Chapter IV - Hedge Funds in Different Financial Market Environments

Part II. The Impact of Hedge Funds on Corporate Governance System

Hedge funds do not often remain passive arm’s length investors and try to make substantial changes to firms’ business strategies and financial policies. For instance, in January 2005 the Anglo-Saxon hedge funds TCI and Atticus attacked the German security exchange firm Deutsche Börse arguing that management was not putting sufficient effort into creating shareholder value. As a result of this interference, the Deutsche Börse made important changes to its corporate governance as well as to its financing and investment policies. This example suggests that the increased activism by hedge funds can change the balance of power between managers and shareholders and therefore has significant implications for corporate governance.\(^\text{40}\) This growing influence of hedge funds in corporate governance raises some interesting questions. Most importantly, does this new form of shareholder activism make corporate governance more efficient? From an economic point of view, this is the case if hedge funds promote more efficient investment and financing decisions leading to a more efficient allocation of capital. For instance, the campaign by TCI and Atticus against the Deutsche Börse led to a substantial outperformance of its share price between the beginning of the activist campaign and the end of 2007. However, over the longer run the Deutsche Börse’s performance deteriorated when its share price suffered substantial losses during the recent subprime crisis. This raises the question of whether hedge funds really increase shareholder value or whether short-term increases in share prices reflect other effects. For instance, short-term increases in share prices might also be the result of wealth transfers from debtholders or from long-term shareholders.

This part investigates these issues in more detail and is structured as follows. Chapter I focuses on the approaches of activist hedge funds. It analyzes their restructuring demands in order to determine whether they ameliorate agency problems or whether they create new agency problems. Chapter II investigates the potential impact of hedge funds on the German corporate governance system. This is also an important research question since the implications of hedge fund activism might depend on the overall corporate governance and capital market environment.

\(^{40}\) Hedge funds can also have other implications for firms because their dynamic trading strategies affect market liquidity and might create additional opportunities for raising financing and sharing risk.

Chapter I. Hedge Fund Activism and Corporate Governance

Some hedge funds have specialized in shareholder activism. These hedge funds acquire small stakes in target companies and use them to call for substantial changes in business strategies, financial policies and governance arrangements. These attacks are typically associated with significant increases in share prices. Thus, it is often argued that hedge funds perform a monitoring function in corporate governance and that they focus on firms that do not maximize firm value. In particular, hedge funds seem to improve corporate financial policies and help to reduce agency problems of free cash flows by forcing managers to disgorge excess cash flows to shareholders. Moreover, they seem to force managers to dismantle inefficient corporate empires and push them into value-creating mergers & acquisitions. Consequently, hedge funds help to constrain managerial moral hazard and reduce agency problems of free cash flows. However, their measures also often increase the risk of the operations and financial policies of target firms and lead to a front-loading of payouts to shareholders. This suggests that hedge fund activism might also create new agency problems and destroy firm value in the long run.

This chapter investigates how activist hedge funds exert control over target firms and evaluates the potential impact of their demands on firm value. It begins with a brief overview of the most important corporate governance mechanisms in section A. Subsequently, the focus of section B is on the tactics employed by activist hedge funds. This highlights how they can exert control over target firms even though they hold only small stakes in target firms. In section C the hypothesis that activist hedge funds perform a monitoring function in corporate governance is analyzed. Specifically, it investigates under what conditions the proposed changes to firm-level corporate governance, business strategies and financial policies can help to increase the value of target firms. Section D investigates the alternative hypothesis that activist hedge funds generate returns by expropriating long-term shareholders and debtholders. The final Section E concludes this chapter.

A. An Overview of Corporate Governance Mechanisms

The separation of ownership and control between shareholders and managers creates agency problems which can destroy firm value. These agency problems arise because shareholders have to delegate control of the firm’s daily operations and many important decisions to the firm’s management. As a result, managers have substantial informational advantages and have the discretionary freedom to pursue their own