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How does hedge fund activism reshape corporate innovation?☆

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ABSTRACT

This paper studies how hedge fund activism impacts corporate innovation. Firms targeted by activists improve their innovation efficiency over the five-year period following hedge fund intervention. Despite a tightening in research and development (R&D) expenditures, target firms increase innovation output, as measured by both patent counts and citations, with stronger effects among firms with more diversified innovation portfolios. Reallocation of innovative resources, redeployment of human capital, and change to board-level expertise all contribute to improve target firms' innovation. Additional tests help isolate the effect of intervention from alternative explanations, including mean reversion, sample attrition, voluntary reforms, or activist stock-picking.

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1. Introduction

There has been an ongoing debate since at least the 1980s among academics, practitioners, and policymakers about the consequences of stock market pressure on managerial incentives to engage in innovative activities that have long-term value consequences but are not easily assessed by the market. The idea that stock market pressure

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leads to "managerial myopia" has been a recurring concern (Stein, 1988, 1989) and has evolved into a heated debate in recent years as activist hedge funds have increasingly come to dominate discussions of shareholder empowerment. The concern reached a heightened level in 2015 when Laurence Fink, the chairman and CEO of BlackRock, the world's largest institutional investor, argued that activist investors put pressure on and create incentives for corporate leaders to generate short-term gains at the expense of long-term value creation.[1]

Between 1994 and 2007, there were about 1,800 engagements by hedge fund activists in which hedge funds proposed changes to payout policy, business strategy, and corporate governance, often publicly and aggressively. Recent studies, covering both the U.S. and international markets, have documented a 5% to 7% short-term average abnormal stock return when the market first learns of the activist's intervention. Moreover, the interventions are not, on average, followed by a decline in either stock returns or operating performance over the five-year window after the arrival of the activists.[2] Yet, measurement of the long-term impact of hedge fund activism has proven challenging to evaluate due to data restrictions and methodological limitations. As a result, it has been difficult to assess claims made by opponents that activists' agendas are biased towards the pursuit of short-term stock gains at the expense of firms' long-term values.[3]

Our goal is to inform the debate by analyzing how hedge fund activism reshapes corporate innovation—arguably the most important long-term investment that firms make, but also the most susceptible to short-termism.[4] A priori, neither the direction nor the magnitude of activists' impact on overall innovative activities is clear. First, activists might have a negative impact on innovation because, as Holmstrom (1989) argues, innovative activities involve the exploration of untested and unknown approaches that have a high probability of failure with contingencies that are impossible to foresee. Given the lack of observability and predictability, the concern is that management might respond to pressure for near-term performance by adopting investment/innovation policies that are detrimental to long-term firm value. More powerful current shareholders could potentially lead to greater misalignment.[5]

Second, although managerial preferences and objectives may not be aligned with firm value maximization, the order of the relative preference is not clear a priori. Like any other investment decision, a firm should only engage in innovative activities that offer an expectation of positive net present value, and agency problems may lead to either over- or under-investment. For example, over-investment may arise if specialized investment entrenches the management (Scharfstein and Stein, 2002) or if managers derive private benefits from such activities (e.g., "grandstanding" suggested by Gompers (1996)). In such a scenario, shareholders can legitimately demand that firms spend fewer resources on innovative activities. The opposite is also plausible since agency problems may lead to under-investment: shareholders may demand higher levels of research and development (R&D) than management wants if diversified investors have more capacity to absorb innovation risk (Aghion et al., 2013).

To set the stage, we first examine innovation activities at target firms before and after hedge fund intervention, measured by both inputs (R&D expenditures) and outputs (patent quantity and quality). Consistent with previous findings that target firms reduce investment and streamline their asset base following activist intervention, we find that R&D spending drops significantly in absolute amount during the five-year window subsequent to hedge fund activism. Interestingly, there does not appear to be a reduction in output from innovation—as measured by patent counts and citation counts per patent—after the intervention. In fact, most of these measures increase significantly, on average, consistent with the idea that target firms' innovation efficiency improves after hedge fund intervention.

Next, we explore four mechanisms through which hedge fund activism reshapes targeted firms' innovation. First, the improvement in patent quantity and quality is driven by firms with a diverse portfolio of patents prior to the intervention that refocused their efforts after the arrival of activists. Moreover, the increase in innovation is concentrated in technological areas that are central to the core capabilities of target firms. This set of results constitutes preliminary evidence that firms tend to improve in-

[1] In a letter sent to chief executives of the 500 largest publicly traded U.S. companies, Fink stresses the importance of taking a long-term approach to creating value and his concern with management "...response to the acute pressure, growing with every quarter, for companies to meet short-term financial goals at the expense of building long-term value. This pressure originates from a number of sources–the proliferation of activist shareholders seeking immediate returns, ..." See blackrock.com, "Delivering long-term value - Letter to corporates," March 31, 2015.

[2] See Brav, Jiang, Partnoy, and Thomas (2008), Clifford (2008), Klein and Zur (2009), Greenwood and Schor (2009), He, Qiu, and Tang (2014), and Krishnan, Partnoy, and Thomas (2016) for U.S. companies; and Becht, Franks, Mayer, and Rossi (2009), and Becht, Franks, Grant, and Wagner (2017) for non-U.S. markets. For general information about hedge fund activism, see Brav, Jiang, and Kim (2015a).

[3] See Bebchuk, Brav, and Jiang (2015), Cremers et al. (2018), and Coffee and Palia (2016) for detailed discussions regarding the debate. Outside academia, Presidential candidate Hillary Clinton, throughout her campaign, issued sharp criticism against activists whom she viewed as promoting "quarterly capitalism" with "hit-and-run" strategies (see, e.g., https://www.bloomberg.com/politics/videos/2015-07-24/hillary-clinton-seeks-end-to-quarterly-capitalism-). The chief justice of the Delaware Supreme Court, Leo Strine, has expressed a similar view in Strine (2015).

[4] In the same letter referenced in Footnote 1, Fink argues that, "In the face of these pressures, more and more corporate leaders have responded with actions that can deliver immediate returns to shareholders, such as buybacks or dividend increases, while underinvesting in innovation, skilled workforces or essential capital expenditures necessary to sustain long-term growth."

[5] Activist hedge funds have targeted R&D policies at technology powerhouses Microsoft, Google, and Apple in recent years. See "Hedge fund activism in technology and life science companies" in the Harvard Law School Forum on Corporate Governance and Financial Regulation, April 17, 2012. Such engagements are exemplified in the recent hostile intervention by Trian Partners at DuPont, an R&D powerhouse. See "DuPont's R&D is at center of fight with activist," *The Wall Street Journal*, October 27, 2014. The fund criticized DuPont's R&D efforts, proposing that the company consider splitting its agriculture, nutrition and health, and industrial biosciences divisions from its materials businesses.

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