

## Hedge fund activists 2.0: They are back!

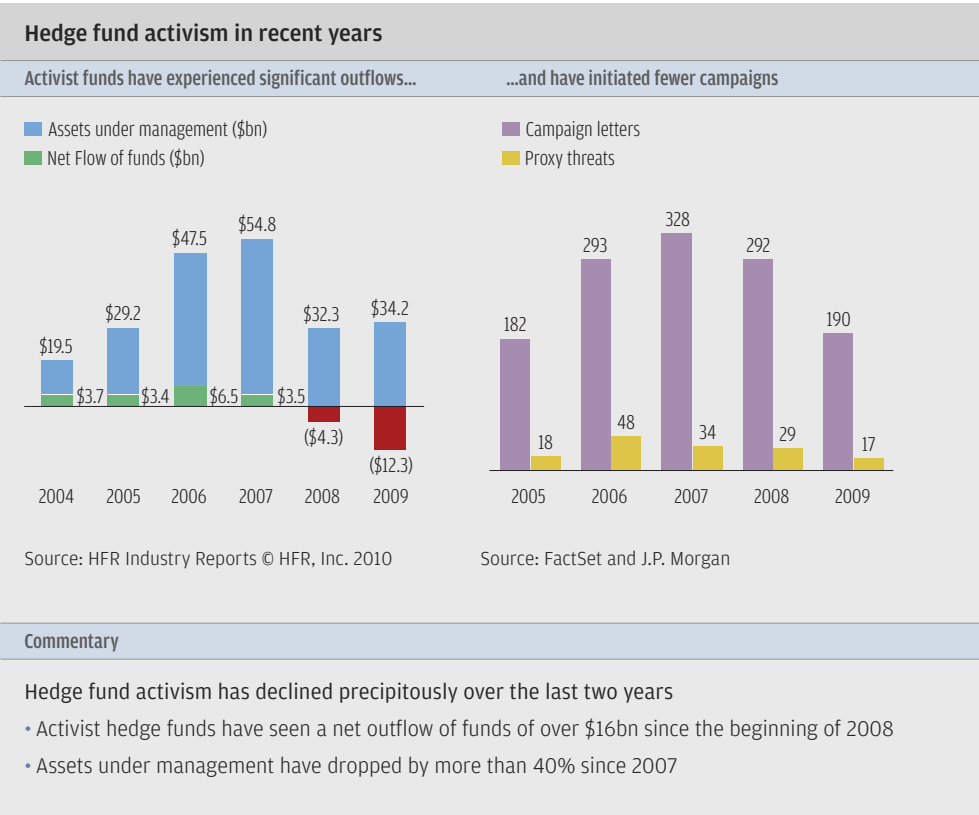
Creating value through pro-active strategies in response to hedge fund activism



# 1. Hedge fund activism 2.0: Ripe for resurgence

**Times are a-changing:** Three years ago, hedge fund activists were making the front page of the Wall Street Journal almost on a daily basis. Unprecedented liquidity in the credit markets allowed hedge fund activists to acquire material stakes in both large and small companies. A testimony to the success of activism was the growth in activist hedge funds’ assets under management, which increased from about \$20bn in 2004 to almost \$55bn in 2007 (Figure 1). The burst of the credit bubble and the beginning of the recent financial crisis, however, brought the wave of activism to an end. Capital markets shut down and the attention of investors and companies shifted to liquidity and survival. Without the support of active capital and M&A markets, activism became a less visible part of the markets in 2008 and 2009. In turn, activist funds’ outflows in 2008 and 2009 equaled the inflows of the previous four years. Times have rapidly changed. In the first quarter of 2010 there have been several visible campaigns by Carl Icahn, Relational and others. Will more activism return to the markets in 2010? With vibrant capital markets, record levels of corporate and investor cash, impatient investors, and declining organic growth opportunities, **we believe that the conditions are ripe for a resurgence in shareholder activism.**

Figure 1



**Likely targets:** During the previous activist wave, targets tended to display a number of non-mutually exclusive characteristics: poor performance, excess cash, low leverage and asset portfolios that could be reconfigured to create value. As firms focused on liquidity over the last two years, they de-levered actively and cut back on capex, R&D and distributions. Corporate cash balances are now at record levels. Interestingly, most large non-finance firms have not taken advantage of this flexibility to buy “cheap” assets. Some activists might suggest that they have maintained too much flexibility.

**Common attack strategies:** Activists are ultimately seeking to create catalysts to improve stock price performance (most prominently a sale of the company). Activist attacks, however, commonly center around a few themes designed to achieve that ultimate goal. These “Trojan Horse” activist tactics might come in the form of demands in the following areas: (i) improving governance practices or executive compensation (taking advantage of this popular theme in the broader markets); (ii) optimizing portfolios (separating non-core assets, focusing on core businesses); (iii) utilizing the balance sheet to return capital to shareholders; (iv) criticizing announced M&A transactions (either ill-perceived acquisitions or a sale of the company at the wrong price or time); or (v) suggesting operational improvements (benchmarking margins, corporate spending, etc. against peers).

**Offense is the best defense:** : How should senior decision-makers and Boards of Directors prepare for activism? We recommend a pro-active three-pronged strategy to engage the Board in preparing for the new activism wave. First, the Board should be aware of the main drivers of activism, be familiar with the key activist funds, and understand their tactics,

investment horizons, and common attack strategies. Second, we recommend that the Board use our customized checklist of likely activist issues relating to asset mix, operational performance, capital structure, excess cash, and distributions. We recommend that management regularly evaluate its financial and asset mix decisions against this checklist. Third, if the firm makes a pro-active decision regarding asset mix or financial policy, it should clearly communicate this decision to its investors.

EXECUTIVE TAKEAWAY

Firms have accumulated record levels of cash while facing a sharp decline in growth opportunities. The recent normalization in capital markets and M&A activity suggests that activist hedge funds are poised to return from hibernation. Who will they target? What will they look for? What is the best defense? What is the best way to create long-term value in this environment? Senior decision-makers should anticipate that hedge fund activism will be back, and they should pro-actively engage the Board to consider potential vulnerabilities and defense strategies.

## 2. Back from hibernation in 2010?

Hedge fund activism comes in different shapes and forms, but it typically flourishes when liquidity is abundant, capital markets are open, and markets for corporate assets are active. From 2005 to 2007, for instance, the number of campaign letters and proxy fights almost doubled as credit markets provided easy and cheap access to debt financing, equity markets rallied, and mergers and acquisitions (M&A) activity reached record high levels.

The financial reality of the last two years, however, led many firms to shore up the balance sheet to weather the financial markets storm. Challenging access to debt markets coupled with higher risk premia and a massive flight to quality by equity investors, limited the firepower of private equity and strategic buyers. The value maximization proposition of the boom cycle years, which commonly incorporated higher leverage, increased shareholder distributions, and asset sales/spin-offs was less appealing in 2008 and 2009. Many hedge fund activists, struggling with significant net outflows and reduced leverage capacity, either focused on smaller firms or adopted new strategies (e.g., investments in distressed firms).

Recently, many of the trends that drove hedge fund activists into hibernation have reversed (Figure 2). Improvement in credit and equity markets, record levels of corporate liquidity and private equity capital commitments, and investors who are refocused on shareholder distributions and corporate governance, are expected to support the comeback of hedge fund activists this year.

Figure 2

Activists are coming back from hibernation		
	Why were activists in hibernation?	Why are they back?
Leverage	<ul style="list-style-type: none"><li>• Focus on liquidity and balance sheet strength</li></ul>	<ul style="list-style-type: none"><li>• Record levels of cash, cost of capital minimized at lower rating compared to the peak of the crisis</li></ul>
Markets	<ul style="list-style-type: none"><li>• Capital markets frozen and high cost of debt financing</li></ul>	<ul style="list-style-type: none"><li>• Improvement in credit markets, all-in debt yields approaching historical lows</li></ul>
Distributions	<ul style="list-style-type: none"><li>• Massive cuts in buybacks and distributions due to focus on liquidity</li></ul>	<ul style="list-style-type: none"><li>• Investors focused on distributions as capital gains from growth are elusive</li></ul>
Spin-offs	<ul style="list-style-type: none"><li>• Financial synergy benefits for large diversified firms</li></ul>	<ul style="list-style-type: none"><li>• Investors are more focused on corporate clarity</li></ul>
Asset sales	<ul style="list-style-type: none"><li>• Private equity firms not getting leverage, strategic firms concerned about their own financial condition</li></ul>	<ul style="list-style-type: none"><li>• Private equity has record high capital commitments, strategic firms looking for growth through M&amp;A</li></ul>
Operational Benchmarking	<ul style="list-style-type: none"><li>• Limited room for incremental operational improvements as firms were already focused on liquidity</li></ul>	<ul style="list-style-type: none"><li>• Operational improvements enhance investor returns in the absence of top line growth</li></ul>
Governance	<ul style="list-style-type: none"><li>• Investors focused on survival and balance sheet strength, less on governance</li></ul>	<ul style="list-style-type: none"><li>• Investors and media are less patient with what they perceive as poor governance</li></ul>
Source: J.P. Morgan		

EXECUTIVE TAKEAWAY

The recent financial crisis led to a significant reduction in hedge fund activism. As capital markets continue to improve and investors shift their focus from fortress balance sheets and liquidity towards corporate governance, asset portfolio mix, and shareholder distributions, hedge fund activism is expected to re-emerge.

### 3. Who are they? From the Icahns to Steel Partners

The universe of activist funds can be categorized in several different ways:

**(1) Specialist vs. occasional:** The specialists funds take a few large positions and generally pursue activist strategies. Prominent firms in this arena include Tracinda, Relational, and Icahn. At the other end of the spectrum are funds that occasionally become activists, but do not always pursue such strategies. Examples include SAC, GAMCO, and Sandell.

**(2) Sector specialists vs. broader economy:** Sector specialists tend to focus on a limited number of sectors. For example, Nelson Peltz focuses on consumer products and Pershing Square focuses on retail. Other funds are generalists who look for ripe targets in all sectors of the economy (e.g. Icahn, Relational).

**(3) Large vs. small:** The large funds are capable of taking on the largest targets (e.g., Icahn, Pershing Square). Alternatively, mid-cap specialists may have long activism track records but focus on small to mid-sized firms (e.g., Steel Partners, MMI).

**(4) Common attack strategies:** Certain funds tend to use specific attack strategies (e.g., Relational – governance, GAMCO – shareholder rights plans). Most funds do, however, tend to pick from the usual menu of attack themes.

The figure below includes a list of some of the most dominant activists over the last several years and how they fit into the categories described above.

EXECUTIVE TAKEAWAY

While most executives recognize Carl Icahn’s name and are likely to be familiar with his track record, companies must carefully cross-check their shareholder base against a long list of activist funds – some of which may not have previously made investments in the company’s sector.

Figure 3

Who are the most dominant activists?	
Profile of selected activists	
Icahn	Led many of the landmark activist campaigns in recent years, mainly active in healthcare/biotech, technology/media, real estate and natural resources
JANA	Not a pureplay activist, but conducted several high-profile campaigns, often in partnership with other activists
TCI	Historically a European activist, TCI has also been active in US markets
Pershing Square	Traditionally focused in retail and consumer sectors, recently expanded to other areas including real estate
Relational	Launched campaigns across a variety of sectors, including telecom, metals & mining, financial services, energy, business services, and healthcare/biotech
Tracinda	Focused on value investing with interests in autos, oil & gas and casinos
Elliott	Particularly focused on distressed situations
Triun	Historically focused in operational activism in the foodservice, restaurants and consumer sectors
Knight Vinke	European activist hedge fund, mainly focused on the energy and financial services sectors
Atticus	Not a pureplay activist, but conducted several high-profile campaigns particularly in the metals & mining, energy and financial services sectors
Source: J.P. Morgan	

## 4. Does hedge fund activism create shareholder value?

To gauge whether hedge fund activism creates shareholder value, we examine the market reaction to shareholder activism. Existing research and our own analysis suggest that investors have responded positively to “shareholder value” related activism. Activists intend to create value in various ways, such as encouraging firms to increase shareholder distributions, change their asset mix (sell non-core assets), or revise their capital allocation and M&A strategies.

To better understand the investor reaction, we studied the stock market performance of 85 targeted firms from 2005 to 2009. We focused on three time windows. The first window starts a week before the first activism announcement and ends a day before the announcement. During this window targeted firms outperformed the market by 2% probably because the hedge fund was accumulating a stake during this period and/or information about the forthcoming targeting was leaked out. The second window is around the announcement day, when the targeted firms outperformed the market by 3.3%. The third window starts the day after the announcement and ends a week after the announcement. During this time the targeted firms continued to outperform the market by 0.7%. Overall, the targets outperformed the market by 6.1%.

Figure 4



### EXECUTIVE TAKEAWAY

Our analysis and other research suggest that, on average, equity investors respond positively to hedge fund activism. The overall gains appear to be around 6%. There is scant evidence that targeted firms were forced to make decisions that help in the short term but hurt their performance during the recent financial crisis. There is, however, much evidence that firms with liquidity and fortress balance sheets outperformed during the crisis.

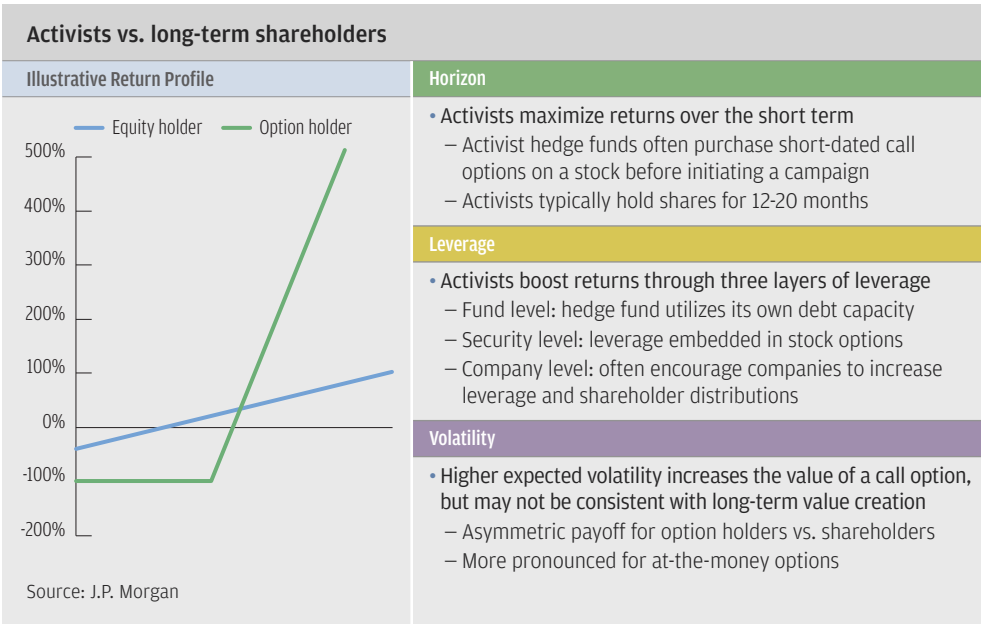


## 5. Activists vs. long-term shareholders: different goals and incentives

Hedge fund activists often adopt investment tactics that diverge from long-term shareholders. A shorter investment horizon, higher leverage, and the use of financial derivatives suggest a return profile that favors myopia, volatility and a greater appetite for risk.

While activists obtain significant influence on a firm’s financial strategy by acquiring voting rights through common stock, some activists complement their holdings with call options and/or total return swaps. Figure 5 demonstrates how the return profile of a call option holder differs from that of a common shareholder. Stock options tend to have a short maturity, provide levered returns, and benefit from increased volatility. As a result, activists could favor a risky financial strategy which may drive high returns in the short term but destroy long-term value (e.g., excessive leverage during boom years). This phenomenon is particularly pronounced in cyclical sectors, where long-term shareholders experience the full business cycle while activists exit after only a few months.

Figure 5



### EXECUTIVE TAKEAWAY

Boards and senior management should be aware of the different investment horizon and return profile that hedge fund activists may have relative to long-term shareholders. Understanding activists’ goals and incentives can help in evaluating proposed strategies to ensure they do not only boost short-term returns, but also maximize long-term shareholder value.

## 6. Who are likely targets?

There is not much debate about the characteristics of firms targeted by hedge fund activists. Hedge fund activist targets tend to have poor stock returns and depressed valuations. In addition, activist hedge funds focus on firms with disparate asset portfolios or “lazy” balance sheets. Amongst firms with these characteristics, the most likely targets are small to midsized firms and firms with relatively diffuse share ownership.

Figure 6

Who is a likely target of hedge fund activism?	
Target characteristics relative to peers	
Performance	Poor performance and low valuation metrics relative to peers
Capital structure	Low leverage, but substantial debt capacity
Distributions	Steady cash flow, but low shareholder distributions
Asset mix	Diverse set of assets, but strategic fit can be challenged
Ownership	Diffuse ownership, high institutional ownership, liquid stocks
Governance and size	Small to midsize, poor governance (e.g., more takeover defenses)
Source: J.P. Morgan; “Hedge Fund Activism, Corporate Governance, and Firm Performance”, Journal of Finance, 2008	

### EXECUTIVE TAKEAWAY

Likely targets of hedge fund activism tend to be poorly performing firms with significant financial flexibility including excess cash, unused debt capacity, and non-core assets.

## 7. Being pro-active and preparing the Board’s response to activism

**A pro-active strategy is superior to a re-active strategy.** Senior management should discuss “hedge fund activism targeting risk” with the Board on a regular basis. To facilitate this process, we have provided a checklist of discussion points. We suggest a pro-active value maximizing strategy, which includes enhancing Board awareness to hedge fund activism; identifying potential threats and vulnerabilities; and revisiting the firm’s asset portfolio, capital allocation process, capital structure, and shareholder distribution strategy.

Figure 7

Checklist for preparing your Board for shareholder activism	
✓ Board awareness	<ul style="list-style-type: none"> <li>• Explain to your Board why activist hedge funds are likely to re-emerge</li> <li>• Discuss whether any of your peers have been recently targeted</li> </ul>
✓ Shareholder structure	<ul style="list-style-type: none"> <li>• Review key shareholders and their expectations</li> <li>• Flag any potential activist shareholders</li> </ul>
✓ Asset portfolio	<ul style="list-style-type: none"> <li>• Has the strategy for non-core assets been communicated to the market?</li> <li>• Are there likely buyers for these non-core assets today?</li> <li>• Communicate to the Board areas that may be targets for acquisitions</li> </ul>
✓ Operational benchmarking	<ul style="list-style-type: none"> <li>• How do you compare to peers from an operational perspective?</li> <li>• If you are an outlier, are the underlying reasons well understood?</li> </ul>
✓ Capital structure	<ul style="list-style-type: none"> <li>• Review current capital structure strategy and compare to peers</li> <li>• Can an argument be made that more leverage would enhance value?</li> </ul>
✓ Distributions	<ul style="list-style-type: none"> <li>• Review current distribution strategy and compare to peers</li> <li>• What are the good reasons for distribution levels that are lower than peers?</li> </ul>
✓ Public relations	<ul style="list-style-type: none"> <li>• Have you effectively communicated your financial policies to investors?</li> <li>• How is your firm viewed from an environmental and stakeholder perspective?</li> <li>• Prepare for a more pro-active public relations campaign</li> </ul>
Source: J.P. Morgan	

We strongly believe that it is critical to communicate key financial policies clearly and effectively to investors. Adopting a value creating strategy only due to public pressure by activists may reflect poorly on both the management and the Board or may suggest that the strategies have been adopted to benefit only a small, yet vocal, subset of shareholders. We

**EXECUTIVE TAKEAWAY**

Senior decision-makers should adopt a pro-active strategy against hedge fund activism. Management teams and Boards of Directors should regularly assess the type of value enhancing financial policies that hedge funds tend to propose. Effective communication to shareholders about these decisions is also paramount to creating long-term shareholder value.

have developed analytical tools to evaluate the appropriateness of various financial strategies, the firm’s competitive positioning, and the firm’s likelihood of being the target of hedge fund activism.

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