



IS SHAREHOLDER ACTIVISM EFFECTIVE

All forms of shareholder activism are not created equal.

IN INFLUENCING CORPORATION ACTION?

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Shareholder activism can take many forms including proxy fights, threatened takeover attempts, 13D filings with the SEC indicating an intent to influence corporate management, private negotiations, public relations campaigns through the financial press, and so on.

In examining over 50 studies, it can be said the results of shareholder activism are mixed. This may be due to the methods used, the time period examined, or the sample involved. Nevertheless there are some important observations to be made that may be of value to the investor or researcher when he or she sees a given

company first being involved in an activist campaign.

Because of the mixed nature of the empirical research, the author has done a survey study of financial analysts as listed under Institutional Research Firms in the *Nelson's Directory of Investment Research*.¹ It is the author's intent to tie together the results of the academic literature with the opinions of the practicing financial analysts.

Historical background

As described by Gillian and Starks,² in the early 1900's there was a great deal of shareholder activism as financial insti-

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EXHIBIT 1 Classification of Respondents

Industry Classification	Number	Percent
Private Money Management Group	58	21.5
Brokerage	52	19.1
Hedge fund	48	17.5
Pension fund	30	11.2
Mutual fund	27	9.8
Pension fund	15	5.4
Investment Management Consulting	13	4.9
Bank Trust Department	12	4.5
Investment Banking	10	3.6
Other	7	2.5
	<u>272</u>	<u>100.0</u>

tutions tried to influence the actions of corporate management.

However, after the market crash of 1929, the enactment of securities legislation limited the power of financial institutions, and this diluted their ability for involvement in corporate governance activity. The gap between corporate management and investors continued to increase.

Fortunately, in 1942, the SEC enacted rule changes allowing investors to submit proposals to be considered on corporate ballots. Shareholder activism was born again. However, it did not become a major force until the late 1970's—early 1980's when institutional investors replaced individual investors as the key participants in the market. Since then, every decade has seen increased activities. Pension funds, mutual funds, corporate raiders, and others have all increased their participation. Leaders among the movement have been CalPERS, TIAA-CREF, Carl Icahn, and other corporate raiders. Another major movement began in the mid-1990's and continues until today—the strong presence that hedge funds have brought to the activist movement.

The author used the *Nelson's Directory of Investment Research's* listing of

“Institutional Research Firms” as the database for the study. One thousand and four firms were listed in the 2009 edition. Following a pilot study, a three page questionnaire was mailed to the firms. The questionnaire covered various issues related to stockholder activism. Two hundred and seventy two responses were received from financial analysts at the 1,004 firms (27.1 percent response). Characteristics of the 272 respondents are shown in Exhibit 1 and Exhibit 2.

A follow-up telephone survey of 40 randomly selected non-respondents indicated no statistically significant difference between those who initially answered the questionnaire and those who elected not to participate.

As previously indicated, the responses of the survey participants were compared to the academic literature on shareholder activism. This study is an attempt to integrate the opinions of practicing financial analysts with the academic literature.

Goals of shareholder activism

The goals of shareholder activism are many and varied. Looking particularly at the studies of Strickland, Wiles, and Zenner, Karpoff, and Klein and Zur,³ the primary goals of shareholder activism are shown in Exhibit 3.

The first three goals have the strongest support. Seeking a board seat is viewed as the most important tool in influencing the corporate target. Whether there is success or failure, it is a threat to the status quo. Also, one or more new outside board members can clearly influence the corporation. Even if motions by the new board member(s) are voted down, they are placed on public record for all to see.

The second item in Exhibit 3 is changing corporate governance; which reflects back to Jensen's 1986 article⁴ in which he suggests top corporate managers act as poor agents for stockholders. He suggests, in many cases, management is more

EXHIBIT 2 Years of Experience of Respondents

Experience	Number	Percent
0-5 Years	24	8.7
6-10	84	31.0
11-15	69	25.4
16-20	50	18.4
21-25	18	6.6
26-30	17	6.2
Over 30	10	3.7
	<u>272</u>	<u>100.0</u>

interested in empire building than stockholder wealth maximization. This is evidenced by questionable acquisitions and high cash balances and low debt ratios.

Furthermore, because of insensitivity to shareholders, the firm may pay low cash dividends and not engage in stock buybacks.

As changing corporate governance is viewed in the study by the respondents, it encompasses such items as splitting up the position of chairman of the board and CEO, increasing the number of outside directors on the board, allowing cumulative voting for directors, and closely monitoring the compensation and activities of top management.

The third most cited objective in Exhibit 3 for shareholder activism is corporate restructuring. This often relates to the divestiture of unprofitable divisions or the spinoff of profitable divisions in which the original firm maintains majority control.

The effect of shareholder activism on stock market value

This is where the true battleground lies. There is strong evidence both ways. We will begin with the non-believers. In a survey of research studies on the effect of activism on stock values Karpoff⁵ found nine studies with negative returns and only five with positive returns. Shareholder activism was defined as submit-

EXHIBIT 3 Primary Goals of Shareholder Activism

Rank
1. Seeking a board seat
2. Changing corporate governance
3. Restructuring and divestiture
4. Changing profitability
5. Opposing or favoring a merger
6. Changing management compensation
7. Amending a poison pill
8. Increasing dividends
9. Increasing stock buybacks
10. Increasing/decreasing R&D
11. Increasing/decreasing capital expenditures

ting proposals at a company's annual meeting (and private negotiations).

Karpoff went on to state, "Shareholder proposals are not associated with short-term changes in firm value or with earnings improvements although both proposals and private negotiations sometime prompt organization changes." Karpoff did not stand alone in his dubious view of the impact of shareholder activism on stockholder value.

Gillian and Starks,⁶ after an exhaustive historical study of stockholder activism on value, state, "Empirical evidence suggests that efforts of such activism are mixed. While some studies have found positive short-term reaction to certain types of activism, there is little evidence of improvement in the long-term operating or stock market performance of the targeted funds."

Then came the hedge funds to provide a whole new perspective. Basically hedge fund activism is conducted through 13D filings with the SEC, a mandated action when a firm acquires five percent or more of the equity holding of another firm. The 13D filings may be friendly or unfriendly. To be included in the hedge funds activism studies, the 13D filing must indicate an unfriendly intent. The hedge fund may indicate an intent to obtain a board seat, a change in corpo-

rate governance, opposition to a merger, or even liquidation of the firm.

The filing of an unfriendly 13D form is the trigger point for the event study. If there is prior knowledge of the intent to file a 13D form, it is excluded from the studies.

In a recent article covering many more firms than earlier studies, Klein and Zur⁷ found in the time period of 2003 to 2005 that hedge funds generate a 10.2 percent positive abnormal return for the target firms around the filing of the 13D document with the SEC. The Klein and Zur study covered 101 hedge funds and 151 target firms and the results were statistically significant. Of equal importance for one year after the filing, the positive abnormal returns were even higher at 11.4 percent. Based on the results, Klein and Zur state, "These findings suggest, that on average, the market believes activism creates shareholder value."

Brav, Jiang, Partnoy, and Thomas⁸ also found similar results with hedge funds. Using 13D filings by activist hedge funds between 2001 and 2006, their sample of 236 activist funds produced seven percent positive abnormal returns by the target firms around the announcement of the 13D filings, with no reversal during subsequent years.

Limitations to the latter studies

Not only do the hedge fund studies produce positive results, but there are no hedge fund studies which produce inconclusive or negative results.

However, this still does not answer the question about whether shareholder activism, in general, produces uniformly positive results. Almost all the recent studies use 13D hedge fund filings for event studies. Keep in mind, this only takes place when the hedge fund acquires a five percent or greater position in the target company. This five percent metric eliminates many other forms of activists from the sample pool.

For example, for a target company with a \$10 billion market cap, the shareholder must own \$500 million of the firm's equity. Few pension funds or mutual funds are likely to hold such a position. They are

EXHIBIT 4 Does Shareholder Activism Create Value?

Response	Percent
Large Increase in Value	20.2
Moderate Increase in Value	31.8
Insignificant increase in Value	24.1
No Increase in Value	23.9
	<hr/> 100.0

mandated by law to diversify their holdings, while a hedge fund is free to concentrate on a limited number of holdings.

To take this to an extreme, Exxon-Mobil, which has come under a large amount of criticism for failing to separate the positions of Chairman of the Board and CEO as well as for failure to aggressively pursue alternate forms of energy, had a market cap of \$360 billion in August of 2010. A five percent position would require an ownership interest of \$18 billion. Few could qualify for such a lofty amount.

Response by survey participants to value creation by shareholder activists

When the 272 respondents to this study were asked whether shareholder activism created value, they provided the results reported in Exhibit 4. Only 52 percent thought the announcement of a challenge would generate significant positive results.

When further asked whether there was a difference in the impact of different types of shareholder activists such as hedge funds, pension funds, mutual funds, venture capital funds, private equity funds, and wealthy individuals, the answer was positive. A chi-square independence of classification test with a null hypothesis that there is no difference between the type of shareholder activism and value creation could be rejected at an .05 level of significance. That is to say, the type of activist matters. A further question asked the respondents to list the activists by level of

EXHIBIT 5 Ranking of the Most Important Types of Shareholder Activities

Types of Activist	Percent
Hedge fund	39.8
Pension fund	27.9
Mutual Fund	11.4
Venture Capital fund	10.8
Wealthy individual	9.2
Private equity fund	0.9
	<u>100.0</u>

influence and the results are shown in Exhibit 5.

The answers by the respondents are consistent with the results in the marketplace. Hedge fund activism, via 13D filings, tend to have the greatest effect on market value and should be the circumstance most likely to produce a positive return. All other forms of activism are subject to uncertainty in terms of change in value.

Activism and corporate policy

In addition to stock market results, there were interesting results for changes in corporate policy. Klein and Zur⁹ found a significant change in policy for corporate directors and dividend policy.

Others found an increase in divestitures announcements for firms placed on the Council on Institutional Investors focus list for possible targeting. As another example, Sears, Roebuck and Company announced the breakup of its financial services division after it received pressure to make changes from several institutional investors, including CalPERS. Bizjak and Marquette¹⁰ concluded that firms receiving proposals to amend their poison pills were more likely to change their poison pill provisions than a control group that did not receive such a proposal. Even TIAA-CREF got its say on firms adding women as board members. A majority of firms contacted and pressured by TIAA-CREF made such a change or indicated an intention to do so in the future.

EXHIBIT 6 Industry of Origin of Target Firms

Industry	Percent
1. Technology	15.8
2. Energy	13.7
3. Financial	11.8
4. Health Care	10.8
5. Communication Services	10.5
6. Consumer Discretionary	8.7
7. Consumer Staple	8.6
8. Industrials	8.5
9. Materials	7.4
10. Utility	4.2
	<u>100.0</u>

Respondents views of areas of influence

When the 272 respondents to the study were asked to identify primary areas of influence on corporate policy, the results are consistent with the research in Exhibit 3. Shareholder activism has been generally successful seeking board seats, changing corporate governance, and initiating restructuring and divestitures. However, the relatively high ranking of changing profitability in Exhibit 3 is not supported by the survey. The respondents indicated a change in corporate profitability is not likely to take place three/fourths of the time.

Industry of the target

A question of possible interest is whether the targets tend to originate from different industries. It is well known that targeted firms are smaller and less profitable than other public firms. The question remains; are they more likely to originate from one industry than another? In Exhibit 6, 150 targeted firms were screened for industry classification between 2006–2010 and reported in percentages. The Standard and Poor's 10 basic industries were used as the basis for classification.

The table indicates that a higher percentage of firms fell in the technology sec-

A SAMPLE SURVEY BY THE AUTHOR OF 272 FINANCIAL ANALYSTS INDICATES ONLY 52 PERCENT BELIEVE THAT SHAREHOLDER ACTIVISM CREATES INCREASED VALUE FOR THE TARGETED FIRM.

tor (15.8 percent). This may be due to the lack of a well-defined business model and clear governance in rapidly growing technology companies. At the other extreme are utilities (4.2 percent), where the maturity of the industry may indicate strong corporate governance.

The Klein and Zur study

One of the most significant activism studies to date is by Klein and Zur.¹¹ The authors divide the activists into two distinct groups: hedge funds and entrepreneurial activists. The latter group is composed of non-hedge fund activists and includes venture capital funds, private equity funds, and asset management groups for wealthy individuals. It specifically excludes asset managers that are subject to government controls such as mutual funds and pension funds. Because the latter are regulated, they must maintain a high degree of diversification which inhibits their ability to take a large (threatening position) in any one target.

There are 101 hedge funds (with 151 targets) and 134 entrepreneurial activists (with 154 targets) in the study. They both create positive abnormal returns, around 13D filings, but the hedge funds positive abnormal returns are larger in the event study surrounding the 13D filing (10.2 percent versus 5.1 percent). However, they both are statistically significant. One year after the filing, both groups also have strong statistically significant returns, indicating the importance of 13D filings.

Of equal or greater importance is what the two divergent groups try to accomplish. The hedge funds target larger, healthier companies with an intent to change corporate governance (rather than actual operations). They are strongly influenced by the Jensen¹² literature and try to improve the agency function. The hedge funds try to discourage empire building through acquisitions and high cash balances that tend to facilitate unnecessary growth. They also discourage low debt levels, which indicate target companies are not minimizing cost of capi-

tal and maximizing stockholder wealth. Klein and Zur say hedge funds achieve all or part of their goals 60 percent of the time.

Entrepreneurial activists have an entirely different focus. They deal with smaller, less profitable targets and their interest is generally not in corporate governance, but on actual operating issues such as capital expenditures, research and development, and other similar topics. They achieve their goals 65 percent of the time. Interestingly enough, neither group is able to force an increase in earnings, profit margin, or EBITDA.

Summary and conclusion

The results of the effect of shareholder activism are mixed, with later studies offering some promise for firms filing 13D documents with the SEC. Hedge funds were able to generate positive returns.

A sample survey by the author of 272 financial analysts indicates only 52 percent believe that shareholder activism creates increased value for the targeted firm. The respondents viewed hedge funds as being the most effective activists followed by pension funds and mutual funds. Although technology was the most challenged industry for shareholder activism, a chi-square independence of classification test showed no statistically significant difference for the 10 industries under study.

Activism may focus on operations of the firm or corporate governance. The latter addresses many of the issues related to the Jensen paper on agency theory. Activists appear to achieve some success in suppressing empire building, increasing cash dividends or share buybacks for the benefit of shareholders, and increasing debt to minimize the cost of capital and maximize shareholder wealth. Achieving a seat on the board of directors is considered the most significant achievement. ■

NOTES

¹ *Nelson's Directory of Investment Research*, 2008 Vol. 1, New York: Thompson Financial/Nelson, Publisher.

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- ³D. Strickland, K. W. Wiles, and M. Zenner, "A Requiem for the U.S.A. Is Small Shareholder Monitoring Effective?" *Journal of Financial Economics* (Vol. 40, 1996): 319–338; J.M. Karpoff, "The Impact of Shareholder Activism on Target Companies: A Survey of Empirical Findings," University of Washington Working Paper, 2001; A. Klein, and E. Zur, "Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors," *Journal of Finance* (Vol. 64, 2009): 187–229.
- ⁴M. Jensen, "Agency Costs of Free Cash Flow: Corporate Finance, and Takeovers," *American Economic Review* (Vol. 76, 1986): 323–329.
- ⁵*Op. cit.* Note 3, Karpoff.
- ⁶S.L. Gillian, and L. T. Starks, "The Evolution of Stockholder Activism in the United States," *Journal of Applied Corporate Finance* (Vol. 19, 2007): 55–73.
- ⁷*Op. cit.* Note 3, Klein and Zur.
- ⁸A. Brav, W. Jaing, F. Partnoy and R. Thomas, "Hedge Fund Activism, Corporate Governance, and Firm Performance," *Journal of Finance* (Vol. 63, 2008), 1729–1775.
- ⁹*Op. cit.* Note 3, Klein and Zur.
- ¹⁰J. Bizjak, and C. Marquette, "Are Shareholders all Bark and No Bite? Evidence from Shareholder Resolutions to Rescind Poison Pills." *Journal of Financial and Quantitative Analysis* (Vol. 33, 1998): 499–521.
- ¹¹*Op. cit.* Note 3, Klein and Zur.
- ¹²*Op. cit.* Note 4.