



Corporate Finance Theory

Lecture 19

Soft shareholder activism (2)

Levit (2019)

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Intended outcomes for the day:

1. **To analyze** how the activist's ability to launch a public campaign ("voice") makes communication more effective.
2. **To show** whether the activist's ability to exit strengthens or weakens the effectiveness of voice.
3. **To carry out** a brief review of the semester.



Recap

Board must choose between making a change or keeping the status quo

Change is risky: shareholder value known to the activist, not to the board. "State: θ "

Board is biased towards the status quo

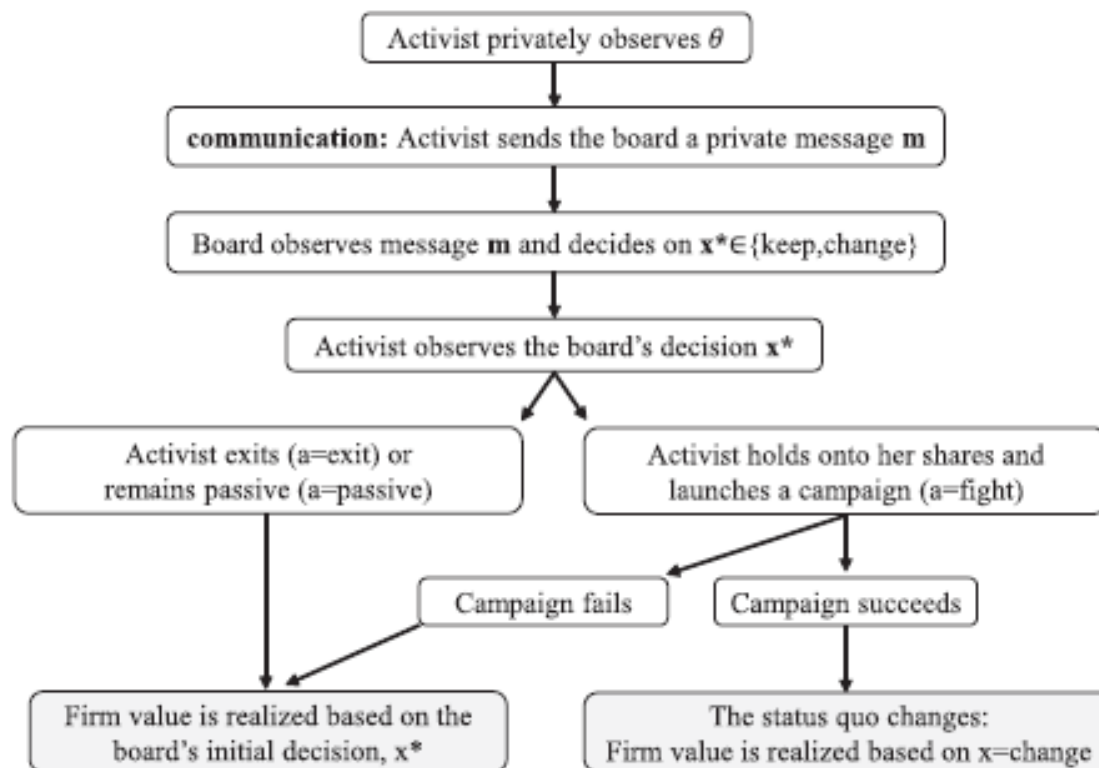
Activist can communicate, possibly convince the board to make a change. But talk is cheap!

Following the board's decision, the **activist** can:

- Do nothing
- **Exit:** sell shares
- **Use Voice:** launch a public campaign



Model: players, actions, timing



Model: payoffs (normalized)

Shareholders:

$$v(\theta, x) = \begin{cases} \underline{\theta} & \text{if } x = \text{keep} \\ \theta & \text{if } x = \text{change}. \end{cases} \quad (1)$$

Activist:

- $v(\theta, x)$ if no exit, no campaign; where x chosen by Board
- p if exit
- $v(\theta, x') - c$ if no exit, then campaign; x' maximizes shareholder value, conditional on message m sent by the activist and decision to have a campaign.

Board:

- $v(\theta, x) + \beta$ if outcome is $x = \text{keep}$
- $v(\theta, x)$ if outcome is $x = \text{change}$
- Reputation cost, if campaign gives outcome $x' \neq x$:

$$\kappa (\theta - \underline{\theta}), \text{ where } \kappa \geq \omega.$$

Under prior beliefs F , Board prefers "keep" to "change": $\mathbb{E}[\theta] \leq \underline{\theta} + \beta$,



Results from last time

We saw that:

Proposition 1. A babbling equilibrium always exists.

Proposition 2. Consider the communication game without voice and exit. An influential equilibrium exists if and only if

$$\beta \leq \mathbb{E}[\theta - \underline{\theta} | \theta > \underline{\theta}]. \quad (5)$$

Proposition 3. Consider the communication game with exit. An influential equilibrium exists if and only if

$$\beta \leq \mathbb{E}[\theta - \underline{\theta} | \theta > p]. \quad (6)$$

In particular, the activist's ability to **exit** makes **communication more credible**.



Communication with Voice

Suppose that after the Board's decision, the activist cannot exit, but can launch a **public campaign**.

Given that the Board keeps the status quo, the activist will launch a campaign whenever:

Notice that such a campaign will always succeed, because reversing the Board's decision benefits shareholders:

In the communication phase, the activist will still recommend a change whenever:



Figure to Illustrate



Communication with Voice (continued)

As a result, the Board's expected payoff from $x = \text{keep}$, given the activist's recommendation for a change, is:

$$\underline{\theta} + \beta - [\Pr(\theta > \underline{\theta} + c \mid \theta > \underline{\theta}) (\beta + (k - 1)E(\theta - \underline{\theta} \mid \theta > \underline{\theta} + c))]$$

Denote the above expression in square brackets, given a recommendation to change, by $\mathbb{E}[K(\theta, \underline{\theta}) \mid \theta > \underline{\theta}]$

Captures is the reduction in the board's expected payoff due to the activist's intervention.



Communication with Voice (continued)

Then the Board will follow the recommendation if and only if:

$$\underline{\theta} + \beta - \mathbb{E}[K(\theta, \underline{\theta}) | \theta > \underline{\theta}] < E(\theta \mid \theta > \underline{\theta})$$

Or equivalently:

$$\beta \leq \mathbb{E}[\theta - \underline{\theta} | \theta > \underline{\theta}] + \mathbb{E}[K(\theta, \underline{\theta}) | \theta > \underline{\theta}].$$



Figure to illustrate



Communication with Voice: take away

An influential equilibrium exists if and only if:

$$\beta \leq \mathbb{E}[\theta - \underline{\theta} | \theta > \underline{\theta}] + \mathbb{E}[K(\theta, \underline{\theta}) | \theta > \underline{\theta}].$$

In the baseline model, without voice, the second term on the right-hand side was absent, since there was no punishment.

Implications:

- voice can help promote communication, by giving the Board an added incentive to follow the Activist's recommendation.
- The most effective campaigns do not have to be launched: activist "persuades" the Board with its recommendation.



Communication with voice and exit

The analysis with **exit** showed that the activist will recommend a change if and only if $\theta > p$.

The analysis with **voice**, but no exit, showed that the activist will launch a campaign if and only if $\theta > \underline{\theta} + c$.

With **both exit and voice**, the activist will recommend a change if and only if $\theta > p$, but launch a campaign if and only if $\theta > p + c$

Reasoning

- if $\theta < p$, then the activist can exit and get share price p .
- Only worthwhile to launch a campaign if the benefit from doing so, $(\theta - p)$, exceeds the cost, c .



Communication with voice and exit (continued)

The Board's expected payoff from $x = \text{keep}$ is now:

$$\underline{\theta} + \beta - [\text{Pr}(\theta > \underline{p} + c \mid \theta > \underline{p}) (\beta + (k - 1)E(\theta - \underline{\theta} \mid \theta > \underline{p} + c))]]$$

with $\underline{p} > \underline{\theta}$. Compare to the situation without exit:

$$\underline{\theta} + \beta - [\text{Pr}(\theta > \underline{\theta} + c \mid \theta > \underline{\theta}) (\beta + (k - 1)E(\theta - \underline{\theta} \mid \theta > \underline{\theta} + c))]]$$

Green expression is now larger: campaign gives larger punishment

Blue expression may be smaller or larger: campaign now less likely, but campaign **conditional** on a recommendation may be more or less likely.



Figure to illustrate



Communication with voice and exit: take away

Proposition 5. Consider the communication game with voice and exit. An influential equilibrium exists if and only if

$$\beta \leq \mathbb{E}[\theta - \underline{\theta} | \theta > p] + \mathbb{E}[K(\theta, p) | \theta > p], \quad (10)$$

Voice and **exit** can make communication more credible

But **exit** can either make **voice** more or less effective: affects both the probability of voice between used, and the severity of the punishment that voice (when used) inflicts on the Board.

See Section 3 for comparative statics and empirical predictions.



Overall

When can communication constitute an effective form of shareholder activism?

- Absent voice and exit, conflicts of interest may prevent effective communication: Board will not listen to activist investors.
- Threat of voice (potential for public campaign) can facilitate communication. Reputational costs to the Board if a successful campaign reverses its decision.
- Threat of exit (selling shares) can do the same, by making activist communication more credible.
- Threat of exit affects the effectiveness of voice: makes a potential campaign more effective, but less likely (cut and run); impact on the probability of a campaign, conditional on ignoring the activist's recommendation, is ambiguous.



Initial lectures based on the Tirole textbook

Lectures 1 (part) and 2

Topic: financing under moral hazard

Market imperfection: lack of commitment towards outside investors: exerting effort / behaving / acting diligently

Implication: credit rationing limits potential funding.

Implications related to diversification, asset substitution, debt overhang, liquidity management and more.

Lecture 3

Topic: financing under asymmetric information

Market imperfection: outside investors less informed about quality

Implication: lemons problem limits potential funding.

Implications related to market timing, negative stock price reaction, pecking order theory



Academic articles

1. Admati et al. (2018)

Topic: debt levels

Market imperfection: lack of commitment: keeping debt low

Implication: Excessive debt, or no debt

2. Edmans and Mann (2019)

Topic: equity vs asset sales

Market imperfection: private information about quality

Implication: Lemons problem. And yet, balance sheet effect pushes firm towards equity sales.

3. Malenko and Malenko (2015)

Topic: leveraged buyouts

Market imperfection: lack of commitment: truthfully reporting cash.

Implication: driving force behind LBOs, importance of reputation, repeated interactions



4. Banal-Estañol et al. (2013)

Topic: joint vs separate financing

Market imperfection: bankruptcy costs

Implication: Joint financing (if coinsurance) or separate financing (if contamination)

5. Bayar and Chemmanur (2011)

Topic: acquisition vs IPO

Market imperfection: private information about firm strength.

Implication: Strong choose IPO, weak may choose acquisition despite overvaluation in IPO market.

6. DeMarzo et al. (2014)

Topic: optimal compensation

Market imperfection: lack of commitment: truthfully reporting cash, and project risk.

Implication: Relative performance evaluation, reward for medium outcome in bad state.



7. Fahn et al (2019)

Topic: debt levels and worker motivation

Market imperfection: lack of commitment: bonus payments to agent, disclosure to creditors

Implication: Low debt in order to implement relational contracts, honor commitment to workers

8. Levit (2019)

Topic: communication and shareholder activism

Market imperfection: private information about shareholder value.

Implication: 'Threat' of exit or voice to enhance the effectiveness of communication.



Intended outcomes for the day:

1. **To analyze** how the activist's ability to launch a public campaign ("voice") makes communication more effective. The threat of facing a campaign gives the Board an extra reason to follow the activist's recommendation of making a change, and thereby promotes communication.
2. **To show** whether the activist's ability to exit strengthens or weakens the effectiveness of voice. Multiple effects. The activist's ability to exit makes the threat of a campaign, if the Board defies the recommendation, more severe; but can drive the conditional probability of a campaign up or down.
3. **To carry out** a brief review of the semester. Interpretation both in terms of topics and in terms of market imperfections.



Question

Please discuss the following questions:

Which idea from the theory we've seen this semester is the **BEST** (i.e. most interesting/relevant)?

Which idea is the **WORST** (i.e. least interesting/relevant)?

Go to socrative.com, room 897458

Best: this idea, because (1-3 sentences)

Worst: this idea, because (1-3 sentences)

I will post your answers on Absalon



This is the end of the course material!

Dec. 13 lecture slot will serve as a drop-in session, where you can stop by and ask questions:

- ***You can send questions about any ideas seen in the course.***
- ***Please send them at least 48 hours in advance.***
- ***I will adresse all questions sent to me.***

