Investment Rationales of Hedge Funds and Private Equity Funds in the German Stock Market

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Introduction

- PE and HF have become prominent players in equity markets
- Interference with corporate policy
- PE are well-known for changing capital structure, improving operational efficiency, inducing divestment...
- Examples for HF activism
  - TCI pressures Deutsche Boerse to cancel LSE takeover and make CEO Seifert resign
  - Wyser-Pratte and Marcap demand divestment of Hapag-Lloyd and replacement of CEO Frenzel

Key characteristics

Characteristics	Hedge funds	Private equity funds
Investment focus	Variety of asset classes	Primarily private and public equity
Expertise	Focus on financial	Both financial and operational
Lock up period	On average 10 months	On average 10 years
Compensation	Periodical marking to market	On a cash flow basis at the end of the holding period
Admittance of new investors	On a periodical basis	No

⇒Key differences in organizational set-ups but active on the same playground

Motivation: why compare?

- Regulatory debate hardly differentiates: joint or separate regulation?
- As opposed to traditional investors, incentives to invest in monitoring due to increased effective ownership via
  - higher degree of performance-oriented compensation
  - heavy use of leverage
- Previous empirical research suggests a positive role of HF and PE with respect to the reduction of agency conflicts (see Klein and Zur 2009, Brav et al 2008 for HF and Renneboog et al 2007 and Weir et al 2005 for PE)
- Do they address the same agency conflicts?

Motivation II:why the German market?

- Typical continental European market
- Weaker protection of minority shareholders (la Porta et al 1999)
- Reduced exposure of managers to hostile takeovers (Franks and Mayer 1998, Loderer and Peyer 2002)

$\Rightarrow$Potential for corporate governance improving strategies

- High degree of ownership concentration (Andres 2008)

$\Rightarrow$Conflicts between large and small shareholders dominate conflicts between managers and shareholders

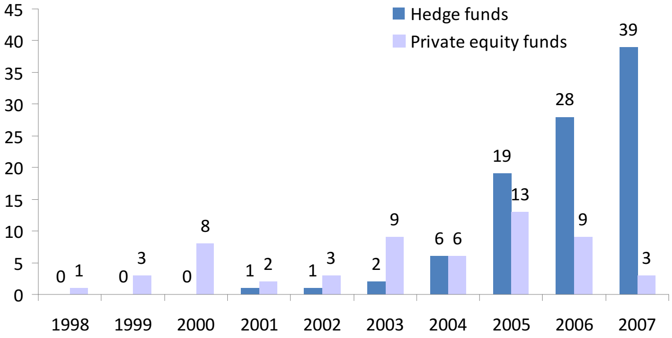
Research objectives

- Identification of systematic target characteristics to enhance the understanding of sources of value creation
- Discrimination between HF and PE investment styles
- Focus on monitoring and agency cost reduction as main value drivers of interest

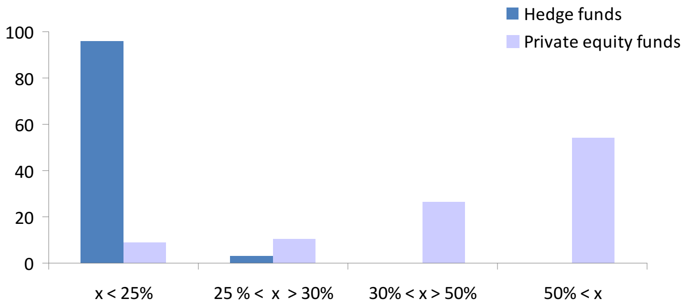
Research design

- Hand-collected dataset of HF and PE entries from BaFin shareholdings database, Factiva and Mergermarket
- Final sample: 57 PE and 96 HF targets from 1998 to 2007, non-financial firms listed in Germany
- Random control sample with temporal matching (Halpern et al 1999)
- Binomial logistic regression analysis to link the likelihood of becoming a PE/HF target to firm characteristics

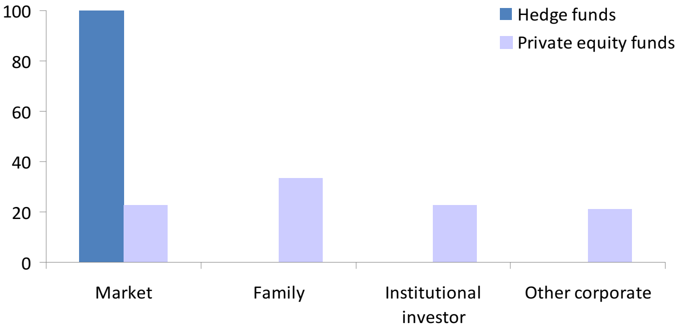
Distribution of entries over time



Acquired stake sizes



Sources of shares



Determinants of HF investment

- Freefloat: reduce control deficits and preference to hold liquid assets
- Low level of family ownership: improve governance
- Above-average CEO tenure: reduce managerial entrenchment
- High Tobin's Q: invest in growth firms, which potentially suffer from problems of asymmetric information
- Dividend potential: reduce free cash flow problems

Determinants of HF investment

- High R&D expenditures: release free cash, invest in undervalued firms (R&D as proxy for asymmetric information)
- High expected financial distress costs
- M&A rumours: merger arbitrage or corporate control agent

Determinants of PE investment

- Low managerial ownership: incentive alignment potential
- Concentrated ownership structure: maximizing deal success probability
- Absence of private benefits: reduce acquisition premium
- Stable cash flows, low growth prospects and little R&D: low financial distress costs and well-suited for leverage increase

Concluding remarks

- HF and PE follow distinct investment motives when acting on the same playground
- Both investors target corporate governance improvements, but differ in the means of reaching these goals
- Due to distinct set-ups, HF implement measures which create value in the short run, PE in the long run

Research under construction

- Value *creation* or value *transfer*?
- Limitation: study is constraint to ex-ante perspective
- Analysis of long-term consequences: long-run event study for the firms who remain listed, changes in firm fundamentals
- HF: does their involvement really affect firm fundamentals?
- PE: consequences of leverage increase for other stakeholders and shareholders
  - Debtholders: leverage increase, bankruptcy risk?
  - Employees: cuts in staff?
  - Growth and profitability
- Analysis of investment in private firms