AN EMPIRICAL STUDY ON THE EFFECT OF THE INVESTMENT PURPOSE CHANGE UNDER THE NEW 5 % RULE OF KOREA

By

Kap-Sok Kwon

THESIS

Submitted to
KDI School of Public Policy and Management
in partial fulfillment of the requirements
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ABSTRACT

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This paper examines the relationship between the investment purpose of toehold investor and the target firm's value using a hand-collected sample of 101 changes in investment purpose from Korea during 2005. I find evidence that a toehold investor creates value by changes in the declared intention of investment from passive to active participation. Specifically, the announcement is followed by statistically significant abnormal returns of 1.97% and 2.82% during the 3 day window and 11 day window surrounding the announcement date respectively. The highest abnormal returns occur when toehold investors are foreign and declared investment purpose is comprehensive. The results suggest that even simple change in investment purpose, not accompanied by additional share acquisition, can affect firm value by influencing the likelihood and magnitude of value enhancing events.

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Section I. Introduction

Corporate governance is related with the resolution of collective action issues among investors and the reconciliation of conflicts of interest between various corporate stakeholders. Although there has been voluminous research on corporate governance issues, it is also true that there are still many areas to be explored further. One of those areas is the shareholder activism. It is still unclear how various types of the shareholder activism influence the firm value.

This paper examines the relationship between the investment purpose of minority investor or toehold investor[1] and the target firm's value. Differently from prior research which focused on share acquisition of toehold investors, this paper shows how they influence the target firm's value only by declaring the intention of active management participation. Since the declaration, on average, is not accompanied by significant changes in equity holdings, the empirical tests are relatively free from the

[1] This paper uses the term "minority investor" and "toehold investor" interchangeably. These terms here mean any person who holds 5 percent or more of the equity securities of a target company together with the specially related person. Based on the 5 percent rule of Korea, equity securities mean not only common stocks but also any securities with equity conversion features or options such as convertible bonds, bonds with warrants, exchangeable bonds, and stock warrants that grant voting rights in the target company.

possibility that the purchase or sales of the equity securities may influence the share price.

The change of regulation environment in Korea makes it possible to examine the market reaction toward investor's declaration of the changes in investment purpose. The newly amended 5 percent rule of Korea took effect on March 29, 2005. One of the important changes in the newly amended 5 percent rule is that a change in investment purpose triggers mandatory filing of the change. In order to examine the market reaction, this paper focuses on the change of the investment purpose which is from 'investment only' to 'exercising influence on the management'. Using filings from Korean electronic disclosure system from March 29, 2005 through December 2005, I identify 101 events available for the empirical study. These events are just the disclosures of the intention that investor may exercise influence on potential management issues, not necessarily related to specific actions such as proxy fights, acquisitions, and so on. Moreover, since investors are required to file even without any changes in equity holdings, we can observe relatively clearly how the declaration of shareholder's activism has influenced the shareholder value in the market.

I find evidence that changes in the investment purpose to the direction of more active participation creates value. The announcement of investment purpose change generates statistically significant cumulative abnormal returns. Specifically the average abnormal returns are 1.97% and 2.82% during the 3 day window and 11 day window around the announcement date respectively.

I then divide my sample into several sub-samples based on the nationality of the investor –foreign or domestic - and the degree of the investor's intentions to exercise influence – comprehensive if an investor selects more than 7 management items in the section of investment purpose, or limited if less than 3. I find that foreign or comprehensive investors generate larger and more significant abnormal returns. The abnormal returns are the largest when the investors are both foreign and comprehensive at the same time.

These findings suggest that firm value can be influenced by the investor's declaration of potential active participation on the management without the additional acquisition of equity securities. Moreover, the degree of market reaction is influenced by how much actively and broadly a toehold investor is expected to exercise influence on the management.

This paper is organized as follows. Section II reviews the literature on toehold investors and shareholder activism and builds this paper's hypothesis. Section III explains the details of newly amended 5 percent rule in Korea. Section IV describes the data set. In section V, I examine the returns surrounding the announcement and the cross-sectional relationship between the returns and ownership characteristics.

Section VI summarizes and concludes the paper.

Section II. Literature Review and Hypothesis Building

The effect of investor's disclosure about its investment purpose change on target firm's value is related with 1) the effect of holding more than 5 percent or more of equity securities, 2) the effect of investor's active participation on the management of the target company, 3) the relationship between better governance and better firm value or performance.

Mikkelson and Ruback's (1985) show that on the market response to the news of an accumulated position of 5 percent or more of the equity is significantly positive. They assert that the possible outcomes of the toehold investment positions include a completed takeover, a completed takeover by another firm, a repurchase of the investment position by the target firm, and a sale of shares in the market or to a third party. They find that shareholders of target firms, which experienced one or more of these investment outcomes, earn positive abnormal returns.[2] Meanwhile, the average cumulative prediction errors are negative for investments without outcomes from the

[2] See Mikkelson and Ruback (1985), Table 7.

day before the initial announcement through the last trading day of the third calendar year following the initial announcement.[3] This implies that market participants might perceive a toehold acquisition as an increased probability of subsequent takeover bids.

The study of Mikkelson and Ruback can be applied to the investment outcomes of toehold acquisitions, but not to the outcomes that involve transfer of control. Choi (1991) expands the analysis of Mikkelson and Ruback's study by testing the proposition that toehold acquisitions facilitate value-enhancing control transfers. He shows that control transfers[4] are more likely among firms that are subject to toehold acquisitions than among firms that are not. He also shows that toehold acquisitions followed by takeovers, proxy fights, and management turnovers exhibit abnormal increases in share value and the absence of control transfer events lowers share price.[5] This explains the relationship between the initial toehold acquisition and the outcomes related to the transfer of control, but it does not show how firm value can be influenced by the change of investor's intention or its characteristics around the announcement date.

The paper of Malatesta and Thompson (1985) presents a model of stock price

[3] See Mikkelson and Ruback (1985), Figure 1.

[4] The control transfer events include: (1)those affected by "takeovers" or "ownership changes" such as mergers, tender offers, leveraged buyouts, management buyouts, and liquidation; (2) those caused by "management changes" that include top management turnover (i.e., all changes in the top three management positions, CEO, president, and chairman of the board), proxy fights, and consent solicitations.

[5] See Choi (1991), Figure 2.

reactions to partially anticipated events. As a partial acquisition may generate market expectations of subsequent events such as a takeover bid, a part of the economic impact of the event is capitalized at the time of the partial acquisition. Based on this argument, we can expect that the investor's investment purpose change will be reflected in the firm value because it will influence the market expectation of the benefits from toehold investor's activism. We can also expect that the impact of the disclosure may be different because the different characteristics of investor's intention will vary the likelihood and magnitude of subsequent corporate control event and its benefit.

Then, a minority investor, which has the intention of the investment in the direction of more active participation, will improve the governance of the target firm and hence firm value can be increased?

In theory, shareholder activism should make the corporate management more responsive to value-maximizing policies. By increasing management efficiency through external or internal mechanism of corporate governance, shareholder value may increase. However, previous papers, summarized by Black (1998), Karpoff (2001) and Romano (2001), find that institutional investors in the United States spend a trivial amount of money on overt activism efforts, and that when they do, their actions have little impact on the firms they target. Nor is there consistent evidence that investors earn significantly positive returns surrounding the disclosure of governance improvement actions, or that institutional shareholder activism produces long-term tangible benefits to investors (Black, 1998; Karpoff, 2001).

Studies on hedge funds provide a somewhat different picture. Klein and Zur (2006) argue that hedge funds differ substantially from mutual funds and pension funds in ways that make it beneficial for them to become activists. They define hedge fund activism as when a hedge fund files a 13D filing after taking an initial stake of 5 percent or more in the company, and clearly states in the filing's "purpose" section that it intends to proactively influence management's future decisions. Through the analysis of a sample between January 1, 2003 and December 31, 2005, they find that the hedge fund activist gets the firm to acquiesce to its demands on the corporate governance issues in 60 percent of the cases and the market reacts favorably to the filing of the 13D. Over a 61 day period, surrounding and including the filing date, firms targeted by hedge funds activists have an abnormal return of 10.3%.

The next issue is the relationship between better firm performance and better governance. In the United States, efforts to find a correlation between a firm's governance attributes and its value mostly show weak or no results. Black (2001) interprets that this weak correlation between the corporate governance practices of U.S. firms and firm value or performance could reflect the restricted domain of data, meaning that the minimum quality of corporate governance, set by securities law, corporate law, stock exchange rules, and behavioral norms so widely accepted that almost no public firms depart from them, is quite high. Unlikely from U.S. sample, he finds from Russian sample that governance improvement has strong relationship with the improvement of firm value. A worst to best governance improvement predicts a 700-fold increase in firm value.[6] This result shows that corporate governance behavior has a powerful effect on market value in a country where legal and cultural constraints on corporate behaviors are weak.

As far as Korean firms are concerned, Black, Jang and Kim (2005) construct a corporate governance index (KCGI, 0~100) for 515 Korean companies based on a 2001 KSE survey. They find that a worst-to best change in KCGI predicts a statistically significant 0.47 increase in Tobin's q, which is about 160% increase in share price, in OLS offering evidence consistent with a causal relationship between an overall governance index and higher share prices in emerging markets. They also find that Korean firms with 50% outside directors have 0.13 higher Tobin's q (roughly 40% higher share price).

[6] See Black (2001), Table 4 and Figure 1.

Section III. Overview of Korea's 5 % Rule

III-1. Background of Korea's 5 % rule

5 percent rule states that a person who holds 5 percent or more of the equity securities of a publicly held company ("target company") or who thereafter changes its holdings by 1 percent or more in the target company must file a report with the Financial Supervisory Commission (FSC) and the Korea Exchange (KRX) within 5 days[7] from the date of the transaction or the change. The same rule is applicable to a person who changes the purpose of the investment in the target company.

Originally, this 5 percent rule was adopted on December 31, 1991. The goal was to provide a fair level of protection for the management of publicly held companies and for investors. In January 5, 1994, the scope of the reporting person was broadened to include related persons so that shares owned by related persons in a target company must be disclosed together with those of the reporting person. In January 13, 1997, the concept of related parties was introduced, which encompass related persons and the

[7] In U.S. the reporting deadline of original report is 10 days.

persons[8] that concurrently hold interests with the reporting person. For legal entities, the provisions on related persons were broadened to include any entity (including its directors and officers) that holds 30 percent or more in the reporting person (or vice versa) or any entity (including its directors and officers) that effectively exercises controlling influence on the reporting person (or vice versa). The range of securities subject to mandatory reporting was also extended to securities with equity conversion features or options. In January 17, 2005, the 5 percent rule was amended to require the reporting person to state the investment purpose whether it was to exercise control over the management or to attain investment gains only. The current 5 percent rule was passed by the National Assembly on December 31, 2004 and took effect on March 29, 2005.

III-2. Contents of Newly Amended 5 % rule

According to the press release of FSC, the amendment of March, 29, 2005 can be summarized by four distinctive features compared to the previous version.

[8] The term "concurrent holder" denotes any person that agrees to (1) acquire or dispose of shares and/or other interests in the subject company jointly with the reporting person, (2) receive or transfer shares or other interests from or to the reporting person after the acquisition, or (3) jointly exercise voting rights arising from shares or other interest in the subject company.

1) Re-filing of disclosures for investors subject to the 5 percent rule.

2) Five-day "cooling-off period" after reporting exercising influence on the management as the intended investment purpose.

3) Reporting of a change in investment purpose.

4) More specific disclosures on the reporting entity and the source of investment capital.

Under the amended provisions, if an investor has an intention of exercising influence on the management as of the effective date, re-filing of disclosure should be done within 5 days after the new reporting requirements take effect on March 29, 2005. Therefore, investors who, as of the effective date, changed the investment purpose to exercising influence on the management after a previous filing should file a new disclosure even if no change in share ownership had occurred since.

The amended 5 percent rule also mandates a five-day cooling-off period. Investors are barred from acquiring any additional interests in the target company or exercising any voting rights in the affairs of the target company. If market participants observe an investor, who re-files a disclosure during mandatory re-filing period (March 29 to April 2) and changes its intention from investment only to exercising influence on the management, they possibly perceive that the investor may have a plan of some actions.

Differently from the previous version, more specific disclosures on the reporting entity and the source of investment capital should be reported. If the reporting entity is a business entity, disclosures are to be made on the legal form of the business entity, its officer, and its largest shareholder. If the purpose of the investment is exercising influence on the management, disclosures are to be made on the investment purpose and how the investment capital was formed. But these are not required if the investment purpose is investment only.

The most interesting part of the newly amended 5 percent rule is reporting a change in investment purpose. Under the old rule, reporting of a change in investment purpose was required as supplementary information when a change in share ownership occurs. That is, no reporting was required for a change in investment purpose if no change in share ownership occurred. Under the newly amended 5 percent rule, investors are required to not only disclose the specific purpose of the investment in the target but also report a change of investment purpose within 5 days from the date of the change even if no change in share ownership had occurred.

There is one more important change related to reporting of a change in investment purpose. Korean regulation authorities define that exercising influence[9] on the

[9] This includes exercising the right of minority shareholders to call for shareholders' meeting, submit shareholder proposals, and give a third party the right to vote their shares as provider for under the Commercial Code of the Securities and Exchange Act.

management of the subject company means effectively exerting influence on the company or on its directors and offices to achieve any of the 10 management items. These 10 management items are as follows.

1) Appointment, dismissal, or suspension of directors or the auditor of the company,

2) Changes in the articles of incorporation concerning the board of directors or other organizational structures of the company,

3) Changes in the company's capital,

4) Dividend distribution,

5) Merger or spin-off,

6) Stock exchange[10] and stock transfer[11],

7) Whole or partial transfer of a corporate business to or from another company,

8) Whole or a significant disposition of company assets,

9) Whole or significant renting of the company business to a third party, contracts for third-party management of the company, profit-loss sharing agreement with a third party, and other similar contracts and changes in or termination of

[10] This term is used to describe share transfers between two companies in which one becomes a wholly owned subsidiary of the other.
[11] This term is used to describe share transfers in which a company becomes a subsidiary of a newly incorporated parent.

such contracts, and

10) Dissolution of the company as a going concern.

An investor who has the intention of exercising influence on the management should choose from none[12] to all items among these 10 items. Therefore, we can identify the characteristics of an investor by analyzing the choice of the investor.

Section IV. Sample and Data Description

IV-1. Sample Selection and Data Collection

In order to examine the market reaction toward investor's declaration of the

[12] In our sample, there is only one investor (Hermes Pensions Management Ltd.) which chose none of 10 items, even though it declared to have the intention of exercising influence on the management. Their description of investment purpose provides an idea of what these investors' intentions are, which we provide below. "Basically, we purchased the shares of A Company in order to invest the fund of our client in a way of increasing the value of equity assets and achieving economic value. When we invent in a firm, we sometimes meet a representative of the firm to invest and discuss. In that case, we propose various things to order to improve long-term value of the firm. We have not done this kind of discussion with a representative of A Company. As of today, we do not have any plan to have this kind of discussion in the future. However, there is possibility that we can have a talk with a representative of A Company for understanding the prospect of the firm. As we always do in our equity investment all over the world, we are going to reserve our rights to encourage the firm to improve management when we judge it is appropriate in order to increase the long-term value of assets owned by our client."

investment purpose change, this paper focuses on the change of the investment purpose which is from ‘investment only’ to ‘exercising influence on the management’. ‘Investment only’ means the current goal of an investor is restricted to capital gains only. In contrary, ‘exercising influence on the management’ means that an investor intends to effectively exert influence on a company or on its officers to achieve some goals such as appointment, dismissal, or suspension of the duties of directors or the auditor of the company.

I obtain my sample of events from the news database of various Korean internet portals and DART (Data Analysis, Retrieval and Transfer System)[13], which is an electronic disclosure system in Korea that allows companies to submit disclosures online, where it becomes immediately available to investors and other users. The daily returns for the target companies are obtained from the database maintained by Korea Securities Research Institute (KSRI). I manually searched these information sources for data from March 29, 2005 and December 31, 2005.

The criteria that I use for sample selection are as follows.

1) An investor changes investment purpose from ‘investment only’ to ‘exercising influence on the management’,

[13] http://dart.fss.or.kr

2) Prior disclosures of the investor should be found from DART so that I can identify its prior investment information,

3) Only the initial disclosure of investment purpose change, not updates or revisions,

4) Daily return data for the event window should be available from the KSRI database,

5) An investor or its related parties are neither the management nor a member of the board,

7) Only one should be selected if there are disclosures related to 5 percent rule from more than one investor at the same date.

I use two steps for identifying an event. At first, I initially examine all reports of large equity ownership reported in DART system between March 29, 2005 and April 2, 2005. During this period, an investor who has an intention for exercising influence on the management has to re-file a disclosure. In total, there are 1,940 filings under mandatory re-filing policy including 182 filings for revisions. By examining these 1,758 filings manually based on the previous criteria, I identify 50 events. Then, I compile a list of detailed information from the event disclosures. For example, the name and nationality of the toehold investor, the name of the target company, the equity holdings of the investor, the change in the equity holdings of the investor compared to prior disclosure, the equity holdings of the largest shareholder in the target company[14], the number of management items the investor chooses in the section of investment purpose, and so on.

For period between April 4, 2005 and December 31, 2005[15], I perform a comprehensive news search in various internet portals for identifying investment purpose changing events. Through this process, I identify additional 51 events. Then, I go back to DART and collect the detailed information described above. So, the final sample consists of 101 disclosures of declaring the investment purpose change.

Table 1 shows the characteristics of the sample. 47 events are from Korea Stock Exchange (KSE) and 54 events are from Korea Securities Dealers Automated Quotation (KOSDAQ), which is similar to NASDAQ in United States. The number of investors is relatively small compared to the number of events. This is because a small number of investors invest in many companies. For example, ABN AMRO Bank N.V. (London Branch) and Templeton Asset Management, Ltd (including its related parties) changed the purpose of investment in 24 and 23 companies respectively. While 43% of sample shows no change in the equity holdings, 34% increases the

[14] Since this information is not included in the filing, I refer to other recent filing which I can get the equity holdings of the largest shareholder of the target company.
[15] The total number of large equity ownership filings reported in DART during this period was 6456, which is well beyond the limit of manual verification, considering the limited amount of resources.

percent of ownership and 24% decreases. However, this change does not mean an investor purchases or sells its ownership at the point of the disclosure. This is just from the comparison between event disclosure and prior disclosure. As far as the ownership of the largest shareholder is concerned, mostly it is less than 50%.

The events are classified into two types: 'Comprehensive' if an investor chooses more than 7 items of management issues in the section of investment purpose and 'limited' if less than 3 items. Since no investors choose between 3 and 7 in my sample, this provides a very clear cutoff. In 63% of sample companies, investors declare that they are interested in more than 7 items among 10 management issues mentioned in Section III. 'Limited' type of investor typically chooses the combination of items among 1), 2), 3), and 4) mentioned in Section III.

Table 2 presents the distribution of the equity holdings of the investors, the change in the equity holdings, and the ownership of the largest shareholder. The mean (median) of the equity holdings is 12.74% (11.48%), which seems large enough to influence the management. The mean (median) of change in the equity holdings is 0.23% (0.00%) points implying that these investment purpose changes are not accompanied by major changes in shareholdings.

IV-2. Method of Measuring Abnormal Returns.

In order to measure how the market responds to the disclosure, I compute the abnormal share price reaction around the announcement date. The basic return data for the market index and selected sample companies are from the KSRI database. The market index return is calculated as follows:

$$R_{mkt,t} = \frac{V_t - V_{t-1}}{V_{t-1}}$$

V_t : The sum of market capitalization of KSE and KOSDAQ

I compute $AR_i(T)$, the T-day cumulative market-adjusted return for stock i since the investment purpose changes, as follows:

$$AR_i(T) = \prod_{t=o}^{T}(1+R_{i,t}) - \prod_{t=o}^{T}(1+R_{mkt,t})$$

Where, t = 0 is the announcement date, $R_{i,t}$ and $R_{mkt,t}$ are the return for stock i and the market return on day t, respectively.

I also compute $AR_i(T)$ for the event window surrounding the announcement date, as follows:

$$AR_i(T) = \prod_{t=t_1}^{t_2}(1+R_{i,t}) - \prod_{t=t_1}^{t_2}(1+R_{mkt,t})$$

Where, t_1 and t_2 are the first and last days of the event window.

I measure the event time not in calendar days, but in trading days.

Section V. Results

V-1. CARs Associated with the Sample Characteristics

Table 3 presents the cumulative abnormal returns for two event windows and the t-statistics associated with the average returns. Panel A is based on 3 day window (-1, 1) and Panel B is based on 11 day window (-5, 5). The results indicate that the announcement of investment purpose change generates statistically significant cumulative abnormal returns. The cumulative abnormal returns are 1.97% (t = 2.52) and 2.82% (t = 2.45) for 3 day window and 11 day window around the announcement date respectively. This shows market participants believe that changes in the intention of the investment in direction of more active participation creates value.

The results seem to be clearer in the test of sub-samples. I divide the sample into several sub-samples based on the nationality of an investor – foreign or domestic - and the type of an investor's willingness to exercise influence – comprehensive purpose if an investor selects more than 7 management items in the section of investment purpose, or limited if less than 3. In particular, a sub-sample, which is categorized as 'comprehensive' group, can be regarded as a group of more active investors. In their filings, they declare they are willing to exert influence on almost all issues of the management. In those issues, not only management change issues such as appointment of directors or change of the articles about board of director, but also fundamental issues such as acquisitions or even dissolution of the company are all included.

The cumulative abnormal returns in a sub-sample, which is categorized as comprehensive purpose or foreign investment, are larger and more statistically significant. For example, abnormal returns are 3.31% (t = 2.83) for comprehensive investors and 3.18% (t = 2.92) for foreign investors over 3 day window. Over 11 day window, the corresponding abnormal returns are 4.83% (t = 2.91) and 3.22% (t = 2.21) respectively. The abnormal returns get much larger if we restrict the sample to foreign investment and comprehensive purpose at the same time. For 3 day and 11 day windows, the cumulative abnormal returns are 7.32% (t = 3.58) and 7.40% (t = 2.71) respectively.

Since this is just the declaration of investor's intention, not an actual governance action undertaken by the investor, this result supports the anticipated takeover bid hypothesis and the control transfer hypothesis. These two hypotheses explain the value increase as a result of investor's perception of the increased likelihood of a subsequent takeover or subsequent value-enhancement by management.

Table 4 and Figure 1 present the cumulative abnormal returns from Day -5 through Day + 10 for the sample. A reporting person should report the information within 5 days if there is significant change in holding amount by 1 percent or more or if there is change in investment purpose. In the papers of Mikkelson and Ruback (1985) and Choi (1991), they show the leakage of information is reflected in the pre-announcement abnormal returns. This evidence makes it possible to interpret that the market reacts to increased trading activity in the target firm's shares prior to the disclosure. However, I am not able to find a drastic and statistically significant increase in abnormal return before the announcement date. Rather, as Table 4 and Figure 1 show, there is a relatively drastic and statistically significant increase in abnormal returns during three days after the announcement date. One possible reason is that it is unlikely to happen the leakage of information without trading activities.

V-2. Regression Analysis

In order to examine whether the effect of foreign ownership and comprehensive investment purpose are independent from the changes in ownership, I regress the abnormal returns on the foreign ownership dummy and comprehensive investment dummy, controlling for changes in ownership and other ownership characteristics. The following provides a detailed description of the regressions, as well as some priors on the sign of the coefficients.

1) Foreign investment dummy (Type of the investor's nationality): Market participants may perceive there is higher probability of value enhancing events from foreign investors.
2) Investment purpose dummy (Type of the investor's willingness to exercise influence): Market participants may perceive that there is higher probability of value enhancing events in the comprehensive type of investor
3) Changes in the equity holdings of an investor: If an investor increases the ownership in a target company since the prior disclosure, the abnormal return may get larger. Market participants may perceive that there is higher probability of value enhancing events in increased ownership.
4) Equity holdings of an investor: If an investor's holding is large, it may have more influence on the abnormal returns. For example, market participants may perceive that there is higher probability of value enhancing events when the block ownership by an outside investor is large (Shleifer & Vishny, 1986).
5) Ownership of the largest Shareholder: Market participants may perceive there is

less probability of value-enhancing events when the ownership of the largest shareholder is bigger.

6) Type of market dummy: Market participants may perceive there is higher probability of value-enhancing events in KOSDAQ rather than KSE.

Table 5 presents the correlations across the regressions. As can be seen, there seems to be no serious issue regarding multicollinearity. Investment purpose dummy has relatively stronger negative correlations with foreign investment dummy and market dummy than other variables. Possible reason may be that most of foreign investment cases in KSE declare they are interested in less than 3 items among the 10 management issues.

Table 6 reports the regression results for the 3 day (-1, +1) window and 11 day (-5, +5) window respectively. In contrast to my prior expectations, the estimated coefficients on ‘Equity Holdings’, ‘Change in Equity Holdings’, ‘Ownership of the Largest Shareholder’ and ‘Type of Market’ are all statistically insignificant. At least in my sample, these independent variables do not seem to explain the variations in abnormal returns. The dummy variable, ‘Investment Purpose’, which is directly related with the degree of willingness to actively participate in governance issues, explains the abnormal returns in both of two windows. The estimated coefficient on

‘Investment Purpose’ is positive and statistically significant as well. However, in case of ‘Foreign Investment’, the statistical significance of the estimated coefficient on the variable does not persist in 11 day window. This result may show the nationality of an investor itself alone can not be a factor of generating additional firm value in the longer term and ‘Investment Purpose’ is the only key factor of value creation among the variables that I come up with.

Section VI. Summary and Conclusion

This paper examines the relationship between the investment purpose of toehold investor and the target firm’s value from the sample of 101 events between March 29, 2005 and December 31, 2005. Under the newly amended 5 percent rule of Korea, which took effect on March 29, 2005, we can identify the relatively pure effect of the changes in investment purpose on the target firms’ value.

I find that the market reacts favorably to the filings which toehold investors declare to become active investors from passive investors. The announcement of investment purpose change generates statistically significant cumulative abnormal returns. The average abnormal returns are 1.97% and 2.82% for 3 day window and 11 day window around the announcement date respectively. Furthermore, the highest abnormal returns occur when toehold investors are foreign and their investment purpose is comprehensive at the same time.

Finally, the abnormal returns generated by the filings of investment purpose change are not associated with the size of the equity holdings of toehold investors, its change, and the size of the largest shareholder’s ownership, but associated with the magnitude of investment purpose and the nationality of investor.

The results suggest that even simple changes in investment purpose, not accompanied by additional share acquisition, can affect firm value by influencing the likelihood and magnitude of the value enhancing events.

Table 1. Characteristics of the Sample

This table reports the characteristic of the sample. The sample period is from March 29 to December 31 2005. The target firms of the sample are all the publicly traded firms of which the investors holding more than 5% declared a change in investment purpose from portfolio investment only to active participation during the same period. In calculating the number of investors, an investor who invested in more than one firm is counted as one investor. The change of ownership is estimated through the comparison between the disclosure of investment purpose change and prior disclosure. The events are divided into two types: Comprehensive if an investor chooses more than 7 items of management issues in the section of investment purpose and limited if less than 3.

		KSE	KOSDAQ	Total
Number of Events		47	54	101
Number of Investors		18	16	27
Foreign Investment		31	32	63
Equity Holdings	Increase	20	14	34
	No Change	19	24	43
	Decrease	8	16	24
Ownership of Largest Shareholder	> 50%	6	3	9
	1/3 < < 50%	10	24	34
	< 1/3	31	27	58
Investment Purpose	Comprehensive (more than 7)	19	45	64
	Limited (less than 3)	28	9	37

Table 2. Distribution of Equity Holdings

This table reports the distribution of equity holdings in the target firms in the sample. ‘Equity holdings’ is the ownership of the reporting investor in the each sample. The equity holdings is calculated by dividing the sum of equity securities, held by the reporting investor together with related parties, by the sum of total number of issued stocks and the number of stocks to be held from exercising stock options or bonds with equity conversion features. ‘Δ Equity holdings’ is the change of ownership of the reporting investor since the prior disclosure. ‘Largest Shareholder’ shows the equity holdings of the largest shareholder and its related parties.

	Mean	Std Dev	Median	Min	Max
Equity Holdings	12.74%	0.0686	11.48%	4.61%	38.68
Δ Equity Holdings	0.23%	0.0283	0.00%	-5.19%	26.48%
Largest Shareholder	32.04%	0.1378	32.43%	3.74%	69.02%

Table 3. CARs Associated with the Sample Characteristics

This table reports the cumulative abnormal return for two event windows and the t-statistics associated with the average returns. Panel A covers 3 day window (-1, 1) and Panel B covers 11 day window (-5, 5). Two Panels also present the average abnormal return and the t-statistics for the sub-samples based on the following two factors; the nationality of the investor and the type of the investor's willingness to exercise influence on the management.

Panel A (-1, 1):

		Type of the investor's willingness to exercise influence		
		All	Comprehensive	Limited
Nationality Of the investor	All	**N=101** **1.97%** **(2.518)**	**N=64** **3.31%** **(2.834)**	N=37 -0.36% (-0.705)
	Foreign	**N=63** **3.18%** **(2.918)**	**N=29** **7.32%** **(3.584)**	N=34 -0.35% (-0.629)
	Domestic	N=38 -0.05% (-0.054)	N=35 -0.01% (-0.014)	N=3 -0.49% (-0.632)

Panel B (-5, 5):

		Type of the investor's willingness to exercise influence		
		All	Comprehensive	Limited
Nationality Of the investor	All	**N=101** **2.82%** **(2.449)**	**N=64** **4.83%** **(2.911)**	N=37 -0.66% (-0.602)
	Foreign	**N=63** **3.22%** **(2.207)**	**N=29** **7.40%** **(2.713)**	N=34 -0.34% (-0.313)
	Domestic	N=38 2.16% (1.139)	N=35 2.70% (1.358)	N=3 -4.22% (-0.732)

Table 4. CARs from Day -5 through Day +10

This table reports the cumulative abnormal returns from Day -5 through Day +10 and the t-statistics associated with average values.

N=101	CAR	t-stat
D-5	0.73%	1.681
D-4	1.51%	2.737
D-3	0.97%	1.666
D-2	0.81%	1.295
D-1	0.66%	0.955
D	1.16%	1.514
D+1	2.76%	2.919
D+2	2.47%	2.664
D+3	3.29%	2.742
D+4	2.85%	2.653
D+5	2.82%	2.449
D+6	2.67%	2.286
D+7	2.76%	2.083
D+8	3.24%	2.166
D+9	3.05%	2.028
D+10	2.62%	1.697

Table 5. Correlation Matrix for Explanatory Variables

This table reports the correlation between explanatory variables. ‘Equity Holdings’ is the percentage of share-holding by the investor who changed its purpose of investment from ‘investment only’ to ‘exercising influence on the management’. ‘Δ Equity Holdings’ is the change of investor’s ownership between event disclosure and prior disclosure about its equity holdings. ‘Investment Purpose’ is dummy variable equal to 1 if the number of items that the investor wants to exert its influence exceeded 7 and zero if less than 3. ‘Foreign Investment’ is a dummy variable equal to 1 if the investor is classified as a foreign investor and zero otherwise. ‘Largest Shareholder’ is the percentage of equity holdings by the largest shareholder and its related parties. ‘Type of Market’ is dummy variable equal to 1 if the targeted firm is traded in KSE and zero if traded in KOSDAQ. Statistically significant correlations (at 5% level or better) are shown in boldface.

	Equity Holdings	Δ Equity Holdings	Investment Purpose	Foreign Investment	Largest Shareholder	Type of Market
Equity Holdings	1					
Δ Equity Holdings	**0.461**	1				
Investment Purpose	**0.384**	0.025	1			
Foreign Investment	**-0.283**	-0.148	**-0.463**	1		
Largest Shareholder	0.051	-0.094	0.111	-0.186	1	
Type of Market	-0.149	-0.017	**-0.444**	0.069	-0.175	1

Table 6. Regression Analysis

This table reports coefficient estimates and their t-values of cross-sectional regressions of the returns on various characteristics. The dependent variable is the 3 day window CARs in Panel A and the 11 day window CARs in Panel B.

Panel A (-1, 1):

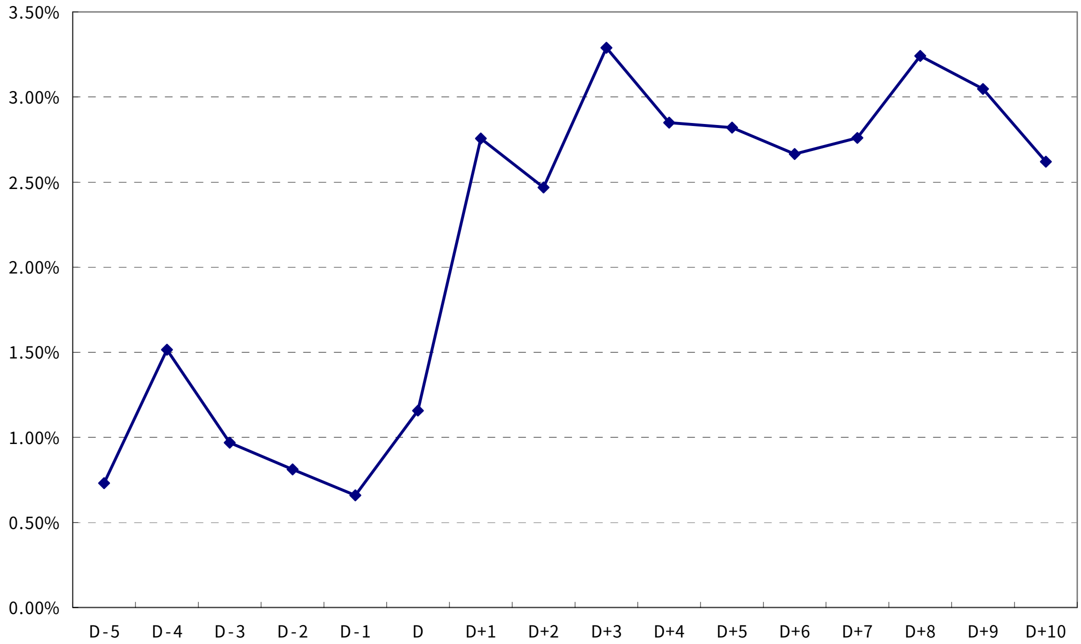
Explanatory Variable	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Intercept	-0.058 (-2.984)	0.020 (2.495)	0.012 (0.699)	0.049 (2.478)	0.029 (2.730)	-0.032 (-0.903)
Foreign Investment	**0.060** **(3.539)**					**0.057** **(3.182)**
Investment Purpose	**0.064** **(3.804)**					**0.066** **(3.232)**
Δ Equity Holdings		0.007 (0.024)				0.104 (0.344)
Equity Holdings			0.063 (0.552)			-0.014 (-0.105)
Largest Shareholder				-0.091 (-1.609)		-0.077 (-1.380)
Type of Market					-0.020 (-1.294)	-0.001 (-0.039)
Adjusted R^2	0.14	-0.010	-0.007	0.016	0.007	0.126
N			101			

Panel B (-5, 5):

Explanatory Variable	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Intercept	-0.052 (-1.714)	0.029 (2.488)	0.008 (0.333)	0.033 (1.136)	0.047 (3.042)	-0.035 (-0.640)
Foreign Investment	0.049 (1.889)					0.043 (1.565)
Investment Purpose	**0.078** **(2.982)**					**0.062** **(1.944)**
Δ Equity Holdings		-0.268 (-0.654)				-0.347 (-0.742)
Equity Holdings			0.158 (0.934)			0.128 (0.620)
Largest Shareholder				-0.016 (-0.193)		-0.033 (-0.379)
Type of Market					-0.041 (-1.804)	-0.017 (-0.645)
Adjusted R^2	0.067	-0.006	-0.001	-0.010	0.022	0.038
N	101					

Figure 1. CARs from Day -5 through Day +10

This figure presents graphical illustration of the cumulative abnormal returns from Day -5 through Day +10



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