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# Investor activism and takeovers ☆

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ABSTRACT

Recent work documents large positive abnormal returns when a hedge fund announces activist intentions regarding a publicly listed firm. We show that these returns are largely explained by the ability of activists to force target firms into a takeover. For a comprehensive sample of 13D filings by portfolio investors between 1993 and 2006, announcement returns and long-term abnormal returns are high for targets that are ultimately acquired, but not detectably different from zero for firms that remain independent. Firms targeted by activists are more likely than control firms to get acquired. Finally, activist investors' portfolios perform poorly during a period in which market wide takeover interest declined.



## 1. Introduction

Theory predicts that large shareholders should be effective monitors of the managers of publicly listed firms, reducing the free-rider problem (e.g., Shleifer and Vishny, 1986; Grossman and Hart, 1980). Yet the evidence that large shareholders increase shareholder value is mixed. In two recent surveys, Karpoff (2001) and Romano (2001) conclude that activism conducted by large institutional shareholders has had little impact on firm performance. Karpoff, Malatesta, and Walkling (1996), Wahal (1996), and Gillan and Starks (2000) report that shareholder proposals have historically done little to improve firms' operations. On the few occasions when investors have attempted to remove managers from their jobs, they generally encountered resistance (Brav, Jiang, Partnoy, and Thomas, 2008) or faced high costs (Black, 1990; Roe, 1994; Bainbridge, 2005; Kahan and Rock, 2006), and as a result were unsuccessful (Black, 1998; Karpoff, 2001; Romano, 2001; Bebchuk, 2007).

Recent research suggests that hedge funds might be up to the task of monitoring management. Brav, Jiang, Partnoy, and Thomas (2008) find that the announcement of hedge fund activism generates abnormal returns of more than 7% in a short window around the announcement. In addition, the authors document modest changes in operating performance around the activism. Klein and Zur (2009) and Clifford (2007) also document significant positive abnormal returns around the announcement of

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activism.[1] Many of these studies also document positive abnormal returns in a longer period after the initial filing.

What accounts for the returns to hedge fund activism? While the studies listed above go to great lengths to document changes in performance measures following activism, it is still largely unanswered where the announcement premium (and the upward drift in stock prices thereafter, for that matter) comes from. A reasonable starting hypothesis might be that activism creates value by improving the firm as a going concern, either by firing management or by forcing management to institute operational, financial, or governance reforms. Brav, Jiang, Partnoy, and Thomas (2008) and Klein and Zur (2009) document modest increases in leverage and the payout ratio following activism, but have less success finding evidence of other improvements.

In this paper, we suggest and test a simple alternate hypothesis: returns to investor activism are driven by activists' success at getting target firms taken over. Under this hypothesis, the high returns documented around the announcement of activism reflect investors' expectations that target firms will be acquired at a premium to the current stock price. From the perspective of the activist, exiting the position in the stock via a merger or a takeover is doubly beneficial: it generates a high premium, as well as allowing the activist to avoid the price pressure associated with an exit in the public markets (in a merger or acquisition, the activist exits in cash or with stock of a larger, more liquid company).

We construct a comprehensive database of activist filings with the Securities and Exchange Commission (SEC) from 1993 to 2006, focusing on instances where the target is a US firm. Our main result is that activism targets earn high returns primarily when they are eventually taken over. However, the majority of activism targets are not acquired and these firms earn average abnormal returns that are not statistically distinguishable from zero. These findings apply both to announcement returns and to the drift in long-term returns following the initial activist filing. Thus, the returns associated with activism are largely explained by the ability of activists to force target firms into a takeover, thereby collecting a takeover premium. An interesting observation, in our view, is that in many of the events in which we eventually observe a takeover, the initial demands of the activist were quite different. For example, in 15.7% of incidents in which the activist targeted "corporate governance" issues, the final result was a takeover.

Our evidence is consistent with many hedge funds' characterizations of their activism. The activist Robert Chapman, for example, seeks out companies that are "digestible" in the sense that they are easy to market to bidders as potential takeover targets.[2] However, our characterization differs markedly from previous research on investor activism, which tends to attribute high announcement returns to improvements in operational performance, increases in the leverage or payout ratio, or reductions in agency costs. The evidence in our paper helps explain why there is no significant correlation between accounting-based measures of operational change and subsequent returns—the most "successful" targets of activism are those that leave the public markets (and hence the Compustat database) soon after the activist becomes involved. Thus, there is a significant selection bias, in that the firms with the largest returns tend to drop out of the sample by way of takeover.

In addition to our hypothesis, we consider a closely related explanation. Suppose that activist investors make no changes, but that the returns associated with their involvement reflect an ability to pick undervalued stocks. Suppose also that these undervalued stocks are probable acquisition targets regardless of activist intervention. Put differently, perhaps the path of the target and its ultimate takeover would have been no different absent the activist intervention. Consistent with this, activist targets tend to be small firms with low valuation ratios and thin analyst coverage, and have underperformed relative to other firms in their industry. These characteristics could all reasonably be associated with a higher probability of takeover. To address this concern, we form a matching portfolio based on industry, size, and pre-activism return. We show that matching firms are less likely to be acquired within the next year, compared with firms that are targets of activism. In our full sample, activists increase the probability of takeover by about 11 percentage points. That is, activists put firms into play.

One implication of our work is that the announcement returns to investor activism should depend on the overall takeover interest in the market. Evidence from the credit crunch period from July to September 2007 confirms this intuition. During this time, private equity interest in debt-financed buyouts declined dramatically due to changes in credit market conditions. Many activists saw corresponding drops in the value of their holdings of target firms whose stock had been purchased in the hope of a takeover, the probability of which declined when rates increased. In the final section of the paper, we gather data on the positions of all serial activists during the time of the crisis. We show that the value of these activists' largest positions declined sharply during this short period, especially surrounding news of failed takeover attempts. This evidence is consistent with our hypothesis that activism targets were bought in the expectation of a takeover.

The paper proceeds as follows. The next section describes our data. Section 3 relates activism event returns to takeover outcomes and also examines the incidence of takeovers in our sample. Section 4 studies the implications of the credit crisis in mid-2007 for the

[1] Becht, Franks, Mayer, and Rossi (2008) also find that activist investments of the UK pension fund Hermes significantly outperformed benchmarks. Clifford (2007) shows that hedge funds earn a significantly higher return on their activist positions compared to their passive positions, suggesting that hedge funds may use these higher returns to counteract the costs of managing and monitoring an activist holding.

[2] Marcia Vickers, "Companies Beware…It's Shark Season", BusinessWeek, June 10, 2002.