

Thesis

Leopold Ingenohl

8th March 2018

Much attention has been recently given to the current Securities and Exchange Commission reporting requirements for Schedule 13D, governing the disclosure of beneficial ownership interests in excess of five percent of outstanding common stock of a U.S. public company (Giglia, 2018). Amongst other causes, it is due to the fact that the targeted corporation experiences significant gains when the partial acquisition is announced (Akhigbe et al., 2007).

In fact, many event studies have been conducted for analysis of what happens to the target's stock when there is such a filing. However, it is still largely unanswered where this upward drift comes from (Greenwood and Schor, 2009). An approach to this issue was presented by Akhigbe et al. (2007), mentioning that the market reaction is associated with the size of the announced partial position and the degree of the target's free cash-flow. Greenwood and Schor (2009) address this issue by presuming that the runup is a reflection of investors' expectations of the target firm being acquired at a premium to the current stock price. Another approach is objective of this paper. It's aim is to address this issue by examining the link between the company condition of the investor and the subsequent market reaction on announcement of the filing. The following argumentation gives motivation for this approach.

In recent research Collin-Dufresne and Fos (2015) observed a positive significant market reaction upon a more general sample of Schedule 13D filings. Brav et al. (2008) have shown a favorable market reaction – 7%-8% average abnormal returns in the (-20|20) event window – particularly to Schedule 13D's filed by hedge funds. Similar results have been shown by Klein and Zur (2009) who observe 10.2% average abnormal stock returns specifically for hedge fund

targets. Furthermore the runup is even higher if the acquirer is a private investor or a non-financial corporation (Brigida and Madura, 2012). This is matching with Akhigbe et al. (2007) findings who observed greater gains for the target's stock if the partial position was initiated by a corporate bidder. Hence filings by corporate investors seem to have the highest impact.

Beyond the effect these filings have on the target's stock, Akhigbe et al. (2007) observe that partial acquisitions, if carried out by corporate investors, are more likely to result in a full acquisition when compared to all other activist investors. Within the mass of Schedule 13D filings, institutional investors are unlikely to pursue a complete takeover whereas corporations are potential full acquirers (Brigida and Madura, 2012). This would indicate a higher probability for corporate investors to ultimately acquire the target following their minority stake in it (Greenwood and Schor, 2009) ¹.

Since filings by corporate investors are followed by larger average abnormal returns, it seems that out of all, their filings have the highest impact. Considering this, limiting the sample to corporate investors seems reasonable. By applying a higher probability of acquisition to these filings, and tracing the strong abnormal returns back to this assumption, the condition of the investor, in order to carry out a possible acquisition, must play an important role in the calculation process. Based on these findings, the economic significance of corporate cross-holdings in the context of investor activism is apparent and the link between the financial condition of the investor and the subsequent abnormal returns on the target stock is an interesting issue to examine.

1 Literature Review/Theory

With regards to stated objective, this paper is combining literature on investor activism and fundamental analysis in determining a companies strength.

Recent research in the field of investor activism by Brav et al. (2008) shows that hedge fund activism has a positive effect on the performance of the target company, creates

¹expressed by a SC 13D filing

a favorable market reaction and activist hedge funds have a high succession rate in achieving their main objectives ². Klein and Zur (2009) not only analyse activism by hedge funds but also incorporate private investors into their analysis. In accordance with Brav et al. (2008) they observe a positive market reaction around the announcement date and highlight the success rate of activists in achieving their campaign's main objectives. Coffee Jr. and Palia (2014) are in line with a market runup in response to investor activism by hedge funds but focus on their real value creation. They find that hedge fund activism may result in a severe externalities namely at the shortening of investment horizons and the discouragement of research and development. Greenwood and Schor (2009) also document large positive abnormal returns when hedge funds announce their activist intentions and show that the ability to force the target into a takeover is attributable to the abnormal returns. In addition they find that the highest impact on the market is for those ultimately acquired. While all of these studies involve a deepened investigation of hedge-funds, especially their impact and motivation, most of them leave the remaining investor types aside. In particular, there has been no study that independently evaluates corporate activism and directly investigates the relation of the investor's strength with the subsequent market reaction.

In a study of 2010 *BCG* notes that many of the year's acquisitions would involve a financially strong acquirer. However, the attribute of being financially strong is not ambivalent in its definition. With the objective of separating strong from weak value firms, Piotroski (2000) established the F-score. The F-score represents a simple application of fundamental analysis and is the sum of nine binary signals that form a "... composite measure of firm strength" (Fama and French, 2006, p. 496). In order to legitimize the explanatory power of the F-score in separating strong from weak firms he formed portfolios. In doing so he showed that an investment strategy of shorting expected losers (weak firms) and buying expected winners (strong firms) would "generate a 23% average annual return" (Piotroski, 2000, p. 4). Hyde (2014) have matching results and observe significant return premiums for stock with a high F-score over stocks with a low F-score. Although the F-score was established to distinguish among value firms, Mohr (2012) shows that an application on growth stocks yields similar

²They analyse the following objective of activist campaigns: (1) Maximize shareholder value (2) changes in the capital structure (3) changes in the business strategy (4) sale of the target company (5) changes in corporate governance

results without losing the predictive ability ³.

In conducting the analysis, the F-score will be used to separate the sample of 13D filings among strong and weak corporate investors. Since it is able to separate firms in portfolios into strong and weak performing ones, an application to this analysis seems reasonable.

However, components of the f-score include changes in leverage and The score itself can be divided into the three dimensions profitability, balance sheet health and operating efficiency. In the context of this analysis As Mohr (2012) states: the f-score considers in what direction the fundamentals of a company are trending and whether financial health conditions are met. Because high F-scores imply higher returns hence stronger firms should have higher returns, investors must see a high F-score as a representation of financial strength. In the context of this paper those practices would have only been applied to the target and not the investor. An application of the F-score on the investor with the aim of distinguishing between strong and weak firms

Choi and Sias (2012) formulate it from a target perspective - "does financial strength predict subsequent institutional demand"?

On the other hand, Akhigbe et al. (2007) examine the characteristics of final acquisitions following partial bids. They find that involvements by corporate bidders are more likely to result in a full acquisition.

³This is in line with Piotroski (2000) and confirms earlier research conducted by him

2 Overview

3 Data

3.1 Constructing the Sample

Basis of the following analysis are all Schedule 13D filings from the 13 year period starting in 2004 and ending blabla 2017 (available on SEC's EDGAR). Information important to the analysis and contained in the filings are (1) the filing date, (2) the filer and (3) the subject. The sample is then constructed as follows. As the analysis is focusing on corporate investors and their cross-holdings the sample is further restricted by cross-referencing the 13D filings with a corresponding sample of 10-K filings of the firms. It is done to separate corporate investors from institutional investors (e.g. hedge-funds, pension-funds, real estate investment trusts (REITs)). The daily stock returns and prices come from the Center for Research in Security Prices (CRSP). The accounting fundamentals come from the COMPUSTAT database. This is in accordance with Fama and French (2006) and Brigida and Madura (2012) resulting in (1) an exclusion of targets in the financial and utility industries, (2) firms being required to be listed CRSP and have share codes (10) or (11) (i.e. ordinary shares) and (3) firms being listed in the COMPUSTAT database and having sufficient data for the relevant periods. In a last step company web sites and newspaper articles are used to determine whether or not the remaining activists are corporate investors or not.

This sample differs from Brav et al. (2008) who considered only filings by hedge funds, and Collin-Dufresne and Fos (2015) who involved all investor types in their sample. Table *xx* summarizes the selection process.