Shareholder Activism and Firms' Performance

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Abstract

Activism campaigns are on the rise and have been in the spotlight of practitioners and academics for their increasingly bold moves and strategic actions. The increasing attention worldwide of this trending movement raises the question of whether shareholder activism can effectively return better performance to shareholders. To address this issue, we analyse a unique dataset of activist campaigns targeting firms which have their head office in the US, during the period of 2002 to 2017. Our results suggest that shareholder activism does indeed influence firms' profitability following activist campaigns, albeit not in the expected direction. We find that firms experience a decrease in profitability immediately following the activist campaigns, although the effect is unclear during the following years. We took the additional step of looking at the type of demand in activist campaigns. The results suggest that campaigns which largely focused on demanding a change in strategical direction or on obtaining board control augment the decrease in profitability, and that seeking board representation is the demand type that effectively enhances the profitability of the target firms. Overall, our analysis adds to the existing literature by demonstrating that the type of demand in activist campaigns shapes how activist activity influences returns.

Keywords: shareholder activism; corporate governance; shareholder resolution; financial performance

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1. Introduction

The participation of activist shareholders in firms has been growing over the recent years (Hadani et al., 2011; Hadani et al., 2019), particularly after the financial scandals and the financial crisis. Activist shareholders demand that firms be more transparent and provide more relevant and timely information (Goranova & Ryan, 2014; Denes et al., 2017). They also demand that managers carry out the necessary actions and measures to improve firm performance and generate a return in the medium and long term (Gantchev, 2013; Cundill et al., 2018). Shareholders are now using their ownership rights, whether through a vote on shareholder proposals or by means of direct dialogue with the firm about a specific issue, to pressure the firm to change its corporate behaviour (O'Rourke, 2003). Apart from the goal of improving the firm's performance, shareholder activists are also concerned with improving the firms' social responsibility and increasing its impact on the circumjacent society (Guay et al., 2004).

As a consequence, the number of activist proposals have been increasing. According to a 2018 report by Activist Insight, the number of governance-related proposals from activists has registered an average annual growth of about 11% from 2014 to 2018, with campaigns targeting 805 firms worldwide in 2017. The amount invested in these campaigns has increased as well, attaining $200 billion in 2016, compared to $47 billion back in 2010. There is also a notable geographic expansion of this movement outside the US: national campaigns have been launched in various European countries, including France, Germany, Switzerland, Italy and Spain. Nevertheless, only about 20% of total activist shareholder funds are located outside the English-speaking world (Ponomareva, 2018).

Despite the importance of shareholder activism for the shareholder and firms alike, this topic is still relatively unexplored, and there is still no clear understanding regarding the impact of such interventions on the performance of the target firms. As shareholder activists claim that their actions are designed solely to increase firms' performance or to improve social responsibility, and that they are not related with maximisation of returns and value creation for shareholders (contrary to the primary goal and motivation of shareholder activist campaigns to date), this paper aims to assess whether the entrance of an activist shareholder to a firm has an impact on performance.

This paper examines whether shareholder activism impacts the targeted firm's performance by using a unique dataset which combines information concerning activist shareholders' proposals for target firms, such as the target firm's and industry, the type of proposal, the announcement date, the current status of the campaign, among other significant aspects.

Our empirical analysis finds that the entrance of activist shareholders actually decreases firms' profitability, especially immediately after the activist campaigns. It was found that profitability decreases in the short-term, however the effect of activism is unclear over the following years. We took the additional step of looking at the type of demand in activist campaigns. We find that campaigns which mainly focused on demanding a change in strategical direction or on obtaining board control augments the decrease in profitability, and that seeking board representation in the only demand type that effectively enhances the profitability of the target firms. From a managerial perspective, our results suggest that activist movements may not improve profitability levels for both the firm and shareholders in the short- and medium-term, although the long-term impacts are still reasonably unexplored.

2. Literature review

2.1. Shareholder activism

The current wave of shareholder activism began back in 1942, when the U.S. Securities and Exchange Commission (SEC) introduced the first regulation to allow shareholders to submit proposals for inclusion for corporate voting (Gillan & Starks, 2007). In the past, activists announced their participation by acquiring 5% of a firm and then filing a 13D form with the SEC. Nowadays, although shareholders can hold a smaller stake, they can still convince other investors to take their side, whether through the use of media exposure, a letter to shareholders, or high-profile proxy fights (Biggar, 2018). In fact, investors now seeking bigger targets, having gained confidence and credibility over the years. For instance, General Electric and Procter & Gamble recently worked with activist shareholders in an attempt to turn around their businesses (Biggar, 2018). Furthermore, shareholder activism is becoming more collaborative and more willing to work with management teams. This represents a relevant contrast to the behaviour of the large institutional investors in the past, which pursued purely financial strategies and maintained a low profile in terms of governance (Ponomareva, 2018).

Passive-management voting patterns are changing as well, with large passive fund managers increasingly voting against management on topics such as director elections and shareholder rights. For instance, in mid-2017, both BlackRock and Vanguard pushed the giant ExxonMobil to provide annual climate-risk reporting (Biggar, 2018). Activism can also be relevant in enhancing value in takeover deals (Guo et al., 2020). Finally, activist investors are becoming more adventurous and bolder. According to Cyriar et al. (2014), in 2013 US-listed target firms had an average market capitalisation of $10 billion – up from $8 billion just a year earlier and $2 billion at the end of the previous decade. This was complemented by an increase in the number of activist campaigns, with an average of 240 campaigns launched between 2010 and 2013, which was double the number from the previous decade. Although activist investors still represent a relatively small group ($75 billion in combined assets by 2014) when compared with the hedge-fund industry ($2.5 trillion), the truth is that activist firms reveal a higher rate of asset growth than hedge-funds, and in this way they attract new partnerships with traditional investors. After all, activist shareholders possess both the capital and the leverage to continue engaging large-sized firms.

2.2. Resolution process

Before exploring the impacts and motivations of shareholder activism, it is relevant to discuss how this journey truly starts: through the filing of a resolution. Logsdon and Buren (2009) describe the resolution process in three steps. First, shareholder activists identify an issue in which they wish to intervene, an example being issues related to corporate social responsibility (CSR), non-ethical behaviour that is not effectively reproached (or not at all), or management issues. Second, shareholders engage in researching about and discussing with potential allies. The goal is clearly to define the best implementation strategy, taking into account the practices and dynamics of the target firm which are in force. Typically, the more complex the issue is, the more research and discussion is required. Finally, shareholders proceed to request the production of a report or indications that provide them with the impression that the firm can resolve the issue.

In cases when the firm's response is insufficient from the shareholders' point of view, these can either write to the firm requesting an opportunity for dialogue, or, alternatively, they can file a resolution. However, in order to proceed with the filing of a resolution without a previous attempt to communicate with the firm is considered to be incorrect behaviour within the industry. With regards the writing of the initial letter, the target firm can choose to either ignore it, or to engage in dialogue with the activists. In contrast, when a resolution is submitted, a firm can request a "no-action" letter – a *reactive* response – which permits the firm to abstain from including the filing of the resolution in the proxy statements to all of its shareholders, without being penalised in any form. Nevertheless, the absence of requesting this "no-action" letter, together with the omission of the mention of the resolution is punishable, and coercive action is expected to be enforcement by the SEC. The alternative to the "no-action" letter is to enter in dialogue with the activist shareholders who filed the resolution – the *proactive* response – in an attempt to come to an agreement. In fact, the majority of targets either adopt the resolutions proposed by the activists, or they alter their behaviour towards the issue at the organisational level successfully, leading to a possible withdrawn of the resolution (Smith, 1996) – which is usually what happens after the onset of dialogue with the firm (Logsdon & Buren, 2009). As follow up, a constant evaluation by the shareholders of whether the issue is being dealt with correctly by the firm is carried out; if this fails to occur, then the resolution can be filed a second time.

Together with the development of activism among shareholders, there is an emerging interest among researchers in understanding what urges and motivates these shareholders to opt to influence a firm's practices. According to Judge et al. (2010), two types of motivations for shareholders' actions exist: (i) financially-motivated activism, and (ii) socially-motivated activism. In the first case, the activist's investors pressure the managers and/or directors to alter certain issues which appear to be mismanaged by the firm. The proposals resulting from this type of motivation are usually related to excessive levels of executive pay and the failure to pay out dividends, among others. In the second case, socially-motivated activist shareholders are driven by social issues, such as the environment, human rights, employee welfare, and other issues. The degree of "exposure" to shareholder activism also varies according to the motivation of the activist, the nature of the firm, and the national context (Judge et al., 2010). For example, when the resolutions are product-related, it is more than likely that the target firms are producing products with negative contingencies. Therefore, in the cases of product-related resolutions, the most common industries to be targeted are the food, textiles and clothing, cigarettes, and the forestry, paper and publishing industry (Rehbein et al., 2004). With regards the filing of environmental-related resolutions by activist shareholders, the target firms tend to be from industries with a more unsatisfactory environmental performance, in particular oil refining, rubber and plastic, communications, and utilities (Rehbein et al., 2004). In contrast, industries such as wholesale and retail – that evidence a lower incidence of environmental problems – are not a preferred target of shareholders for the filing of such resolutions. Additionally, firms with questionable employment practices are also targeted – mainly from the oil refining, rubber and plastic, and hotels and entertainment industries.

The degree of exposure argument can also be looked at from an activist point of view. According to Rehbein et al. (2004), shareholders activists are motivated to file resolutions in order to solidify the identity of their group. That is to say, "activists file with corporations to increase the external attention that they receive" (Rehbein et al., 2004, p. 262), which can be one of the reasons why they prefer to target larger firms, even when smaller firms exhibit just as many issues as the larger ones. This could simply be the result of larger firms being more visible and more socially-exposed (Sjöström, 2008). In other words, activists' shareholders can file resolutions just to pursue their own agenda (Judge et al., 2010; Smith, 1996).

The problems addressed by shareholder activism are dependent and are closely related to the issues that are currently affecting and changing society. This is consistent with the belief that issues (and, therefore the motivations for activism among shareholders) can follow different patterns over time. Certain issues arise (and die) all of a sudden, while others remain in force without being resolved or simply disappearing over relatively long periods (Graves et al., 2001). For example, environmental crisis and climate change are currently affecting our daily life and activities increasingly, and, as such, are also being cited as concerns by shareholder activists and are well represented in their proposals. The result is the increasing pressure from shareholders who use their rights to influence firm's organisational practices and to force them to change their practices in response to prevalent safety and environmental issues, in order to avoid threatening the long-term reputation and visibility of the firms in question (Monks et al., 2004). To this end, there is a substantial level of support for the categories of both Corporate Social Responsibility (CSR) and Corporate Governance proposals (Chung and Talaulicar, 2010).

Overall, three main types of activist shareholders interventions are addressed in the literature (Cundill et al., 2018), namely: divestment of shares, dialogue with management, and shareholder proposals at general meetings. Additionality, the demands from these activist shareholders can be categorised into three main areas (Klein and Zur, 2009; Cundill et al., 2018). First, government-related issues, which aim to influence the management and the overall corporate governance mechanism in vigour in target firms. Second, demands concerning mergers and acquisitions, which can result in campaigns to restructure target firms, or in taking actions which encourage inorganic growth. The third area of intervention targets the firm itself, where, specifically, activist campaigns in this area of intervention usually demand changes at the operational and strategical level.

2.3. Shareholder activism and performance

Shareholder activism is mainly driven by financially-motivated activism, despite the existence of a certain level of socially-motivated activism (Judge et al., 2010; Hadani et al., 2019). This financially-driven activism results in pressurising managers to act against the pitfalls and inefficiencies that affect the firm's financial performance – but also in pursuing strategies to enhance the firm's performance (David et al., 2007). Activist investors require higher and faster returns from target firms, even if this is achieved at the cost of other shareholders – which raises issues regarding the conflict of interests (Anabtawi & Stout, 2007). However, the actual question is whether this financial motivation is the case for all interventions, and, furthermore, whether the firm benefits from the resolutions in terms of performance? An analysis of the studies carried out to date presents conflicting results – both with regards the short-term and long-term consequences of shareholder activism on target firms.

On the one hand, some studies find that there is no substantial evidence that firms benefit from activist resolutions in terms of performance, or of their market value (Karpoff et al., 1996), although performance can be influenced by the institutional context (Yeh, 2014) or type of shareholder (Marler and Faugère, 2010). Nevertheless, it is likely that some positive changes will result from such resolutions, or in the aftermath of them. For example, Smith (1996) tested whether target firms experienced changes in governance structure, shareholder wealth, and operating performance, during the periods before and after being targeted by activist shareholders. According to the author's findings, the targets did not perform significantly differently from their respective peers in their respective industries. However, the stock market price reaction was not indifferent to the targeting announcements. According to Smith (1996), a significant positive stock price reaction exists in the case of successful targeting events, with the evidence of a significant adverse reaction in the case of unsuccessful events. All-in-all, Smith's study shows that shareholder activism is mainly successful in changing governance structure, which, when successful, leads to an increase in shareholder value. Some qualitative improvements were also reported in the targets' return on assets (ROA) and cash balances, as well as a decrease in leverage (Venkiteshwaran et al., 2010).

On the other hand, some studies point to the tendency to achieve certain gains in performance or value, although these gains can be conditional to the timing, ownership stake, or the type of resolution or external context. For example, Yeh (2017, p. 245) find that for large shareholders "(…) resolutions initiated by large shareholders have positive impacts on the target firms, which reported positive announcement-associated abnormal returns". Similarly, when large shareholders initiate proposals for the election of members of the board, or amendments to the statutes, then there is evidence of an increases of post-resolution operating performance (Graves et al., 2001). This improvement is accompanied by an increase of management share buyback options and dividend payouts. When environmental issues are cited by investors for resolutions, the findings of Kim and Lyon (2011) show that institutional investor activism towards climate change can increase shareholder value when the external business environment becomes more climate-conscious. On a related theme, Clifford (2008) finds that, for hedge funds, shareholder activism is associated with positive wealth creation and better operating performance in target firms one year before the block (percentage of the firm acquired) acquisition. When accounted for together with the findings of Gillan and Starks (2000), Venkiteshwaran et al. (2010) and Denes et al. (2017), the argument is that the activism of special types of investors, such as institutional investors and coordinated groups appears to have had slightly more success in obtaining positive results. Klein and Zur (2009) advance that the reason why such investors obtained better results may be that these investors could be pursuing different post-intervention strategies, rather than immediate profitability. Such investors can demand specific-adjusted strategies in order to achieve their goals. For example, the authors show that hedge funds "address the free cash flow problem by frequently demanding the target firm to buy back its shares, cut the CEO's salary, and initiate dividends".

As presented, the evidence regarding the association between shareholder activism and performance is mixed. Nevertheless, it seems evident that shareholders activists pursue such intervention in order to change the firms' management path, by contributing with new ideas and new processes which can improve operations and enhance shareholder value. Alternatively, it can be that shareholders activists aim to obtain gains, even if these gains are not obtained immediately. Accordingly, in this study we depart from the assumption that the entry of an activist shareholder in the target firm's investor structure has a positive impact on the firm's performance, both in the short-term and in the long-term. When all is considered, we propose the following as our hypotheses:

Hypothesis 1: The entrance of an activist shareholder influences firm performance.

Hypothesis 2: Performance is affected after the entrance of an activist shareholder.

Hypothesis 3: Performance is affected by the type of demands from shareholder activism.

3. Methodology and data

To analyse the impact of shareholder activism on firm's performance, we collect data from US firms over the period of 2000-2019. Data on shareholders' proposals were collected from the "Corporate Governance Market Overview", a subsection of Thomson Reuters Eikon. The data obtained included information about the activist shareholders' campaigns, such as the announcement date, the activist shareholder responsible for the proposal, the target firm, the current status of the proposal, and the specific demands of the investor. The data was then cross-checked to ensure reliability.

The final list contained campaigns from different geographic locations, although we focussed exclusively on target firms whose head office is the US. The option to restrict the analysis for US-based firms is twofold. Firstly, we limit the influence of country-level variability on the outcome. Secondly, about 70% of campaigns listed in the "Corporate Governance Market Overview" contains firms whose head office is in the US, which leaves only a limited number of events from non-US countries to be used to generalise the findings to most of the countries that have a different cultural landscape, socioeconomic institutions, and which implement a variety of governance models (Shin and You, 2020). Activist campaigns have been on the rise ever since the 2000s, with the number of proposals submitted increasing year-after-year, attaining maximum levels in recent years, with more than 200 proposals being filed in the US alone (Figure 1), according to our initial database. However, the data accounts for more than one campaign for the same target firm.

[Insert Figure 1 around here]

To ensure the efficient tracking of each firm during the years before and after the first activist campaign, the sample selection ensures data availability for the range of t-2 to t+2, with t representing the campaign year. However, for some firms, the period is larger. With the sample period running from 2000 to 2019, although the campaigns themselves only run from 2002 to 2017. Firms in the financial sector were excluded, as, in their case, dissimilar variables drive profitability and these firms are frequently explored autonomously in the literature on finance. The final sample comprises 5,105 firm-year observations of 320 unique firms which were the target of activist campaigns in the US. In the robustness analyses, the sample is restricted to the period of t-2 to t+2, which reduces the sample to 1,600 firm-year observations. The main objectives in activist shareholder demands in our sample cover three main areas of intervention: governance-related (9.4% board control, 36.9% board representation, 15.3% shareholders' rights); M&A related (2.2% force a sale, 1.0% oppose a sale, 1.9% spinoff, 2.2% hostile acquisition); and business-related (28.4% seek alternatives, 2.8% strategic direction).

Variables

Table 1 contains the variable definitions. The dependent variable is the return on equity (*ROE*) of each firm. The ROE captures the firm performance from the shareholder perspective, as it is calculated as being the net income divided by the book value of equity. For robustness purposes, we also used return on assets (ROA), which is defined as being the ratio between net income and total assets and is intended to measure the performance from the firm perspective. Both variables are truncated at -1 and +1, in order to remove the effect of extreme values for the ratio. Furthermore, all firms presenting negative equity were excluded, as the ROE would otherwise be misleading. The average firm presents an ROE of 4.0%, leveraging a ROA of 1.7% by moderate leverage – with an average D/E of 0.72. Nevertheless, the ROE demonstrates relevant variability, even after removing extreme observations.

We used the following econometric model with fixed effects specification for firm and year:

$$Y_{it} = B_0 + \alpha\ Activism + \theta\ Firm\ controls + \mu_{it} \tag{1}$$

where the variable *Activism* is used to analyse the impact of shareholder activism on profitability. This variable assumes the value one from the year of the entrance of the first activist shareholder onwards, and zero before. For robustness purposes, we used a dummy variable, which captures the effect of the activist shareholder in the entrance year (*T0*) and one and two years after (*T1* and *T2*, respectively).

A set of firm-specific variables are included as controls in this study. We used *Size* (the ln of the value of total assets) to control for the firm's dimension, as larger firms tend to exhibit a better performance, due to the effects of scale. We also control for leverage, which is captured by the *D/E* ratio (the ratio of debt-to-equity). Firms with more debt can demonstrate a better performance, both due to the benefits of leveraging returns and also the incentives to repay debt. We also control for the firm's operational profitability (measured by *EBITDA margin*), together with the firm's capital intensity, which is measured by the *PP&E* variable (Property, Plant, & Equipment). The market valuation of firms is controlled by the *Market/Book* variable (the firm's market value, divided by the corresponding book value). Finally, we also control for the firm's effective tax rate (*Book ETR*), as taxation naturally impacts firms' returns and performance (Jacob & Jacob, 2013). The number of analysts following each firm was also used

(*N. Analysts*). Table 1 presents the dependent variables and the explanatory and control variables. The descriptive statistics are presented in Table 2. Usual econometric diagnostic tests were performed (multicollinearity, Wald test, omitted variables test), and robust standard errors were used to circumvent heteroscedasticity.

[Insert Table 1 and Table 2 around here]

4. Results and discussion

To understand whether activist campaigns give rise to increased profitability, we run Equation (1), using a fixed effect specification for both firm and year. Column (1) of Table 3 presents the results for our primary analysis. Surprisingly, the negative coefficient suggests that activist campaigns are associated with a decrease in profitability. Shareholder activists claims that they carry out a role in influencing the implementation of operational and strategical decisions which enhance efficiency and yield greater returns, although our results suggest the opposite. The variable *Activism* captures all the years following the first activist campaign.

Next, we restrict our analysis in column (2) by interacting the variable *Activism* with the period *T0*. The latter assumes the value of one for the year of the first campaign, leaving the interaction for the remaining years with the value of zero. Column (3) and (4) adopt a similar approach and measure the effect of campaigns for both the year after the campaign (*T1*) and two years later (*T2*). Shareholder activism can lead to exercising pressure on management to implement short-term restructuring to boost long-term growth, which tend to jeopardise lucrative performances in the short term. The results in Table 3 totally support this rationale. Overall, ROE decreased by about 3% following activist campaigns, which represent the major effect for the T1 of such campaigns.

[Insert Table 3 around here]

Consistent with existing empirical evidence, larger firms are associated with better returns for shareholders. Furthermore, the *EBITDA margin*, which measures operational performance, is a proxy which is positive in cases of profitability. Multiples for firm's book values highlight how the market is valuing the firm's growth potential and therefore it is not surprising that *Market/Book* has a positive association with the profitability reported in firms' accounts. Analysts can exert opposite effects on firms. Indeed, there is a stream of existent literature which supports a monitoring effect, while an alternative view considers analysts as a source of pressure for managers to attain estimated performance levels.

Activism accounts for all the years following the first activist campaign. For some firms, data is available beyond the range t-2 to t+2, and variability exists across firms. However, as a robustness analysis, we restricted our sample for the period of t-2 to t+2, before and after the activist campaign. At this point in the study onwards, all analyses are run for a restricted sample. The results in Table 4 support the previous conclusions. The ROE measures the accounting return to shareholders and is dependent on capital structure decisions, in addition to operational performance. Constraints on the funding of target firms can drive shareholder activism. Furthermore, the reputation and size of shareholder participants in campaigns can enable target firms to gain access to funding sources which they would not otherwise be able to have access to. One can argue that our results are biased towards leverage effects and therefore to address this potential issue, we perform an additional robustness analysis. In Table 5, the firms' profitability is measured from the firm perspective and is proxied by ROA, with the results being very similar for the *Activism* variable, which once again suggests that profitability decreases in the short-term.

[Insert Table 4 and Table 5 around here]

While profitability appears to decrease in the first year of the campaign (T1), there is no relevant association afterwards (Hypothesis 2). We suspect that our results provide the explanation for two consequences. First, firms targeted by shareholder activism can be pressurised to implement post-intervention strategies regarding restructuring activities in the period immediately following activist campaigns (Klein and Zur, 2009), although the benefits from this restructuring may not be manifested quickly. If our analysis had been carried out for a longer time span, it could well have revealed a crossover point where the coefficient for *Activism* switches to become statistically positive. However, due to the lack of availability of comparative data beyond t+2 of our balanced dataset, it was not feasible to attain this point. Secondly, often activist shareholders are looking for a cash return for their investments. As an accounting measure, ROE does not play a significant role as insurance for the investment return over the period of the campaign. Activist shareholders are subject to risk during each campaign, although recovering a portion of the cash invested expeditiously can function as a risk management mechanism; the firm's dividend policy can also play a role in risk mitigation (Ahmad et al., 2018; Barros et al., 2020, 2021). Graves et al. (2001) timidly addressed this issue by suggesting an increase in buyback and dividend payouts during the post-resolution period. In addition, Klein and Zur (2009) documented that when the activists are hedge funds, they frequently demand buyback options. In addition, the type of demand can exert a dissimilar effect on profitability, whereby certain aims of a campaign differ in terms of the timing of the implementation and the intensity of change.

Building on the second issue, we derive an additional analysis in the form of looking at the type of demands made by activist shareholders in each of the 320 campaigns in our sample. This analysis is related to our third hypothesis and is performed because the data available allow us to carry out an incursion into a parallel, yet relevant topic. Interaction terms are added to Equation (1) for each of the nine types of campaigns, namely: seeking board control, board representation or protecting shareholders rights, which are both governance-related demands; M&A-related demands to force a sale, demands to oppose a sale, spinoff or engaging in hostile acquisitions, and; business-related demands, such as seeking alternatives or demanding a shift of strategic direction. In our analysis, we defined each type according to the primary demand established for each campaign, although campaigns may not necessarily be mutually exclusive in their goals. The results for this additional analysis are presented in Table 6.

Our base estimation in Column (1) of Table 3 pointed to a contraction of 2.9% in ROE following the activist campaigns. The results suggest that the campaigns under study mainly focused on demanding change in strategical direction or obtaining board control, which respectively augment the decrease in profitability by an additional 6.5% and 12.0%. Nevertheless, seeking board representation in the only demand type that effectively enhances the profitability of the target firms, which thus offsets the overall negative effect by about 0.4%. Similar results were found for excluding the effect of capital structure decisions on firm’s profitability. For robustness, we present the analysis for the ROA as a proxy for profitability in Table 7, and the results are maintained.

[Insert Table 6 and Table 7 around here]

5. Conclusions

This study aims to assess whether shareholder activism increases firms’ profitability following activist campaigns. Activist investments are a consistent trend, with the prevailing view that they add value to organisations. However, the current debate on this topic is still not consensual and our research is designed to contribute further clarification. Our analysis considered firms which were the target of activist campaigns during the period of 2002 to 2017, whilst exclusively focusing on US-based firms.

Our analyses reveals that shareholder activism does indeed influence firms' profitability following activist campaigns, however, not in the expected direction. We find that firms decrease profitability immediately following an activist campaign. Arguably, this effect does not come as a surprise, when one considers the restructuring effect that is common in such campaigns. The results suggest that profitability decreases in the short-term, but that this effect is much less obvious during the following years. The conclusions are robust for different proxies for firms' profitability – specifically when using an equity approach with ROE and also when using ROA to account for a firm approach.

The discovery of an opposite, yet economically relevant effect led us to further explore the topic by examining another potential driver of activist campaigns – the type of demand. Our rationale is that not all demands by activist shareholders embrace the same timing of implementation, and neither do they exert the same intensity of change. The results reveal that the intensity of change shapes the effect of campaigns on profitability in different ways. For instance, demands which require more significant structural change in governance traits, such as seeking to obtain board control through the replacement of the CEO or another member, or changes in the strategic direction of the firm, tend to penalises even more the return for investors. On the other hand, the demand for board representation by the activist shareholders does not necessarily imply relevant structural changes, albeit such activists may well create the foundations for further change. Our results suggest that less-intensive demands for the required changes are exert a residual effect on the level of profitability. In fact, when all things considered, campaigns driven by the desire to obtain board representation yield a positive, yet timid effect on ROE of about 0.4%.

From a managerial point of view, our results suggest that activist movements might not necessarily trigger better levels of profitability for both firm and shareholders, in the short- and medium-term. However, the long-term impacts are still reasonably unexplored. Furthermore, our analysis adds to the existing literature by demonstrating that the type of demand in activist campaigns shapes how activist activity influences returns.

Our results highlight several avenues for future research. Firstly, by exploring that the motivations for initiating a campaign should be accounted for in future research. Secondly, it was found that although profitability is negatively affected in the short-term, there is no evidence of any association in the medium-term. Consequently, there is a need to understand what is the point of inflexion in firms' profitability, which is relevant for the ability of stakeholders to assess better how and when activism campaigns can really guarantee a return for incumbent shareholders.

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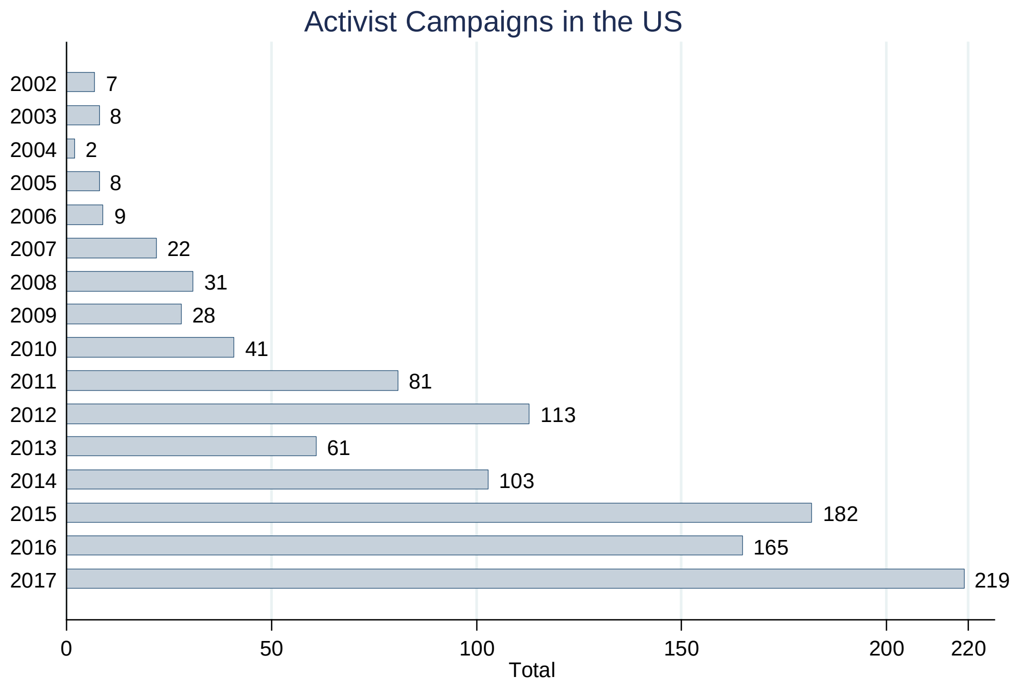
Figure 1 – Evolution of Activist Campaigns in the US that are listed in Thomson Reuters



Source: Thomson Reuters Eikon

Table 1 – Definition of Variables

Variable	Description
Dependent variables	
ROE	ROE is the firm's return on equity, measured as the ratio between net income and the book value of equity. Firms presenting negative equity are excluded. The variable is truncated at -1 and +1.
ROA	ROA is the firm's return on assets measured as the ratio between net income and total assets. The variable is truncated at -1 and +1.
Activism	
Activism	Activism is a treatment variable that takes the value one from the year of the first activist campaign on firm *i* onwards, and zero otherwise.
T0	T0 is a dummy variable taking the value one in the year of the activist campaign, and zero otherwise.
T1	T1 is a dummy variable taking the value one a year after the activist campaign, and zero otherwise.
T2	T2 is a dummy variable taking the value one for the second year after the activist campaign, and zero otherwise.
Demands	
Board Control	Dummy variable taking the value one if the activists demand to obtain board control, and zero otherwise. Examples of shaping the control of the board include replacing the CEO or another board member.
Board Representation	Dummy variable taking the value one if the activists demand aims to have board representation by the activist shareholders, and zero otherwise.
Shareholder Rights	Dummy variable taking the value one if the activists demand to ensure shareholders rights, and zero otherwise. Shareholder rights focus on the ability to grant the right to call a special meeting, independent auditing, and other actions.
Force Sale	Dummy variable taking the value one if the activists demand to force a sale, and zero otherwise. In the cases of the demand to force a sale, activist shareholders intervene to force the sale or the merger of the target firm.
Oppose Sale	Dummy variable taking the value one if the activists demand to oppose a sale, and zero otherwise. Contrary to forcing a sale, these campaigns demand not to effect a sale or merge the target firm.
Hostile Acquisition	Dummy variable taking the value one if the activists demand to engage in a hostile takeover of both an ongoing attempt or to foster further takeover, and zero otherwise.
Spinoff	Dummy variable taking the value one if the activists demand the target firm to sell themselves or to spin off business units or subsidiaries, and zero otherwise.
Seek Alternatives	Dummy variable taking the value one if the activists demand to seek alternatives through actions of dialogue with the management team aimed at benefiting shareholders and delivering them greater value, and zero otherwise.
Strategic Direction	Dummy variable taking the value one if the activists demand a shift of strategic direction, and zero otherwise.
Control variables	
Size	Size captures the firm's size and is measured by the log of the firm's total assets.
D/E	D/E is a proxy for leverage, being set as the ratio of debt-to-equity. The variable is winsorised at 0.5%.

EBITDA margin	EBITDA margin is measured as earnings before interest, taxes, depreciation and amortisation (EBITDA) scaled by revenues. The ratio is winsorised at 0.5%.
PP&E	Property, Plant & Equipment (PP&E) is a proxy for capital intensity. The variable is computed as PP&E over the firm's total assets and is winsorised at 0.5%.
Market/Book	Market to Book is the market ratio that measures the relationship between equity at market values and the corresponding book value. The variable is winsorised at 0.5%.
Book ETR	Book ETR is the book effective tax rate (ETR). The variable is set as income tax scaled by pre-tax profits and is winsorised at 0.5%.
N. Analysts	N. Analysts is the number of sell-side analysts covering the firm each year.

Table 2 – Descriptive statistics

The table presents descriptive statistics for all variables.

	N	Mean	St. Dev	Q1	Median	Q3
Dependent Variables						
ROE	5,105	0.040	0.235	-0.028	0.075	0.158
ROA	5,105	0.017	0.122	-0.013	0.035	0.074
Activism						
Activism	5,105	0.391	0.488	0.000	0.000	1.000
Activism × T0	5,105	0.063	0.242	0.000	0.000	0.000
Activism × T1	5,105	0.063	0.242	0.000	0.000	0.000
Activism × T2	5,105	0.063	0.242	0.000	0.000	0.000
Controls						
Size	5,105	20.44	2.304	18.72	20.33	22.09
D/E	5,105	0.720	1.627	0.01	0.325	0.824
EBITDA m	5,105	-0.056	2.817	0.047	0.113	0.196
PP&E	5,105	0.257	0.245	0.071	0.165	0.368
Market/Book	5,105	2.824	3.075	1.230	1.982	3.264
Book ETR	5,105	0.183	0.756	0.026	0.297	0.373
N. Analysts	5,105	8.460	9.469	1.000	5.000	13.00
Demands						
Board Control	320	0.094	0.292	0.000	0.000	0.000
Board Representation	320	0.369	0.483	0.000	0.000	1.000
Force Sale	320	0.022	0.147	0.000	0.000	0.000
Hostile Acquisition	320	0.022	0.147	0.000	0.000	0.000
Oppose Sale	320	0.009	0.097	0.000	0.000	0.000
Seek Alternatives	320	0.284	0.452	0.000	0.000	1.000
Shareholder Rights	320	0.153	0.361	0.000	0.000	0.000
Spinoff	320	0.019	0.136	0.000	0.000	0.000
Strategic Direction	320	0.028	0.166	0.000	0.000	0.000

Table 3 – Profitability (ROE) following activist campaigns – full sample

This table presents the main results for the assessment of the association between activist shareholders campaigns and firms' profitability. The sample allows for firms to add observations beyond the period t-2 to t+2, and thus enables a broader period for the treatment effect. The dependent variable is firms' ROE. Robust standard errors are in brackets, and the symbols *, **, and *** represent significant levels of 10%, 5%, and 1%, respectively.

ROE	(1) All Period	(2) t=0	(3) t=1	(4) t=2
Activism	-0.029***			
	(0.009)			
Activism × T0		-0.031***		
		(0.012)		
Activism × T1			-0.021*	
			(0.012)	
Activism × T2				-0.020
				(0.013)
Size	0.034***	0.028***	0.028***	0.028***
	(0.010)	(0.009)	(0.009)	(0.009)
D/E	-0.006	-0.007	-0.007	-0.007
	(0.008)	(0.009)	(0.008)	(0.008)
EBITDA m	0.007***	0.007***	0.007***	0.007***
	(0.002)	(0.002)	(0.002)	(0.002)
PP&E	-0.281***	-0.278***	-0.277***	-0.277***
	(0.061)	(0.061)	(0.061)	(0.061)
Market/Book	0.015***	0.015***	0.015***	0.015***
	(0.003)	(0.003)	(0.003)	(0.003)
Book ETR	0.000	0.001	0.001	0.001
	(0.006)	(0.006)	(0.006)	(0.006)
N. Analysts	-0.001	-0.001	-0.001	-0.001
	(0.001)	(0.001)	(0.001)	(0.001)
Constant	-0.595***	-0.480***	-0.480***	-0.481***
	(0.191)	(0.180)	(0.182)	(0.181)
Obs.	5,105	5,105	5,105	5,105
Adjusted R-squared	0.056	0.054	0.053	0.053
F	11.424	12.042	10.912	11.074
Year FE	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes

Table 4 – Profitability (ROE) following activist campaigns – restricted sample

This table presents a restricted sample as a robustness analysis. The sample is constricted to the period t-2 to t+2, restricting the variability in the outcome variable for the years before and after the activist campaign. Thus, the sample is restricted to 5 observations for each of the 320 firms targeted by activist campaigns. The dependent variable is firms' ROE. Robust standard errors are in brackets, and the symbols *, **, and *** represent significant levels of 10%, 5%, and 1%, respectively.

ROE	(1) All Period	(2) t=0	(3) t=1	(4) t=2
Activism	-0.023**			
	(0.012)			
Activism × T0		-0.019*		
		(0.010)		
Activism × T1			-0.010	
			(0.012)	
Activism × T2				-0.005
				(0.013)
Size	0.072*	0.069*	0.070*	0.070*
	(0.039)	(0.038)	(0.039)	(0.039)
D/E	-0.026*	-0.027*	-0.027*	-0.027*
	(0.014)	(0.014)	(0.014)	(0.014)
EBITDA m	-0.002	-0.002	-0.002	-0.002
	(0.001)	(0.001)	(0.001)	(0.001)
PP&E	-0.649***	-0.655***	-0.650***	-0.649***
	(0.143)	(0.143)	(0.143)	(0.143)
Market/Book	0.020***	0.019**	0.019**	0.020***
	(0.008)	(0.007)	(0.008)	(0.007)
Book ETR	0.010	0.011	0.011	0.011
	(0.010)	(0.010)	(0.010)	(0.010)
N. Analysts	0.000	0.001	0.001	0.001
	(0.003)	(0.003)	(0.003)	(0.003)
Constant	-1.319	-1.270	-1.284	-1.286
	(0.809)	(0.800)	(0.804)	(0.805)
Obs.	1,600	1,600	1,600	1,600
Adjusted R-squared	0.074	0.072	0.070	0.070
F	5.628	5.717	5.207	5.192
Year FE	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes

Table 5 – Profitability (ROA) following activist campaigns – restricted sample

This table complements the previous analyses by introducing a different variable to capture firms' level of profitability - ROA. The sample is constricted to the period of t-2 to t+2, restricting the variability in the outcome variable for one year before, and two years after the activist campaign. Thus, the sample is restricted to 5 observations for each of the 320 firms. The dependent variable is, therefore, firms' ROA. Robust standard errors are in brackets, and the symbols *, **, and *** represent significant levels of 10%, 5%, and 1%, respectively.

	(1) All Period	(2) t=0	(3) t=1	(4) t=2
Activism	-0.012**			
	(0.006)			
Activism × T0		-0.013**		
		(0.006)		
Activism × T1			-0.005	
			(0.006)	
Activism × T2				0.001
				(0.007)
Size	0.057***	0.055***	0.055***	0.055***
	(0.018)	(0.018)	(0.018)	(0.018)
D/E	-0.011***	-0.011***	-0.011***	-0.011***
	(0.004)	(0.004)	(0.004)	(0.004)
EBITDA m	-0.002	-0.002	-0.002	-0.002
	(0.001)	(0.001)	(0.001)	(0.001)
PP&E	-0.377***	-0.380***	-0.377***	-0.378***
	(0.081)	(0.081)	(0.082)	(0.082)
Market/Book	0.008***	0.007***	0.007***	0.007***
	(0.002)	(0.002)	(0.002)	(0.002)
Book ETR	0.002	0.002	0.002	0.002
	(0.005)	(0.005)	(0.005)	(0.005)
N. Analysts	0.001	0.001	0.001	0.001
	(0.001)	(0.001)	(0.001)	(0.001)
Constant	-1.079***	-1.053***	-1.061***	-1.057***
	(0.373)	(0.370)	(0.372)	(0.372)
Obs.	1,600	1,600	1,600	1,600
Adjusted R-squared	0.077	0.077	0.074	0.073
F	6.198	6.752	5.579	5.578
Year FE	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes

Table 6 – Profitability (ROE) and type of demand by activist campaigns – full sample

This table presents the results for the type of demand by activist shareholders. The interactions with the Activism variable account for the main types of demands set by activist shareholders in their campaigns, as follows: *Board Control* refers to the aim of activist shareholders to control the board of directors; *Board Representation* refers to campaigns with the primary aim of seeking board representation; *Force Sale* and *Oppose Sale* refer to demands to force or constrain the transactions of the target firm; *Hostile Acquisition* demand aims to persuade the target firm to engage in hostile acquisitions; *Seek Alternatives* concerns actions of dialogue with management to the benefit of shareholders with the objective to deliver greater value; *Shareholder Rights* focus on the ability to grant the right to demand a special general meeting, independent auditing, and other activities; *Spinoff* is the demand for target firms to sell themselves or to spinoff units, and; *Strategic Direction* demands a shift of strategic direction. The dependent variable is firms' ROE. Robust standard errors are in brackets, and the symbols *, **, and *** represent significant levels of 10%, 5%, and 1%, respectively.

	(1) All Period	(2) All Period	(3) All Period	(4) All Period	(5) All Period	(6) All Period	(7) All Period	(8) All Period	(9) All Period
Activism	-0.023**	-0.051***	-0.031***	-0.029***	-0.029***	-0.026**	-0.027***	-0.029***	-0.026***
	(0.010)	(0.011)	(0.009)	(0.009)	(0.009)	(0.011)	(0.010)	(0.009)	(0.009)
Activism × Board Control	-0.065**								
	(0.026)								
Activism × Board Representation		0.055***							
		(0.018)							
Activism × Force Sale			0.072						
			(0.070)						
Activism × Hostile Acquisition				-0.019					
				(0.053)					
Activism × Oppose Sale					-0.038				
					(0.108)				
Activism × Seek Alternatives						-0.013			
						(0.019)			
Activism × Shareholder Rights							-0.011		
							(0.023)		
Activism × Spinoff								-0.021	
								(0.047)	
Activism × Strategic Direction									-0.120***
									(0.042)
Obs.	5,105	5,105	5,105	5,105	5,105	5,105	5,105	5,105	5,105
Adjusted R-squared	0.058	0.060	0.057	0.056	0.056	0.056	0.056	0.056	0.059
F	11.106	11.375	10.299	10.146	10.109	10.241	10.137	10.181	11.566
Other Controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

Table 7 – Profitability (ROA) and type of demand by activist campaigns – full sample

This table presents the results for the type of demand by activist shareholders. The interactions with the Activism variable account for the main types of demands set by activist shareholders in their campaigns, as follows: *Board Control* refers to the aim of activist shareholders to control the board of directors; *Board Representation* refers to campaigns with the primary aim of seeking board representation; *Force Sale* and *Oppose Sale* refer to demands to force or constrain the transactions of the target firm; *Hostile Acquisition* demand aims to persuade the target firm to engage in hostile acquisitions; *Seek Alternatives* concerns actions of dialogue with management to the benefit of shareholders with the objective to deliver greater value; *Shareholder Rights* focus on the ability to grant the right to demand a special general meeting, independent auditing, and other activities; *Spinoff* is a demand on target firms to sell themselves or to spinoff units, and; *Strategic Direction* demands a shift of strategic direction. The dependent variable is firms' ROA. Robust standard errors are in brackets, and the symbols *, **, and *** represent significant levels of 10%, 5%, and 1%, respectively.

	(1) All Period	(2) All Period	(3) All Period	(4) All Period	(5) All Period	(6) All Period	(7) All Period	(8) All Period	(9) All Period
Activism	-0.014***	-0.029***	-0.019***	-0.018***	-0.017***	-0.017***	-0.014**	-0.017***	-0.016***
	(0.005)	(0.006)	(0.005)	(0.005)	(0.005)	(0.006)	(0.005)	(0.005)	(0.005)
Activism × Board Control	-0.037**								
	(0.017)								
Activism × Board Representation		0.029***							
		(0.010)							
Activism × Force Sale			0.064						
			(0.047)						
Activism × Hostile Acquisition				0.033					
				(0.030)					
Activism × Oppose Sale					-0.024				
					(0.056)				
Activism × Seek Alternatives						-0.002			
						(0.010)			
Activism × Shareholder Rights							-0.023**		
							(0.011)		
Activism × Spinoff								-0.013	
								(0.024)	
Activism × Strategic Direction									-0.056***
									(0.021)
Obs.	5,105	5,105	5,105	5,105	5,105	5,105	5,105	5,105	5,105
Adjusted R-squared	0.063	0.065	0.062	0.061	0.061	0.061	0.062	0.061	0.062
F	11.374	12.092	11.151	11.202	11.070	11.085	11.240	11.085	12.060
Other Controls	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes