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Activist hedge funds and firm disclosure☆

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ABSTRACT

This study examines whether firms' disclosure decisions are affected by the presence of activist hedge funds. Using a large sample of firms that experienced increases in ownership by activist hedge funds, we find that firms are more likely to cease providing financial guidance or reduce the information in the guidance in the quarter subsequent to new investment by activist hedge funds. These results hold even for firms that experienced good quarters and consistently provided guidance in previous quarters. Since guidance has been shown to be beneficial to capital market participants in many ways, reduced guidance has meaningful market implications. Our findings highlight a negative and possible unintended consequence of activist hedge funds' investment in firms, which provides some counterbalance to the numerous positive consequences documented in the prior literature on hedge fund activism.

1. Introduction

This study examines a possible unintended consequence of activist hedge funds' investment in firms—a reduction in firms' voluntary disclosure. The prior literature on activist hedge funds has documented numerous positive consequences after their investment in firms, including reduced agency costs (Brav, Jiang, Partnoy, & Thomas, 2008; Clifford, 2008; Klein and Zur, 2009), improved corporate innovation, productivity, and tax planning (Brav, Jiang, Ma & Tian, 2014; Brav, Jiang, & Kim, 2015; Cheng, Huang, Li, & Stanfield, 2012), reduced earnings management (Hall & Trombley, 2012), and greater accounting conservatism (Cheng, Huang, & Li, 2015). However, little research has focused on governance reforms involving disclosure practices, as evidence has been based on a small number of cases in which activist hedge fund blockholders (who own >5% equity) expressly state in Schedule 13D filings that they seek more information disclosure from target firms (e.g., Brav et al., 2008).[1] There has also been limited evidence of negative capital market consequences of activist hedge funds' investment in firms. We posit that, on a broader scale, a possible negative consequence is firms' reduced likelihood to issue public management forecasts, also known as management guidance, after investment by activist hedge funds.

Some institutional evidence suggests that firms reevaluate their policies regarding guidance as activist hedge funds begin to take initial positions in the firms. Firms cognizant of being targeted by an activist hedge fund or a "wolf pack" of funds (Briggs, 2007) are advised by numerous law firms and investment banks to regularly monitor changes in activist hedge fund holdings and to prepare for potential confrontational campaigns by continuously reviewing external communications policies (Christopher & Sheng, 2007; Gelles, 2013; Lipton, 2013; Sullivan, & Cromwell, 2013; Zenner, Gosebruch & Berkovitz, 2010). Since activist hedge funds tend to target firms with predictable revenues and positive cash flows (Brav et al., 2008; Klein & Zur, 2009), firms that provide

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[1] Section 13(d) of the 1934 Exchange Act mandates investors to file with the SEC within 10 days of acquiring more than 5% of any class of securities of a publicly traded company if they have an interest in influencing the management of the company. Alternatively, investors may file a simpler 13G within 45 days of the end of the calendar year if they do not intend to attempt to change control of the issuer.

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long-term guidance have been susceptible to becoming a target (NIRI, 2006). This scenario suggests that firms that have detected even small increases in ownership by one or more activist hedge funds may reduce the guidance information that they provide to avoid attracting further attention from the funds.

We also posit that firms' ability to forecast future financial results, which directly affects their propensity to issue guidance, is reduced by the governance reforms documented in prior studies. Once activist funds begin proactive campaigns against firms, the actions they initiate include requesting meetings with management, seeking board representation, filing formal shareholder proposals, recommending disposal of unproductive assets, demanding changes in capital structure, and lobbying for the sale of the entire firm (Brav et al., 2008; Clifford, 2008; Greenwood & Schor, 2009; Klein & Zur, 2009). Under these conditions in which a firm's operating, investing, and financing environment is in flux, it would not be surprising for new or existing management to lose some ability to accurately forecast future sales, expenses, earnings, and cash flows. Therefore, even though activist hedge funds may not explicitly demand governance reforms related to firms' disclosure practices in general, and guidance policies in particular, an unintended consequence can be the cessation or reduction in guidance information provided to capital market participants.

Since firms' guidance has been shown to be beneficial to capital market participants in many ways (Ball & Shivakumar, 2008; Beyer, Cohen, Lys & Walther, 2010), including increased stock liquidity (Balakrishnan, Billings, Kelly & Ljungqvist, 2014) and reduced stock volatility (Billings, Jennings & Lev, 2015), reduced guidance has meaningful market implications. Reductions in firms' guidance have also been shown to be associated with increases in analyst forecast dispersion and decreases in forecast accuracy (Chen, Matsumoto & Rajgopal, 2011), suggesting greater market uncertainty regarding firms' future earnings.

We begin our empirical analysis by examining the quarterly guidance decisions from 1999 to 2011 for a large sample of firms owned by one or more of the activist hedge funds identified in Brav et al. (2008).[2] To control for potential self-selection bias arising from activists' possible preference for firms with less transparency and limited disclosure practices, we use a propensity score-matched control sample of firms with similar likelihood of ownership by activist hedge funds. Our sample consists of 6127 firm-quarters from 2689 unique firms and an equivalent number of firm-quarters from control firms. We use regressions in which the variables are measured in changes rather than levels because they are less prone to a correlated omitted variables problem and eliminate firm fixed effects, and we use lead-lag change regressions to test two directions of causality. To isolate new investment in a firm by activist hedge funds, which are our construct of interest, we measure changes in both new and existing investments by activist hedge funds for each firm-quarter.

Our first finding is that firms are less likely to provide any type of guidance in the quarter subsequent to an increase in first-time ownership by activist hedge funds. This result holds after controlling for changes in ownership by other institutional investors, changes in analyst coverage, and changes in firm and stock characteristics that may be associated with firms' guidance decisions. To investigate whether this result is spurious or correlated with poor firm performance, we repeat the analysis on a subsample of firms that consistently provided guidance in previous quarters and also met or exceeded the analyst consensus earnings estimate for the quarter. We find that even these types of "consistent guider firms" that experienced good quarters are less likely to provide guidance after an increase in first-time ownership by activist hedge funds.

We next examine whether two aspects of guidance change even if firms continue to provide guidance after initial activist hedge fund investment. We find that firms tend to reduce the precision of their guidance, as well as the amount of guidance, after an increase in first-time ownership by activist hedge funds. For example, guidance for revenue and point earnings-per-share (EPS) targets can be reduced to only range EPS targets in the subsequent quarter. These results also hold for the subsample of consistent guiders that met or exceeded analyst expectations. Thus, even if firms continue to provide some guidance, there tends to be less information in the guidance.

We test the opposite direction of causality by regressing prior quarter's change in guidance on current quarter's change in activist hedge fund ownership. We do not find any associations between prior quarter's change in guidance, precision of guidance, or amount of guidance and current quarter's change in new or existing ownership by activist hedge funds. Therefore, we only find that changes to firms' guidance decisions tend to come after investment by activist hedge funds.

In additional analyses, we relate to prior studies that have used smaller samples (relative to this study) in which an activist files a Schedule 13D for a target firm (e.g., Brav et al., 2008; Klein & Zur, 2009). While we do not limit our sample solely to these cases, we create a reduced sample in which total activist hedge fund investment in a firm is at least 5%, and include an indicator variable in our regressions for whether a Schedule 13D or 13D/A was filed by any activist hedge fund during the quarter. We again find that firms are more likely to cease guidance, reduce precision in the guidance, and reduce the amount of guidance in the quarter subsequent to an increase in first-time ownership by activist hedge funds. We then examine longer-term guidance patterns for a subset of firms that decreased their incidence, precision, or amount of guidance and find that the reduced guidance persists into future quarters. Lastly, we check that our results are robust to the measurement error documented by Chuk, Matsumoto, and Miller (2012) in the First Call Company Issue Guidance (CIG) database.[3]

Our study contributes to the literatures in activist hedge funds and firms' voluntary disclosure decisions, namely management guidance. We show that one unintended consequence of activist hedge funds' investment in firms is a reduction in the firms' guidance information. Since guidance has been shown to be beneficial to capital market participants in many ways, reduced guidance has meaningful market implications. In addition, because we do not limit our sample to only cases in which a Schedule 13D is filed by an activist hedge fund, our results suggest that any other potential consequences of their ownership in firms are likely to be more subtle than previously examined. Our findings may be generalized to suggest that other corporate governance issues can be affected by activist hedge funds without a public hostile or non-hostile campaign against management.

The remainder of this paper is organized as follows. In the next section, we review the prior literatures on activist hedge funds. In Section 3, we describe our sample and data. Section 4 discusses our empirical analyses and results. We conduct additional robustness checks in Section 5. Finally, we conclude in Section 6.

2. Literature review and hypothesis development

2.1. Activist hedge funds

There is an emerging literature in finance and accounting that examines the effect of activist hedge funds on the firms they target.

[2] We thank Wei Jiang and her coauthors for sharing an updated list of activist hedge funds used in Brav et al. (2008). We obtain all firms owned by the funds using the Thomson Reuters Schedule 13F database, which contains the equity holdings of all institutional investors with over $100 million in assets or hold over 10,000 shares of a given stock.

[3] A common challenge we have with other disclosure studies is that firms' disclosure decisions and the factors that affect them are not directly observable. As a consequence, even though we use a propensity-matched control sample, run lead-lag change regressions, and form several subsamples to further test our hypothesis, our findings should be interpreted with this caveat.