Columbia Business School

Companies, Governance, and Markets

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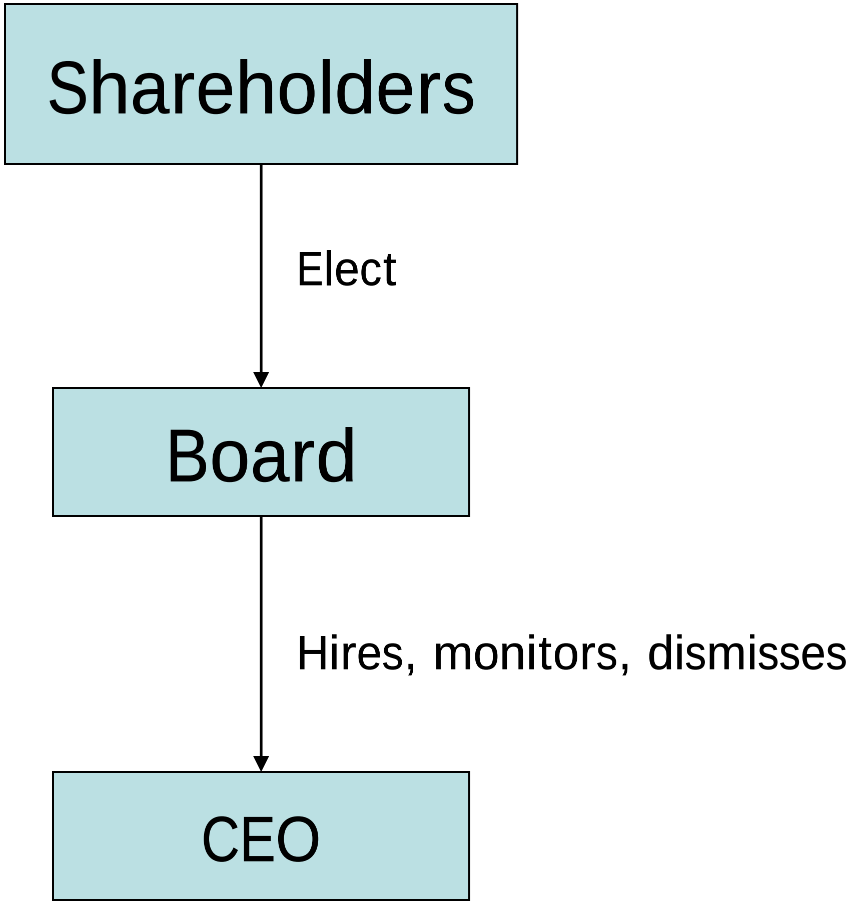
Facts

- The U.S. economy is dominated by large, diffusely owned public companies.
  – 20% of all types of businesses, 83% of revenues.
  – The median largest shareholder holds 10-20%.
- Control of large publicly traded firms.
  – “Truly” widely held: Australia, Canada, UK (no family presence among the top 20 firms), U.S., France, Switzerland.
  – Widely held with cross-ownership: Japan, Korea.
  – Family dominance: Argentina, Hong Kong, Mexico (nearly 100% among the top 20).
  – State dominance: Singapore, China.

Parties in corporate governance

- Potential pairs in conflicts of interest:
  - Manager – shareholder.
  - Shareholder – Stakeholder.
  - Shareholder – shareholder: between controlling shareholder and others (dual class, pyramids, etc.).
- Forms of corporate governance.
  - External: Market discipline. – Investor perspective.
  - Internal: monitoring. – Board perspective.
  - Watchdogs: auditors, regulators, rating agency…

Organizational Structure of Firms



Balancing the power

- Board effectiveness:
  - Impose fiduciary duties on directors and managers.
  - Board independence.
- Empowerment of shareholder:
  - Give shareholders rights.
  - Make shareholder voting meaningful.
  - Facilitate effectiveness of activist block investors.
  - Effective market for corporate control (hostile takeovers and proxy contests).
- Effective external monitors:
  - SEC, auditors and other “gatekeepers.”

Case for board effectiveness

- The board must be able to stand up to the CEO.
- A majority of directors of listed companies must be independent.
  - Key board committees should consist of only independent directors. (Dodd-Frank, sec. 952)
- What does “independence” mean?
  - No material relationship with the company.
  - Process by which directors are chosen?
  - Friends of the CEO?
- The “all-star” board of HP in the early 2000s.

Empowerment of Shareholders

- Vote on increasingly more regular and critical matters.
- The “proxy access.”
- Activism:
  - Some activist shareholders and institutional investors (notably hedge and private equity funds) have successfully influenced company policies and strategies.
- Hostile takeover:
  - Have decreased dramatically since mid-1980.
- Most institutional investors are known for being “reticent.” Why?

The inevitable “passivity?”

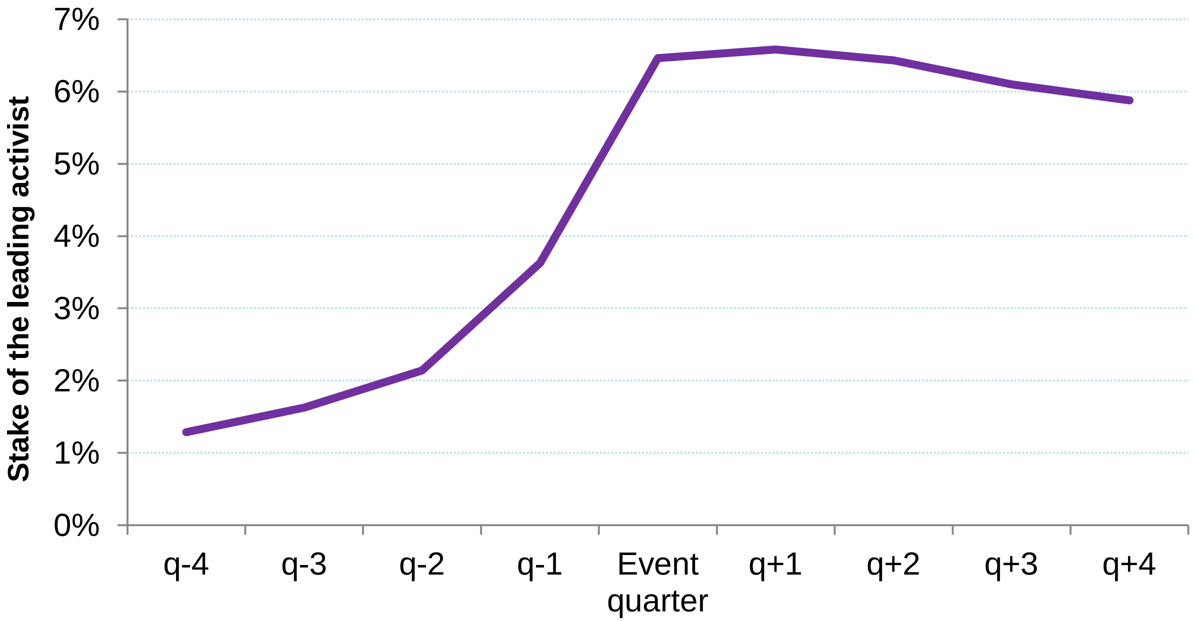
- “Prudent man” rule for pension and banks.
- Diversification requirement.
- Trading liquidity required for open-end funds (mutual funds).
- Business relations with portfolio firms and other dubious goals.
- Legal risk.

Two generations of shareholder activism

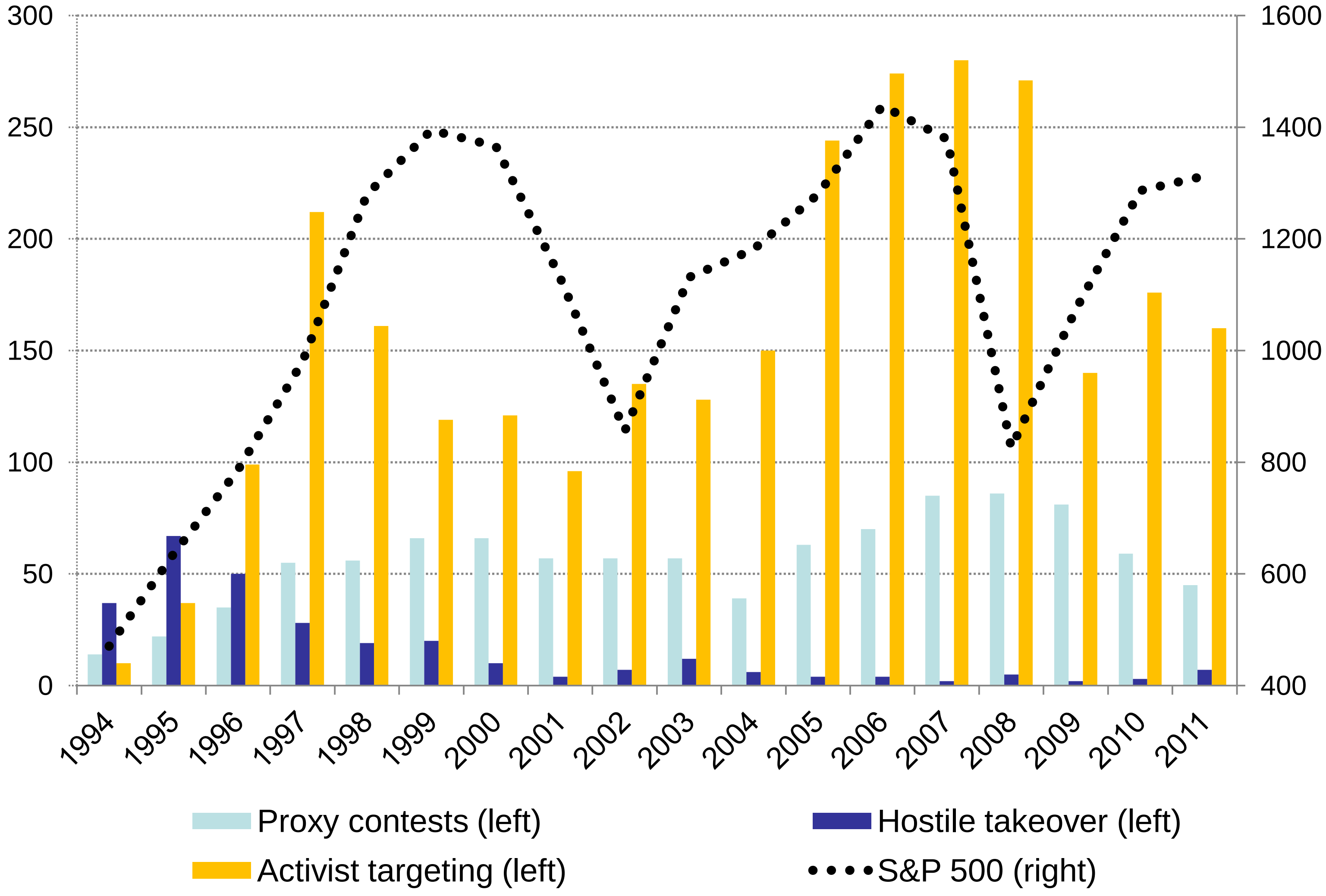
- Traditional institutional investors (mutual and pension funds):
  - Incidental and ex post.
  - To contain damage.
  - “Wall Street Walk” to avoid underperformers.
- Hedge fund activists.
  - Strategic and ex ante.
  - To make a profit.
  - Seek investment opportunities in underperformers.
- Defensive vs. offensive activism.

Potential impact of a proposed new rule

- Enable shareholders to nominate up to 25% of a company's board of directors using the company's proxy statement.
- To nominate directors in this fashion, the shareholder must hold 3% for at least three years (who are they?).



Changing landscape of external governance



Why against shareholder empowerment

- It weakens internal governance: "Shareholder activism is destroying the role, focus, and collegiality of the board of directors."
- It leads to short-termism: "Activists create pressure on boards [and managers] to manage for short-term share performance rather than long-term value."
- It leads to more, not less conflict of interests: "…shareholders do not deserve more shareholder democracy because the majority of them are intermediaries, such as pension funds and mutual funds, which have governance problems of their own – they may act against the interests of owners." ("Agents watch agents")
- Shareholder primacy per se is questionable: Did Jack Welch term it the **Dumbest idea in the world?**

The rationale for shareholder primacy

- Who are shareholders?
- Why are shareholders special?
- Shareholder value maximization needs to observe constraints.
- Analogy to Winston Churchill's "worst form of government."

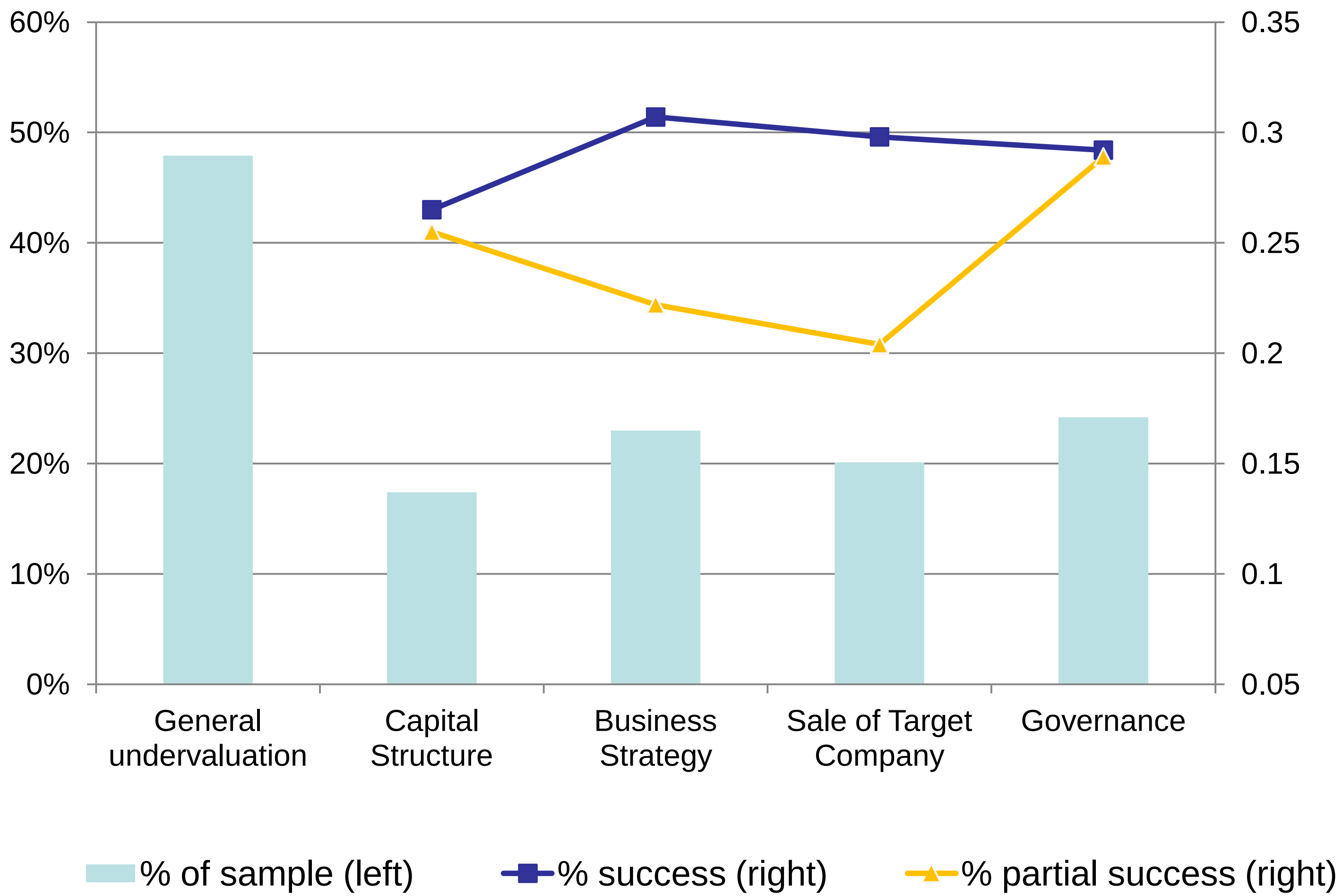
Managing conflict of interest

- A new genre of institutional investors.
- Sizable but strictly minority stakes.
- No other business relations with portfolio firms.
- Influence instead of control:
  - Not enough to dictate corporate policy.
  - Enough stake for garnering support for the changes they advocate.
- Support from fellow shareholders important.
  - “Sharks,” “wolf packs,” and “remoras.”
  - Limiting scope for extracting private benefit.

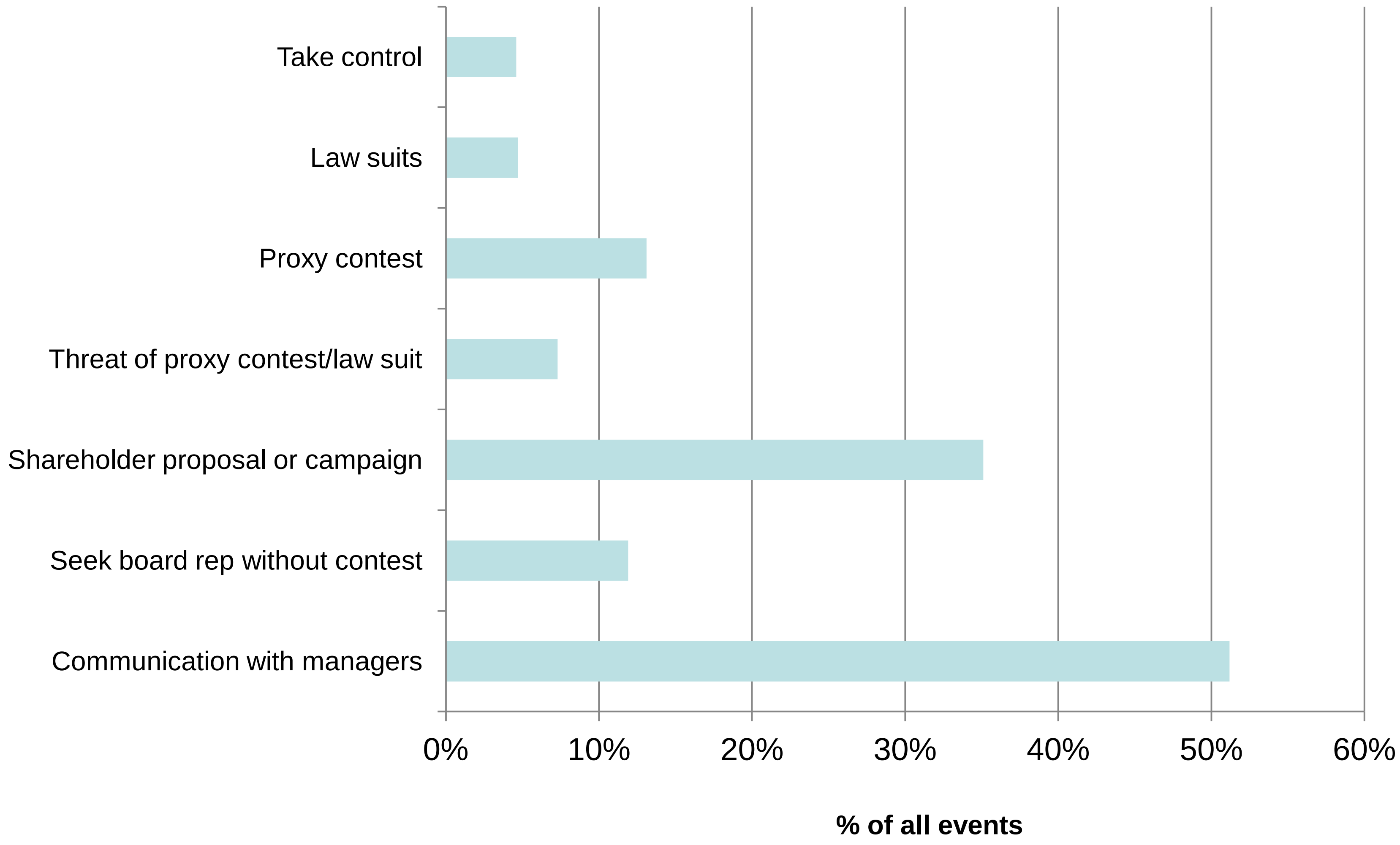
Strategy—implementation

- Secrete toehold.
- Launch public activism, often in the form of a Schedule 13D filing.
- Start friendly (shareholder proposal), could turn hostile (proxy contest).
- Usually not interested in seeking control—takeover defenses not effective deterrence.
- Coordinate with other institutional investors.

What do they want and get



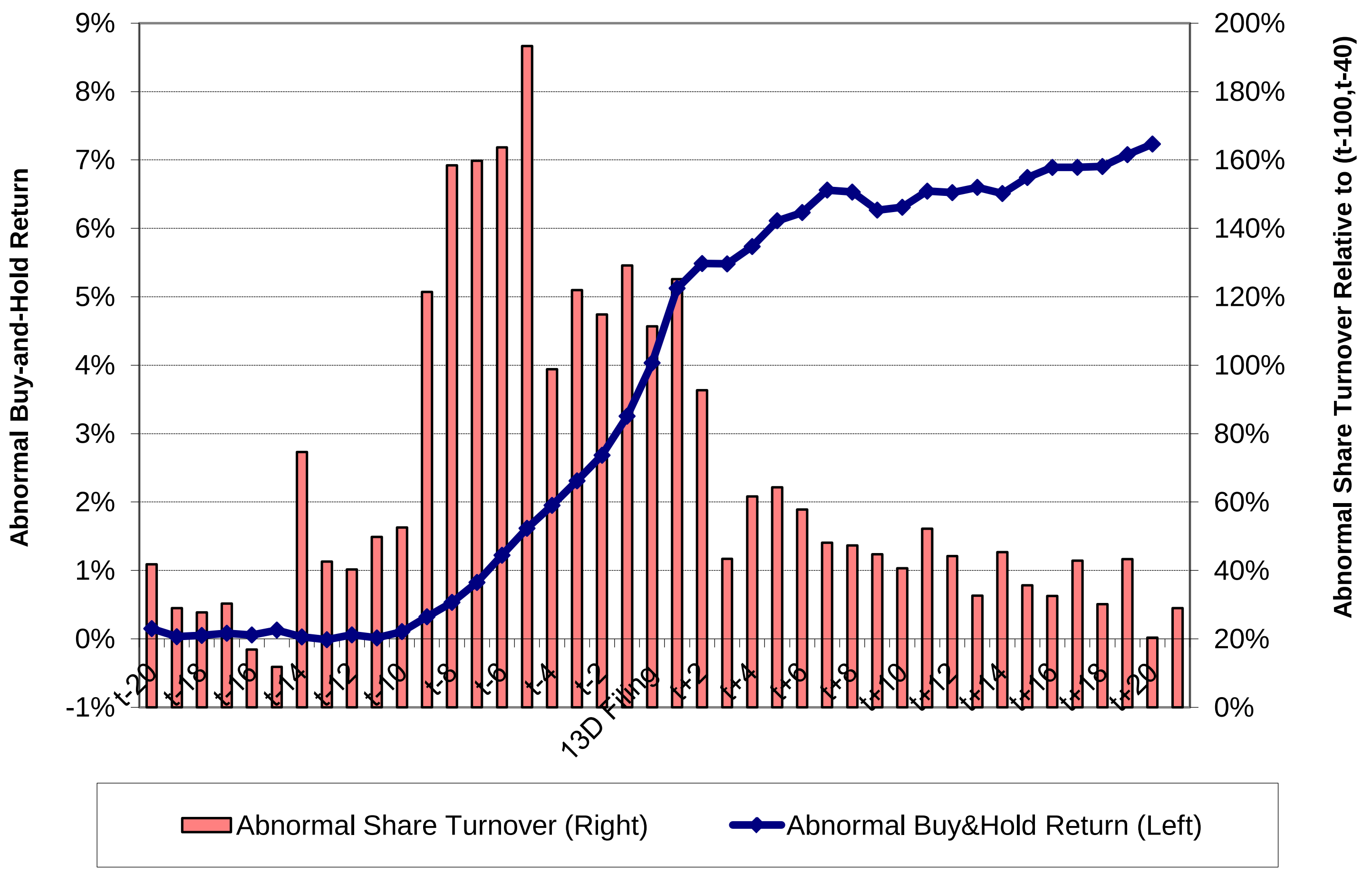
Activist tactics



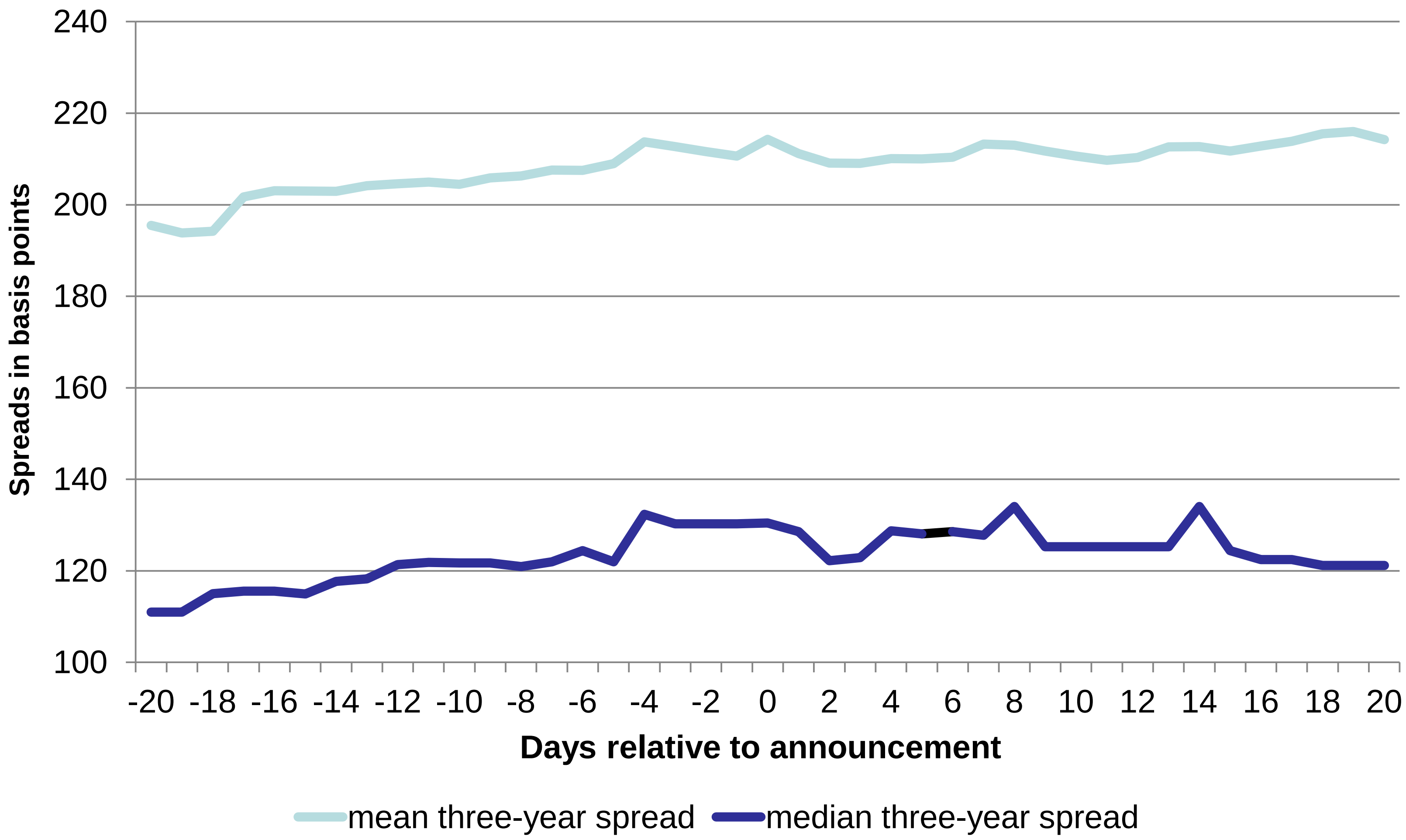
Which firms get targeted?

- Low relative valuation: a branch of value investing.
- Mature cash cows.
- Excess cash but low payout, high diversification, and dubious acquisitions.
- High takeover defenses and high executive compensation: governance problems.
- High analyst coverage, high trading liquidity, and high institutional ownership: ease of toehold; and sophisticated shareholder base.
- Summary:
  - Badly governed firms with strong fundamentals.
  - “Better income statements than balance sheets.”
  - Issues for correction are “general” in nature.

Does the market (shareholder) like it?

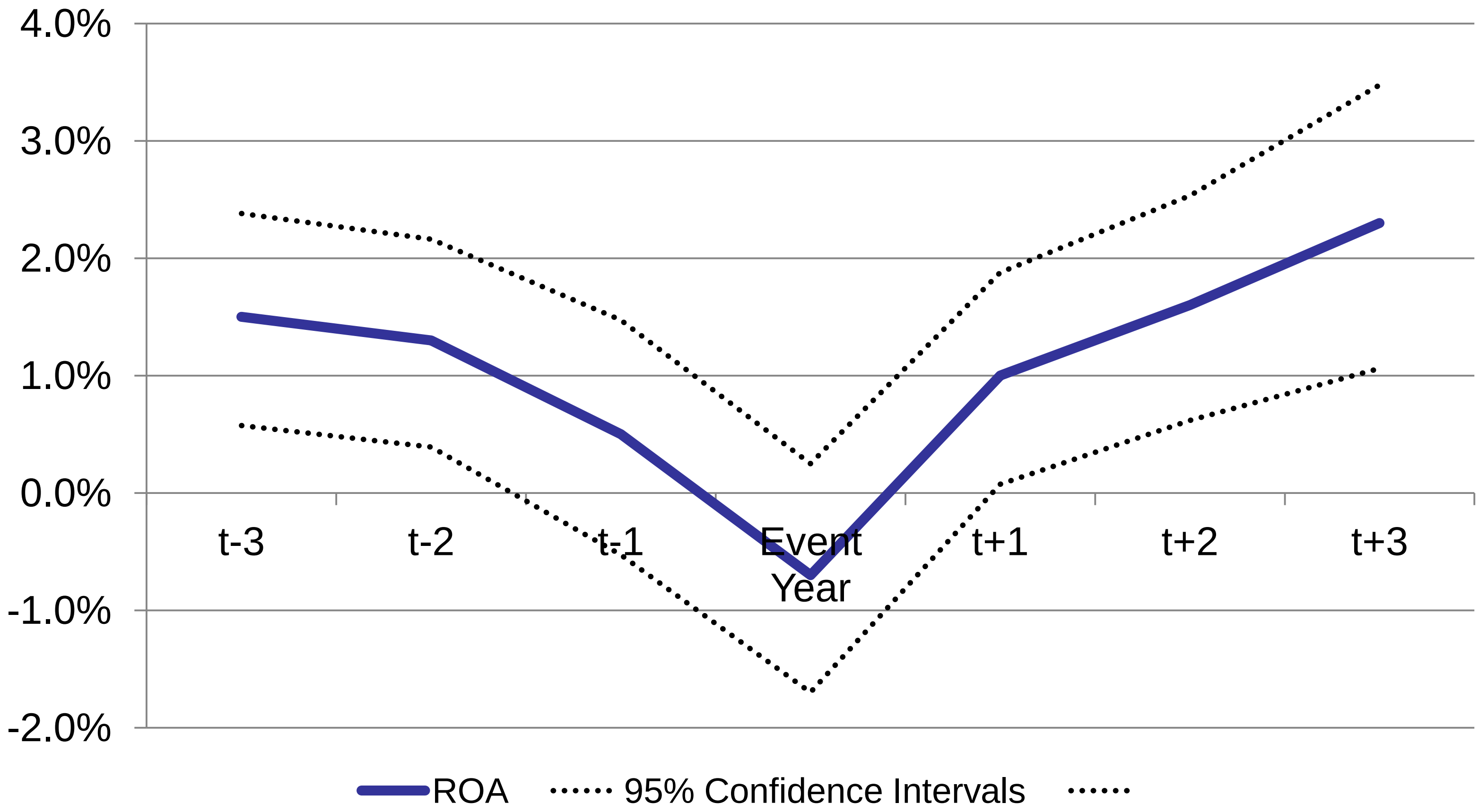


Does the market (bondholder) like it?



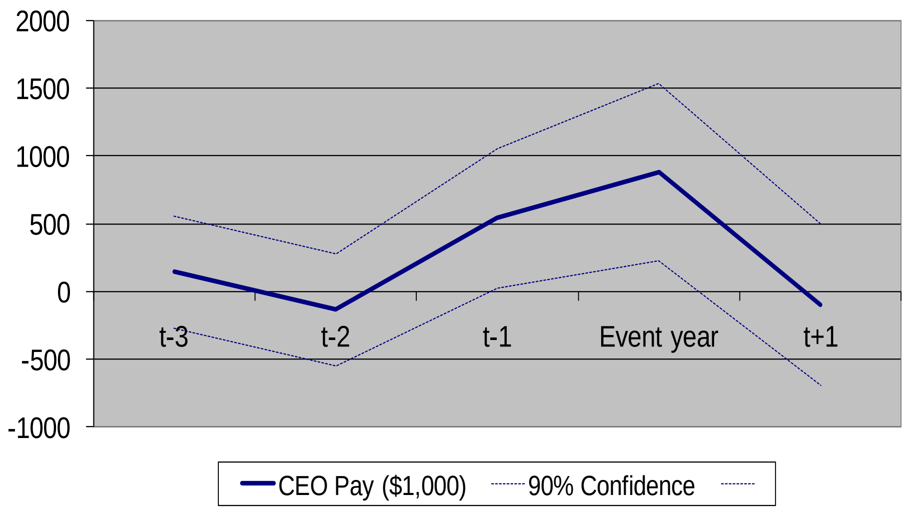
There are “real” effects

Peer-adjusted return on assets

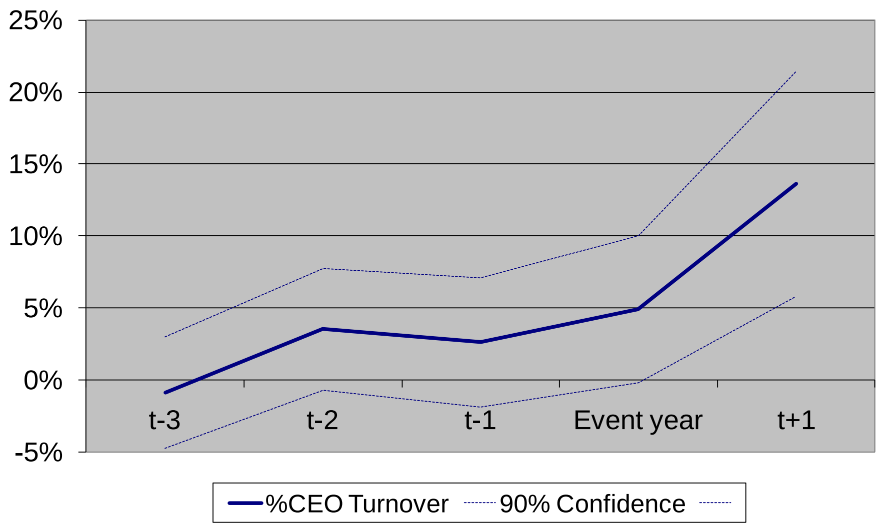


Someone (CEO) loses…

CEO excess pay to peers ($1,000)



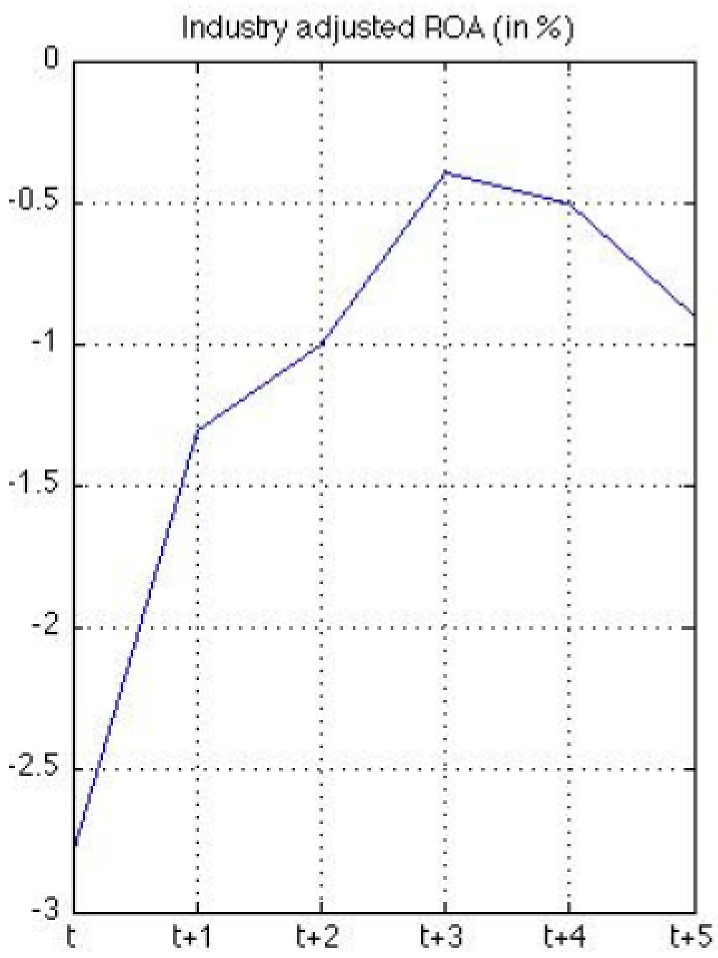
CEO abnormal turnover (%)

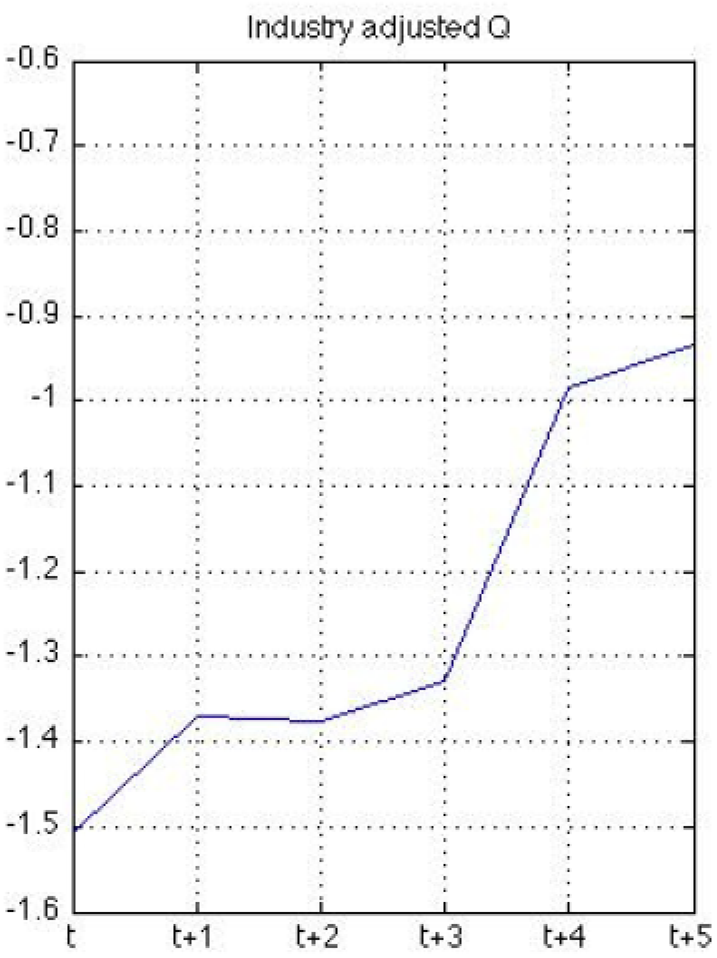


Does activism promote “short-termism”

- Any “short-termism” claim relies on the stock price being inefficient—failing to reflect the discounted value of future cash flows.
- The “myopic activists” claim is easily tested, but none of the people making the claim conducted any large sample empirical analysis.
  - “[f]or companies that are the subject of hedge fund activism and remain independent, what is the impact on their operational performance and stock price performance relative to the benchmark, not just in the short period after announcement of the activist interest, but after a 24-month period.” See Wachtell, et al., *Bite the Apple; Poison the Apple.*

The long term evolution of ROA and Q





Pump and dump?

- For the full sample, there is no longer-term reversal of the announcement return.
- Stock returns after hedge fund exit is neutral to slightly positive.
- Further investigation of a likely subsample of "adversarial interventions:"
  - Hostile.
  - Leverage-enhancing, payout-increasing, and investment-reducing.
  - Operating and stock performance are at par with the rest of the sample.
- Targeted firms fared no worse during the financial crisis years (2008-2009).

Summary

- Separation of ownership and control is the ultimate source of agency problems.
- Internal governance has limited effectiveness.
- Ultimately the market imposes basic discipline.
- Regulation should work through the basic governance mechanisms.