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The costs of shareholder activism: Evidence from a sequential decision model ☆

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ABSTRACT

This paper provides benchmarks for monitoring costs and evaluates the net returns to shareholder activism. I model activism as a sequential decision process consisting of demand negotiations, board representation, and proxy contest and estimate the costs of each activism stage. A campaign ending in a proxy fight has average costs of $10.71 million. I find that the estimated monitoring costs reduce activist returns by more than two-thirds. The mean net activist return is close to zero but the top quartile of activists earns higher returns on their activist holdings than on their non-activist investments. The large-sample evidence presented in this paper aids in understanding the nature and evolution of activist engagements.

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1. Introduction

Does shareholder activism generate positive *net* returns for the activist? Answering this question will help us evaluate the potential for activism to mitigate agency costs due to the separation of ownership and control. Activist shareholders occupy an important "middle ground" between internal governance by blockholders and the board of directors and external governance by the market for corporate control. As a result, the presence of an activist can be crucial for the proper functioning of a firm's corporate governance system.

Several recent studies on hedge fund activism have shown that activists generate significant abnormal returns both in absolute terms and in comparison to non-activist investing.[1] Brav, Jiang, Partnoy, and Thomas (2008) report that the average hedge fund activist in 2001–2006 earned a 14.30% higher return than the size-adjusted value-weighted portfolio of stocks. Klein and Zur (2009) compare the hostile activist campaigns of hedge funds to those of other entrepreneurial activists, and find that the market reacts more favorably to hedge fund activism. Clifford (2008) demonstrates that hedge funds earn significantly higher holding period returns from activist investing than from their passive holdings. Becht, Franks, Mayer, and Rossi (2008) show that the activist

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[1] Even though hedge funds have initiated the majority of activist campaigns since 2000, most hedge funds are non-activist. Kahan and Rock (2007, p. 1046) report estimates by J.P. Morgan that only 5% of hedge fund assets in 2006 were allocated to shareholder activism.

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investments of the U.K. Hermes Focus Fund significantly outperform the market.

Do these substantial returns cover the costs of executing an activist campaign? In addition to unobservable costs such as the time and effort of negotiating with a target, an activist bears disclosure, legal and other fees of hiring proxy advisors, corporate governance experts, investment banks, public relations, and advertising firms. The existing literature on shareholder activism lacks a reliable measure for these costs and ignores them in the calculation of activist returns. Consequently, prior work may have overestimated the returns generated by activism.

A shareholder's incentives to actively monitor are determined by a trade-off between the private costs of monitoring, which are fully internalized by the activist, and the public benefits of monitoring, which are shared among all firm shareholders (Grossman and Hart, 1980; Shleifer and Vishny, 1986). The theoretical literature has emphasized the importance of monitoring costs in determining this incentive trade-off.[2] However, the empirical literature has faced some challenges in measuring the cost function of an activist shareholder.

The first challenge has been finding the right institutional setting to analyze an activist's incentive trade-off. Most earlier work focuses on pension funds, mutual funds, and labor unions and shows that these institutional monitors are severely restricted by regulatory rules and conflicts of interest.[3] More recent studies of hedge fund activism (see Kahan and Rock, 2007; Gillan and Starks, 2007; Yermack, 2010) have contrasted hedge funds to other institutional activists. Hedge funds are arguably better positioned to be active monitors because they suffer from fewer conflicts of interest, face fewer regulatory restrictions, and have a better-aligned incentive structure.

A second challenge in measuring the costs of activism has been the lack of empirical data. Most evidence about monitoring costs is anecdotal and limited to proxy solicitations—the most public activist approach. Stephen M. Bainbridge of the University of California Los Angeles (UCLA) School of Law estimates the costs of a proxy contest at $1.8 million based on a survey conducted in the late 1980s but points out that "costs almost certainly are much higher today." Hedge fund activists estimate proxy costs at "upwards of $10,000,000."[4] However, most activist campaigns rely on less confrontational approaches such as informal demand negotiations and board representation, whose costs are unobservable and cannot be estimated from public data.

This paper complements recent work on hedge fund activism by providing cost benchmarks for evaluating the *net* returns to activism. To account for the large heterogeneity of activist events, I estimate the costs associated with three common activist approaches: demand negotiations, board representation, and proxy contest. I find that a campaign ending in a proxy fight has average costs of $10.71 million. Subtracting costs reduces the mean abnormal activist return by two-thirds suggesting that costs play a major role in an activist's decision-making behavior.

The approach taken in this paper involves two interrelated parts. First, I model activism as a sequential decision process consisting of three consecutive stages of demand negotiations, board representation, and proxy contest, and define the activist's break-even constraint for monitoring for each stage. Then, I examine this trade-off condition in a discrete-choice framework and estimate the costs of activism implied by the observed decisions of hedge fund activists in 2000–2007.

The starting point of this paper is a novel definition of activism as a sequence of escalating decision steps, in which an activist chooses a more hostile tactic only after less confrontational approaches have failed. A typical campaign starts with the announcement of activist intentions (usually reported in a regulatory filing), followed by communication of specific demands to the target. Initial negotiations between the activist and the target are rarely successful. The activist may choose to terminate his campaign after failed negotiations, or pursue a more direct approach by requesting a board seat. In most instances, the activist is denied board representation, in which case he has the option to solicit input from other shareholders, and eventually wage a proxy fight.

The activist's decision problem is modeled as a basic trade-off between the expected benefit from campaign continuation with a specific approach and the expected cost of activist involvement. This decision can be described by the activist's break-even profit constraint for monitoring and consists of two steps. First, the activist estimates a net continuation benefit by comparing his expected reward from the campaign to the cost of intervening with a particular tactic. Then, he compares this net benefit to the market value of his current ownership stake. The activist's continuation decision defines a minimum cost threshold, at which he is indifferent between continuation and exit.

I study the activist's break-even condition as a discrete-choice problem under the assumptions of random utility theory. The activist's decision is summarized by the expected gross return in a successful campaign, which relies on an estimate of its benefit, and the activist's marked-to-market investment in the target, which captures the opportunity cost of the campaign. The expected reward in a successful intervention equals the target's potential value if the activist's demands are successfully implemented. Empirically, I estimate the potential benefit from an activist engagement based on the difference in Q ratios between the target and a matched peer, and calibrate it to the actual valuation improvement in successful activist events.

[2] See Admati, Pfleiderer, and Zechner (1994), Kahn and Winton (1998), and Maug (1998) for theoretical models of the incentive trade-off of a monitor in terms of liquidity, risk aversion, or information acquisition. More recent theory work on activist monitoring includes Edmans and Manso (2011) and Cohn and Rajan (2011).

[3] Romano (2001), Kahan and Rock (2007), Davis and Kim (2007), and Cohen and Schmidt (2009) discuss regulatory constraints and incentive biases preventing mutual funds and pension funds from active monitoring. Del Guercio (1996) considers the prudent man laws in distorting the incentives of institutional monitors. Agrawal (2012) studies conflicts of interest in unions. Karpoff (2001), Gillan and Starks (2007), and Yermack (2010) conclude that institutional activism by pension funds, mutual funds, and unions has had limited impact on firm governance and performance.

[4] See Stephen M. Bainbridge (http://www.sec.gov/rules/proposed/s71903/bainbridge121903.htm); Ralph V. Whitworth (http://www.sec.gov/comments/s7-10-09/s71009-185.pdf); Carl Icahn (http://dealbook.nytimes.com/2009/03/30/were-not-the-boss-of-aig/).

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