

The Implications of Hedge Fund Activism on the Target Firm's Existing Bondholders

By
April Klein* and Emanuel Zur*

This paper examines the effects that hedge fund activism has on existing bondholders by examining a comprehensive sample of corporate bonds for 253 U.S. firms targeted between 1996 and 2006. We find that 29 percent of these firms have their corporate credit rating lowered by a U.S. credit agency within one year of the initial 13D filing. This compares to 10 percent for a control sample of bonds within the same industry and initial credit rating. In addition, almost 50 percent of the sample bonds have their ratings discontinued within one year of the initial 13D filing. In terms of bond returns, we find a mean (median) -8.19 (-5.26) percent change in bond prices around the initial 13D filing date. To understand the reasons behind these changes in bond ratings and bond prices, we examine one-year changes in key ratios used by the rating agencies. Consistent with their bond rating criteria, we find statistically significant declines in profitability and cash on hand ratios, as well as significant increases in debt-based ratios. We conclude that the intervention of the hedge fund activist results in a short-term increase in the risk of the existing bondholder.