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CEOs and CFOs in the Cross-hairs of Activists

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CEOs AND CFOs IN THE CROSS-HAIRS OF ACTIVISTS

Shareholder activism of the hedge fund variety has become a hot topic lately. The Bill Ackman, Carl Icahn, Nelson Peltz and others are almost household names, at least in the financial press and on business TV networks.

The impact and results of this sort of activism remain the subject of an-going, statistics loaded debate in Academia and of vitriolic dispute between legal experts and fund managers.

The key issue, the bone of contention, is whether activist hedge funds, through their actions and demands, manage to raise the performance of lagging companies in an enduring manner; or do these funds only generate returns for themselves by pushing companies to implement measures, usually of a financial nature, that boost stock prices in the short term but leave the company weaker in the longer term?

We contributed to the debate with a study of our own. Surveying all activist events of the years 2010 and 2011, we obtained a sample of 290 campaigns by 165 activist hedge funds targeting 259 firms. To map out the actions and performance of these 259 targeted companies, we have set up a random sample of 259 companies selected to match the targeted companies in terms of industry classification and market value.

A striking result of our study was the number of targeted firms that were sold or that disappeared over a four-year span: 95 targeted firms or 37% of the total, while the random sample shows a "normal" attrition rate of some 15% over the same period.

Ultimately, getting the firms sold off was the strategy with the highest payout for the activist hedge funds, so it comes as no surprise that they pursue this objective most vigorously, as shown in Table 1.

TABLE 1

Activist Hedge Funds Stated Objectives and Tactics Used (259 interventions)

Objectives	**Total**	**% of cases**
Sell the company or asset restructuration	80	30.89%
Governance structure or board change	74	28.57%
Change in payout policy	45	17.37%
Cost reduction	15	5.79%
Omnibus	16	6.18%
Other	16	6.18%
Undisclosed or vaguely described	13	5.02%
Tactics	**Total**	**% of cases**
Communicate with board/management	45	17.37%
Seek board representation without confrontation	19	7.34%
Publicly criticize the company	73	28.19%
Use the threat of proxy contest or legal action	40	15.44%
Launch a proxy fight	65	25.10%
Sue the company	5	1.93%
Make an unsolicited/hostile offer	12	4.63%

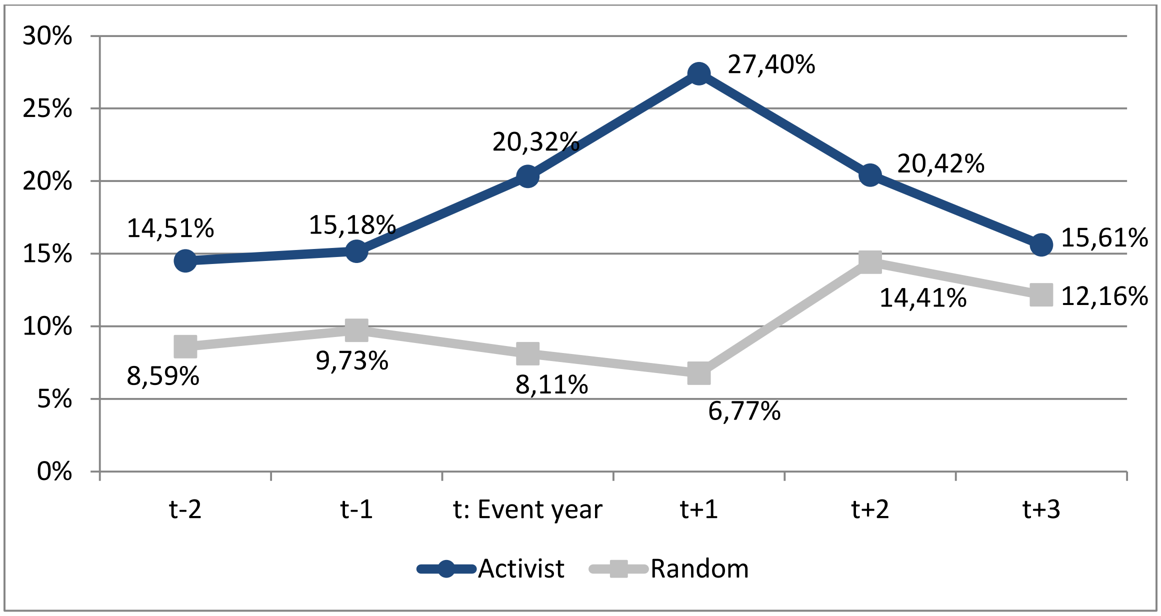
As part of our study, we examined the impact of these funds on executive turnover, in particular on CEOs and CFOs. The objectives laid out in Table 1 (selling the company, share buybacks, spin-off of assets or divisions, etc.) put the CEO and the CFO of targeted firms in the cross-hairs of the activists. These executives are then in a quandary. If they believe that the moves urged on them and on the board by these funds are not in the best, long-term interest of the company, then they would have to engage in a bitter confrontation with the activist, including a full-fledged proxy fight. As hedge funds nowadays win their battles in 72% of cases (83% when they launch a proxy contest), the CEO or the CFO or both are slated for quick replacement after the hedge fund wins the day.

But even if the CEO and CFO are compliant and willing to pursue the objectives set out by the activist, their position is not secure as the hedge fund may find it useful to publicly point fingers at these executives, holding them responsible for poor performance and questioning their ability to carry out the actions needed to bring up the stock price.

Indeed, Figure 1 shows that, beginning in the year when activists show up (t=event year), CEOs are replace at a much higher rate than in the random sample. The turnover rate returns to "normal" at t+3.

FIGURE 1

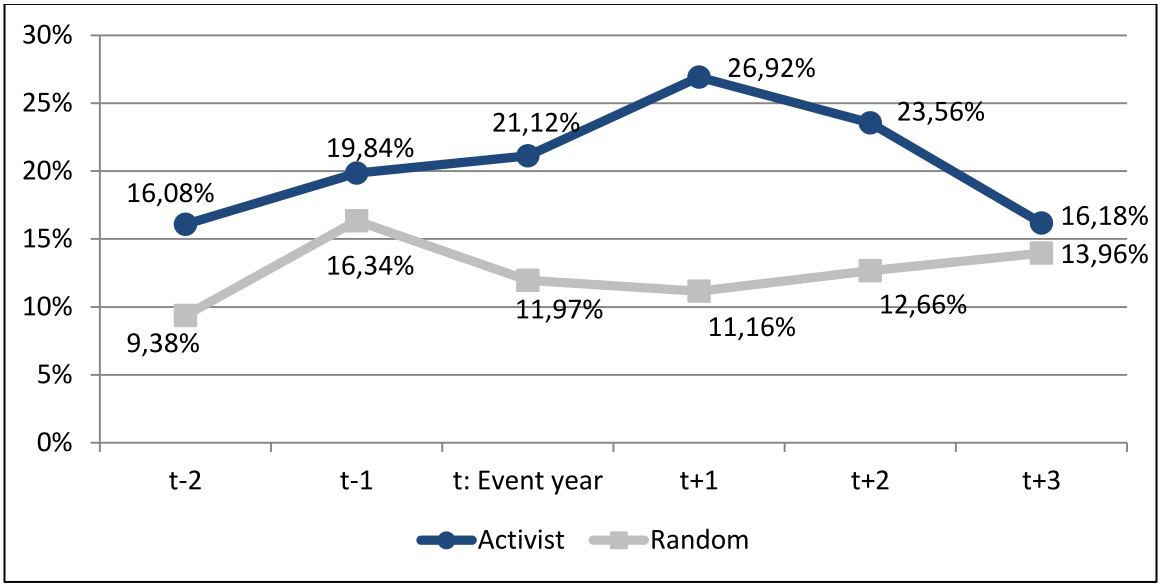
Turnover Rate of CEOs



CFOs exhibit a very similar pattern as shown in Figure 2.

FIGURE 2

Turnover rate of CFOs



Delving deeper into the data, we found, as Table 2 shows, that more than half of the targeted firms changed their CEO before the end of the second year after the arrival of the activist fund, while close to 75% of the firms in the random sample kept the same CEO in office over the same period.

TABLE 2

Percentage of surviving firms at t+2 with the same CEO after activist intervention

	Activist sample	Random sample
Same CEO as previous year (end t=event year)	78.3%	91.5%
Same CEO for 2 years or more (end of year t+1)	57.2%	85.2%
Same CEO for 3 years or more (end of year t+2)	46.4%	74.9%

The figures are similar for the CFOs (Table 3).

TABLE 3
Percentage of surviving firms at t+2 with the same CFO after activist intervention

	Activist sample	Random sample
Same CFO as previous year (end of year t)	78.9%	87.9%
Same CFO for 2 years or more (end of year t+1)	58.4%	78.5%
Same CFO for 3 years or more (end of year t+2)	45.2%	70.4%

Even more striking, only 30.7% of the targeted firms had *the same CEO and CFO* at the end of the second year (versus 59.2% for the random sample).

Such high turnover rate for CDOs and CFOs in the first three years of the activist intervention may indicate either rank incompetence or that many CEOs and CFOs resist implementing the activist's game plan and end up losing their job.

Defenders of hedge fund activism favour the first explanation. Targeted companies were particularly deficient at the senior management level and, thus, hedge funds were right to aggressively correct this sort of deficiency. After all, ***The Economist*** recently stated that "[A]ctivists are a force for good", in part because "plenty of companies suffer from rotten management"[1].

Then, if senior management is replaced by people of superior ability, the benefits of this executive turnover should show up in the operating and stock market performance of targeted firms. We failed to detect that benefit.

Performance of targeted firms

We found *no* statistically significant differences between the mean performance of the targeted firms and the random sample of firms (based on ROA, ROE and Tobin's Q). Furthermore, we found no differences between the two samples for *compounded annual stock price returns* over the three years following the activist intervention.

[1] ***The Economist*** "Capitalism's unlikely heroes: Why activist investors are good for the public company" February 7th 2015.

So the targeted firms did no better and no worse than randomly selected matched firms[2].

But, the agitation and relentless pressure by activists may get boards and management to take whatever actions will please them: new or increased share repurchase programs, workforce reduction, cuts in R&D and SG&A expenses, sell all assets generating only "low" profitability, stop all expansion plans, and of course, sell the company if at all possible.

Of course, one could argue that restructuring a firm, undertaking a turnaround, takes more than three to four years (the length of the period studied after the intervention). Then why would the activist hedge funds sell their stake in the targeted firms within less than 2 years on average (458 days at the median, 527 days on average)? In fact, they exit the company quite often after a very short period following the changes in the C-Suite. If they have faith in the new appointees to unlock great value within five years, why are they exiting before?

So the most immediate consequence for a company of being targeted by an activist hedge fund has to be the likelihood of being sold off. *We shall never know whether these sold-off companies could have developed into industrial champions on their own*. For other, surviving, targeted companies, this hedge fund episode often results in radically changed senior management and board membership, cuts in people, stagnant capital expenditures and R&D; while not lethal over the short period of time that these hedge funds hang around, *many companies come out of the experience as shrunken firms that may have lost a couple of years to their competitors*.

This article is based on the authors' forthcoming paper, entitled "The game of «activist» hedge funds: Cui bono?" and is available here or here.

[2] Yet, activist hedge funds may well achieve highly positive results for themselves and their investors by timing their entry and exit of a stock, by using derivatives and leverage on occasion to enhance their yield, and by benefiting from the "control" premium when getting companies sold off.