

The Effects of Hedge Fund Activism

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Background

Activist arrival

- positive short term abnormal returns
- increase in payout
- increase in leverage
- reduction in CAPEX and R&D; but increase in innovation
- increase in takeover likelihood
- reduction in empire building M&A, increase in divestitures, spinoffs, carveouts
- increase in managerial and board turnover
- spillovers to industry peers ; leverage, payout, investment and M&A behavior of industry peers changes

This paper

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- proposes a new methodological approach to evaluate effect of activism taking into account targeting decision of activists
- activists are no longer associated with improvements when targets are compared to non targets using the new matching approach

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- Not clear why shareholder payouts and takeover likelihood associate with a myopic response. Both could be closely related to change in firm performance!

Do activists do anything useful, cont'd

- payouts serve many purposes:
 - reallocation of capital from firms in excess of resources to firms in need of resources
 - they signal managers are not wasting excess cash by undertaking bad projects

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- increase in payout and takeover probability can lead to positive short term abnormal returns because of a change in firm's operating performance not because of myopic investors: they imply more efficient use of target firm's resources

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- pushing firms into takeovers can be a very good thing! Selling firms receive sizeable premium.
- dividends and share repurchases do not necessarily imply reduced investment!
 - John and Williams (1985): theoretical model where firms pay dividends to signal good prospects. Stock price responds positively, The firm reduces its cost of capital and improves its investment efficiency

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 - today's firms' investment is not limited to CAPEX, M&A and R&D
 - firms are acquiring a large number of innovative startups
 - they are investing billion dollars in startups through corporate venture capital (CVC) programs: Lego and Sony invested \$2bn in metaverse in April 2022
 - most productive and prolific investments are occurring outside firm boundaries

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- how do we follow the stock price performance of firms which are taken over?
- with the exception of very few target firms like LinkedIn and Slack, most acquired firms are absorbed by the acquirer. We don't observe their stock price, their operating performance once they are taken over

Measuring effects of activism

two challenges

- control group
- activist targets go through significant transformation

Measuring effects of activism, cont'd

- target firms engage in divestitures: they get smaller
- they engage in spinoffs and carveouts: initial target firm is split into two, sometimes three firms (GE split into 3 different firms)
- important to take into account performance of the initial target as well as divested, carved out and spun of units

Employment

- employment outcomes at target firms need to take into account employment outcomes at divested, spun-off and carved out units

Selection concern

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- V shaped charts in Figure 8 show that bounce back in performance perfectly coincides with activist arrival
- If activist don't have any causal effects on performance, they must have perfect/magical timing ability to be at the firm at the precise moment when rebound starts

Being able to select the right firm at right time is a skill

- WSJ, May 31, 2022: "...presence of an activist investor may speed up the disposal of Unilever's less appealing brands..."
- activists bring a sense of urgency in addressing and fixing inefficiencies. "Mr Peltz lent urgency to P&G's restructuring"

Activists and COVID

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- Have activist targets been less or more resilient during covid
- If activists strip target firms off their assets, make them much smaller and risky, then activist targets should have performed badly during the pandemic
- WSJ, May 31, 2022: "during Mr Peltz's tenure on P&G board, the company overhauled its operations, and accelerated sales growth, positioning itself to capitalize on the pandemic and regularly outperform its rivals."

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- however, given all the evidence we have on activism, it is hard to claim that they do not do anything useful! If they are not doing anything useful, it is hard to justify the existence of a \$3 trillion industry
- given activist targets generate same operating performance as control group by using less labor and capital, they seem more efficient!