Overview of Activist Investing

Sector Overview

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specialists in alternative investments

Evolution of global "activism"

- There is a broad group of funds classified as "activist" in the US, Europe & Japan → who try to change the status quo of a firm through 'voice', without necessesarily requiring a change in control
- Growth of hedge fund capital → increase in activist strategies, particularly post 2000
- But: many of the most prominent "activist" funds use activist tools in the context of a broader set of investment activities → there are a much smaller number of dedicated activist funds
- Dedicated activist funds have strong support from a group of high quality institutional investors in US/ Canada, Europe and Asia
- US pension and union fund interest:
  - Mid-to-late 1980s with mega pension funds in the US, including CalPERS and TIAA-CREF
  - Initial focus on governance → sponsorship of specialist 3rd party engagement funds (mid-1990s)
- Developed first in the US; UK & German speaking Europe next → Japan as yet unproven
- Greater FUM → more vocal and public campaigns
- No private activist funds domiciled in Australia and very limited Australian institutional investment on record

Key elements of a dedicated activist investment proposition

- "Deep value" focus → buy underperforming companies that are fundamentally sound
- Attitude towards control varies considerably → <1%, 5%,10%,15% . . . >50%, depending on liquidity requirements
- Principally publicly traded securities → top 10 shareholding status preferred for engagement purposes
- Asset-rich, cash-generative companies where source of value impairment is capable of redress
- The activist manager can be a catalyst for change that will unlock or restore market value
- A broad set of "capabilities" can be deployed to precipitate change
- Highly concentrated portfolio
- Typically implemented on a heavily net-long basis → offer relatively little protection in the event of an "extreme beta" event, i.e. a sell-off of risk assets irrespective of underlying value
- Often with modest market hedges and short selling based on shorter term trading opportunities (valuations, fundamentals)
- Modest leverage, if at all
- Small, tight and widely respected and experienced professional team

Leading global activist funds managers
Dedicated Activist Funds and broader based hedge fund investors

Notable Market Leaders:

- Atlantic Investors (1988; $4.5bn; Alexander Roepers)
- Atticus Capital (1995; $21bn; David Slager, Timothy Barakett)
- Barrington Capital (1991; James Mitarotonda)
- Blum Capital (1975; $3.4bn; Richard Blum)
- Bulldog Capital Management (1989; $500m; Philip Goldstein)
- Breeden Capital (2006; $1bn; Richard Breeden)
- Chapman Capital (1996; 300m; Robert Chapman)
- ESL (1988; $18bn; Eddie Lampbert)
- Icahn Management (2004: $7bn; Carl Icahn)
- Jana Partners (2001; $5bn; Barry Rosenstein)
- Newcastle Capital Group LLC (1993; $585m; Mark Schwarz)
- New Mountain Vantage (2003; Stephen Klinsky)
- Pershing Square Capital (2003; $4bn; Bill Ackman)
- Relational Investors (1996; $7bn; Ralph Whitworth)
- Shamrock Partners ($1.3bn; Stanley Gold, Roy Disney)
- Steel Partners (1993; $4bn; Warren Lichtenstein)
- TCI (2003; $10bn; Chris Hohn)
- Third Point Management (1995; $5.5bn; Daniel Loeb)
- ValueAct Capital (2000; $1.5bn; Jeffrey Ubben)

UK Focus:

- Hermes Focus Asset Mgt (1998; BT Pension Scheme & CalPERS)

Western Europe Focus:

- Audley (2005; $1.0bn; Julian Treger)
- Hermes Focus Asset Mgt (2002; £2.1bn)
- Knight Vinke (2003; $2.25bn; Eric Knight)

Japan Focus:

- Fugen Capital (2007; Kenzo Kuroda)
- Nissay Hermes Stewardship Fund (BT Pension Scheme & Nippon Life)
- Steel Partners (2002; Liberty Square Asset Mgt)
- SPARX (2003)
- Taiyo (2003)

Notes:
1. Includes a sample of the more prominent activist funds
2. Brackets denotes (Year founded activist strategy; USD FUM; Key Founder)
3. Details based on last information publicly available to Brookvine, may be inaccurate or otherwise out of date

An institutional investor's preferences for dedicated activist funds

Preferred characteristics of dedicated activist managers[1]:

1. First and foremost, they must be talented stock-pickers who have a proven track record of identifying undervalued investment opportunities in the public markets
2. They bring substantial financial, strategic, operational or governance tools to their target investments — expert knowledge and ability to employ financially-oriented activism is but one of the tools available to them
3. Their portfolios consist overwhelmingly of businesses whose value derives principally from branding, hard assets or other sources not associated with individual executives
4. They approach their investments from a collaborative perspective and seek to engage companies in a constructive dialogue in an attempt to create value in an expedited, non-public fashion — but they are prepared to aggressively defend their positions when necessary
5. Lastly, they implement their portfolios in a highly concentrated fashion

1. Shareholder Activism. David Ben-Ur. Corbin Capital Partners. January 2007.

Case study 1: Long Only Activism

- 10 years+ track record as a team; <$5bn AUM
- 10 – 15 investment professionals
- US, Europe & Asia mid market :
  - Market cap of less than $20 billion but more than $1 billion
  - Good businesses; always EBIT profitable; investment-grade balance sheet; minimum of uncontrollable factors
  - Typically 5 – 7 positions; long only; no leverage
- Value-based investment philosophy:
  - Value/ cash flow driven
  - Low insider ownership → vulnerable to takeover bids
  - Concentrated portfolio (5% to 25% of net assets per holding)
  - Favour constructive engagement with management/ Board so that manager-initiated financial/ business strategies can drive excess returns → As needed will apply public pressure through press articles, regulatory filings and engagement with broader stakeholders
  - 1 – 3 year holding period
  - Goal to be a top 10 shareholder, but with full liquidity within a trading month → 2% to 10% of company

Case study 2: Long Only Activism

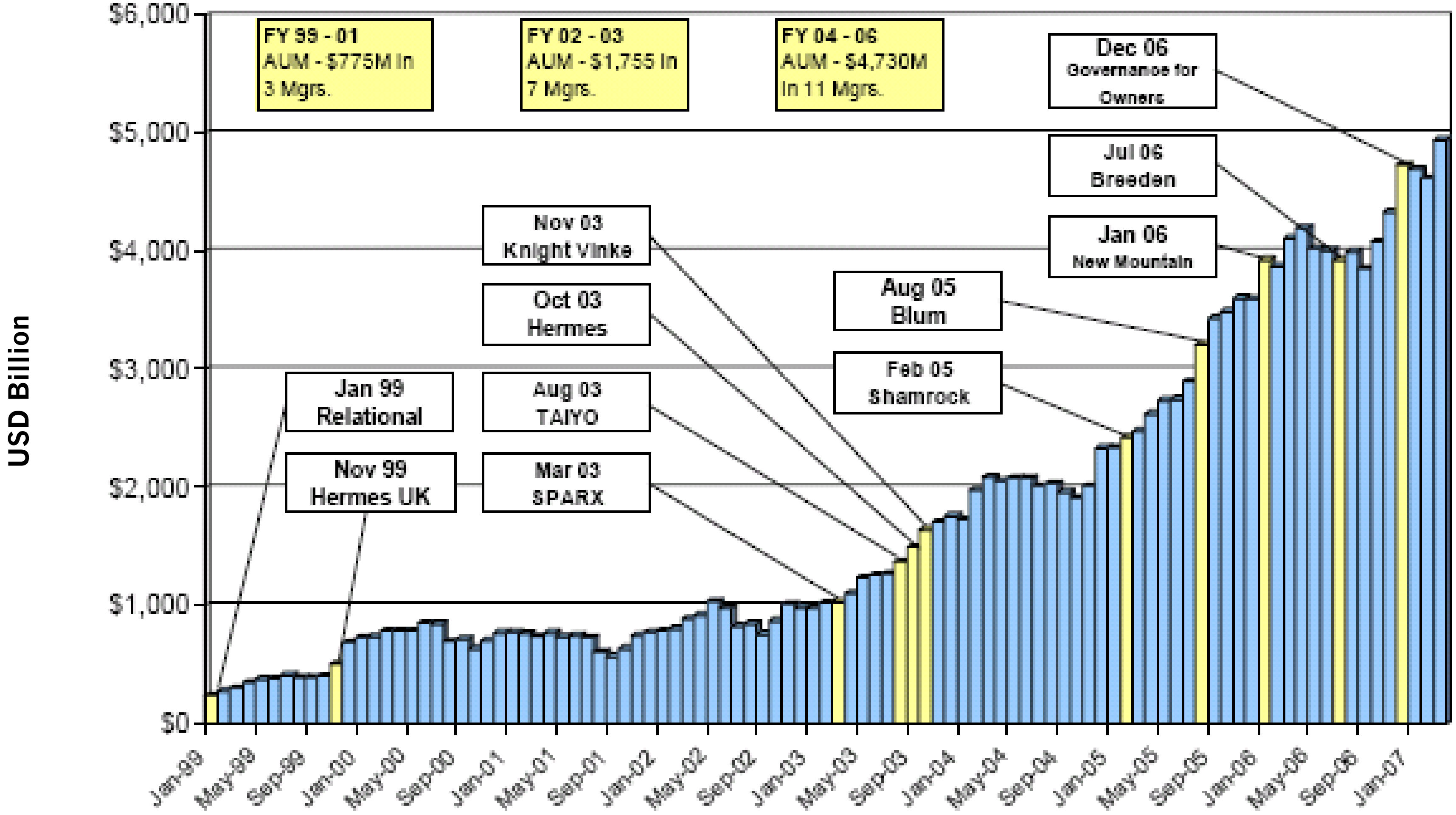
- 10 years+ track record as a team; <$5bn AUM
- 10 – 15 investment professionals
- US small – mid market:
  - Market cap of $350m to $3bn
  - Good businesses; minimum of uncontrollable factors
  - 75% assets in <15 positions; long only; no leverage
- Value-based investment philosophy:
  - Value/ cash flow driven
  - Fully flexible between public and private securities
  - Concentrated portfolio (4-6 new investments per year)
  - Not hostile → active partnership with management/ Board so that manager-initiated financial/ business strategies can drive excess returns
  - 1 – 3 year holding period
  - Goal to be largest shareholder → 5%,10%,15% . . . >50% ownership

CalPERS' activist program

- Favours dedicated activist managers, with a strong governance and operational focus
- US, UK, Western Europe & Japan allocations
- $4bn+ & 11 manager program at June 2007

CalPERS' activist program[1]

Allocations as at 30 June 2007



1. Source: CaLPERS website

General observations regarding investor interest in dedicated activist funds

- Investors find it difficult to discern what activists actually do and how what they do creates value for shareholders
- But: a convincing case can be made for 3rd party activist fund investment:
  - Widespread and long-standing disappointment with traditional asset management
  - Traditional funds managers are averse to/ incapable of engaging in broad activism
  - Institutional investors on the whole engage in little activism and even when they do, there is little or no link between activism and performance
  - The head-line performance numbers of the leading funds tend to support 3rd party activist investment
  - A few US institutions (i.e. CalPERS Focus List) manage in-house activist/ governance campaigns[1]
  - Fiduciaries may increasingly feel that they are not fulfilling their duties if they do not take activism seriously
  - For all but the mega funds activism must be delegated to third parties
- Well established offshore “category”
- Growing acknowledgement from Australian asset consultants

1. The so-called “CalPERS Effect” is reported to be very small or non-existent. See English, P. C., T. I. Smythe, and C. R. McNeil. 2004. The “CalPERS effect” Revisited. *Journal of Corporate Finance* 10:157–74

- **ECGI Hermes U.K. Focus Fund Study (2006)[1]:**
  - 4.9% excess return (1998–2004; versus broad index; not strategy specific index)
  - Position size 1–13.5%, mean of 4.8%; 4–8 new investments a year
  - The median term of investment was 517 trading days (approx. 2 years)
  - 90% of excess returns attributed to activist engagement, highest in cases restructuring & change of CEO/ Chairman (often associated with a restructuring)
  - Largest returns stem from mixed or confrontational engagements (77% of engagements) as opposed to collaborative (33%)
  - 60% - 90% success rate across each individual strategy pursued
  - There are returns to free-riding → public shareholders would have done better than Hermes by buying at the public announcements of the disclosed stakes

Notes:

1. Based on data made available by Hermes, the fund manager owned by the British Telecom Pension Scheme (BTPS), on engagements with management in companies targeted by its U.K. Focus Fund. See Becht, M., Franks, J., Mayer, C., Rossi, S., 2006. Returns to shareholder activism: evidence from a clinical study of the Hermes U.K. Focus Fund. Unpublished working paper. European Corporate Governance Institute.
2. In the U.S., a study of Relational Investors' activities provides evidence that the fund has succeed in targeting underperformers and beating benchmark returns. See Bethel, J., and S. Gillan, 2007, Relationship Investing, Corporate Change and Shareholder Value, Babson College and Texas Tech University working paper.

Other studies into activist investing

- The proposals of traditional institutional shareholders have done little to affect firms' performance (Karpoff, Malatesta and Walkling 1996; Wahal 1996; Gillan and Starks 2000)
- Firms targeted by hedge fund activists earn abnormal short term returns upon announcement of their involvement ~7% – 10% → these abnormal returns do not dissipate in subsequent years (Brav, Jiang, Partnoy and Thomas 2006; Klein and Zur 2006)
- Improved medium term abnormal returns accrue to non-hedge fund activists incl. private equity firms (Klein and Zur 2006)
- Non-hedge fund activists demand more changes in operating strategies (Klein and Zur 2006)
- Most engagements by activist funds are non-confrontational ~ 60% cases (Brav et al 2006)
- Hostile activism generates the strongest market reaction (Brav et al 2006; Clifford 2007)
- At best, only modest changes in operating performance can be attributed to activism, and these are mostly to do with asset divestitures (Brav et al 2006; Klein and Zur 2006)
- ~ 25% of all engagements involve groups of hedge funds (Brav et al 2006)
- Hedge funds earn significantly higher returns on their activist positions compared to their passive positions (Clifford 2007)

Other studies into activist investing

Continued

- The average holding period (post announcement) is slightly less than 2 years (Brav et al 2006)
- The success rate of activism across different tactics varies widely → activism that targets large allocative inefficiencies such as the sale of the company and changes in business strategy (i.e. refocusing and spinning-off non-core assets) is associated with the largest abnormal returns (Brav et al 2006)
- Activist funds achieve success (i.e. achieve main stated goals) in ~ 40% – 60% of cases (Brav et al 2006; Klein and Zur 2006)
- Takeover premia is the single biggest driver of returns → Some evidence of changes in operating performance, but there is no match for takeover in creating stock returns for shareholders (Greenwood and Schor 2007)
- Activists increase the conditional probability of takeover → Returns are highest for targets that are acquired within 18-months of the activist filing (Greenwood and Schor 2007)

Notes:

1. Karpoff, Jonathan, Paul Malatesta and Ralph Walkling, 1996, "Corporate Governance and Shareholder Initiatives: Empirical Evidence," *Journal of Financial Economics* 42, 365- 395 Brav, A., W. Jiang, F. Partnoy, and R. Thomas. 2006. Hedge Fund Activism, Corporate Governance, and Firm Performance. Working paper, Vanderbilt University.
2. Wahal, Sunil, 1996, "Public Pension Fund Activism and Firm Performance," *Journal of Financial and Quantitative Analysis* 31, pp. 1-23.
3. Gillan, Stuart L., and Laura T. Starks, 2000, "Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors," *Journal of Financial Economics* 57, pp. 275-305.
4. Brav, A., W. Jiang, F. Partnoy, and R. Thomas. 2006. Hedge Fund Activism, Corporate Governance, and Firm Performance. Vanderbilt University.
5. Klein, April, and Emanuel Zur, 2006 "Hedge Fund Activism," European Corporate Governance Institute Finance Working Paper No. 140.
6. Clifford, Chris, 2007, "Value Creation or Destruction? Hedge Funds as Shareholder Activists," Working Paper.
7. Greenwood, R., and M. Schor. 2007. Investor Activism and Takeovers. Working Paper. Harvard Business School

Standard structure

- **Portfolio Structure:**
  - Number of positions: Top 5 – 10 account for majority of risk
  - Position limit: Normally < 15% of fund expected, but may be up to 25%
  - Gross exposure: Gross exposure up to 125%
  - Net exposure: Heavily net long; >85% expected
  - Ownership: Varies considerably; <1%, 5%,10%,15% . . . >50%
  - Holding period: Typically 1 – 3 years
  - Target return: Varies from absolute return (<15% p.a. typical) to index-relative (index plus 5 - 8% p.a. typical)

Standard terms

- **Standard Terms:**

Structure:	Offshore LP; typically (but not always) open-ended	
Management fee:	"New" funds[1]:	2%
	"Old" funds[1]:	1% – 1.5%
Performance fee:	20%	
Hurdle:	"New" funds[1]:	No hurdle (net positive returns)
	"Old" funds[1]:	Index return i.e. S&P500
High Water Mark:	Yes	
Lock-up:	Each application separate; min. 1 Year; 2 – 3 years common; 3 – 5 years sometimes	
Hard/ Soft Lock:	Varies; 1% – 5% penalty	
Liquidity Gate:	10% – 25%	
Side Pocket:	Common; 10% – 20%; often 8% preferred return	
Notice period:	60 days+; quarterly or semi-annually	
Minimum:	USD5m	

1. New funds typically launched after 2000 &/ or with a distinct hedge fund element vis leverage, shorting and dynamic management of expsoures. Old funds typically launched prior to 2000 &/ or with a more traditional long-only private markets type approach

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