study include companies listed on the IDX that carried out corporate actions in the 2014-2018 period.

Methodology: The sampling technique used is purposive sampling, and the data analysis method used is the SPSS and Smart PLS applications. This research used return-on-assets, cash flow from operations and market-to-book ratio to measure the firm's operational performance and buy-and-hold abnormal return to measure company's stock return.

Findings: The results of this study indicate that managerial ability affects the firm's operational performance. This study also shows that CEO overconfidence can strengthen the relationship between managerial ability and the firm's operational performance along with the rate of the acquiring companies stock returns.

Originality/Value: The managerial implications of this study suggest that companies should prioritize CEO overconfidence in the fit-and-proper test. CEO overconfidence can bring the company forward and earn higher returns. Novelty in this study provides a new insight of corporate action that CEO overconfidence can moderate the relationship between managerial ability and the firm's operational performance and the company's stock return.

Introduction

Merger and acquisitions have been implemented since the promulgation of Law No. 20 of Republic of Indonesia and Law No. 8 year 1947 on Capital Markets and Mergers. Mergers and acquisitions are a popular investment strategy among companies looking to increase corporate growth or increase their competitive advantage over their competitors (Normalita, 2018). Generally, the reason for participating in mergers and acquisitions is to achieve synergies and efficiency effects that ultimately increase the shareholder wealth of the acquiring company. To survive in persistent economic conditions, merger and acquisitions have taken place in companies in various industrial sectors. This is because mergers and acquisitions are considered the fastest way to achieve a physical goal without starting from scratch (Demerjian et al., 2013; Hariyani & Serfianto. D.P, 2011).

The performance of the enterprise after the implementation of the merger and acquisition should be better than before the corporation action. However, in some cases, merger and acquisitions do not improve the entity's financial performance, even reduce it. An example is one of the telecommunications companies in the cellular operator sector, PT XL Axiata Tbk's in handling the acquisition of PT Axis Telekom Indonesia which also a telecommunications company in cellular operator sector. Due to this acquisition, in the early post-acquisition period, the acquired company made a negative contribution due to increased operating costs and increased investment in the company. This didn't last long, however as in the second year after the acquisition, companies began to contribute positively to the financial performance of the acquiring company (Suryahadi, 2021). The acquisition of PT Perusahaan Perkebunan London Sumatra Tbk by PT Indofood Sukses Makmur Tbk has had a negative impact in the acquiring company compared to the acquisition processing between PT XL Axiata Tbk and PT Axis Telekom Indonesia.

The purpose of this study was to determine the relationship between the managerial ability of the acquiring firm on operating performance and its rate of return, as well as the relationship between managerial ability moderated by CEO overconfidence. The benefit of this research is that it can be considered by investors when analyzing

management and company performance, and it is also a consideration for companies to conduct mergers and acquisitions. The Novelty in this study provides a new insight of corporate action that CEO overconfidence can moderate the relationship between managerial ability and the firm's operational performance and the company's stock return.

Literature Review

Managerial Ability

In the processing of mergers and acquisitions, management ability becomes a market measurement mechanism, if a company underperforms it may be caused by management ability and will become the target of mergers and acquisitions of high ability companies (Sugeng, 2017). Managerial ability includes a variety of managerial activities including the process of planning, investigating, coordinating, evaluating, monitoring, negotiating, and representing (Mulyani, 2016). Managerial ability measures the level of effectiveness by revenue and efficiency by forecasting future demand and the development of company industry trends (Demerjian et al., 2012). The decision to implement a merger and acquisition in a company is to improve the financial performance of the company without having to re-establish it from the initial stage. Therefore, management needs to manage and consider the company's interest when making mergers and acquisitions, otherwise, it will have the opposite effects. As mentioned in (Cui & Leung, 2020) research, the formula for finding M&A is as follows:

M&A= Sales/ (COGS + SG&A + PPE + Operating Lease + R&D + Goodwill + Other Intangible Assets)

Return-on-Assets (ROA)

Return on assets (ROA) is a measurement capable of the company's success rate in generating profits through the effectiveness of the total assets available (Aggarwal & Garg, 2022). ROA measurement can measure the company's ability to generate past profits, which are then used for the future (Rosikah et al, 2018). With an increase in the value of the ROA ratio, the company's performance is getting better. A high ROA

value also reflects that it has utilized its assets effectively to generate high profits (Erari, 2014). The formula for measuring the company's ROA is as follows:

$$\Delta\text{ROA} = \text{Net Income} / \text{Total Assets}$$

Description:

ΔROA = the difference between ROA in the year of acquisition and two years after the acquisition.

Cash Flow from Operations (CFO)

Cash Flow from Operating Activities (CFO) is a measurement of cash flow in operations to measure the effectiveness of operating cash flows generated from each asset owned. Operating cash flow can be a guide given by management to minimize information asymmetry, and help investors and creditors to reduce risk in decision-making (Widiatmoko & Indarti, 2019). In his research, (Bandi, 2012) states that operating cash flow can project future income, so it can be concluded that the higher the cash flow, the higher the persistence of earnings. As the statement above, it can be concluded that the CFO formula is as follows:

$$\Delta\text{CFO} = \text{Net Cash Flow from Operating Activities} / \text{Total Assets}$$

Description:

ΔCFO = the difference between CFO in the year of acquisition and two years after the acquisition.

Market-to-Book Ratio (MTB)

Market To Book Ratio (MTB) is a measurement that shows the value allocated to the general equity or net assets of the company. The market-to-book value ratio also reflects the management's ability to manage assets, for the company's development (Sharma et al., 2013). A high market-to-book value ratio may reflect higher or higher marginal efficiency, as well as high value-added by management to the cost of net assets (Sarwendhi & Samekto, 2014). The formula for measuring the company's MTB is as follows:

$$\Delta\text{MTB} = \text{Market Capitalization} / \text{Book Value}$$

Description:

Δ MTB = the difference between MTB in the year of acquisition and two years after the acquisition.

Stock Return

This study measures the rate of return on shares resulting from mergers and acquisitions, and the difference between actual and expected returns as measured by the market (Lakonishok & Vermaelen, 1990). Conrad & Kaul (1993) in their research argue that BHAR is used to reduce statistical bias in measuring the long-term cumulative performance of CARs. In measuring its long-term abnormal performance, the effect of shareholder wealth in an M&A deal can be captured with BHAR (Edi et al., 2020; Popli et al., 2017). The presence of positive or negative BHAR can assist investors in determining performance by the risks to be borne. A positive BHAR value indicates an actual rate of return that is greater than the expected return. As mentioned in (Edi et al., 2020) research, the formula for finding BHAR is as follows:

$$\text{BHAR} = (\text{Market Price } (t+2) - \text{Market Price } t) / \text{Market Price } t$$

Descriptions:

Market Price t = stock closing price on the acquisitions date.

CEO Overconfidence

There are six main factors of company performance in the treatment of mergers and acquisitions, one of which is found that every decision in acquisitions is in the hands of the CEO (Faff et al., 2019). The influence of the CEO on the company's performance after seeking portfolio mergers and acquisitions is assessed from two main things related to the CEO, namely the experience of the CEO and the length of time he has served as the CEO. The level of trust of the CEO is certainly a question of its effect on the managerial level of a company after acquisitions and acquisitions. It is explained in the Hubris Theory that overconfident CEOs always use ways to empower company resources to be highlighted by the media. That way, the company he leads will get increase in reputation in the short term. (Edi et al., 2020)

In the behavioral finance literature, a common approach to measuring the level of CEO overconfidence is the decisions that executives have made on their preferred personal portfolio of companies (Malmendier & Tate, 2015). Overconfident

executives will try in various ways to overestimate their future performance because they expect profits and stock price appreciation in the future (Malmendier & Tate, 2005).

Managers with excessive self-confidence will also affect the company's performance. In previous research conducted by (Lin et al., 2005, 2008) it was found that an excessive level of management trust is a factor that affects investment and financing decisions, where management is too confident. It is easy to make decisions on projects that will harm the interests of the company.

Managerial Ability and Firm's Operational Performance

The development of large business sectors in the world and the establishment of many companies have led to increasing business competition. Management performance becomes the process of implementing management related to leaders and their subordinates in the sustainable development of enterprises (Ivani et al., 2014). Management performance evaluates the success of a company's corporate actions based on actual performance reported in financial and annual reports. The insights that management possesses provide relevance for the implementation of operational decisions and decisions in merger and acquisitions implementation (Demerjian et al., 2012). Well-performing companies can improve their operating performance by reducing the company's financing of long-term and short-term debt (Jebran & Chen, 2022) and preventing the waste of the company's cash reserves (De Franco et al., 2017). High managerial ability are also believed to improved profitability (Inam Bhutta et al., 2021) and even optimize the use of company resources through effective internal controls in times of crisis (Andreou et al., 2013). Based of the statement above, the hypothesis of the research are:

H_{1A} : Managerial ability is positively related to the acquiring firm's operational performance as measured by ROA.

H_{1B} : Managerial ability is positively related to the acquiring firm's operational performance as measured by CFO.

H_{1C} : Managerial ability is positively related to the acquiring firm's operational performance as measured by MTB.

Managerial Ability and Stock Return

The success or failure of a company's handling of mergers and acquisitions can be judged not only based on the company's operating performance but also based on the market performance that generates stock returns. This is in the same direction as the strategic goal of corporate action, which is to maximize shareholder wealth (Papadakis & Thanos, 2010). Market transactions of firms with high management performance are thought to generate higher returns, especially in uncertain environments (Chen & Lin, 2018). Highly skilled management can indirectly influence the market's response to mergers and acquisitions processing (Doukas & Zhang, 2020). Firms with high managerial ability witness higher stock returns in times of crisis through effective cash management, and therefore share price declines less than firms with a low managerial ability (Kumar & Zbib, 2022; Neukirchen et al., 2022). Based on the statement above, the hypothesis of the research is:

H2 : Managerial ability is positively related to the rate of stock returns of the acquiring company.

Managerial Ability, Firm's Operational Performance, and CEO Overconfidence as Moderator

The decision to handle mergers and acquisitions rests with the incumbent CEO (Faff et al., 2019). The CEO's impact on post-mergers firm performance can be assessed from two main factors that make up the CEO's portfolio, the CEO's experience, and the CEO's competency. The Hubris theory states that overconfident CEOs are always unscrupulous in empowering the resources of the companies they lead to get exposure to the media, thereby giving the companies they lead a reputation boost in the short term. The characteristics of the CEO influence the performance of the company empirical (Edi et al., 2020). With more and more companies set up in Indonesia, intense market competition has pushed CEOs to make decisions quickly and legally. Based on the statement above, the hypothesis of the research are:

H_{3A} : CEO Overconfidence can moderate the relationship between managerial ability and the acquiring company's operational performance as measured by ROA.

H_{3B}: CEO Overconfidence can moderate the relationship between managerial ability and the acquiring company's operational performance as measured by CFO.

H_{3C}: CEO Overconfidence can moderate the relationship between managerial ability and the acquiring company's operational performance as measured by MTB.

Managerial Ability, Stock Returns, and CEO Overconfidence as Moderator

Over time, this excessive CEO trust can drive profitable decisions (Kim et al., 2022). In general, overconfident CEOs invest with internal funds before switching to external financing which is relatively risky and pays fewer dividends than companies with rational CEOs. When evaluating returns, companies led by overconfident CEOs have higher stock return volatility than less confident CEOs (Bharati et al., 2016). Hubris' theory explains that experienced and capable CEOs can maximize the company's performance returns when making acquisitions (Edi et al., 2020).

H₄: CEO Overconfidence can moderate the relationship between managerial ability and the rate of stock returns of the acquiring company.

Research Methodology

To obtain objective research results, this research design used descriptive, associative, and quantitative research methods. This type of research uses a lot of numbers, starting with data collection, data interpretation, and data results. This study uses the event study method which describes the effect of managerial ability variables on operational performance and the rate of return on shares of the acquiring company after corporate action and is moderated by CEO overconfidence. The object of this research was selected using purposive sampling, in which each sample was selected based on certain considerations and conditions for the research. The period of the sample that used in this study is 2014-2018, with the reason for choosing the research period being due to the achievement of the highest Composite Stock Price Index since the 2008 crisis (Edi & Susanti, 2021). The further conditions that must be met in selecting the sample of this research model are a list of companies involved in the treatment of mergers and acquisitions; the companies that are listed on the Indonesia Stock Exchange (IDX); and the company that has Indonesia Competition Commission report on mergers and acquisitions. The source

of data in this study is secondary data obtained from the Indonesia Stock Exchange and will then be processed with the statistical application of Smart PLS (Partial Least Square) 3.2.9.

Findings and Discussion

Table 1: Descriptive Statistics Result

	N	Min.	Max	Mean	St. Deviasi
MA	90	0.067	1.745	0.679	0.311
ROA	90	-0.127	0.283	-0.008	0.047
CFO	90	-0.331	0.446	0.008	0.097
MTB	90	-5.246	3.560	-0.335	1.205
BHAR	90	-0.807	1.273	-0.075	0.447
SIZE	90	6.044	8.944	7.267	0.601
LEV	90	0.007	6.912	1.398	1.428
GROWTH	90	-0.855	0.915	0.114	0.308
CEO Overconfidence Index	90	2.000	7.000	4.333	1.563

Source: Authors' calculations (2022)

Table 2: Descriptive Statistics Result

		Frequency	Percentage
CEO Experience	0 = No managerial experience.	1	1.1%
	1 = Has managerial experience but not as CEO.	50	55.6%
	2 = Has managerial experience as CEO in a company that's not listed on the stock exchange.	18	20%
	3 = Has managerial experience as CEO in a company that's listed on the stock exchange.	20	22.2%
	Total	90	100%
CEO Tenure	1 = Served less than three years.	18	20%
	2 = Served three to six years.	12	13.3%
	3 = Served six to ten years.	39	43.3%
	4 = Served more than 10 years.	19	21.1%
	Total	90	100%

Source: Authors' calculations (2022)

Descriptive statistics provide information briefly about the managerial ability of companies in Indonesia on operational performance and also the rate of the company's stock returns. It can be seen in Table 2, the average value of the managerial ability of companies in Indonesia is 0.679 and the maximum is 1.745. This indicates that generally, the managerial ability of companies in Indonesia is still relatively low. In measuring the company's operational performance, it can be noted that the ROA variable obtained an average value of -0.008 and a maximum value of 0.283, so it can be concluded that companies in Indonesia have not been able to manage the company assets properly to earn a profit. In the CFO variable, the average value is 0.008 and the maximum is 0.446, indicating that the company's asset management has not been efficient so it affects the company's cash operational financing more than the total assets it has. Then on the MTB variable, the maximum value obtained is 3.560 and the average is -0.335. This indicates that the assessment of the book value of companies in Indonesia does not get a good response from investors. Meanwhile, in the measurement of the company's stock returns, the maximum value obtained is 1.273 and the average is -0.075, which indicates that for two years, investors have not been able to get a return on their market portfolio investment. For the moderating variable in the form of CEO overconfidence, the maximum value is 7 with an average value of 4,333, it can be concluded that broadly speaking, decision-making on mergers and acquisitions of companies in Indonesia is not based on the confidence of the CEO, but reasonable considerations.

Table 3: Regression Result to Firm's Operational Performance

No.	IV		DV	Original Sample	P-value	Criteria	Description
H _{1a}	Managerial Ability	→	Return-On-Assets	0.023	0.867	< 0,05	Not Significant
H _{1b}	Managerial Ability	→	Cash Flow from Operations	0.271	0.002	< 0,05	Significant (+)
H _{1c}	Managerial Ability	→	Market-to-Book Ratio	-0,235	0,048	< 0,05	Significant (-)

Source: Authors' calculations (2022)

This study finds that managerial ability does not have a significant effect on the company's operational performance as measured by ROA two years after the corporate action. In general, corporate action have a decreasing effect on company performance, especially for acquiring companies (Edi & Cen, 2016). This is due to the long-term effect of ROA which has not shown the synergy of mergers and acquisitions in the two years following the mergers and acquisition activity. Another effect that may occur is that most mergers and acquisitions in Indonesia are carried out with funding in cash or errors in the acquisition strategy so has an impact on the company's asset turnover. With this statement, it can be concluded that the H_{1A} hypothesis is rejected, where managerial ability has no significant positive effect on the company's operational performance as measured by ROA.

Different statements are shown in the managerial ability research on the company's operational performance as measured by CFO two years after the mergers and acquisition activity. To optimize the value of the company and attract more investors, company management must pay more attention to the company's CFO (Kasmiasi & Santosa, 2019). CFO determines the ability of a business to carry out its activities, so it can be concluded that companies with high managerial capabilities in managing cash flow are a key to maintaining an effective and efficient business (Belobo & Pelsler, 2014). The presence of a high CFO can give a positive signal to the company to increase its sales, thus enabling the company to obtain higher profitability. Thus, the H_{1B} hypothesis is accepted, where managerial ability has a significant positive effect on the company's operational performance as measured by CFO

While the measurement of managerial ability on the company's operational performance as measured by MTB two years after the mergers and acquisition activity, the results obtained that the H_{1C} hypothesis is rejected, where managerial ability has a significant negative effect on the company's operational performance as measured by MTB. The value of MTB that is assessed shows high growth opportunities for the company, but the company is also faced with a higher risk (Dewi & Purnawati, 2016). This is because the company requires large funds to finance the company's growth and these funds usually come from third parties. So it

can be assumed that companies with high managerial ability can minimize the risk of financing the company's growth by controlling the company's MTB value from debt.

Table 4: Regression Result to Stock Return

No.	IV		DV	Original Sample	P-value	Criteria	Description
H ₂	Managerial Ability	→	Buy-and-Hold Abnormal Return	-0.061	0,627	< 0,05	Not Significant

Source: Authors' calculations (2022)

The measurement of managerial ability on the company's stock return as measured by BHAR shows that managerial ability doesn't affect on the company's stock return two years after the mergers and acquisition. Positive or negative returns on a previous company cannot be used as an assessment of the company's future corporate actions (Fang et al., 2015). Investors who become capital market participants are accustomed to corporate actions carried out by companies, so they do not provide a large response to the company's stock price so that the company's stock price does not experience significant changes (Dananjaya, 2015). So, it can be concluded that hypothesis H₂ is rejected, where managerial ability does not have a positive significant effect on the company's stock return as measured by BHAR two years after the mergers and acquisition activity.

Table 5: Regression Result to Firm's Operational Performance with CEO Overconfidence as Moderating Variable

No.	IV		DV	Original Sample	P-value	Criteria	Description
H _{3a}	Managerial Ability*CEO Overconfidence	→	Return-On-Assets	-0.024	0,862	< 0,05	Not Significant
H _{3b}	Managerial Ability*CEO Overconfidence	→	Cash Flow from Operations	0.152	0.019	< 0,05	Significant (+)

H _{3c}	Managerial Ability*CEO Overconfidence	→	Market-to-Book Ratio	0.377	0.002	< 0,05	Significant (+)
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Source: Authors' calculations (2022)

This study shows that CEO overconfidence cannot moderate the relationship between managerial ability and company operational performance as measured by ROA. CEO overconfidence changes the direction of the relationship between managerial ability and company operational performance as measured by ROA from positive to negative. This is presumably because the CEO's excessive level of confidence can increase the risk of errors in the implementation of mergers and acquisitions (Edi & Susanti, 2021). Another statement obtained in Hubris' theory is that takeover actions destroy shareholder value if the acquiring company is large company while the target company is small. Thus, it can be concluded that H_{3A} is rejected.

On the influence of managerial ability and CFO moderated by CEO overconfidence, the research results show a significant effect, so it can be concluded that the H_{3B} hypothesis is accepted. Companies with overconfident CEOs generally pay lower dividends intending to build financial slack on future investments (Deshmukh et al., 2013) and maintain an effective and efficient business (Belobo & Pelsler, 2014). Firms with overconfident CEOs are prone to engage in larger operating cash flow manipulations to avoid the board of directors' possible rejection of future investments (Yang & Kim, 2019).

In research on the hypothesis that CEO overconfidence can moderate the relationship between managerial ability and company operational performance as measured by MTB, the results show that the H_{3c} hypothesis is accepted. CEO overconfidence also changes the effect of managerial ability and MTB from negative to positive. This is because companies with overconfident CEOs tend to invest in research and development to achieve greater innovation (Leontis, 2016). CEO overconfidence captures market share which can ultimately increase the value of the company.

Table 6: Regression Result to Stock Return with CEO Overconfidence as Moderating Variable

No.	IV		DV	Original Sample	P-value	Criteria	Description
H ₄	Managerial Ability*CEO Overconfidence	→	Buy-and-Hold Abnormal Return	0.417	0.007	< 0,05	Significant (+)

Source: Authors' calculations (2022)

Research on CEO overconfidence statements can moderate the relationship between managerial ability and the company's stock return as measured by BHAR, the results show that hypothesis H₄ is accepted. This is in line with Hubris' theory which explains that experienced and capable CEOs can maximize the company's performance returns when making acquisitions (Edi et al., 2020). CEO overconfidence can encourage the reaction of market participants by giving positive signals and influencing stock prices.

Conclusions

This study analyzes the effect of managerial ability on operational performance and the rate of return on company shares two years after the mergers and acquisition activity. CEO overconfidence was added to the study to explain the effect of managerial ability on operational performance and the rate of stock returns of the acquiring company. The results obtained in this study indicate that managerial ability has no significant effect on the company's operational performance as measured by ROA and MTB, and significantly affects the company's operational performance as measured by CFO. Managerial ability also has a significant effect on the company's rate of return as measured by BHAR. In a study on the moderating effect of CEO overconfidence, the results show that CEO overconfidence can moderate the relationship between managerial ability and company operational performance as measured by ROA and can moderate the relationship between managerial ability and company operational performance as measured by CFO and MTB. CEO

overconfidence can also moderate the relationship of managerial ability to the company's stock returns as measured by BHAR.

The managerial implication in this study suggests that companies should prioritize CEO overconfidence in the fit-and-proper test. Overconfident CEOs generally have a higher level of courage in making decisions and courage when speaking in public. Generally, overconfident CEOs can be chosen from start-up companies. CEO overconfidence through strong decision-making can take the company to a higher level and earn higher returns.

Based on the research above, several limitations can be a reference for future researchers, namely, this study only covers companies in Indonesia listed on the Indonesia Stock Exchange in the 2014-2018 period with Indonesia's financial condition starting to rise from the economic crisis in 2008. Experience The COVID-19 pandemic that began in 2019, could affect the company's managerial performance on the company's performance and returns. Another limitation of this study is that the measurement period in this study is limited to two years after the mergers and acquisition activity, so it has not shown a synergistic effect on the corporate actions taken. As a recommendation in future research, future researchers can conduct research on managerial performance on company profitability during the COVID-19 pandemic (Kumar & Zbib, 2022; Neukirchen et al., 2022). Research can also be directed by adding capital structure variables in measuring the managerial ability that is moderated by CEO overconfidence (Cho et al., 2021; Ting et al., 2021).

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