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The effect of shareholder activism on bondholders and stockholders

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ABSTRACT

We examine the wealth effect of shareholder activism on bond returns, as well as the extent to which wealth is transferred from bondholders to shareholders, which we refer to as the wealth-transfer effect. Our activist dataset includes both hedge funds and other large shareholders. Our bond dataset covers both investment-grade and speculative-grade bonds, and extends beyond the 2007–2009 financial crisis period. We find that activists' demands cause a significant decline in bond returns, and affect long-term bonds the most. There exists a strong association between the bond price declines and dividend increases following the activists' demands, with dividends acting as a proxy for the transfer of wealth from bondholders to shareholders. The wealth transfer affects long-term and lower rated bonds more significantly. With stock returns to targeted firms positive, our findings suggest an inverse association between bond returns and stock returns at firms targeted by activists.

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1. Introduction

Shareholder activism has been a frequent topic of discussion in recent years among industry professionals (Gara, 2015), regulators (White, 2015) and researchers (Aslan & Kumar, 2016; Brav, Jiang, & Kim, 2015; Jory, Ngo, & Nguyen, 2016; Norli, Ostergaard, & Schindele, 2015; Wang & Mao, 2015). The targets of shareholder activism used to be underperforming firms with corporate governance problems, but both the type of firm targeted and the activists' goals have broadened. This study examines the effect of shareholder activism on target firm bondholders. The Black–Merton–Scholes approach to firm theory views bondholders as selling a call option on the firm assets to shareholders, with the exercise price being the value of debt. In such a view of the firm as a zero-sum game, actions that generate wealth for the shareholders might come at a cost to the bondholders.

We obtain information on shareholder activism campaigns targeted at U.S. listed firms from 2000 to 2014 from the Thomson Reuters Shareholder Activism Intelligence (TRSAI) database. We acquire the bond transaction data from Trade Reporting and Compliance Engine (TRACE). Since TRACE comprehensive coverage of

all corporate bond transactions only started in February 2005, we restrict our sample to shareholder activism campaigns announced from the year 2005 to the year 2014. In addition, we use Mergent's FISD database for bond characteristic information. We obtain stock price data from the University of Chicago Center for Research in Security Prices (CRSP) database and accounting data from the COMPUSTAT database. Our final sample consists of 372 bonds outstanding and 118 unique firms.

We follow Bessembinder, Kahle, Maxwell, and Danielle (2009) and Ederington, Guan, and Yang (2015) to perform the standard screenings to the bond data from TRACE. Ederington et al. (2015) suggest refinements to the methodology devised by Bessembinder et al. (2009) to improve the statistical power of bond event studies. Following Ederington et al. (2015), we calculate bond returns from day $t-1$ to day $t+1$ (with day 0 representing the activism announcement date), and construct 24 benchmark portfolios: six rating classes (Aaa and Aa, A, Baa, Ba, B, and below B) and four maturity groupings (1–3 years, 3+ to 5 years, 5+ to 10 years, and over 10 years). The bond rating and maturity data is from Mergent's FISD.

In a study of hedge fund activism from 1994–2006 on a sample of mostly speculative-grade bonds, Klein and Zur (2011) find negative returns to bondholders. We follow Klein and Zur (2011) and extend the literature on the effects of activism on bondholders in the following ways. First, in addition to hedge funds, we cover the explicit demands made by all the large shareholders that

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are reported in TRSAI. Hedge fund management's incentive structure has a built-in call option with a high exercise price (Buraschi, Kosowski, & Sritrakul, 2014; Kouwenberg & Ziemba, 2007), making the risk-return structure of their investments and post-investment activities potentially different from other large investors. Second, we study the effects of shareholder activism on a broader sample that includes both investment-grade and speculative-grade bonds. Third, we extend the Klein and Zur paper by looking at shareholder activism during and after the global financial crisis. The onset of the global financial crisis has changed both activists' and bond investors' approach to investments (Friedwald, Jankowitsch, & Subrahmanyam, 2012; Huang & Petkevich, 2016). Lastly, we examine how bond's maturity relate to the effects of shareholder activism.

The summary of our main findings is as follows. The abnormal bond-level returns and firm-level bond returns are -0.601% and -0.484% , respectively, for the three-day window surrounding the activism announcement, significant at the 1% level. This is broadly consistent with Klein and Zur, (2011). Both the mean and median bond returns decrease as the bond maturity increases. When we pool the observations of bonds of targeted firms and those of matching non-targeted bonds in cross-sectional analyses, the coefficient on the dummy variable *TARGETED*, which represents targeted bonds, is negative and significant at the 1% level.¹ The negative effect, though, is confined to the subsample of bonds with maturities of over five years. Our findings suggest that bondholders' investment horizon is an important factor in explaining the divergent incentives between shareholders and bondholders. We find that bonds with longer maturities experience lower abnormal returns. Overall, we show that shareholder activism campaigns have a negative impact on bond returns of targeted firms, with lower returns for bonds with longer maturity, which is in line with the risk-shifting hypothesis of Jensen and Meckling (1976).

We further examine the impact of shareholder activism on stockholders. Their stock cumulative abnormal returns (CARs) range from 2.623% to 2.740% based on four alternative measures, and they are all significant at the 1% level. These findings are consistent with Clifford (2008), who documents an abnormal return to firms targeted by hedge fund activists of 3.39%. Using probit regressions, we document that firms targeted by activists have lower ROA, higher debt and higher institutional ownership. Consistent with the wealth-transfer hypothesis, we find that returns to bondholders surrounding announcements of shareholder activism are negatively related to dividend increases in the subsequent 12 months. Our findings are consistent with the hypothesis that bondholders are wary of future dividend increases at firms that are the targets of shareholder activism. The negative relationship between bondholder and shareholder returns, and therefore evidence of a wealth transfer, is confined to the subsample of bonds with maturity over five years and ratings below grade A. Our tests of the wealth transfer hypothesis show that the relationship between bondholder and shareholder incentives is contingent on the investment horizon of the bondholders. Furthermore, the returns to shareholders relative to long-term creditors exhibit the adversarial relationship implied by the Black–Merton–Scholes' view of the firm.

The rest of the paper is organized as follows. We first provide a literature review of shareholder activism and bondholder event studies. The following section develops the main hypotheses regarding bondholder and stockholder abnormal returns. We then discuss the sampling and the methodology used in our study. We follow by detailing our findings. The last section concludes.

2. Literature review

The theoretical background for the shareholder activism can be traced back to Jensen and Meckling (1976) and their incorporation of agency costs into the theory of the firm. However, empirical studies of activists' behavior are a more recent phenomenon (Gillan & Starks, 2007) provide an overview of the literature), and are focused mostly on their effects on shareholder wealth. Clifford (2008) finds that firms targeted by hedge funds as active investments outperform firms targeted as passive investments. Greenwood and Schor (2009) document positive returns at firms targeted by hedge funds. Though, the findings of Gantchev (2013) suggest that after factoring monitoring costs, the returns are lower. Brav et al. (2015) document improved target firm productivity.

More recently, some studies have expanded the analysis beyond targeted shareholders. Aslan and Kumar (2016) and Jory et al. (2016) examine the effect of shareholder activism on matching samples of non-targeted firms. Their results are inconclusive; while Aslan and Kumar find that targets' improved performance hurts their competitors, Jory et al. see the implied threat of activism having an overall positive effect on non-targets.

In a wider context, the effects of shareholder activism impact the expectations of other stakeholders. Research by Leland and Pyle (1977), Ross (1977), DeAngelo and Masulis (1980) and Renneboog and Szilagyi (2008) suggest that the managerial discipline imposed by activist campaigns will benefit all stakeholders. Among potential firm-wide benefits of shareholder activism, Clifford (2008) finds improvements in operating performance using Return on Assets (ROA) in target firms, which is attributed to the elimination of underperforming assets. Healy, Hutton, and Palepu (1999) and Sengupta (1998) document improvements in the target firm's information environment, while Murphy (1985) reports reductions in compensation inefficiencies.

In this paper, we propose to test for evidence of risk-shifting and wealth transfer between shareholders and bondholders at firms' subject to activists' demands. The theoretical motivation originates from the options theory of Black and Scholes (1973) and Merton (1974). Viewed in this context, shareholders possess a call option on the firm's assets with the strike price set at the firm's debt value. The long position in a call option (held by the target firm's shareholders) benefits from increased asset volatility, which adversely affects the short position (held by the bondholders). Thus, there exists a potential conflict between the shareholders (risk-lovers) and the bondholders (who are risk-averse). This conflict may lead to investment distortions (Myers, 1977; Lyandres & Zhdanov, 2005) that affect all stakeholders. For instance, managers with an undiversified portfolio investment in the firm will exhibit risk preferences similar to the bondholders (Amihud & Lev, 1981; Jensen & Meckling, 1976; Ramakrishnan & Thakor, 1984). In the meanwhile, risk-averse managers act as agents for risk-loving shareholders whose wealth they are supposedly maximizing. Eisdorfer (2008) reviews the hitherto empirical evidence on risk-shifting.

Adams and Mansi (2009) find that CEO turnover is associated with decreased bondholder returns and increased shareholder returns. Elliott, Prevost, and Rao (2009) find that the announcements of seasoned equity offerings, known to lower share prices, have a positive effect on bondholder wealth. Francis, Hasan, John, and Waisman (2010) document higher risk of bonds from takeover-friendly states. Jiraporn, Chintrakarn, Kim, and Liu (2013) report that better firm-level corporate governance leads to higher cost of debt. Imbierowicz and Wahrenburg (2013) find that unexpected increases in firm leverage and the firms' contemporaneous involvement in M&A cause wealth transfers from bondholders to stockholders.

In a related study, Klein and Zur (2011) examine hedge fund activism from 1994–2006 on a sample of mostly speculative-grade

¹ Note that a target is a firm subjected to shareholder activism.

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