Hedge funds more like guardian angels than vultures: research

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(Phys.org) -- New University of British Columbia research shows that – contrary to popular opinion – hedge funds have a positive influence when investing in U.S. companies filing for Chapter 11 bankruptcy.

The study, co-authored by Sauder School of Business finance Prof. Kai Li, reveals that when a hedge fund invests in a distressed company, other creditors in the transaction fare better and there is a greater chance a company will emerge from bankruptcy.

"It's a common view in the media and popular opinion that hedge funds are 'vulture investors' who dismantle companies to maximize profits in the shortest time-frame possible," says Li, who co-wrote the study for the April edition of the Journal of Finance with professors from Columbia and Queens Universities.

"We found the opposite is true. Our data show that hedge funds strategically invest in troubled companies with the intention of becoming major shareholders after they emerge from bankruptcy. They are motivated to strengthen firms, not tear them apart."

Unlike mutual funds and pension funds, which have very stringent requirements on the types of companies they invest in, hedge funds are free to take on the risk of investing in companies in Chapter 11.

Li and her co-authors conclude that this flexibility allows them to make strategic investments in failing companies that exhibit the potential for recovery. They also argue that hedge funds are much more likely to wait while companies successfully restructure under new management than other private investors.

The researchers analyzed 474 Chapter 11 filings in the United States between 1996 and 2007. Looking at firms with assets worth more than $100 million, the researchers examined bankruptcy filings from a wide variety of angles, including the presence of hedge fund investment, CEO turnover, key employee retention, asset liquidation, debt recovery and emergence.

They found that 87 per cent of these bankruptcies had observable hedge fund involvement. The data shows such companies had improved chances of surviving the bankruptcy process. The results also reveal that the presence of hedge funds increased the likelihood of failed CEOs being fired and reduced the liquidation pressure from other stakeholders clamouring for a payout.

“We find that hedge funds are more like mediators than predators,” says Li. “They use the power of a controlling stake to negotiate between the desires of top executives fighting to preserve their high salaries, and the company’s lenders who may want to cut their losses by dismantling the company and selling off the pieces.”

The researchers also found that the presence of hedge funds as the largest unsecured creditors had a favourable effect on stock price, and positive influence on the overall debt recovery for other lenders. Finally, where hedge funds were involved, companies had a reduction in leveraged debt one year after emergence from bankruptcy.

“Until now, hedge funds have been wrongly classified,” says Li. “Instead of vultures, circling overhead above a dying prey, it is better to see them as guardian angels of distressed companies, overseeing their transition into healthier entities."

Provided by University of British Columbia