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A Critical Examination of the Actions and Impact of Activist Investors

Yanjia Zhang
University of Manchester, Chengdu 610000, China.

Abstract: An activist investor's primary strategy is to acquire a large number of shares in the target company, publicly propose a specific set of changes for the company and negotiate with the board of directors, take any additional measures necessary to achieve the desired changes, and eventually sell all of the shares after reaching a specific target. While I believe that activist investing is generally beneficial to corporate governance and development, it is undeniable that activist investors can sometimes be detrimental to a company's development, we should consider the country's realities, capitalize on its strengths, avoid its weaknesses, and play a positive role as an activist investor.

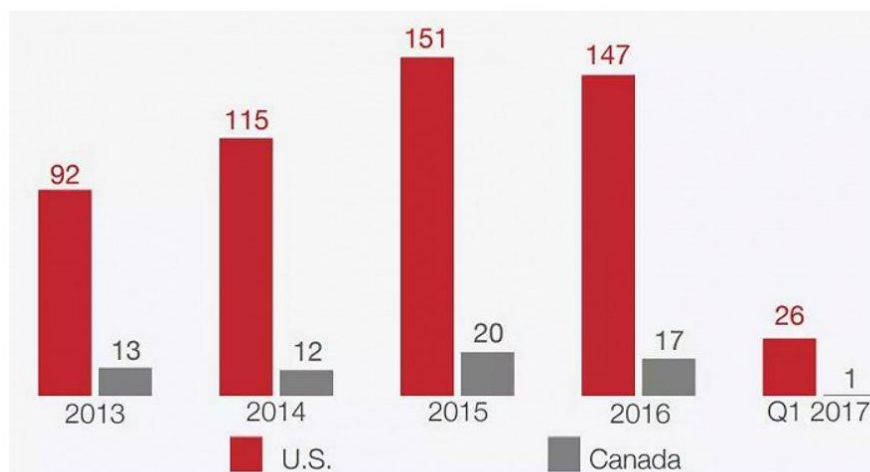
Keywords: Activist Investors

Introduction

Activist investors are hedge funds or institutional investors that advocate for change or even intervene in business decisions to protect their interests. Activist investors often seek out firms with management they feel has fundamental issues and aim to enhance value by influencing existing management's actions or by replacing them with new management. The growing activity of activist investors in general in recent years has elevated this group to a new level of market visibility (Wearing & Millo, 2011)[5].

According to a special study by Kingsdale Advisors on activist investors and M&A, M&A ACTIVISM: A SPECIAL REPORT, activist investors have pushed for numerous significant mergers, split off giants, and cancelled a number of acquisitions since the 2008 financial crisis. Additionally, demand for M&A services has been progressively growing over the last seven years, with an increasing number of significant corporations impacted and more companies poised to be bought in response to activist investor pressure.For example, in North America, where the study is focused, the number of M&A-related activist investor requests has been steadily increasing since 2013.

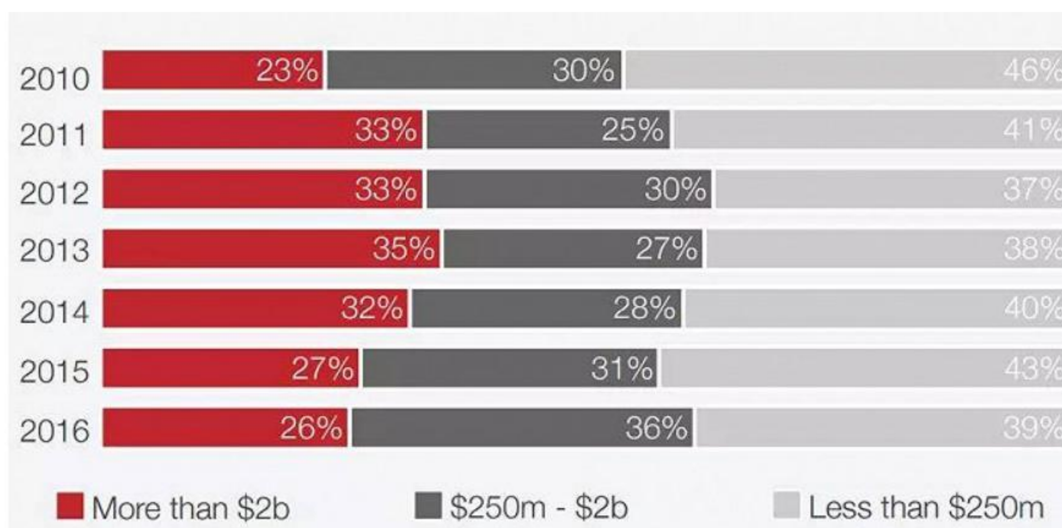
Figure 1 Number of M&A-related activist investors in demand



Source: Activist Insight Online

Indeed, transaction sizes range from over US$2 billion to less than US$250 million. Generally speaking, activist investors will consider any opportunity they come across.

Figure 2 Deal value of activist investor-related M&A (North America)



Source: Activist Insight Online

1. Action by activist investors

1.1 Individual Activist Investors

Activist investors are often very rich and prominent as people. They often do this by investing huge sums of money in a business in order to get sufficient board votes and then utilizing their influence to effect fundamental changes to the firm's strategy with the ultimate goal of influencing the target company's strategic direction. While individual activist investors might contribute value to current shareholders by directing management activities in the owners' best interests, activist individual shareholders may not have the same goals or objectives as other shareholders, therefore undermining shareholder value (Zhao & Guo, 2017)[7].

Carl Icahn is a well-known activist investor who specializes in short-term investments by swooping in and purchasing a particular number of shares in a business and then altering it from inside as a shareholder or director to maximize shareholder interest. Carl Icahn effectively increased his stake in eBay in 2014, therefore gaining a say in the company. Icahn pointed out in his letter to Ebay shareholders that the company's board members had significant conflicts of interest, including funneling interests in the Skype and Kynetic deals and influencing hiring decisions, as well as CEO Donahoe's inaction on these issues, and demanded that eBay split the company's fastest growing business unit - PayPal's electronic Payments - and empower its independent management team to maximize growth (Li, 2011)[2].However, because PayPal accounted for nearly half of eBay's total annual revenue in 2013-2014, and because paypal's platform played a significant role in Ebay's success, eBay management initially rejected Icahn's proposal outright, claiming that spinning off PayPal would jeopardize the company's synergies. Carl Icahn, on the other hand, continued to acquire eBay stock and derivatives and suggested two of his own employees to the company's board of directors in order to obtain a stronger influence. Simultaneously, Icahn proceeded to write open letters to eBay shareholders and to confront eBay management in public (Men, 2012)[4].Finally, eBay's board of directors approved the separation of PayPal into two separate public companies, partly as a result of Icahn's promotion and partly because the three giants, Apple, Google, and Amazon, continued to strengthen the online payment infrastructure, putting PayPal in a highly competitive position, and the split would aid PayPal's business expansion and capital market support.

2. Private Equity Firms

Private equity companies often acquire ownership of a business and transform it into a private one via leveraged buyouts, capital restructuring, or venture capital investments. They actively participate in corporate governance and influence the operating performance of listed companies on multiple levels, thereby affecting the company's market value: i. Participate in corporate governance and work with the company to establish a more reasonable and appropriate governance structure, governance and monitoring system through the relationship between the board of directors, the supervisory board, and management; ii. To leverage industrial resources in the industry and capital markets to provide listed companies with investment and financing, as well as value-added services throughout the supply chain; iii. To establish M&A funds in collaboration with listed companies in order to integrate the industrial chain and strengthen listed companies' position in the industry, as well as to facilitate the efficient implementation of expansion strategies.

In December 2013, SY Fund acquired 22.5 million shares from HB's controlling shareholder, accounting for 5.11 percent of HB's total share capital, and thus became HB's second largest shareholder, allowing it to participate in the company's strategic development, M&A expansion, refinancing, and other significant transactions. Throughout SY Fund's one-year shareholding of HB, it has been an active participant in corporate governance related to the listed company's primary business growth, strategic upgrading, and capital operation. Along with continuing strong development in its core industry, the firm has achieved significant strides in its strategic upgrade. Simultaneously, through giving appropriate market signals to the capital market, the Company's value has been more widely recognized and has seen tremendous growth. Finally, on 9 June 2015, Shanghai JS sold 430,000 shares of HB through the Shenzhen Stock Exchange, representing 0.06 percent of the company's total shares, earning a profit of roughly 312.5 percent on SY Fund's investment in little over a year and a half.

3. Hedge Funds

Hedge funds enhance corporate governance by exercising control over publicly traded firms, primarily through interfering in corporate management to manage risk and maximize shareholder value while mitigating agency risk, for example. Their primary purpose is to generate absolute returns that exceed market interest rates (Zhao & Guo, 2017)[6].On the one hand, hedge funds influence the company's development plan via indirect investments (e.g., the sale of obsolete assets), while activists use the company's surplus retained cash to lower agency expenses through dividend distribution, loan expansion, or stock buybacks. Chen(2011)[1]examines the agency conflict between shareholders and management, suggesting that managers have an incentive to extend the size of the business and would hence mindlessly spend funds on hand to acquire assets. As a result, Chen(2011)[1] emphasizes the prospect of employing extra retained cash for dividend distribution, so raising leverage and consequently interest payments, as a means of lowering agency costs. Meanwhile, Liu (2010)[3]establishes that activist techniques may be used to resolve agency disputes. His examination of 98 businesses involved in agency competitions between 1988 and 2000 found that target firms kept 23% more cash than non-target firms and that surplus cash was dramatically reduced after agency contests in the form of special dividend payouts, for example. As a result, hedge funds are more motivated to boost returns through dividend distributions or special dividend declarations. As a result, the activist tactic is not short-sighted. The target company does not generate an excess return in the early years of the investment and even exhibits a downward trend. The corporation, on the other hand, minimizes agency costs by paying a high percentage of net earnings to shareholders in the form of dividends and by incurring huge amounts of debt. In the long run, this kind of corporate governance is beneficial to the company's long-term sustainable growth.

4. Impact of activist investors

As a result of the above cases, it is possible to infer that activist investors has a beneficial effect on corporate governance.Activist investors' active participation in corporate governance benefits the company's performance because they benefit more from the company's increase in market value, and thus have a greater incentive and motivation to monitor managers, discipline them, and encourage them to improve the company's performance (Zhou, 2018)[8]. Activist investors' active

involvement in corporate affairs and oversight of management via shareholder proposals, private negotiations, proxy voting battles, and class action lawsuits not only strengthens the monitoring mechanism, but more importantly, Activist investors are the new power pole or powerful group forming within the corporate organization, eroding the influence of the existing powerful group. It has a mitigating influence on the company's power imbalance. Simultaneously, institutional investors now have better access to insider information from management, which partially overcomes the capital market's information asymmetry and boosts the company's transparency, so increasing the company's oversight.Additionally, the existence of activist investors makes it simpler for businesses to change ineffective management (Zhao, 2016).

Activist investors, on the other hand, have a detrimental effect on corporate governance.The activist investor has the right to participate in the corporate governance of the investee company, but may lack the necessary skills and experience and thus be unable to improve corporate decision-making; secondly, the institutional investors' own ability to participate, the management system, the external environment of corporate governance, and the institutional investors' individual differences cause each institution to demonstrate a unique motivation to improve corporate decision-making (Men, 2012)[4].

Additionally, institutional investors are long on investment management, and when they employ external managers to manage them, they establish a principal-agent relationship with the external managers. Due to the principal-agent relationship within the institutional investor, the external manager's behavioral orientation in the company's operation is not always in the institutional investor's shareholders' best interests, and thus the institutional investor's shareholders are not always motivated to improve their investment performance through a change in investment strategy.

Finally, institutional investors sometimes exhibit an obvious shortsightedness that is detrimental to the fulfillment of long-term company goals. Institutional investors' interests are not always matched with those of maximising business profit and often include social or political considerations; as a result, institutional majority shareholders may have a deleterious influence on corporate governance.

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