



# **Hedge Fund Activism, Corporate Governance, and Firm Performance**

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# What do we know about activism?

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- Informed shareholder monitoring can reduce agency problems
  - But collective action problem
- Non-HF activism positive but insignificant
  - Other agency problems
  - Regulatory/liquidity constraints

*“Best reading of currently available evidence is that institutional investor activism does not importantly affect firm performance.”* Black (1998)

*“The evidence provided by empirical studies of the effects of shareholder activism is mixed... There is little evidence of improvement in the long-term operating or stock market performance of the targeted companies.”* Gillan and Starks (2007)



# The rise of hedge fund activism

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- Hedge funds are different:
  - Manager's incentives
  - Fewer conflicts of interest
  - Flexibility, unregulated
- Large increase in capital allocated to hedge funds
  - Competition for new investment opportunities
- Interest in improved governance as a result of recent corporate scandals
  - Boards are under renewed pressure by both regulators and shareholders



# Goals of the study

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- Bradley, Brav, Goldstein, and Jiang (2006): the first large-sample study on HF activism, but the targets confined to closed-end funds.
  - Clear identification
  - But closed-end funds are a small set of publicly traded companies
- First large-sample study on hedge fund activism in regular corporations:
  - Type of target?
  - Typical strategies?
  - Success?
  - Short-term?
- Most importantly, does hedge fund activism enhance or destroy shareholder value?
  - Stock returns?
  - Operational performance?
  - Governance change?



# Data

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- No centralized data base for activist hedge funds.
- Purchased a list of all Schedule 13D filers during the period 2001-2006 from LiveEdgar. A total of 11,602 filers.
- Based on the names and the descriptions of the filer type filed on the Schedule 13D, we filtered out banks, brokerage companies, regular corporations, foreign institutions, individuals, insurance companies, pension funds, trusts, and other miscellaneous categories.
- For the remaining filers (hedge funds, private equity/venture capital funds, and some non-fund investment advisors), we searched the internet and news articles and classified into hedge funds and non-hedge funds.
- For the remaining cases, we tried to call the filers and asked for their self-classification. From this set we further excluded filers that had only one Schedule13D filing during the whole 2001-2006 sample period and the Item 4 of the Schedule 13D filing indicated no explicit purpose. This preliminary step led to a list including 311 hedge funds.
- Cross-checked our list with people in the business.



# Data

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- Retrieved all 13D filings and amendments made by the 311 hedge funds through EDGAR. These filings provide information about the filing date, ownership and its changes, cost of purchase, and the stated purpose of the filing.
- Further excluded the following events: (1) The primary purpose of the filer is to be involved in the bankruptcy reorganization or the financing of a distressed firm; (2) the primary purpose of the filer is to engage in a merger and acquisition related risk arbitrage; (3) the target is a closed-end fund or other non-regular corporation. After imposing these screens the number of hedge funds is 236, and the number of events is 1,032.
- Conducted news searches in Factiva. From the news articles we gathered information such as the hedge fund's motive, the target's response, and the development and resolution of the events. When necessary, we retrieved additional SEC filings, such as Schedule 14A (proxy statement).
- Gathered all 13F filings by our funds and identified all companies whose shares were held by our hedge funds. Conducted individual news searches if (i) the company's market value was more than \$1 billion, and (ii) the ownership by the hedge fund was greater than two percent. We are able to add 27 events (these companies tend to be larger and more mature (lower growth and higher cash flows)).



# Sample description

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- 236 activist hedge funds.
- 1,059 hedge fund-target company pairs.
- 882 unique target companies in 62 SIC two-digit industries.
- 51.7% of the sample saw specific issue targeting beyond “communicating with the managers” on “maximizing shareholder value”.
  - Among which 295 cases (27.9% of the sample) are hostile.
- 22.1% of all the 13D filings involve group of hedge funds (not including outside “Wolf Packs” and “Remoras”).



# Derivatives?

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- Exchange traded derivatives must be disclosed, but equity swaps and other OTC derivatives generally do not have to be fully disclosed (Hu and Black, 2006a).
- Offsetting positions are most likely in M&A arbitrage, which is taken out of our sample.
- We do not see a spike in short interest of target companies around the events in our sample.





# Target firms and Hedge Funds by year

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Year	# Events	# Hedge Funds	% Hostile
2001	130	50	20.6
2002	135	52	30.4
2003	130	51	21.6
2004	159	75	32.1
2005	247	108	30.8
2006	252	126	29.0

# Activists' stated objectives

Objective categories:	All Events				Num. of Hostile Events	Hostile Events		Non-Hostile Events	
	Num. of Events	% of Sample	% Success	% Partial Success		% Success	% Partial Success	% Success	% Partial Success
1. General undervaluation/maximize shareholder value	511	48.3%	--	--	--	--	--	--	--
2. Capital Structure									
-- Excess Cash, under-leverage, dividends/repurchases	134	12.7%	32.0%	32.0%	65	23.1%	47.7%	41.3%	15.9%
-- Equity issuance, restructure debt, recapitalization	65	6.1%	37.3%	35.6%	38	18.4%	50.0%	71.4%	9.5%
3. Business Strategy									
-- Operational efficiency	131	12.4%	35.6%	27.6%	63	35.2%	37.0%	36.4%	12.1%
-- Lack of focus, business restructuring and spinning off	96	9.1%	27.8%	38.9%	62	17.7%	51.6%	50.0%	10.7%
-- M&A: as target (against the deal/for better terms)	79	7.5%	36.7%	19.0%	42	33.3%	21.4%	40.5%	16.2%
-- M&A: as acquirer (against the deal/for better terms)	25	2.4%	20.0%	52.0%	22	18.2%	59.1%	33.3%	0.0%
-- Pursue growth strategies	12	1.1%	44.4%		0	--	--	22.2%	22.20%
4. Sale of Target Company									
-- Sell company or main assets to a third party	148	14.0%	37.0%	26.7%	93	30.1%	34.4%	49.1%	13.2%
-- Take control/Buyout company and/or take it private	44	4.2%	43.2%	25.0%	34	38.2%	32.3%	60.0%	0.0%
5. Governance									
-- Rescind takeover defenses	60	5.7%	21.7%	43.3%	43	18.6%	53.5%	29.4%	17.6%
-- Oust CEO, chairman	59	5.6%	39.7%	29.3%	59	39.7%	29.3%	--	--
-- Board independence and fair representation	159	15.0%	34.4%	35.7%	114	31.6%	40.4%	41.9%	23.3%
-- More information disclosure/potential fraud	58	5.5%	42.1%	26.3%	42	38.1%	33.3%	53.8%	6.7%
-- Excess executive compensation/pay for performance	50	4.7%	20.4%	44.9%	38	18.4%	50.0%	27.3%	27.3%
Sum of categories (2) through (5):	548	51.7%	40.6%	25.8%	286	29.5%	38.6%	53.7%	10.7%

# Activists' tactics

<b>Tactic categories:</b>	<b>% of All Events</b>
1. The hedge fund states that it intends to communicate with the board/management on a regular basis with the goal of enhancing shareholder value	48.3
2. The hedge fund seeks board representation without a proxy contest or confrontation with the existing management/board	11.6
3. The hedge fund makes formal shareholder proposals, or publicly criticizes the company and demands change	32.0
4. The hedge fund threatens to wage a proxy fight in order to gain board representation, or to sue the company for breach of duty, etc.	7.6
5. The hedge fund launches a proxy contest in order to replace the board	13.2
6. The hedge fund sues the company	5.4
7. The hedge fund intends to take control of the company, e.g., with a take-over bid	4.2

# Ownership stake and commitment of capital -- not the 1980s raiders.

Percentile	All Events				Hostile Events			
	Invested Capital (\$ Million)		% Ownership		Invested Capital (\$ Million)		% Ownership	
	Initial	Max.	Initial	Max	Initial	Max.	Initial	Max.
5%	0.69	1.0	5.0%	5.0%	1.5	1.9	3.5%	3.6%
25%	3.5	4.6	5.4%	6.5%	4.5	6.8	5.6%	6.9%
50%	11.9	15.8	6.3%	9.1%	14.7	20.45	6.6%	9.5%
75%	40.3	54.6	8.8%	13.2%	44.2	68.8	8.8%	13.0%
95%	186.8	272.5	23.1%	31.5%	321.0	363.8	19.8%	29.5%



## Length of investment for completed spells (by March 2007)

<b>Percentile</b>	<b>Hostile (Initial)</b>	<b>Non-Hostile (Initial)</b>	<b>All Events</b>
5%	26	30	29
25%	116	168	150
50%	248	397	360
75%	458	787	702
95%	1,207	1,717	1,613



## Hedge funds' exits (by March 2007)

Categories	Hostile	Non-Hostile	All Events
Sold shares on the open market	26.1%	39.3%	35.5%
Target company sold	16.2%	6.9%	9.5%
Target company merged into another	9.9%	3.8%	5.5%
Liquidated	1.8%	0.7%	1.0%
Shares sold back to target company	1.8%	0.5%	0.9%
Still holding/no Information	44.1%	48.4%	47.6%



# Long-term holding period return

	Deal Period Raw Return	Annualized Raw Return	Annualized Market Adjusted	Annualized Size Adjusted
1 %	-0.938	-0.933	-1.017	-1.233
5 %	-0.609	-0.607	-0.708	-0.855
25%	-0.068	-0.062	-0.197	-0.250
50%	0.181	0.149	0.042	0.003
75%	0.602	0.411	0.283	0.249
95%	2.372	1.753	1.532	1.459
99%	4.674	4.659	4.393	4.390
Mean	0.420**	0.330**	0.206**	0.143**
Std. Dev.	0.979	1.025	1.004	1.013
P-Val (Mean = 0)	0.00%	0.00%	0.00%	0.01%

# Characteristics of target companies

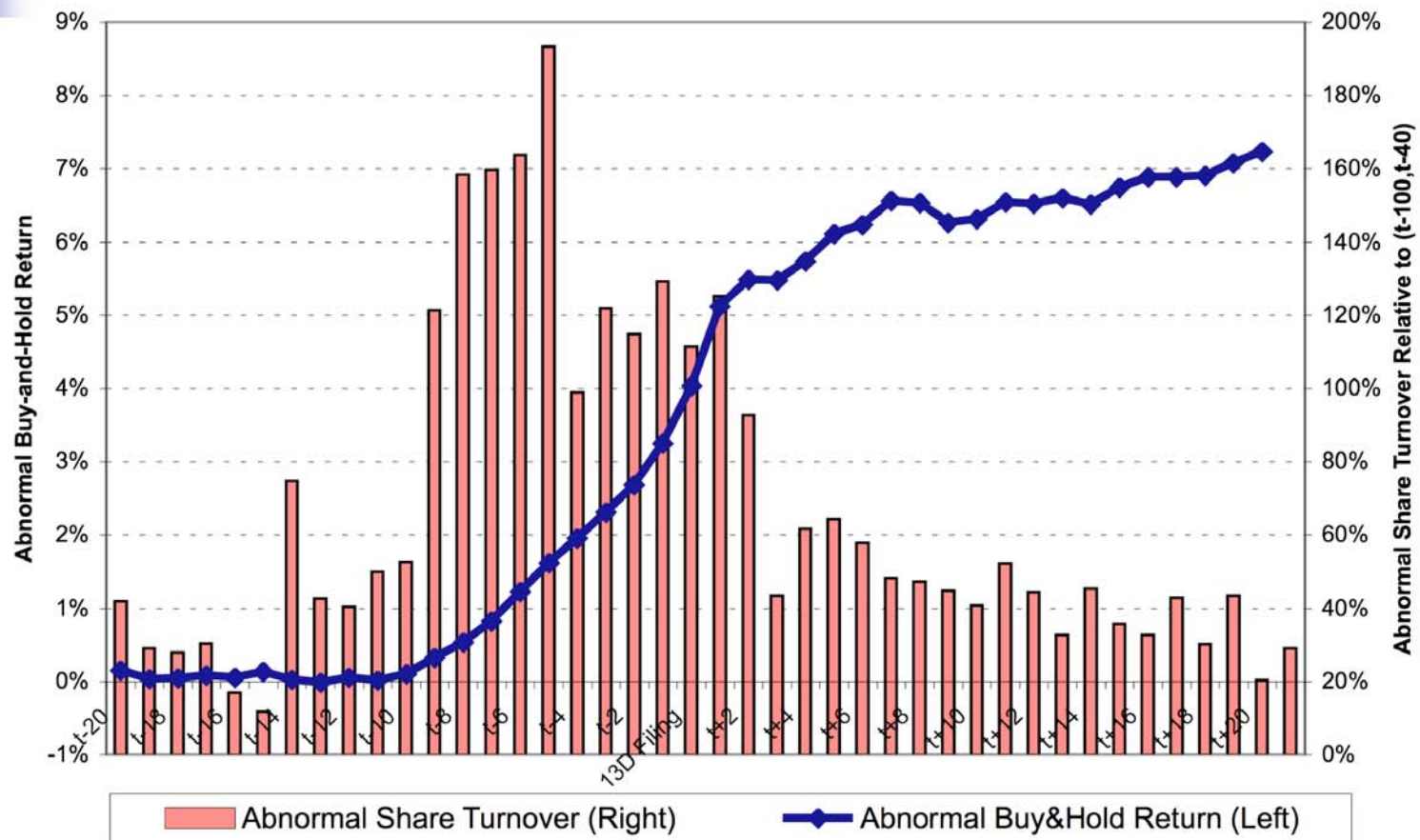
Firm Characteristic	Summary Statistics			Difference with matched firms			CRSP/COMPUSTAT quintile breakpoints				
	Mean	Median	Std Dev	Avg. Diff.	t-stat of Diff.	Wilcoxon	% in Q1	% in Q2	% in Q3	% in Q4	% in Q5
<i>MV</i>	726.56	160.07	1669.17	-63.54	-1.52	-2.05	0.214	0.253	0.239	0.180	0.114
<i>BM</i>	0.773	0.615	0.914	0.081	4.28	3.93	0.133	0.143	0.169	0.195	0.360
<i>Q</i>	1.544	1.238	1.007	-0.397	-9.17	-13.19	0.307	0.203	0.209	0.176	0.106
<i>GROWTH</i>	0.084	0.041	0.357	-0.057	-4.44	-7.72	0.299	0.234	0.194	0.117	0.156
<i>ROA</i>	0.054	0.085	0.201	0.020	3.12	4.18	0.212	0.178	0.217	0.185	0.208
<i>CF</i>	0.022	0.047	0.180	0.018	2.86	3.23	0.231	0.191	0.214	0.195	0.169
<i>STKRET</i>	0.195	-0.010	1.200	-0.073	-3.11	-5.15	0.295	0.160	0.169	0.141	0.234
<i>LEV</i>	0.348	0.327	0.297	0.028	2.91	1.70	0.196	0.197	0.197	0.207	0.203
<i>CASH</i>	0.177	0.088	0.214	-0.026	-3.61	-4.86	0.207	0.178	0.225	0.208	0.183
<i>DIVYLD</i>	0.007	0.000	0.016	-0.001	-2.13	-5.48		-- 0.754 --		0.129	0.118
<i>PAYOUT</i>	0.296	0.000	0.995	-0.035	-1.81	-4.15		-- 0.720 --		0.161	0.119
<i>RND</i>	0.079	0.029	0.114	-0.010	-2.21	-4.51	0.262	0.210	0.157	0.190	0.181
<i>HERFINDAHL</i>	0.800	1.000	0.251	-0.034	-3.64	-1.93	0.212	0.214		-- 0.594 --	
<i>GINDEX</i>	9.005	9.000	2.702	0.353	2.27	2.33	0.176	0.251	0.142	0.210	0.220
<i>ANALYST</i>	4.387	2.000	5.959	0.547	3.01	0.99	0.123	0.156	0.226	0.175	0.320
<i>INST</i>	0.447	0.447	0.274	0.083	9.57	8.82	0.086	0.158	0.409	0.184	0.162
<i>AMIHUD</i>	0.466	0.193	0.699	-0.075	-3.99	-7.65	0.091	0.139	0.434	0.183	0.153



# Predicting targeting (unconditional Pr = 1.78%)

<i>Dependent variable:</i>	<i>Dummy (of being targeted)</i>					
	<b>Coefficient</b>	<b>t-statistic</b>	<b>Marg. Prob.</b>	<b>Coefficient</b>	<b>t-statistic</b>	<b>Marg. Prob.</b>
MV	-0.08**	-7.35	-0.80%	-0.14**	-7.04	-1.01%
Q	-0.07**	-4.77	-0.49%	-0.09**	-3.01	-0.56%
GROWTH	-0.14**	-3.10	-0.23%	-0.10	-1.16	-0.14%
ROA	0.44**	4.30	0.39%	0.33	1.35	0.19%
LEV	-0.02	-0.42	-0.03%	0.06	0.64	0.07%
DIVYLD	-5.26**	-4.57	-0.38%	-4.89**	-2.69	-0.34%
RND	-0.15	-0.77	-0.07%	-0.55	-1.12	-0.18%
HERFINDAHL	-0.22**	-3.61	-0.23%	-0.08	-0.84	-0.09%
ANALYST	0.12**	6.12	0.59%	0.05	1.51	0.24%
INST	0.07**	3.65	0.12%	0.32**	3.34	0.44%
GINDEX				0.02**	2.59	0.28%
CNST	-1.42**	-18.59		-1.26**	-7.04	
Num. of obs and Pseudo R-sqr	39,085	2.68%		14,758	4.39%	
Percent targeted	1.78%			1.83%		

# Value as perceived by the market (short-term)

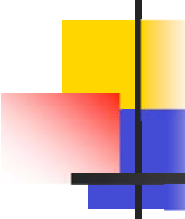


## Which activism matters?

Regressing (-20, 20) abnormal returns on stated objective:

<i>Dependent variables: Announcement window abnormal returns</i>	(1) Full Sample		(2) Hostile (Initial)		(3) Non-Hostile (Initial)	
	Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic
ln(MV)	-1.27%**	-2.39	0.60%	0.50	-1.38%**	-2.09
LTDebt	-2.73%	-0.72	2.70%	0.37	-4.88%	-1.01
Pre-13F	-3.27%**	-2.10	-2.69%	-0.69	-4.43%**	-2.23
Avg Pre>Returns	0.08%	1.36	0.04%	0.28	0.090%	1.34
General	6.28%**	3.70	--	--	6.21%**	3.96
CapStructure	1.47%	0.78	1.23%	0.34	2.54%	1.17
BusStrategy	5.95%**	3.08	3.34%	1.17	8.11%**	3.49
Sale	8.54%**	4.10	10.70%**	3.43	8.33%**	3.15
Gov	1.73%	0.92	4.95%*	1.73	-0.02%	-0.01
Hostile	3.76%*	1.81	--	--	--	--
Nob & R-sqr	724	0.032	140	0.072	584	0.029

- Strongest response to sale (of the company).
- Purely capital structure and governance targeting do not generate abnormal returns.



# Does hedge fund activism create value ?

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- The stock market seems to reflect this:
  - 7% short-run abnormal return.
- Alternative hypotheses:
  - Could it be over-reaction?
    - Is there a longer-term reversal? No. Calendar time portfolios generate insignificant (positive) abnormal returns subsequent to the filing of the 13D.
  - Could it reflect stock-picking ability or information?
    - No. Provide four tests rejecting the information alternative.
  - Is hedge fund activism associated with ex post improvement in performance?
    - Yes. Improvement in operating performance in year  $t+2$ .
  - Could the abnormal return reflect wealth transfer from bondholders?
    - No. Several tests refute this possibility.
  - Could the abnormal return reflect wealth transfer from management?
    - Yes.

# No long-term reversal

Equal-weight four-factor model													
Window (months)	Alpha		Beta(-1)		Beta		SMB		HML		MOM		R <sup>2</sup>
	Estimate	t-stat	Estimate	t-stat	Estimate	t-stat	Estimate	t-stat	Estimate	t-stat	Estimate	t-stat	
(-12,-10)	-1.023	-1.82	0.123	1.04	0.976**	6.81	0.663**	4.40	0.421**	2.41	-0.278**	-3.14	0.578
(-9,-7)	0.283	0.54	0.078	0.67	0.671**	4.94	0.913**	6.69	0.17	1.01	-0.493**	-5.88	0.657
(-6,-4)	-0.513	-1.02	0.252	2.27	0.805**	6.22	0.851**	6.15	0.322*	1.91	-0.243**	-2.84	0.648
(-3,-1)	-0.664	-1.30	-0.057	-0.50	0.57**	4.44	0.906**	5.20	0.333*	1.88	-0.164*	-1.79	0.516
Event	5.095**	6.72	0.371**	2.00	0.401*	1.90	0.644**	2.45	0.205	0.72	-0.274*	-1.77	0.302
(1,3)	1.093**	2.01	0.157	1.23	0.339**	2.26	0.611**	3.26	0.400*	1.74	-0.609**	-4.85	0.540
(4,6)	0.237	0.52	0.195*	1.71	0.727**	5.24	0.989**	5.99	0.428**	2.34	-0.092	-0.84	0.651
(7,9)	-0.093	-0.19	0.118	0.77	0.902**	5.45	0.655**	3.41	0.387	1.48	-0.163	-1.10	0.599
(10,12)	1.124	1.84	0.008	0.04	0.776**	3.65	0.602**	2.41	0.009	0.03	-0.019	-0.10	0.395

Value-weight four-factor model													
Window (months)	Alpha		Beta(-1)		Beta		SMB		HML		MOM		R <sup>2</sup>
	Estimate	t-stat	Estimate	t-stat	Estimate	t-stat	Estimate	t-stat	Estimate	t-stat	Estimate	t-stat	
(-12,-10)	-2.377**	-3.18	-0.06	-0.38	1.18**	6.17	0.413**	2.06	0.723**	3.10	-0.177	-1.50	0.383
(-9,-7)	-0.261	-0.42	0.161	1.17	1.025**	6.46	0.482**	3.03	0.145	0.74	-0.193**	-1.97	0.54
(-6,-4)	-2.122**	-3.34	0.054	0.39	1.032**	6.34	0.834**	4.79	1.054**	4.98	0.025	0.23	0.46
(-3,-1)	-1.663**	-2.33	0.159	0.99	0.731**	4.07	0.235	0.96	0.486*	1.96	-0.301**	-2.35	0.323
Event	1.616	1.18	0.820**	2.44	0.663*	1.74	0.678	1.43	0.112	0.22	-0.021	-0.07	0.173
(1,3)	0.141	0.28	0.211*	1.78	0.522**	3.75	0.450**	2.60	0.604**	2.84	-0.419**	-3.61	0.508
(4,6)	-0.683	-1.24	0.033	0.24	1.005**	6.04	0.959**	4.84	0.99**	4.52	-0.268**	-2.05	0.625
(7,9)	-0.005	-0.01	0.089	0.60	0.742**	4.57	0.587**	3.12	1.03**	4.03	-0.692**	-4.74	0.685
(10,12)	-0.041	-0.08	-0.132	-0.82	0.985**	5.50	0.778**	3.69	0.666**	2.181	-0.165	-1.05	0.61



# Does HF activism create value?

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Can the positive return be due to stock-picking or information?

Distinguish between information about the hedge fund's intention to intervene and information about the firm (w/o the hedge fund).

- Hostile deals are, by definition, resisted by the firm managers, but returns are 3.9% higher (statistically significant).
- Average exit returns positive for success and partial success events, negative when hedge funds withdraw and exit.
- Conditioning on targets that had large hedge fund holdings (4% or higher) results in similar price reactions.
- High positive correlation between the length of time that shares are held by the funds and the decision to exit based on stated goals.

# Before and after: Operational performance

	EBITDA/Assets				EBITDA/Sales			
	<u>Year-by-Year Peer Match</u>		<u>(t-2) Performance Match</u>		<u>Year-by-Year Peer Match</u>		<u>(t-2) Performance Match</u>	
	Diff w/ Match	t-stat	Diff w/ Match	t-stat	Diff w/ Match	t-stat	Diff w/ Match	t-stat
t-2	1.99%**	3.56	0.01%	--	4.41%	1.26	-0.02%	--
t-1	1.16%**	2.17	0.12%	0.30	2.86%	0.81	-1.54%	-0.99
Event	0.01%	0.02	-0.49%	-0.95	2.79%	0.88	-3.03%*	-1.77
t+1	0.97%	1.48	0.29%	0.42	5.35%*	1.84	-2.31%	-1.08
t+2	2.67%**	2.79	1.04%	1.10	8.67%**	3.63	3.15%	1.05
(t+1)-(t-1)	-0.19%	-0.35	0.17%	0.44	2.49%	1.41	-0.77%	-0.23
(t+2)-(t-1)	1.51%*	1.94	0.92%	1.40	5.81%**	4.17	4.69%**	2.67

# Before and after: Payout and Leverage

	Total Payout Yield				Leverage			
	Year-by-Year Peer Match		(t-2) Performance Match		Year-by-Year Peer Match		(t-2) Performance Match	
	Diff w/ Match	t-stat	Diff w/ Match	t-stat	Diff w/ Match	t-stat	Diff w/ Match	t-stat
t-2	0.02%	0.14	0.01%	--	3.96%**	3.69	0.24%**	5.96
t-1	-0.07%	-0.60	-0.15%	-1.37	3.15%**	3.11	-0.91%	-1.48
Event	0.27%*	1.85	0.04%	0.28	3.28%**	3.05	0.18%	0.23
t+1	0.38%*	1.88	0.13%	0.63	3.87%**	2.95	0.29%	0.28
t+2	0.16%	0.72	0.19%	0.80	4.45%**	2.69	0.49%	0.31
(t+1)-(t-1)	0.46%**	2.28	0.28%	1.36	0.72%	0.99	1.20%	1.59
(t+2)-(t-1)	0.23%	1.07	0.34%	1.58	1.30%**	2.70	1.40%	1.19

- Did HF predict dividend payers? Not likely according to the hostile subsample.





# Does HF activism create value?

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Does the excess return to shareholders represent rent extraction from other stakeholders?

## 1. Bondholders:

- The coefficient of abnormal return on LEV is far from significant.
- The subsample of no-debt targets see abnormal returns 2.25% higher (insignificant).
- No evidence of a change in existing bond yields.
- Magnitude of abnormal return is too high to be “explained” by the leverage changes that we observe.

## 2. CEOs:

- Pay goes down.
- Turnover increases.

# CEO pay and turnover

	CEO Contracted Pay (\$1,000)		CEO Pay-for-Performance (%)		%CEO Turnover	
	Diff w/ Match	t-stat	Diff w/ Match	t-stat	Diff w/ Match	t-stat
t-2	-445	-1.33	-7.10%**	-3.33	1.55%	0.62
t-1	18	0.05	0.29%	0.12	2.52%	1.03
Event	914**	2.06	5.70%**	2.56	5.82%*	1.88
t+1	-296	-0.73	6.14%**	2.02	12.42%**	2.85
(t+1)-(t-1)	-315	-0.60	5.85%*	1.94	9.90%**	2.34
(t+1)-(t)	-1,210**	-2.16	0.45%	0.14	6.60%	1.16



# Summary

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- First large-sample analysis on hedge fund activism in regular corporations.
- Implication for informed investor monitoring and a new form of market-based governance.
- Overall, market participants seem to believe that hedge fund activism adds value, but with large cross-sectional variation.
- Hedge funds' positive impact on firm performance.