



Iowa Research Online

The University of Iowa's Institutional Repository

Honors Theses at the University of Iowa

Fall 2017

Hedge Fund Activism: A Review of Wealth Creation, Operational Efficiency and Corporate Strategy in Targeted Firms

Nicholas Barry
University of Iowa

Follow this and additional works at: https://ir.uiowa.edu/honors_theses

 Part of the [Finance and Financial Management Commons](#)

This honors thesis is available at Iowa Research Online: https://ir.uiowa.edu/honors_theses/242

HEDGE FUND ACTIVISM: A REVIEW OF WEALTH CREATION, OPERATIONAL EFFICIENCY AND
CORPORATE STRATEGY IN TARGETED FIRMS

by

Nicholas Barry

A thesis submitted in partial fulfillment of the requirements
for graduation with Honors in the Business

Jeffrey R. Hart
Thesis Mentor

Fall 2017

All requirements for graduation with Honors in the
Business have been completed.

Jennifer A. Blair
Business Honors Advisor

Hedge Fund Activism: A Review of Wealth Creation, Operational Efficiency and Corporate Strategy in Targeted Firms

Nicholas H. Barry

Henry B. Tippie College of Business

University of Iowa

Iowa City, Iowa 52242

nicholas-barry@uiowa.edu

December 2017

Abstract

Shareholder activism, primarily initiated by hedge funds, has given rise to numerous debates regarding value creation in targeted firms. Do activists compromise a firm's long-term performance for short-term profits? Are they actively engaging in practices that impact operational efficiency? Is there evidence that activists are enhancing corporate governance and strategy? The answers to these questions can shape the economic, regulatory and political environments that investors face. This paper aims to assess the current activist landscape by considering both broad and specific activist tendencies brought forth by previous research. Despite management teams and media sources citing the value-destructive nature of activist intervention, academic research largely concludes the contrary. The majority of empirical evidence suggests these practices are not value-destructive, but typically value-accretive, at a statistically significant level. Finally, I suggest future research attempt to quantify the impact of activist-influenced mergers and acquisitions on the acquirer.

*I would like to thank Jeffrey Hart for advising and giving me feedback throughout this project.

1. Introduction

1.1 Background & Inspiration

My analysis is inspired by two items: personal exposure to activist campaigns and previous literature regarding shareholder activism. The goal of this paper is to utilize real-world experience to review previous literature that analyzes activist hedge funds. In a corporate setting I have researched activist tendencies, analyzed takeover defenses and interacted with tenured professionals. As academic researchers and corporate professionals are largely divided on the topic, I hope my tangible experience will offer a unique perspective. I aim to provide an objective, unbiased review of hedge fund activism.

Shareholder activism has spurred discussion about the value of the tactic and its subsequent effect(s) on companies, investors and regulation. There are numerous policy debates, such as shareholder voting rights and SEC disclosure requirements that have resulted from such practices. Most importantly, there has been heated debate about value creation, or destruction, in targets. For these reasons, this research is vital in studying the true impact of activist interventions in targeted firms.

The paper is outlined as follows. Section 2 analyzes the results of shareholder activism on the maximization of shareholder wealth. Section 3 reviews the impact to operating performance and efficiency. Section 4 looks at firm-wide corporate strategy, both in response to and in prevention of, activist intervention. The first three sections analyze data in both the short- and long-term. Section 5 provides a broad overview of

the analysis and concludes my findings. Lastly, Section 5 suggests that future avenues of research study the impact of activist-influenced mergers and acquisitions (M&A) on the acquirer.

1.2 History of Activism

Research shows that activism came about in the 1980s due to an increase in institutional shareholdings that corresponded with an increase in corporate anti-takeover provisions. So when institutions, and investors alike, were purchasing increasingly large quantities of shares, they were finding it increasingly difficult to influence firm performance. Academics argue that activism is a logical progression of shareholder monitoring in a market that is largely restrictive of such practices. Between 1996 and 2005 there were 2,436 activist interventions at 548 different firms. A trend reversal has not been observed and funds have been targeting larger and larger firms over time. Approximately 24% of activist campaigns in 2012 targeted firms with more than \$1 billion in market capitalization compared to just 8% in 2009 (Denes, Karpoff and McWilliams 2016).

Investors such as Bill Ackman, Carl Icahn and Daniel Loeb have been increasing both the severity and frequency of interventions. With activist campaigns in companies as large as General Motors and Proctor & Gamble, no longer is activism a practice fit exclusively for small-cap, undervalued companies. Investors are taking active roles in major corporations that can affect a larger number of investors.

Regulation by the SEC, as per Section 13(d) of the 1934 Exchange Act, requires activists to file a Schedule 13D within 10 days of any “activist” investment. This applies to any such investor that acquires beneficial ownership of more than 5% of the outstanding shares of a public corporation. Additionally, there is a Schedule 13G that funds must file if their intentions of the investment are passive (i.e. they aren’t attempting to influence behavior). This distinction is important for analyzing the difference in outcomes arising from each specific investment type. The 13D / 13G database is the primary source of data for the research found throughout this literature review.

This brief, yet intense, era of shareholder activism provides a broad sample of important research events.

1.3 Long-Term Shareholder Wealth

Arguably the most important question that is asked about shareholder activism considers wealth creation. Do activists create wealth in the long-term? More specifically, is the myopic-activist claim true or false? Advocates of the myopic-activist claim suggest there is tangible degradation of shareholder wealth in the long-term in lieu of short-term gains. Empirical evidence across multiple studies supports the contrary. On balance, there is little evidence showing a meaningful decline in abnormal returns to targeted funds. This returns analysis is done typically by estimating an alpha for the targeted firm using techniques such as the Capital Asset Pricing Model (CAPM) or the Fama-French-Carhart four-factor model (Fama-French-Carhart). This alpha, defined as

a cumulative abnormal return (CAR), then represents the excess, or abnormal, returns above what the model would suggest (Bebchuk, Brav and Jiang 2015). Additionally, multiple research articles have shown no reversal in stock price, and subsequent abnormal returns, for as long as five years post-intervention. However, there are number of critics who suggest these abnormal returns are product of competitive markets and a reversion to the mean rather than activist intervention. Similarly, there are a number of scholars that suggest this evidence is a product of tortured statistics and that real-world experience is being undervalued by the finance community.

1.4 Operational Efficiency

Just as any investor would, activists expect firms to improve operations throughout their investment horizon. This leads to better utilization of assets, stronger profit generation and increased payouts. Historical research has utilized metrics such as, but not limited to, Tobin's Q (Q) and Return on Assets (ROA) to assess operational efficiency. ROA analyzes the transformation of assets into profits while Q is designed to show how successful a company is in turning assets into shareholder value. Empirical data shows that when compared to size- and industry-matched peers, firms that experience an activist intervention typically outperform within two years. Although the outperformance comes in the form of underperforming less (i.e. becoming less negative) than before, firms do show operational improvements at the hands of activists (Bebchuk, Brav and Jiang 2015). These findings are replicated in multiple, dataset exclusive studies.

1.5 Corporate Strategy

Aside from firm performance, activists also directly impact the strategic vision at targeted firms. Activists tend to focus on takeover attempts (both internally and externally), asset divestitures, innovation rates and payout policies. Sometimes influence arises from an activist's intention to take a seat on the board of representatives. If it's a hostile campaign, activists employ what's referred to as a "proxy fight" to obtain these seats. This sort of action tends to receive the most attention, and scrutiny, from the finance community. However, activists don't necessarily need to have a seat at the table to influence firm behavior. They have the power to gain public interest by issuing public reports, called white papers, that outline the inefficiencies of management, contain previously private information and criticize recent developments within the firm. Research suggests that targeted firms are largely innovative, although inefficient in such a manner, and exhibit a higher probability of being taken over. There is little evidence proposing that activists are negatively impacting the corporate governance at targeted firms. The value creation, or destruction, in subsequent M&A activity is a topic yet to be quantified.

2. Long-Term Shareholder Wealth

2.1 The Myopic-Activist Claim

The myopic-activist claim states that activist demands, such as changes in capital structure, asset spinoffs and CEO replacements, sacrifice long-term value for short-term

returns to the activist. There have been a significant number of economists, legal scholars, and business professionals that have been outspoken about this claim. Unlike management teams and boards, activists can exit their investment whenever they please. This gives them an opportunity to invest, promote an agenda, realize a short-term gain and exit immediately. They aren't held to the same accountability standards as management and therefore aren't responsible for the events subsequent their involvement. Thus, the activist has the opportunity to act in a unique environment. They suggest firm-wide actions that influence thousands of individuals, but can exit at their leisure irrespective of the outcomes of their agenda (Bebchuk, Brav and Jiang 2015). This, the core of the myopic-activist claim, is supported by professional experience and simple logic. But what does the empirical evidence show?

2.2 Initial Market Reaction

Research agrees that activist intervention results in an almost immediate increase to the targeted firm's share price and subsequent cumulative abnormal returns (CARs). This market reaction is partially because of an increase in the demand for the stock and the simple buying function. But, more importantly, it is due to the perceived success of activist campaigns. Activists not only publicize their plans for value creation in targeted firms, but they also show commitment through the size of their investment. It's quite possible that investors consider hedge funds to be superior monitors of corporate performance, leading them to overvalue the claims activists make (Clifford 2008). Investors observe this behavior and subsequently believe that the agenda will be

implemented, that it will create value and that they can ultimately realize abnormal returns. Thus, individual investors follow activists and exaggerate the positive price reaction. This behavior is analyzed across numerous event windows in multiple empirical studies.

During the announcement window from 20 days before to 20 days after investment ($[-20,+20]$) targeted firms experience positive excess returns of approximately 7% to 8% (Brav, Jiang, Thomas and Partnoy 2008). These results are replicated in countries other than the United States. Across the same time period ($[-20,+20]$), successful activist campaigns result in abnormal returns of 8.77% and 2.72% in Europe and Asia respectively (Becht, Franks, Grant and Wagner 2017). In a study of 980 events from 1992 to 2006 with an event window of $[-10,+5]$ days, activist targets exhibit CARs of approximately 3.6% after starting at essentially zero (Schor and Greenwood 2009).

These studies employ tactics to ensure the events being analyzed are, in fact, true activist campaigns. For example, Brav et al. (2015) conducts extensive research of news articles in search of language consistent with activist demands. This distinction is important as it allows for meaningful conclusions to be drawn. In a separate study of a 5-day event window ($[-2,+2]$) comprised of 1,605 events, data shows that the mean return to targets of 13G (passive) investments is 1.6%. This is compared to abnormal returns in 13D (active) targets of approximately 3.4%. Thus, the market applies an alpha of almost 2% to companies that have been targeted by true activists (Clifford 2008).

2.3 Extended Abnormal Returns

The logical next step to the initial market reaction phenomenon is to then analyze how sustainable these CARs are in the long-term. A study comprised of 151 events over the years 2003 to 2005 suggests that abnormal returns do not retreat from their immediate spike. As compared to a Fama-French size-matched portfolio, targets that observe a successful activist campaign realize a mean abnormal return of 12.3% during the first year. Further, targets experience CARs of 10.2% when the activist gains a seat on the board and 14.7% when the target is acquired within one year (Klein and Zur 2006).

In a study of more than 2,000 interventions from 1994 to 2007, it is shown through regression analysis that targeted firms experience positive, statistically significant and extended CARs. In the three- and five-year periods post-intervention, targets exhibit alphas superior to the CAPM of 0.49% and 0.65% respectively. These positive returns are confirmed when using the Fama-French-Carhart model where across the same time horizons, targets have CARs of approximately 0.25% and 0.40% respectively. Additionally, the same sample is used to construct a buy-and-hold scenario in which returns in targeted firms are analyzed as compared to a market capitalization and book-to-market value-weighted portfolio. The mean abnormal return is 2.58% for the three-year period and 5.81% for the five-year period. Although the returns in the buy-and-hold scenario aren't statistically significant at a positive level,

they also aren't significant at a negative level. Thus, both analyses of CARs oppose the validity of the myopic-activist claim (Bebchuk, Brav and Jiang 2015).

Therefore, empirical evidence provides no support for the myopic-activist claim. It is not shown that firms experience a degradation in long-term returns in lieu of short-term gains.

2.4 Reversion to the Mean

There is a subset of research suggesting that the abnormal returns observed by targeted firms is a product of selection bias. Said differently, activist hedge funds are good at "stock picking" firms that are already underperforming their peer group. Thus, the subsequent increase in abnormal returns is a mere function of reversion to the mean in a competitive market (Allaire and Dauphin 2014).

This selection bias is analyzed in a study using the same dataset as Brav et al. (2015), but with a few minor changes. Researchers utilize a different peer group than previous research as a way to improve the validity of the results. They use control firms, selected by the Abadia-Imbens matching estimator, that perform equally as poorly as the target in the year prior to intervention but are not a target for activist intervention. In this manner, they are able to study similarly-performing companies while isolating the impact of an activist shareholder. They find that control firms, as measured by Tobin's Q, experience an increase in value parallel to that of targeted firms. For example, in an analysis extending three years post-intervention, evidence

shows that the value of control firms was about 9.8% higher than that of targeted firms. This analysis proposes that the increase in value post-intervention is explained not by the activist, but by general forces present in a competitive market (Cremers, Giambona, Sepe and Wang 2015).

But, if hedge funds truly believe they are good stock pickers, as the previous paragraph predicts, then they wouldn't willingly take on the costs associated with activist intervention. In using their resources to influence behavior, activists are exemplifying their belief that they can positively impact performance (Bebchuk, Brav and Jiang 2015). Similarly, firms targeted for activist reasons earn higher abnormal returns than firms that are passively targeted as shown in a study with the exact same sample group of hedge funds (Clifford 2008). These two pieces of research reject the reversion theory and suggest that there is a meaningful relationship, even in isolation, between activism and abnormal wealth creation.

2.5 The Myopic-Activist Support

Advocates of the myopic-activist theory cite real-world experience, limitations of econometric models and value transfer as primary support. There is a large degree of manipulation in the statistics of most empirical studies. Size, industry, historical performance and expected growth are all variables that are frequently controlled in these studies. It is argued that these "tortured statistics" result in unrealistic outcomes when studied. For example in Bebchuk et al. (2015), the alphas for each group are compared to a dynamic, inconsistent peer group. Each year the benchmark portfolio is

adjusted to new firm attributes. Thus, each year of analysis is potentially being compared to a different set of benchmark firms (Allaire and Dauphin 2014).

Additionally, it's important to understand the type of improvement targeted funds experience throughout an activist investment. Bebchuk et al. (2015) find that the three and five calendar year abnormal returns are statistically insignificant from zero as compared to the Fama-French-Carhart model. This means that an activist investor doesn't obtain a return greater than that of the market portfolio during the same investment horizon. Therefore, a logical and efficient hedge fund will capitalize on the short-term gain and then immediately exit (Coffee and Palia 2014). This is precisely what the myopic-activist theory suggests comes as a result of shareholder activism.

3. Operational Efficiency

3.1 Target Characteristics

Data surrounding the initial state of operations in targeted companies is largely uncontested. Historical evidence proposed that activists tended to target smaller firms with exaggerated growth profiles and more debt than that of, for example, a private equity investor. Hedge fund targets have a median ROA of 3.3%, less than that of the sample of private equity targets (Mietzner and Schweizer 2007). However, a more recent analysis suggests the most successful activist hedge funds show an ability to succeed in difficult interventions with large, multinational firms. In a study conducted from 2008 to 2014, results show that top activists, defined as hedge funds with 21-day

post-announcement CARs of 10% and at least three interventions in the previous three years, target firms with an average ROA of 7%. This is compared to the mean of all other hedge fund groups' average target ROA of -3% (Krishan, Partnoy and Thomas 2016). Thus, one can conclude that the characteristics of targeted firms are changing drastically.

3.2 Return on Assets (ROA)

Arguably the most recognizable measure of operating performance in financial economics literature is Return on Assets (ROA). ROA is commonly used to compare a firm's profitability relative to its assets by dividing earnings before interest, taxes, depreciation & amortization (EBITDA) by total (or lagged) assets. Empirical studies, similar to those of wealth creation, suggest that activists have a statistically significant, positive impact on operational performance in targeted firms.

In Bebchuk et al. (2015), which utilizes a dataset of more than 2,000 interventions, it is shown that ROA steadily increases post-intervention. Excluding industry-related considerations, the sample set experiences an increase in raw ROA of more than 3%, from 2.6% to 5.7%, in the five years following an activist investment. In order to better control test results, results are typically shown on an industry-adjusted basis. Similar to the raw levels, industry-adjusted ROA in targeted firms increases more than 2% across the same time horizon. Although the targets tend to initially underperform relative to their peers (i.e. their industry-adjusted ROA is negative at $t=0$), the growth in ROA

exemplifies substantial increases in operating performance (Bebchuk, Brav and Jiang 2015).

In a different sample comprised of 418 activist events from 1994 to 2005, it is shown that targets interacting with an aggressive activist exhibit an increase in ROA of 24.7% relative to matched peers. The year-over-year (YoY) increase in ROA of passive interventions is just 7.7%. This complimentary study suggests there is a tangible, isolated relationship between changes in firm performance and the degree of intervention that a targeted firm experiences (Boyson and Mooradian 2010).

But, where do these increases in ROA come from? ROA can increase due to an increase in EBITDA (numerator) or a decrease in total assets (denominator). In the year following activist intervention, both actively and passively targeted firms experience a reduction in EBITDA. This is complimented by evidence showing that actively targeted firms experience larger decreases in assets than that of passively targeted firms. With a consistent numerator, it can be concluded that increases in ROA in actively targeted firms is derived primarily from a reduction of assets (Clifford 2008). Hedge funds typically attempt to take value from the balance sheet by divesting underperforming assets, repurchasing significant numbers of shares and using “excess” cash to pay themselves a healthy dividend (Cheffins and Armour 2011). There is little research suggesting that increases in ROA are a result of an activist’s ability to increase firm profitability, as estimated by EBITDA.

3.3 Tobin's Q (Q)

Less utilized in corporate environments, though used frequently by financial economists, is the performance metric known as Tobin's Q (Q). Simply put, Q is a measure that represents a company's success in turning assets into market value. A ratio greater than one (1) indicates that a firm is taking on positive Net Present Value (NPV) projects that meet or exceed expectations (Goodwin 2016). It's calculated in the following manner: $(\text{market value of equity} + \text{book value of debt}) / (\text{book value of equity} + \text{book value of debt})$. This metric can be used to analyze the effectiveness of firm operations relative to wealth creation, the efficiency of governance initiatives and the optimality of various debt and equity distributions (Bebchuk, Brav and Jiang 2015).

Parallel to the results stemming from the ROA analysis, Bebchuk et al. (2015) also provide evidence indicating that Q increases as a result of activist intervention. Q, without industry adjustments, increases from 2.011 to 2.150 in the five years after announcement in targeted firms. Similarly, industry-adjusted Q increases from -0.469 to -0.137. This is an increase of almost 67% relative to the industry average (Bebchuk, Brav and Jiang 2015). Operational improvement is replicated in an additional study with arguably the most exhaustive activist dataset to date. The sample comprised of approximately 4,186 events from between 1990 to 2014. The results indicate that industry-adjusted Q in targeted firms, specifically with board representation battles, increases from -1.47 to -1.20 in the [0,+5 year] event window (Goodwin 2016). However as previously discussed, these observations support the positive impact of shareholder

activism, but raise concern that a rational hedge fund would consistently act in such a manner.

In response to the reversion theory, which suggests increased firm performance following activist interventions is a natural path back to the industry standard, Bebchuk et al. (2015) took their analysis of Q one step further. In order to control against the explanation that increased firm performance is primarily due to the availability of improvement relative to a firm's initial position, they add in a lagged performance variable. This way they can strictly analyze the impact of the activist shareholder without allowing for past performance metrics to skew the results. In this manner, Q is observed to increase to 0.44 five years post-intervention as compared to the year prior to intervention (Bebchuk, Brav and Jiang 2015).

3.4 Earnings and Profitability

Operational efficiency in the form of increased profitability is scarce in the current academic research pool. Activists can more directly influence performance metrics relative to assets, along with other balance sheet items, because there are numerous ways to quickly change those accounts. It is much more difficult to obtain such results on the income statement.

From 2003 to 2005 in an analysis of 151 targets, the change in the industry-adjusted Cash / Assets ratio was -0.096. This indicates that the average cash balance of targets decreases throughout the [-30 day,+1 year] time horizon. To further this idea, the

same study also researched the post-intervention effects of activism on profitability. There is no meaningful increase in EBITDA and / or Cash Flow from Operations (CFO), both relative to assets, across the same event window (Klein and Zur 2006).

Additional research shows that Operating Margin (OM), defined as EBITDA / Sales, exhibits an interesting trend in targets that elect an activist board member. In the window [-5,0 years], OM decreases more than 91% while in the post-intervention window ([0,+5]) OM increases approximately 363%. These metrics coincide with revenue trends of -54% from [-5,0] and 155% from [0,+5]. Because revenue increases at a slower rate than OM, it could be drawn that the increased OM is relative to something other than growth. Excluding the option that a firm drastically reduces operating expenses enough to make up for the gap, another explanation might be increased Capital Expenditures (CapEx). Targeted firms and industry-adjusted peers exhibit CapEx increases of almost 27% and 18% respectively for the event window [0,+5]. It's possible that the increased cash used for CapEx is driving depreciation numbers higher in targeted firms, resulting in exaggerated EBITDA figures (Goodwin 2016).

4. Corporate Strategy

4.1 Governance

In many cases, activists aim to influence various corporate governance initiatives. These include, but are not limited to, items such as board representation, CEO removal and management transparency.

Historically, activists have received a lot of attention for their consistent involvement in proxy fights, or the solicitation of shareholder votes for a certain purpose. A study conducted in 2006 concludes that nearly 40% of activist events involve a threatened or actual proxy fight. This sample subsequently shows that CARs of hedge fund targets during the [-5,+5 day] event window are statistically significant at 4.48% (Klein and Zur 2006). Another way in which activists can influence firm behavior is through the formation of a “wolf pack”. This is a cohort of activists that, possibly by chance or by collusion, aim to influence management without surpassing the 13D threshold. This can prevent defense tactics such as a poison pill or a tender offer (Wong 2016).

The most recent wave of shareholder activism, coming after the financial crisis of 2008, has brought a shift to the way in which firms succeed in such governance initiatives. Firms have been using their reputation, clout and expertise to win activist campaigns. The top activists are more effective in obtaining board representation, improving performance and monitoring strategy. These practices are starkly different from the old strategies of altering capital structure and increasing payouts. Interestingly enough, firms obtain the most respect through their “clout” as measured by the historical size of investments. The funds with the largest historical investments subsequently reap the highest abnormal returns post-announcement. In the [0,+21 day] event window, the top performing funds obtain an abnormal return of 12.4% as

compared to just 6.6% of all other funds in the study (Krishnan, Partnoy and Randall 2016).

Another type of intervention, dubbed offensive shareholder activism, supports corporate governance campaigns by shareholders. Offensive shareholder activism is defined as when a firm takes a significant, proactive stake on the assumption that a company is not currently maximizing value. These activists aim to promote change at the company in order to obtain the unrealized value (Cheffins and Armour 2011). This analysis is extended in an article which empirically studies the results of such interventions. As long as there is a framework in place to protect centralized authority and keep fiduciary responsibility with the board, offensive activism can be utilized as a corrective mechanism in reducing corporate error. Offensive shareholders, who are known to obtain superior information and strategies, are often given some of the authority in order to unlock value (Rose and Sharfman 2015).

4.2 Innovation Rates

The analysis of innovation in targeted firms is important for two main reasons. First, it's vital to understand whether or not hedge fund activists are able to influence company growth at an organic level. Second, and more importantly, innovation projects typically have an extended time horizon with multiple facets of complex issues. This implies that the market typically won't correctly value the activist impact on firm innovation. In such a manner, the myopic-activist claim would reject consistent activist involvement in such projects. This would incentivize the activist to take irrational

measures, such as drastically reducing R&D, in order to realize a short term profit. However, hedge funds have been shown to not act in this way and actually serve as more effective monitors of innovation than other institutions (He, Qiu and Tang 2016).

Research conducted by He et al. (2016) concludes that, with respect to corporate innovation as an effective avenue for value creation, activists benefit innovative firms' long-term performance. Because innovation is a costly, challenging and intense process, there are extensive opportunities for activists to enhance the results of such innovation. In deciding which innovative firms to target, hedge funds are more inclined to analyze the innovation efficiency (i.e. Sales per dollar of R&D) than the sheer amount of input (R&D expense). Controlling for passive investments in order to mitigate the stock picking explanation, the data proposes that activists increase innovation output.

He et al. (2016) utilize the same dataset as Brav et al. (2008) to maintain the consistency of analysis. The input metric is a simple R&D margin to sales while the output is constructed as Patent Index / Sales (as obtained by the National Bureau of Economics Research). In the event window [0,+2 years], evidence suggests that activist interventions increase innovation output by 18.3%, significant at the 1% confidence level (He, Qiu and Tang 2016).

4.3 Takeovers

The last, and arguably most important, strategic initiative that activist hedge funds influence is corporate takeovers. These pursuits are comprised of both internal,

go-private transactions as well as external M&A with strategic and financial buyers. Since the 1990s, there has been an increase in M&A activity parallel to a decline in corporate tender offers. Some point to the legal framework surrounding tender offers and suggest that activism has been made “easier” relative to such offers. Nonetheless, there is a possible connection between the increase in activist intervention and M&A activity (Burkart and Lee 2015).

As previously stated in this review, Schor and Greenwood (2009) find that targeted firms experience abnormal returns of about 3.5% in the [-10,+5 day] event window. They also find that in their dataset of 980 events from 1993 to 2006, the highest abnormal returns are observed, and statistically significant, when targeted firms are involved in M&A activity. It is shown that the majority of the 10% CAR in the event horizon of [-1, +18 month] comes during the [+3,+18] window. This suggests that either the market initially undervalues the activism, or the market systematically undervalues the target as a whole (Schor and Greenwood 2009). Therefore, if wealth creation and / or operational efficiency don't drive the abnormal stock returns in targets, then it might be due to an expected takeover premium (Coffee and Palia 2014).

Numerous studies replicate this phenomenon of increased takeover returns across different sample pools. Brav et al. 2008 show that firms targeted for sale experience average positive CARs of 8.54%, significantly higher than that of their general target pool. Additionally, the target exhibits abnormal returns of 13.1% in

situations where the hedge fund intends to purchase the target for its own portfolio (Klein and Zur 2006).

Further, the takeover premium effect is compared directly to other forms of activist intervention. Schor and Greenwood (2009) outlay a table comprised of CARs under various activist demands. Takeover premiums apply primarily to asset sales, blocked mergers and strategic alternatives. Throughout the [-1,+18 month] window, as observed above, these demands result in excess, abnormal returns of 11.0%, 21.0% and 8.1% respectively. For reference, capital structure demands only result in abnormal returns of 7.2% during the same event window.

The information in the previous paragraphs summarize evidence suggesting that perceived takeover valuations are the significant driver, in excess of operational improvements, of abnormal returns (Coffee and Palia 2014). This inherently makes sense for two primary reasons. First, activists can exit at a premium to the perceived valuation of the target by the market. This is due to the premium that acquirer's typically pay for control of the company and for any potential synergies. Second, activists can altogether avoid the issue of liquidity when exiting their investment. In the public market for a relatively illiquid firm, activists can experience downward price pressure when exiting the investment. It can be concluded that activists enjoy the abnormal returns stemming from takeover bids and therefore will advocate for such strategy at a firm-wide level.

5. Conclusion

5.1 Summary of Findings

This paper identifies, explains and analyzes multiple facets of the current shareholder activist landscape.

The evidence surrounding activist wealth creation is a mixed bag, but largely lies in opposition of the myopic-activist claim. Multiple studies have empirically confirmed, complete with statistically significant results, the positive short- and long-term wealth creation in targeted firms. The supporters of the myopic-activist theory primarily use qualitative, anecdotal evidence to back up its claims. While qualitative factors are undoubtedly important in analyzing the issue, the robustness of the presented empirical evidence greatly outweighs such alternative support. Thus, it should be concluded that activists do in fact generate shareholder wealth in targeted firms.

The majority of research supports the position that activists positively impact operational efficiency in targeted firms. When looking at metrics such as ROA and Tobin's Q, one can make meaningful conclusions regarding their trends both prior to and in response of activist interventions. The data, however, becomes less clear when analyzing the subsequent impact on a firm's profitability. It can be concluded that activist's most effectively influence operational efficiency by increasing asset utilization in targets relative to their industry-matched peers.

Activists aim to influence corporate strategy through practices such as, but not limited to, governance, innovation and takeovers. Research largely finds that activist interventions in each scope of strategy are beneficial to the target at a statistically significant level. In attempting to influence, not control, corporate governance, activists can help monitor and mitigate information asymmetry. Similarly, activists are empirically proven to improve the efficiency of innovation in targets. This type of organic growth can increase returns in the long-term. Lastly, activists are large supporters of takeovers post-intervention. This gives them the highest abnormal returns and facilitates a simple exit.

It's no question that the results of activist interventions have far-reaching impact on investors of all kinds. For this reason it is important to analyze such practices objectively and accurately. The conclusion can be drawn from all sections of analysis that, on balance, activist hedge funds positively impact firms at a statistically significant level. Their intervention produces abnormal returns, increases operational efficiencies and promotes positive strategic initiatives.

5.2 Next Steps

The current literature on hedge fund activism raises a significant question regarding the outcomes, to the acquirer, of activist-influenced M&A activity.

It is shown that targets of activism show a probability of takeover roughly six to eight times higher than that of firms where the same hedge fund is passive (Boyson,

Gantchev and Shivdasani 2017). Previous analysis shows positive returns to the activist, general shareholders and management. But, a vital point of discussion is overlooked throughout all previous research.

Are the deals that are ultimately consummated accretive to the Earnings Per Share (EPS) of the acquisitive firm? The goal, in theory, of M&A is to complete deals that will benefit both parties in the future. However, there is little evidence surrounding the subsequent integration of targeted firms. It's vital to empirically analyze these transactions in order to determine whether activists truly are promoting valuable deals and not just simply creating an exit.

References

- Allaire, Yvan and Dauphin, Francois, 'Activist' Hedge Funds: Creators of Lasting Wealth? What Do the Empirical Studies Really Say? (July 16, 2014).
- Bebchuk, Lucian A. and Brav, Alon and Jiang, Wei, The Long-Term Effects of Hedge Fund Activism (June 2015). Harvard Law School John M. Olin Center Discussion Paper No. 802; Columbia Law Review, Vol. 115, 2015, pp. 1085-1156; Columbia Business School Research Paper No. 13-66.
- Becht, Marco and Franks, Julian R. and Grant, Jeremy and Wagner, Hannes F., Returns to Hedge Fund Activism: An International Study (May 2017). Review of Financial Studies, Forthcoming; European Corporate Governance Institute (ECGI) - Finance Working Paper No. 402/2014.
- Boyson, Nicole M. and Gantchev, Nickolay and Shivdasani, Anil, Activism Mergers (October 31, 2017). Journal of Financial Economics (JFE), Forthcoming
- Boyson, Nicole M. and Mooradian, Robert M., Corporate Governance and Hedge Fund Activism (June 1, 2010). Review of Derivatives Research, Vol. 14, No. 2, 2011.
- Brav, Alon and Jiang, Wei and Thomas, Randall S. and Partnoy, Frank, Hedge Fund Activism, Corporate Governance, and Firm Performance (May 2008). Journal of Finance, Vol. 63, p. 1729, 2008; ECGI - Finance Working Paper No. 139/2006; Vanderbilt Law and Economics Research Paper No. 07-28; FDIC Center for Financial Research Working Paper No. 2008-06.
- Burkart, Mike and Lee, Samuel, Hedge Fund Activism vs. Hostile Takeover Bids (July 7, 2015). Swedish House of Finance Research Paper No. 15-04.
- Cheffins, Brian R. and Armour, John, The Past, Present and Future of Shareholder Activism by Hedge Funds (August 31, 2011). Journal of Corporation Law, 2012; University of Cambridge Faculty of Law Research Paper No. 38/2011.
- Clifford, Christopher P., Value Creation or Destruction? Hedge Funds as Shareholder Activists (April 2008). Journal of Corporate Finance, Vol. 14, No. 4, 2008.
- Coffee, John C. and Palia, Darius, The Impact of Hedge Fund Activism: Evidence and Implications (September 15, 2014). European Corporate Governance Institute (ECGI) - Law Working Paper No. 266/2014; Columbia Law and Economics Working Paper No. 489.

- Cremers, Martijn and Giambona, Erasmo and Sepe, Simone M. and Wang, Ye, Hedge Fund Activism and Long-Term Firm Value (November 19, 2015).
- Denes, Matthew and Karpoff, Jonathan M. and McWilliams, Victoria, Thirty Years of Shareholder Activism: A Survey of Empirical Research (June 8, 2016). *Journal of Corporate Finance*, Vol. 44, June 2017, pp. 405-424.
- Goodwin, PhD, Shane C., The Long-Term Efficacy of Activist Directors (February 11, 2016).
- He, Zhongzhi Lawrence and Qiu, Jiaping and Tang, Tingfeng, Hedge Fund Activism and Corporate Innovation (May 23, 2016).
- Klein, April and Zur, Emanuel, Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors (September 2006). AAA 2007 Financial Accounting & Reporting Section (FARS) Meeting Paper; ECGI - Finance Working Paper No. 140/2006; NYU Law and Economics Research Paper No. 06-41; 1st Annual Conference on Empirical Legal Studies.
- Krishnan, C. N. V. and Partnoy, Frank and Thomas, Randall S., The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise. (July 25, 2016). Vanderbilt Law and Economics Research Paper No. 15-9; *Journal of Corporate Finance*, Vol. 40, No. 296-314, 2016.
- Mietzner, Mark and Schweizer, Denis, Hedge Funds vs. Private Equity Funds as Shareholder Activists - Differences in Value Creation (November 2007).
- Rose, Paul and Sharfman, Bernard S., Shareholder Activism as a Corrective Mechanism in Corporate Governance (August 28, 2015). *Brigham Young University Law Review*, Vol. 2014, No. 5, 2014; Ohio State Public Law Working Paper No. 225.
- Schor, Michael and Greenwood, Robin M., Investor Activism and Takeovers (January 2009).
- Wong, Yu Ting Forester, Wolves at the Door: A Closer Look at Hedge Fund Activism (October 2, 2016). Columbia Business School Research Paper No. 16-11.