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Barbarians in the kitchen

A strategic approach to battling activist shareholders (even in a downturn)

by Michael Armstrong and Jonathan Joffe

Introduction

During the 2008 economic downturn on Wall Street, and amidst the news of hedge funds furiously selling their positions to cover fund withdrawals, it would be easy to assume that these funds and the aggressive brand of shareholder activism pursued by them were on death's door. We would not be so quick to dismiss them. There are enough drivers behind shareholder activism for its continued vibrancy in the current downturn, and that it may even emerge stronger, although changed. In this article, we will describe the typical behavior of shareholder activists and how CEOs and board members can deal with them. We will also describe the impact of the current economic crisis on activist hedge funds, and how activism is likely to evolve in response.

What does an activist approach look and feel like? Consider the following letter to the CEO of Angelica Corp., a $500 million healthcare textile provider:

> "Since the beginning of 2007, Angelica shares have fallen by 34.1% while the S&P 500 has risen over 2.5% ... Clearly, such underperformance is COMPLETELY UNACCEPTABLE (especially given the fairly benign operating environment over the past four years) for Angelica shareholders.
>
> Ultimately, [Pirate Capital] believe[s] this failure by management results from a lack of (1) understanding of the underlying operations of the business, (2) sense for pursuing an appropriate strategy for growth, (3) ability to execute and (4) coherence in communicating with shareholders and the broader investment community."[1]

Pirate Capital sent this message in September, 2007 via letter and press release.[2] The shareholder re-asserted its demands for a change in strategy and sought to elect two directors to the company's board. After several months of continued pressure from Pirate, the company announced it was exploring "strategic options" and ultimately sold itself to a private equity fund. Angelica is not an isolated case. Activists have become a substantial force in the United States, targeting over 500 companies in 2007, 17 percent more than in the prior year.[3] And in Canada, though activism has gained ground less quickly, it is seen by many as poised for growth.

Unhappy investors don't just sell and move on like they used to. They stay, agitate for change and even join the board of directors, if necessary. The barbarians are not at the gate anymore, they are right in the kitchen. To address this threat, chief executives and directors need to understand better what makes activists tick, and how they, as stewards of the company, can deal with them, especially in the current market downturn.

Activism in the current crisis

Activism is not going away, and may return in force. Financial institutions are being hit hard by the current financial crisis, and hedge funds are no exception. They are being depleted by investor withdrawals, which force share sales that in turn push down overall share prices. Compounding the problem, most hedge funds use leverage to amplify their returns (i.e., they buy on margin), so one dollar withdrawn from a fund requires more than a dollar of shares to be sold. Add to these forces the possible imposition of new capital adequacy and disclosure regulations in wake of the crisis, and you have a severely weakened hedge fund industry. There is no question that the activist funds will be hurt, and we expect a significant number of the smaller activist funds to close in the next twelve months as investors pull their funds from them and re-direct a portion to larger, more stable funds. The result will be fewer, larger funds pushing the activist agenda.

That being said, activist hedge funds and shareholder activism are likely to weather the storm better than the average fund. This is partly borne out by early data that shows several activist funds continuing to increase their positions, and/or explicitly changing from "passive" to "active" investor status—even in the catastrophic month of October. There are several reasons to expect continued activity from the activists.

Activist hedge funds are slightly different animals from other hedge funds. They generally have longer lock-up periods on funds invested with them, 2-3 years on average, which makes it more difficult for their investors to withdraw funds quickly in times of crisis. Activists also carry less leverage than the average hedge fund, and this means less forced selling in a market downturn. With cleaner balance sheets, they will generally be in better positions to buy shares on the cheap, which several have been doing during the downturn.

There may well be more opportunities for activists to target companies as the spotlight falls increasingly on poor corporate governance and issues like top management pay.

For the hedge funds that do remain in business, less debt is likely to be available to boost returns, forcing the funds to seek other means of increasing performance. Activism is one such means, so we are likely to see several established funds begin to experiment with activism for the first time.

In credit crises like the current one, cash is king, and few places are more cash-rich than the private pools of capital in the Middle East and Asia. It is expected/anticipated that these pools of capital will move in to replenish existing hedge funds (in the same way they are funding banks) or even start up their own funds in order to take advantage of depressed share prices.

The phases of activism

Phase	Identifying characteristics
Observation	Target displays several characteristics of the typical activist target, including a languishing shareprice, solid cash flow, low price-to-book ratio, etc. Activists/hedge funds consider investment.
Accumulation	Hedge funds begin accumulating shares in target (10-15% or more of target's shares in aggregate, but no firm individually holding more than 5%).
Activation	One or more shareholders file a Schedule 13D and issue a press release stating the changes they intend to bring about in the business. Other filings and press releases may follow, including threats of taking action to force change.
Escalation	Activist takes concrete steps to force management's hand (e.g., files proxy card, initiates litigation). Management and activist may begin negotiations towards a compromise outcome.
Cohabitation	Activist secures one or more seats on the target's board of directors (often through negotiation) and begins pressuring the company from the inside.
Resolution	Activist fully or partially succeeds in achieving its goal, or withdraws.

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Ten things you should know about activist shareholders

1. Activism punches above its weight.

Activist hedge funds receive a lot of attention, targeting large-cap companies such as Yahoo!, Motorola,[4] Target,[5] and CSX[6] in the past year, not to mention scores of well-known mid-cap companies like Brink's,[7] *The New York Times*,[8] and Unisys.[9] The result is that activist funds have created an image of enormous scale and influence. While they do have influence, it does not come from scale so much as from effective promotion. Whereas the typical hedge fund works under the radar, activist funds broadcast their moves through carefully orchestrated media campaigns that are a core part of their strategy for value creation. As a result, a relatively small corner of the hedge fund industry enjoys an outsized reputation.

2. Activists like healthy companies.

Although target companies generally have underperforming share prices, activists aren't overly drawn to ones with serious operational difficulties. CSX was a typical target with a share price that lagged its peers, but solid operating fundamentals. Some market-watchers have therefore likened hedge-fund activists to "value investors."

3. Activism is about pressure.

Activism generally involves placing increasing pressure on management and the board through a series of phased activities (see table on page 5). Some activists are professional and measured in their approach, relying primarily on analysis and private discussions with the target. Others are more openly hostile and prone to making incendiary public statements. Either way, targets will feel increasing pressure as the process evolves.

4. Activist tactics are getting more sophisticated.

Traditional tactics employed by activists include publicly criticizing the company, seeking support from proxy advisory firms, holding investor conferences, setting up critical websites, withholding votes, making shareholder proposals to be voted on at annual meetings, starting proxy fights to win board seats, and initiating litigation. Recent campaigns have shown an increasing sophistication in activist tactics. For instance, after experiencing difficulties in electing entire slates of directors, activists have switched to demanding only a few board seats, and filling those seats with highly credible industry veterans. Other activists have begun hiring their own law firms, investment bankers and management consultants to pursue certain options such as sales and restructurings independently of the company's management. Harbinger Capital, for example, hired a banker to solicit bids for some of its targets of activism.[10] Going forward, we can envisage activism becoming increasingly democratized by low-cost, high-visibility communication channels such as social networking sites, in the same way that aggrieved investors in Canada's Asset-Backed Commercial Paper (ABCP) vehicles organized themselves through Facebook to raise funding and instruct counsel for a class-action suit.[11]

5. Activists don't want control.

Whether they are hedge funds or not, activists generally do not want to own control stakes in the companies they target. They simply want to leverage a small equity foothold to influence company decisions that they believe will improve share price or otherwise advance their agenda. More often than not they take stakes between 5 percent and 10 percent. This is not just because they want to limit their use of capital, although that is a critical factor. They generally take at least a 5 percent stake because passing that level requires them to file a Schedule 13D, giving them a platform for a press release and conferring added seriousness to their intervention. They tend to stay below 10 percent in order to avoid the "short-swing profits" filing requirements triggered by that level of ownership. In Canadian jurisdictions, larger positions can be built under the radar since an "early warning report" must generally be filed only at the 10 percent level.[12]

6. Activists hunt in packs.

Activist hedge funds have plenty of time to hound the target and communicate directly with the markets to step up the pressure on management. The hounding metaphor is appropriate, too, because they work in packs. Where one activist jumps in, others soon follow, sensing a kill. At the height of the Brink's battle, for example, three hedge funds had filed notices demanding a spin-off of the company's home security unit.[13] Explicitly coordinated efforts among activists are not allowed unless the joint activity is declared in a securities filing, in which case their positions are aggregated and considered jointly held. That said, explicit coordination is not required for the funds to work successfully together, given the very public nature of the activist campaign which allows for open signaling.

7. Once activists go "active", the odds are stacked against you.

When an activist has filed a 13D with a declared intent of influencing management, the gauntlet has been thrown down and the activist's reputation is on the line—particularly that of an activist hedge fund. The fund will not want to back down without extracting concessions at this point. Keep in mind that many activist hedge funds have a concentrated portfolio, meaning that a large portion of their fund, and the personal wealth of the managers, is tied up in each portfolio company. With so few investments, activist hedge funds are highly incentivized to devote a lot of their resources to analyzing each target company. They will typically call customers, suppliers, former executives, and industry experts, and become surprisingly well-informed on the company's strategic options. As a result, the pressure on the target can be intense and long-lasting, and can end in a war of attrition that the activist is better-equipped to win. The data are compelling: according to a 2008 report on hedge fund activism by Alon Brav of Duke University and Wei Jiang of Columbia Business School,[14] once the hedge funds activate, they achieve their goals fully or partially two-thirds of the time.

What is an activist shareholder?

Activist shareholders are minority investors that use a number of tactics, especially public media campaigns, to put pressure on a company to make certain business decisions. Their motivations differ widely, from advancing social causes, to improving corporate governance, to simply (and most often) making money. Some activists ("legacy activists") are aggrieved individuals with strong family or managerial attachments to the company (e.g., Roy Disney,[15] Hank Greenberg[16]). Some are private endowments and funds with clearly-defined social agendas (Rockefeller Foundation,[17] Calvert Funds[18]). Even straightforward institutional investors like pension funds, mutual funds, labor unions and insurance companies have played activist roles. Increasingly, however, hedge funds are playing the most visible and disruptive activist role. For the purposes of this article, we will define an activist shareholder as any shareholder that has a history of filing Schedule 13D or similar notices with the intention of influencing management's decisions. A Schedule 13D is a notice that must be filed by an investor with U.S. securities regulators once it owns 5 percent of a company and intends to effect material changes in that company. Although this article covers shareholder activism generally, most of the observations here relate particularly to activist hedge funds.

What is a hedge fund?
Hedge funds are lightly-regulated, private pools of capital that, unlike private equity funds, invest primarily in publicly-traded securities. The owner-managers of these funds (general partners, or "GPs") invest their own money and that of their investors (limited partners or "LPs", which are usually institutions and high net worth individuals) and normally earn "two and twenty" returns. That is, the general partner collects an annual management fee of 2 percent of the value of the assets under management plus a performance fee of 20 percent of profits. (The LPs earn all profits less the "two and twenty" payments). Consequently, hedge funds are highly incentivized to be both big and profitable on a year-to-year basis. Not all hedge funds are activists, however. It is estimated that there are 7,500 hedge funds worldwide, of which only 300–400 are activist-oriented. Hedge fund strategies fall into four broad categories:

Global macro investing
A hedge fund strategy based on anticipating and exploiting global macroeconomic shifts such as foreign exchange movements or relative changes in inflation.

Equity hedge investing
An investment strategy involving the use of long/short funds, short bias funds and/or sector funds.

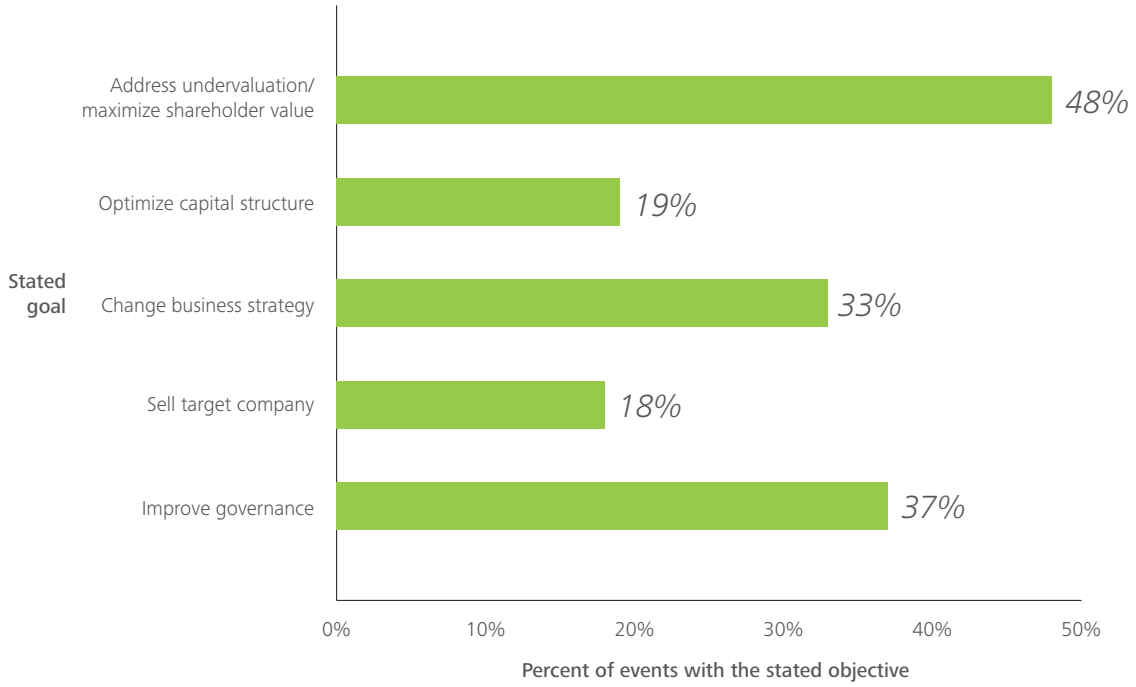
Market neutral investing
Investing based on the exploitation of pricing inefficiencies between related assets, such as convertible bonds and underlying stocks or stocks of the same company traded on different exchanges.

Event-driven investing
An investment strategy focused on exploiting pricing inefficiencies and asymmetric knowledge relating to corporate events like mergers and acquisitions, bankruptcies, refinancings and restructurings. Activist funds are generally considered part of this group.

8. Many activists demand a change in strategy.
Activist hedge funds target companies for a wide range of reasons including achieving a general increase in shareholder value, forcing a sale of the company, demanding a payout or other change to capital structure, and improving governance (e.g., a change in management or the board, removal of takeover defenses, etc.). In roughly a third of the cases, the activist demands some form of change to the target's strategy, including the sale or spin-off of a unit, new growth plans, or cost-cutting efforts. In almost 20 percent of cases, the activist seeks to start or stop the sale of the target company itself. In downturns, when credit is constrained and capital markets are depressed, it is likely that a number of activist strategies may be curtailed, including recapitalizations to fund dividends or buybacks, the sale of the target company, or spin-offs of business units as separate listed companies. On the other hand, depressed share prices do offer an opportunity for cash-rich buyers to "double down," and spin-offs have not completely disappeared, as demonstrated by the spin-off of Brink's home security unit at the end of October 2008.[19]

9. Activists have reasonable hold periods.
Hedge funds have a reputation for using extremely short hold periods and benefiting from quick swings in share prices. For typical long/short hedge funds, that reputation is warranted. For activist hedge funds, however, the hold periods are longer: almost two years on average, with roughly a year of that time in "active" mode (from the 13D filing to the reduction of the stake below 5 percent). Activists often think in terms of increasing the share price through a series of events. For example, one hedge fund manager we have dealt with demanded the spin-off of a target's business unit, and claimed he was hoping for a series of small share price rises: one on the press release announcing the 13D filing, a second on the company's announcement of the spin-off, a third on the completion of the spin-off, and a final increase if the spun-off entity were subsequently acquired.

Summary of stated goals of activist shareholders 2001-2006



Source: Alon Brav, et al. *The Long-term Effects of Hedge Fund Activism*. Columbia University. April 1, 2015.

10. Activists may create value, but rarely without severe disruption.

The record of activist hedge funds in increasing shareholder value is mixed, with some industry watchers observing a net benefit and others seeing little impact at best. What is clear, however, is that even if net shareholder value is created, the process of getting there with the push of an activist is more distracting, costly and painful than getting there oneself. Activist campaigns consume large amounts of the target management's and the board's time. The cost of activism comes in the form of management time as well as fees paid to legal, financial and communications advisors. And the pain comes quite often in the form of pointed, public attacks by the activists on management, and in unpleasant, dysfunctional board meetings. One targeted CEO we spoke to expressed deep frustration at the activist's ability to destroy the trust built between board members and management. Not all hedge funds are openly hostile. However, as M&A lawyer Martin Lipton has remarked, many hedge funds understand that "destroying the role, focus and collegiality of the board of directors" is an effective way of achieving their goals.[20]

What can you do?

A. Get ahead of it.

Chief executives and directors can and should do a number of things to avoid being the target of an activist.

Have a growth story:

If you do nothing else, make sure you are communicating a clear and compelling growth story to the market. It is not always enough to deliver solid, steady growth on the P&L. In fact, even a big transaction or re-organization may not buy a company any breathing space if the company's next step is not clear to the markets. Consider the case of Brink's, which came under activist pressure soon after selling its large freight-forwarding business in a highly successful auction in 2005.[21] Our work in Expectations-Based Management® has demonstrated that the markets value companies largely on expectations of growth three to five years into the future. If you do not have a powerful growth story to create those expectations, or you communicate it poorly, your share price will erode, creating an arbitrage opportunity for hedge funds to exploit.

Think like the enemy:

To understand your vulnerability, you need to have an objective view of how the markets perceive you at all times. As always, keep close tabs on your share price and the evolving profile of your investor base. Stay in regular contact with your analyst community and investors and ask them what issues are front-of-mind for them. However, you also need to think like the activist. Ask yourself whether you have the characteristics of a typical activist target. An underperforming share price is a fairly important criterion, either in terms of share price growth or trading multiples compared to peers. The Brav report has shown that, compared to non-targeted firms, targets of hedge fund activism tend to have the following characteristics:

Checklist of activist target characteristics

- ✓ Small or mid-cap in size (that is, the target is small enough for an activist to build a meaningful position in, with limited investment)
- ✓ Higher operating cash flows and return on assets (i.e., offers limited downside risk)
- ✓ Simpler business model with lower levels of R&D (i.e., has an easier business to understand and fix, with results more quickly reflected in share price)
- ✓ Higher diversification of business lines (i.e., displays a lack of investment focus)
- ✓ Lower price-to-book value (i.e., reasonably-priced, but possessing solid tangible assets)
- ✓ Lower dividends and buybacks (i.e., demonstrates a reluctance to return cash to shareholders)
- ✓ More takeover defenses and higher-paid executives (i.e., exercises sub-optimal corporate governance)
- ✓ Higher institutional ownership and analyst coverage (i.e., offers more liquidity, allowing faster entry and exit, and more media impact from activist intervention).

B. Gird for battle.

If it appears hedge funds are accumulating positions in your stock, heighten your preparation.

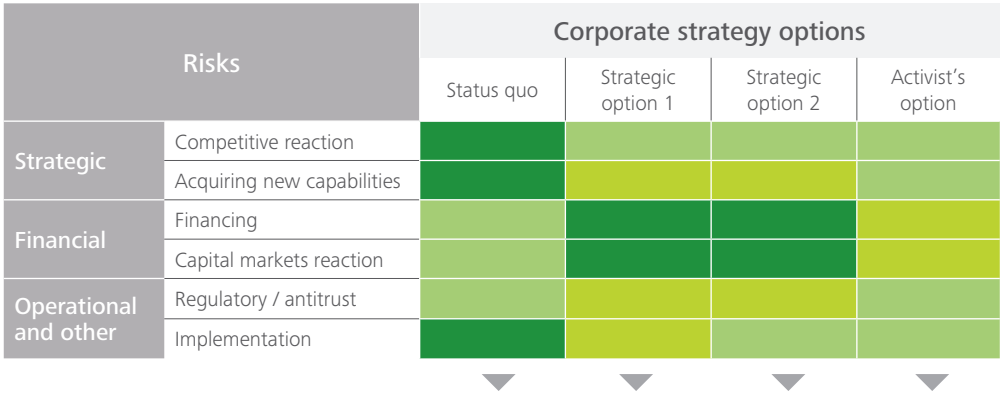
Know your activist:

If you notice unusual hedge fund ownership in your base (i.e., more than 10-15 percent of the total), there are some obvious things to do. Look at the fund's size and track record to determine if it is a proven threat. Review the activist's stated investment philosophy. Examine their prior communications with targets to understand their level of aggression or reserve. However, you have to go beyond these standard steps if you want to understand the activist's true modus operandi. Explore the backgrounds, networks, and interests of the fund managers to understand what drives them personally. Talk to the CEOs or directors previously targeted by the fund. Examine the fund's structure, staffing and financial condition to assess the likely strength and sustainability of a possible attack. For example, are the fund's investments underwater or in-the-money (i.e., how desperate are they for a "liquidity" event that your firm might provide)? Do they have a large staff boring into a handful of companies, or a skeleton crew spread across many targets? What percentage of their portfolio does your company represent (i.e., is your company in the cross hairs or just a secondary target)?

Assess your board dynamic:

The CEO and chairman must make a clear-eyed assessment of how "battle-ready" the board is. Many boards are used to dealing with collegial situations, and are wholly unprepared for the disruptive tactics of the hostile activist. Weak boards can disintegrate in the face of sustained, vocal activism, and may migrate towards activist positions not only out of a fear for their own exposure to litigation, but to put an end to unpleasant, tension-filled board meetings.

Risk assessment of corporate strategy options—illustrative



Share Price Impact of corporate strategy options—illustrative

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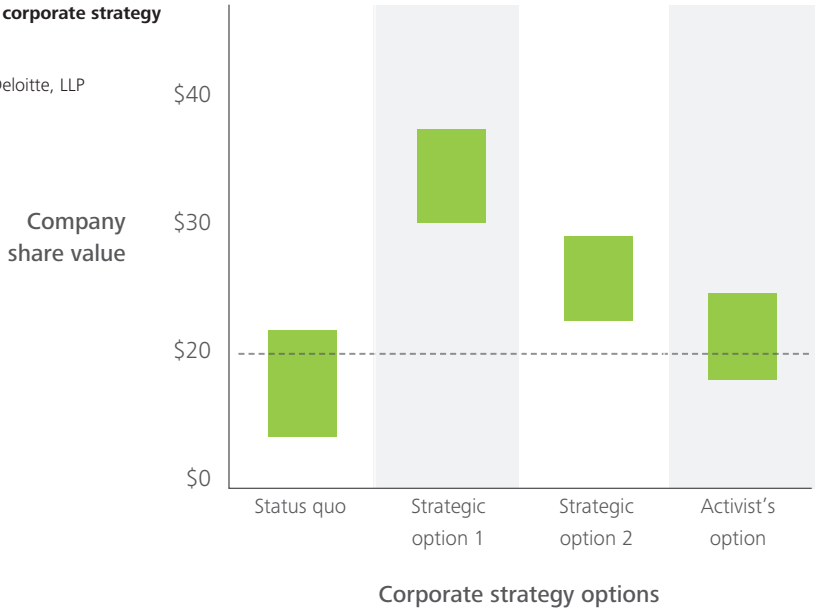

Be wary of procedural defenses:
Targeted firms have employed a number of defensive tactics in the past, both before and after an activist attack. These procedural measures include staggered boards, shareholder rights plans, and constraints on making shareholder proposals. We advise caution in the use of such measures because they have real limitations. Defensive moves like these risk attracting the attention of governance watchdogs and independent proxy firms, garnering negative press and pressuring your company's share price. More importantly, however, tactical defenses generally help you only to delay an activist, not defeat it. Public pressure is the activist's primary weapon and there are few procedural defenses that can withstand a well-executed negative media campaign. In our experience, the most effective way for management to defeat an activist campaign is through a substantive counter-attack; that is, crafting a better plan for creating shareholder value.

C. Engage and respond.

Once the investor activates his campaign through a 13D, you will need to open the lines of communication fully and assess the activist's case.

Engage early:
Nothing riles an activist more than getting "stiff-armed." Communicate a willingness to discuss their point of view, while respecting the constraints of the SEC's Regulation Fair Disclosure. Activists quite often come with sensible ideas, so it is worth listening. And stay engaged: the old adage applies here–keep your friends close and your enemies closer.

Pick an independent point team:
Good corporate governance suggests that the board should ensure they are getting, and be seen to be getting, an unfiltered view of the activist's claims and demands. To that end, some lawyers recommend that targeted companies strike a committee of independent directors to deal directly with the activist and develop the strategy for responding.

Develop a proxy strategy:
If the activist demands board seats, the key question becomes "Do we want to admit new directors or not?" Often you do not, but in many cases you do. Key factors to consider include the strength of the activist's case, the cohesiveness of your board, the perceived loyalty of the shareholder base to current management, the quality and temperament of the proposed directors, and the financial condition of the activist. On the latter point, the more dire the activist's financial straits, the more urgent will be its need for a short-term "liquidity event" like a sale or spin-off, that will allow it to sell down its position without pressuring the share price. Joining a board can actually blunt this activist's attack by subjecting it to a director's fiduciary responsibilities. In particular, the director's fiduciary duty to protect the interests of all shareholders will in many cases force the activist to give greater consideration to longer-term value creation strategies than might be optimal for itself. At a minimum, it will force the activist to be more circumspect.

Assess your valuation and its drivers: Often at the crux of the activist's argument for change is a view that the company's stock is undervalued. To respond effectively to the activist, the company must have an informed view of whether the firm is fairly valued or undervalued, and if the latter, by how much and what is driving the valuation gap. Sometimes the gap is driven simply by poor operational performance. At other times it is a lack of transparency or inconsistency in earnings. For diversified companies it can be a holding company discount. Sometimes it is simply an unclear strategy or growth story. And often it is a combination of these factors. Only with this information can management properly assess whether the activist's agenda is sound (that is, will close the valuation gap by addressing the right drivers) or whether management can offer a better solution.

Develop and evaluate your strategic options: An activist's campaign often pushes the company back on its heels. To get back on its front foot, the company needs a set of well-defined and quantitatively evaluated corporate strategy options to hold up against the activist's recommended solution. If they are not already developed, the options will have to be developed quickly. These options should include several integrated strategies, combining organic moves (e.g., acceleration of core businesses, creation of new growth platforms) and financial options (e.g., major acquisitions or mergers, sale of the company, spin-offs, recapitalizations, etc.), because real-world corporate strategies are rarely one-dimensional. The evaluated set should also include the activist's recommended option. All options should be expressed objectively in terms of expected share price impact and risk (see illustrative figures on page 11). Presented in this way, the options can be compared side-by-side on a common basis and the most attractive one selected by the board. This approach provides a transparent justification for the board's acceptance of or rejection of the activist's agenda, and puts the company back in control of the debate.

Following these guidelines consideration cannot guarantee that you will prevail in an activist battle. Sometimes the activist is right, after all, and your efforts may end up validating some or all of its claims. These guidelines can, however, reduce your chances of an attack in the first place, blunting it if necessary, and ultimately finding the answer for your company. If you prepare and execute well, you may be able to push the barbarians out of the kitchen and back to the gates.

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Michael is a director in the Strategy practice of Deloitte Consulting LLP. Prior to joining the firm, he was a partner of Monitor Group and chief executive of the firm's M&A advisory practice. He has worked on a variety of corporate strategy projects and inorganic growth mandates across a range of industries including heavy industry, specialty chemicals, life sciences, and consumer durables.

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Michael received his B.A. and law degree (J.D.) from the University of Toronto and an MBA from INSEAD in Fontainebleau, France.

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