Int. Fin. Markets, Inst. and Money 39 (2015) 181–194

Contents lists available at ScienceDirect

Journal of International Financial Markets, Institutions & Money

journal homepage: www.elsevier.com/locate/intfin

Active block investors and corporate governance around the world

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ARTICLE INFO

Article history:
Received 30 April 2015
Accepted 14 May 2015
Available online 17 June 2015

Keywords:
Block acquisitions
International corporate governance

ABSTRACT

In this paper, we examine a sample of 3119 minority block acquisitions around the world. One in seven firms are targeted by active investors who either have their own representatives on the board or in the extreme case, replace existing CEOs. We find that active investors are more prevalent in countries with good investor protection. Further, firms targeted by active investors experience significantly higher announcement returns and a significantly higher increase in profitability, sales, and investment expenditures subsequent to the block acquisition, especially in countries with good investor protection.

1. Introduction

Theories predict that acquisitions or trades of large block of shares can discipline management (Burkart et al., 1997; Burkart et al., 1998; Edmans, 2009). Furthermore, active investors can impact firm value by influencing policy changes in the target firms (Brav et al., 2008; Klein and Zur, 2009). Active investors have become an increasingly important dimension of the market for corporate control (Cohn and Rajan, 2013). While activist investors are widely studied in the U.S. (Gillan and Starks, 2007), few papers have studied the determinants and consequences of active investors around the world. In contrast, most papers studying governance around the world either focus on internal governance measures (Aggarwal et al., 2009; Durnev and Kim, 2005), or emphasize one of the external governance measures such as mergers and acquisitions (Rossi and Volpin, 2004; Bris and Cabolis, 2008)[1]. In this paper, we study the determinants and the impact of active blockholders around the world by focusing on differences in investor protection across countries.

There are a number of possible theories for equity stake purchases. For example, Allen and Phillips (2000), Fee et al. (2006), Ouimet (2013) argue that equity can play a key role in bonding business partners facing high contracting costs. Alternatively, financially constrained companies can place equity directly with an informed corporation which provides capital directly to the issuing firm or certifies the target's investment opportunities to the capital market or other capital providers (Wruck, 1989; Hertzel and Smith, 1993; Liao, 2014). It is also likely that corporate blockholders can be effective monitors (see Shleifer and Vishny, 1986; Gomes and Novaes, 2006; Kang and Kim, 2008), though some studies have found little evidence of additional monitoring (Wu, 2004), and even some evidence for increased managerial entrenchment (Barclay et al., 2007) or outright resource tunneling (Baek et al., 2006).

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[1] Jenkinson and Ljungqvist (2001) studies examples of hostile stakes in German market for corporate control.

http://dx.doi.org/10.1016/j.intfin.2015.05.009
1042-4431/

Studies on corporate governance show that differences in laws and enforcement are correlated with the development of capital markets, the ownership structure of firms, and the cost of capital (e.g., La Porta et al., 1997, 1998). Though many view country-level legal protection an important factor in positively improving firm value (La Porta et al., 2002; Claessens et al., 2002; Doidge et al., 2004), others have argued that requiring high levels of shareholder monitoring and intervention may undermine managerial initiatives and reduce managers' incentives to exert effort, hence lowering returns and worsening company valuation (Burkart et al., 1997; Burkart and Panunzi, 2006). More recently, Durnev and Kim (2005), Doidge et al. (2007) and Aggarwal et al. (2009) find that country-level investor protection plays an important role in determining firm-level governance practices and the value of such governance practices. Finally, Bruno and Claessens (2010) find that country-level investor protection and firm-level governance practices actually jointly determine firm performance. It's therefore important in studying how country-level investor protection affects the likelihood of corporate blockholders becoming active monitors of target firms and its impact on the market reaction to increased monitoring by corporate blockholders.

We examine 3199 non-financial public target firms. Of these, 24% were U.S. domestic deals, 48% were domestic deals in non-US countries, and 27% were cross-border deals. Other countries whose firms engage actively in block acquisitions are Japan, Australia, and the U.K. 99% of the acquirers pay at least partly in cash, 66% of the deals are done through private negotiations, and 14% are accompanied with governance changes, such as a change in board of directors/CEO. For example, on December 17, 1996, Checkers Drive-In Restaurants announced that members of its new lender group, led by CKE Restaurants, have committed to invest approximately $20 million in Checkers through the purchase of shares of Checkers common stock in a private placement. On the same day, the company also announced that C. Thomas Thompson, President and Chief Operating Officer of CKE Restaurants, has been elected as Vice Chairman and Chief Executive Officer of Checkers, replacing Albert J. DiMarco[2].

There are many interesting differences across target countries in deal characteristics. For example, the majority of Swiss and Singapore firms are targeted by a foreign firm (58% and 51%, respectively), yet only 10% of the American firms and 14% of Japanese firms are targeted by a foreign firm. Another obvious difference across target countries is the proportion of deals done through private negotiations. In Germany and Japan, 90% of the deals are negotiated privately whereas only 36% of the deals are negotiated privately in the U.S. Not surprisingly, there is a significant variation across countries in governance activities around the time of block acquisitions with U.S., U.K., Canada, Singapore, and Australia having much higher incidence of governance activities.

In our first empirical experiment, we show that after controlling for firm-level, industry-level and country-level determinants of governance changes, target firms are more likely to experience a governance change at the time of block acquisitions if they have an outstanding ADR listing or from countries with good investor protection. Furthermore, larger firms and those targeted by foreign investors are also more likely to experience a governance change. Our evidence is consistent with the findings in Aggarwal et al. (2009), who compare governance practices among firms around the globe and find that foreign firms from lower investor protection countries invest less in governance compared to their counterparts in the U.S.

In our second empirical experiment, we find that there is strong evidence that target firms experience 3–4% higher announcement returns when there is a governance change in the target firm at the time of block acquisition. We also compare the announcement returns of block acquisitions across two subsamples depending on country-level investor protection. We find that target firms experience higher announcement returns when they are from countries with better legal protection. More importantly, the announcement returns associated with governance changes in block acquisitions are also higher among firms from countries with better investor protection. Therefore good investor protection is important as it facilitates governance changes in minority block acquisitions and minority shareholders stand to gain more from such governance changes as a result.

Our last experiment focuses on long-run changes in target's operating performance, investment and sales. We find that target firms experience a much higher increase in sales, operating cash flows, and investment expenditures when they are from countries with better investor protection. We run this experiment to learn whether target firms indeed benefit from corporate block acquisitions. However, caution should be exercised in correctly interpreting the results on subsequent changes in operating performance and policies of target firms. It is possible that firms that have most to gain, i.e. those have good investment opportunities, are more likely to be targeted by an active corporate blockholder. Therefore, the changes in operating performance could be simply due to the fact that these are good firms, not as a result of the corporate block acquisition itself.

Our paper contributes to the growing literature on corporate investors. Prior studies that examine this specific type of investor have emphasized their strategic interaction with target firms, their monitoring role, and their impact (or lack of) on dividend policy (Allen and Phillips, 2000; Fee et al., 2006; Kang and Kim, 2008; Barclay et al., 2007). We examine corporate investors around the globe and find that they are more active in countries with good investor protection and the value of active corporate blockholders is higher in countries with better investor protection.

Our findings also add to the law and finance literature. Blockholders are an important governance mechanism (Edmans, 2009) and previous research has shown that firms around the world tend to have higher Tobin's Q when they have higher governance scores (Durnev and Kim, 2005). We study the events that resulted in new blockholders in the target firms and

[2] *Source*: PR Newswire.