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Issues Raised by Activist Shareholders: A Review of Literature

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Abstract:
Shareholders' Activism is nascent and evolving concept in India. This papers aims to review academic literature with focus on types of issues raised by the activist investors. We also tried understanding the characteristics of target companies of these activist investors. Different types of investors have different criteria of targeting the firm and had raised various issues through proposals in past. Issues raised by investors' falls in categories - Idle Cash related issues, Financial Performance and Valuation related issues, Executive/Senior Management related issues and Board of directors related issues. As per our review there are no clear indication about positive impact of shareholders proposals / proxies on firms though few renowned pension and hedge funds have shown good performance as an activist shareholders over the years.

Keywords: *Shareholder Activism, Corporate Governance, Issues in Shareholder's activism, Shareholders Proposal*

I. INTRODUCTION

Albert O Hirschman in 1970 published his work "Exit, Voice and Loyalty". Hirschman talks about stakeholder loyalty / interest towards particular organization and how loyalty decides whether the stakeholder exit (Parrino, 2003) and / or raise their voice (Karpoff, 2001) in case of deterioration in quality of product / services provided by the organisation. This phenomenon is very much applicable to investors who invest in corporates which acts as wealth maximisation tools for these investors. But there are instances where management of corporates take decisions which are beneficial to themselves at the expense of losses to investors. Managers' act in their own interest is a well-known and studied phenomenon. In such cases, investors can either exit (by selling the stake) or can raise the voice against management decision.

Sjöström (2008) defines Shareholder activism as "the use of ownership position to actively influence company policy and practice. Shareholder activism can be exerted through letter writing, dialogue with corporate management or the board, asking questions at open sessions in general meetings, and through the filing of formal shareholder proposals". As per Clifford (2008) activist shareholder has plans to influence firm or its management in future. As per Gillan & Starks (2007), activist investors tries to bring the change in firm without changing the control as they are not satisfied with company management.

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Financially motivated activists typically target companies having deteriorated financial performance (Richardson 2006, Brav 2008, Fama & Jensen 1983). Firms having sound financial health but having corporate governance issues (CG) are also targeted (Baliga 1996) by activist investors. We have identified number of issues (both financial as well as non-financials), as per our understanding these issues falls in one of the category given below.

- Idle Cash and Capital Structure related issues
- Financial Performance and Valuation related issues
- Executive / Senior Management related issues
- Board of directors related issues
- Miscellaneous issues (Other issues which are not part of any of the above category)

Table 1: List of Issues-

Issues discussed in literature	Categories of Issues
Appointment of Board of directors	Board of directors related issues
Compensation of Board of directors	
Gender diversity in Board of directors	
Appointment of Executives / Senior Management	Executive / Senior Management related issues
Compensation of Executives / Senior Management	
CEO Duality	
Financial Performance of the company	Financial Performance and Valuation related issues
Strategy	
Growth	
Earning Management	
Dividend	
Liquidity	
Size of Firm	
Under Valuation	
Capital Structure of the company	Idle Cash and Capital Structure related issues
Capex plan	
Over-Investment	
Idle cash availability	
Ownership type	Miscellaneous issues
Auditor related issues	
Poison Pill	
Executive Behaviour	
Policy	
Regulation	
Risk Taking ability of firm	

Main motive of this paper is to understand the objectives of activist shareholders and issues which these investors try to address through their proposals and other kind of engagements with management of target firms. There is no recent literature available which enlist and covers types of issues raised by activist shareholders in holistic manner, our attempt is to cover and enlist maximum issues raised and covered in the existing literature (we have limited ourselves to Scopus indexed papers that to having at least one citation) which will help academician, investors and policy makers in understanding the shareholders activism framework.

Paper has 3 sections; it starts with enablers of shareholders followed by detailed discussion about issues raised by shareholders and final section is discussion & conclusions.

II. ENABLERS OF SHAREHOLDER'S ACTIVISM

Some of the matrices used by activist investors are sales growth, growth in operating profits, profitability, Return on Equity (RoE), market value to book values ratios etc. Carleton (1998) finds no difference in share price return of firm targeted by activist shareholder and return by non-targeted firms while as per Wahal (1996) and Opler et.al. (1995) return by targeted firm is lower than that of non-targeted firm. As per Karpoff (1996), activist target fimrs having low book value ratio. Karpoff finds no evidence of the

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shareholders proposals on either on firm performance or change in management.

Size of the firms also affects the likelihood of getting targeted by activist shareholders. Woidtke (2002) mentioned that companies having small scale are generally targeted by pension funds. Boyson and Mooradian (2007), also pointed out the same thing in case of hedge fund activism and reason behind this could be cost of associated with activism is on lower side for smaller firms.

Fama and Jensen (1983), talks how ownership concentration could be one of the key factors in activism, larger the ownership concentration lower is the need of activism as these owners are highly incentivised to monitor the management. Other reason cost-benefit equation for smaller stakeholder is not favourable (Ciccotello & Grant, 1999). Investor having large stake have high incentives to monitor management (Edmans A., 2014).

One of the most important factors for activism is legal and regulatory framework (La Porta 1999) to protect shareholders right. Type of investors (Mutual Fund, Pension Funds, and Hedge Fund etc.) also affects the shareholder activism and its outcome.

III. ISSUES RAISED BY ACTIVIST SHAREHOLDERS

3.1 Idle Cash and Capital Structure related issues

Organisation generating high free cash flows have severe agency problem (Chen 2009). Managers of such organisation tend to invest the excess cash at rate below its cost of capital which in turn affect the shareholder's wealth (Stulz 1990). This can been seen from capital markets reaction (Miller & Modigliani 1961) to dividend cuts where stock price of the organisation is reduced which shows high retention of excess of free cash flows are not desirable. In large organisation where more fresh cash flows are available and growth prospect is low, issuing debt up to an optimal level could help in reducing agency cost associated with free cash flows (Opler 1995). Richardson, S. (2006) has reaffirmed the fact of agency cost associated with free cash flows which results in overinvestments (Myers 1984) by such firms and presence of activist shareholders can mitigate overinvestment to some extent.

Hedge funds aims to address agency cost associated with excess free cash flow associated with profitable, low growth matured firms (Brav 2010). Klein, A., & Zur, E. (2011) finds negative effect of shareholder activism on bondholders wealth, primary reason behind this is reduction in cash and increase in total debt in overall capital employed at firm. This effect becomes more negative when activist gets one board seat at targeted firm. Greenwood and Schor (2009) classify the issues as takeover related issues; corporate governance issues and capital structure related issues and studied impact in each case on shareholders wealth. Sunder, J. et. al. (2014) found that the purpose of shareholder activism affect the cost of funds for companies targeted by the activist hedge funds.

3.2 Financial Performance and Valuation related issues

Poor firm performance is the key criteria for activist shareholders. One of the early studies by Eugene F. Fama and Michael C. Jensen (1983) discussed how takeover market could be an effective tool in enhancing corporate governance by replacing management of poor performing firms. Gillan, S. L., & Starks, L. T. (2000) found poor firm performance as key criteria in selecting the target firms by activist shareholders. Authors found that the proposals submitted by the activist shareholders are focused on three areas namely voting rules, board independence and repeal of antitakeover devices. In line with these finding, Del Guercio, D., & Hawkins (1999) studied the pension fund activism of large five US based pension funds and found out pension fund's proposals falls in these categories. As per Karpoff (1996), majority of

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shareholders proposals are related to internal corporate governance which includes issues related to board or other internal policies. Some proposals are related to external control markets (i.e. Poison pills to deter takeovers by executives). Other major category of proposals is executive and director's compensation.

As per Brav (2008) activist hedge fund targets firms having low market value compared to its book value. Activist Hedge funds (Brav 2009) enjoys more freedom in terms of regulation and hedge fund managers have higher incentives in maximizing the firm value as their compensation are directly linked with it. As per Klein & Zur (2009) hedge funds target more profitable firms having corporate governance issues which can lead to poor performance in future which is in line with Brav's findings. As per Becht et al. (2008) shareholder activism is carried out mostly through private engagements with the company management.

Hadani et al. (2011) studied shareholders proposals and proxy contest raising earning management related issues. Earning management is the tool used by management to manipulate the reported financials which eventually affect the risk pertaining to company, its cost of funding and share prices negatively. There are multiple causes of earning manipulations such as pressure to meet internal goals; analyst's expectations; meet debt covenants and raising money from capital market at lower costs. Also, executive pays are linked to financial performance of the firm which entice management to boost the numbers.

3.3 Executive / Senior Management related issues

One of the key issues raised by the activist shareholders is executive (CEO and / or senior management) pay. Executive pay related proposal could be categorised (Retime et al. (2010)) in pay-setting process, pay-design and pay-philosophy. Pay setting processes deals with compensation committee relates issues (such as independence of composition committee), these proposals garner voting support from the other shareholders. Pay-design proposals deals with performance based compensation related issues and Pay-philosophy deals with issues such as linking CEO pay with social performance, setting CEO-worker pay ratio. Activist (mostly Pension funds) target firms where CEO pay is on higher side and are quite successful in reducing the executive pay post such proposals. As per Rehbein et al. (2004) activist investors target companies due to its size and other issues mostly non-financial in nature such as executive compensation, poor employee and community related practices etc. In 2009, Kahan and Rock studied shifting of power from CEOs to directors to shareholders. Conyon, M., & Sadler, G. (2010) studied say on pay cases and found limited effect of such proposals on CEO compensations. One key point to note here is that shareholders tend to vote against executive pay related which includes grating equity options, performance incentives and bonus.

F Ferri and T Sandino (2009) studied employee stock options (ESO) proposals of activist shareholders. As per this study shareholders supported these proposals and resulted in changes in executive compensation. A company where institutional holding is high tends to have lower executive compensation and compensation is generally linked with performance of the company (Bertrand & Mullainathan, 2000). Almazan et.al., (2005) found out high stake held by active investors is linked to pay-performance model of executive compensation. As per Core et.al. (1999), companies having weak corporate governance have higher compensation. Marler & Faugère (2010) studied relationship between shareholders' activism and compensation of mid-level executive, authors differentiated between activists who raises voice verses exit activist. Stake held by voice activist is generally associated with equity compensation of mid-level executives. They also points out that voice activists have higher monitoring cost. As per

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Brunarski et. al. (2014) directors or CEO's tends not to take any action post low SOP support.

3.4 Board of directors related issues

Board of directors and their compensation related issues forms large part of activist proposals.

Wu, Y. (2004) studied the effect of naming the target firms publically by pension funds, proposals demanding changes in board structure such as inducting more independent directors. Naming by popular pension fund seems to have significant impact on firm's board composition also outgoing directors are less likely to take directorship at other firms.

As per Del Guercio et al. (2008) Just Vote No campaigns are targeted towards firm having poor financial performance or firms where shareholders are not satisfied with strategy decisions taken by the board. Guo et al. (2008) studied management cases of destaggering of board. Shareholder's proposals are important factors in dropping staggered board structure.

In detailed study of shareholders proxy proposals, Renneboog & Szilagyi (2010) found that these proxy proposals target firms with weak financial performance and weak corporate governance practices. Cziraki et al. (2010) studied proxy proposals in European countries where they are legally binding in nature (in most of the countries), most of the proposals were asking for change in board. These proposals also get support from other shareholders resulting in favorable outcomes. One striking finding is that proposal submission is followed by negative stock price reactions.

Other important aspect falling in the category is CEO duality. As per organization theory, CEO duality could lead to strong and unambiguous leadership (Daily et al. 1997) whereas as per agency theory CEO duality defeat the purpose of three tier (Barle & Means, 1932) structure of modern corporation. These studies could not establish linkage in performance of the firm and duality structure. Activist shareholders especially institutional ones target firms with duality for enhancing their reputation in investors' community even though such proposals are expensive and ineffective. Baliga et.al. (1996) studied CEO duality and its effect on firm performance and found no relationship between duality and firm performance in short as well as long term.

3.5 Miscellaneous issues

Literature available could be classified in internal and external process (Wash & Seward, 1990) and Corporate governance is based on four key elements Aguilera et al. (2015) – protection of shareholders interest, mediation between internal stakeholders (management and employees), transparency in disclosures and providing strategic and ethical guidance to the company. They have focused on external environment for corporate governance which is legal and regulatory framework, market for corporate control (such as Merger and Acquisitions), Auditors, Rating agencies, activist investors and media.

One school of thought based on cognitive evaluation theory suggest that external pressure on executives by way of takeover threats, activist shareholder proposals could deter them from taking opportunistic decisions (Wei Shi and Connelly, 2017).

IV. DISCUSSION AND CONCLUSION

As per reviewed literature pension funds and hedge funds are the active shareholders. Agenda and target of pension fund and hedge funds are varied and based on their investment philosophies. Pension funds target firms having either track record of poor performance or deterioration is expected in future performance. Hedge funds targets firms having issues with free cash flows and corporate governance.

Activists have raised number of issues but are largely part categories namely – Idle Cash and Capital Structure related issues, Financial

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Performance and Valuation related issues, Executive / Senior Management related issues, Board of directors' related issues and miscellaneous issues.

There are no clear indication about positive impact of shareholders proposals / proxies on firms though few renowned pension and hedge funds have shown good performance as an activist shareholders over the years.

There is further scope of research in activist shareholder's issues in context of emerging economies like India where regulatory paradigm has changed significantly in last few years.

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