Shared Intelligence

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Barbarians Repairing the Gate: A Primer on Activist Hedge Funds

Overview

The flurry of hedge fund activism that we witnessed in 2012 looks poised to continue into 2013 and beyond, as the environment for these strategies remains fertile. Interest in the strategy is continuing to grow, and in XX's view the opportunity set is as well.

Activist hedge funds attracted roughly $3.8 billion in capital in 2012 according to Hedge Fund Research ('HFR'), compared with a net $1.8 billion in 2010, while returns averaged around 20% for the year according to AlphaClone. As of the end of the third quarter there was $57 billion dedicated to activist funds, up from $32 billion at the end of 2008 (HFR).

Generally considered a sub-set of the event driven or long/short equity category of hedge fund strategies, activist funds seek to unlock 'hidden' value in the companies they invest in. **They look for stocks that are trading at a discount to intrinsic value, and then instead of waiting passively for the market to recognize this perceived 'hidden' value (as would a traditional value investor), the activist hedge fund will proactively work to expose – or elevate – that value to the market.** In this way the strategy quite literally attempts to 'generate alpha' (a misnomer often used to describe other hedge fund styles that are in fact 'capturing' alpha but not quite 'generating' it...semantics), by promoting the catalysts that may increase stock value.

Activist funds do not simply press companies to unload assets. The strategy may incorporate a variety of tactics depending upon the circumstance, and in some cases will employ several approaches. These include pushing for companies to increase their dividend, launch a share buyback program, change senior management, or spinoff or restructure 'non-core' assets.

Activist hedge funds can be looked at as taking a private equity-like approach to the public markets, but without some of the downside often attributed to PE investments such as extended lock-up periods, limited liquidity, and the reliance on high levels of portfolio company leverage.

On average, HFR's activist index has outperformed its weighted composite index for all hedge funds over the past four years by more than three percentage points (total return as of 1/31/12)*.

In this installment of XX's Shared Intelligence we expand on various aspects of hedge fund activism, the tactics employed by managers, the utility of activist hedge funds as part of a well diversified institutional portfolio, and lastly why we believe the strategy is particularly attractive today given the current economic and market environment.

*Based on the performance of the HFRI Fund Weighted Composite Index vs the HFRX Activist Index from 1/1/2009 to 12/31/2012. Indices may not be investable and are not subject to fees and expenses. **Past performance is not indicative or a guarantee of future results.**

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Summary

- Considered a sub set of the event driven or long/short equity category of hedge fund strategies, activist funds seek to unlock 'hidden' value in the companies they invest in
- The opportunity set for activist hedge funds is currently very attractive; equity valuations are at fair levels, corporate balance sheets are flush with cash, financing rates are at record lows, and private equity firms are sitting on a large supply of uninvested capital
- Public attitudes toward activist investors are becoming increasingly hospitable as they are viewed as defenders of shareholder interests in terms of corporate governance best-practices

Activism: A Primer

Briefly, the strategy of activist hedge funds involves taking a minority position in a public company, with the goal of unlocking said company's value by influencing management to modify its capital allocation activities – that is to say run their businesses in a more efficient and profitable manner. Tactics include financial restructurings, operational turnarounds, and/or strategic initiatives. Implicit in the strategy is the notion that the targeted company is undervalued and generating earnings below its potential – based on the hedge fund manager's assessment – and the activist has a plan to unlock this potential.

Activist investors were quite busy in 2012 and this trend will likely continue into 2013. Multi-national corporations such as Yahoo (YHOO), Canadian Pacific (CP), Procter & Gamble (PNGSL.BO), JC Penney (JCP), Marathon Petroleum (MPC), McGraw-Hill (MHP), Agrium (AGU), and Hess Corp. (HES) were among some of the larger public names in play this past year.

25+ years ago similar investment strategies (though not quite the same) and involving several of the same players may have grabbed headlines under a different – perhaps less flattering – characterization. Indeed, some of the same iconic (ahem…) names that today are held up as defenders of the average investor, often praised for holding management teams accountable, were in days of yore condemned as robber barons, corporate raiders, and barbarians at the gate.

Not anymore. **The 'barbarians' of the 1980's no longer crash the gates as much as they wish to repair them. The game today is more about diplomacy than aggression, as activist investors have found it easier (and clearly more profitable) to work with corporate management to implement positive change** – versus trying to take full control of a company and possibly liquidate its prized assets. In this way the spoils are shared among many.

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Today it is about building venerable brands versus destroying them, and activists no longer need to take over a company to influence action. Often it is possible for a hedge fund with a minority stake, perhaps just over 5%, to initiate change with cooperation from management – possibly by nominating a member of the hedge fund's team to the company's board of directors.

As one current high-profile activist recently stated to Bloomberg Businessweek, **"the least effective way to do activism these days is to come in with a big club. The best result is to have a board hear your ideas, realize they are good and then acquiesce...we prefer to work with management in making changes that increase shareholder value, but sometimes you have to go to the mat."**

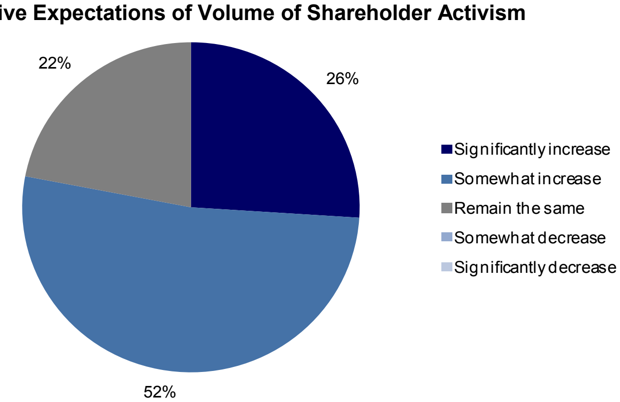
Indeed, while activists have in recent years been successful in implementing change cooperatively, there are instances where management teams resist – and the fight is taken public. In these cases the activist needs to win over fellow shareholders via proxy fights, and much attention is drawn from the press as both parties tend to communicate publicly via press releases and statements. Again, while the hedge fund managers generally prefer to avoid these circumstances, the prevailing attitude among investors today with regard to the desire for good corporate governance often works in the activist's favor. We discuss this in more detail later.

Attractive Opportunity

The market and economic environment is perhaps more favorable to activist investment strategies today than it has been in some time. With the outlook for growth muted, equity valuations at attractive levels, corporate balance sheets flush with cash, financing rates at record lows, a large supply of un-invested private equity capital, and an increasingly hospitable public attitude toward activist investors as defenders of shareholder interests in terms of corporate governance best practices – the opportunity set for activists appears robust.

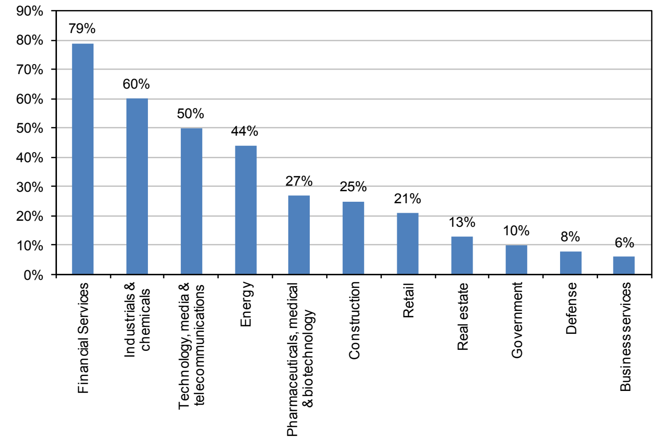
- As of Q2 2012, 78% of corporate executives and activists expected an increase in shareholder activism over the next 12 months
- Top sectors for activism was expected to be financial services, industrials and chemicals, technology, and energy

Executive Expectations of Volume of Shareholder Activism



Source: Schulte Roth & Zabel LLP. Q2 2012.

Expectations of Most Active Sectors for Shareholder Activism



Source: Schulte Roth & Zabel LLP. Q2 2012.

We have outlined below several environmental factors that we believe make the prospects for activist investing today particularly attractive:

— Cash is King

The current fertile landscape was initially cultivated following the credit crisis of 2008, as corporate America (as well as enterprises globally) went into extreme defensive mode, curtailing spending and de-leveraging. This continued well into 2009, resulting in a significant buildup in corporate cash reserves. In early 2012 JP Morgan estimated that S&P 500 companies (excluding the financial sector) had close to $2 trillion in aggregate cash on their balance sheets. Alliance Bernstein estimated that as of 2011 the proportion of net debt to equity in the US corporate sector was the lowest in 60 years. Such huge cash balances create a significant drag on earnings, and it is anticipated many companies will choose to allocate this cash through strategic mergers and acquisitions (M&A) or via stock buybacks and dividends – both significant areas of focus for activist funds. Nonetheless, management teams often lack the skill set or incentives required to successfully undertake such strategic maneuvers, and this is where hedge funds may find opportunity.

In addition, there remains a substantial amount of uninvested private equity ('PE') capital on the sidelines, much of which is likely to be invested over the next several years (as investment periods expire). This activity should increase opportunities for activist investors to participate in buyouts and other strategic acquisition deals.

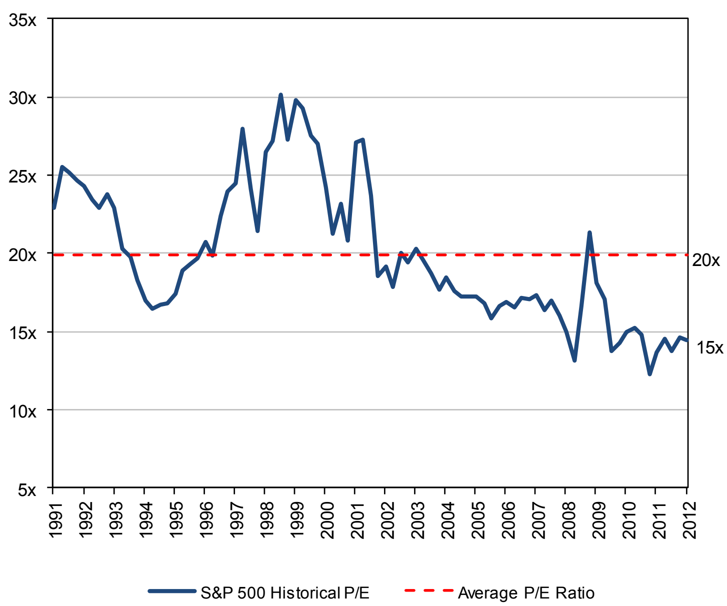
— M&A

After several years of less than robust activity, the M&A environment experienced an observable pickup in 2012, and this trend is expected to continue going forward. As mentioned previously, the excess cash on corporate balance sheets is burning a hole in management pockets, and with muted long-term GDP projections companies may seek strategic M&A transactions to buoy both top and bottom lines.

In addition, company managements and external shareholders are much more receptive to strategic as well as operational tactics that may improve the company's strategic position. Also of note, the spread between the cost of equity and cost of debt is now consistent with the last big M&A wave in 2004 — 2007.

- Equities are cheap by historical standards, and financing rates are attractive
- Both factors are supportive of continued corporate M&A activity
- M&A is traditionally a practical way for activists to unlock value

Historically Low P/E Valuations



Record Low Interest Rates for Corporate Borrowers

Sources: Bloomberg, Barclays Capital Aggregate Bond Index. Data through December 31, 2012.

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Commonly Deployed Activist Tactics

- **Financial Restructuring**

  Create value by restructuring a company's balance sheet, altering the leverage structure in an attempt to impact/unlock value. Tactics include reducing excess cash by increasing dividends, share buyback programs, retiring or refinancing outstanding debt

- **Operational Changes**

  Create value by increasing operating margins. Tactics may include modifying product prices, focusing on core brands/products, changing raw materials suppliers/distribution channels, streamlining logistics, eliminating unprofitable franchises or business units, and restructuring management compensation

- **Strategic Moves**

  Strategic moves may include M&A transactions, joint ventures, and/or the spin-off of incompatible divisions or product lines. Activist hedge funds often maintain a wide network of corporate relationships that may be helpful in implementing such maneuvers

— Shareholder Support

Perhaps the most significant of all the factors contributing to the rise of activist investing today is the role and support of the shareholder.

All of the tools once used to avert activists in the boardroom, from 'poison pills' that derail takeovers to golden parachutes that enrich management, are today generally viewed as negatives for shareholders. Outrage over excessive compensation levels, nepotistic boards and lax oversight has shifted sentiment in favor of activists and away from corporate management. Many investors view the lure of stock options and other cozy perks often available to senior management in public companies as a disincentive to long-term strategic thinking. In this way it makes sense to have an external force, such as a hedge fund, serve as the catalyst to motivate change that will benefit all shareholders and not just corporate heads. At times there can be a misalignment of interest between the two parties, leading to what are referred to as 'agency costs'. These may include:

- High executive compensation
- Poor asset allocation decisions
- Lack of transparency and/or inaccurate reporting
- Lack of independent audit committees
- Misuse of non-public information

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Over the past decade the government has sought to improve corporate governance standards, such as through the passage of the Sarbanes-Oxley Act, as well as through additional listing requirements at the NYSE and stricter SEC disclosure rules. This increased emphasis on agency costs dovetails nicely with the goals of the activist hedge fund to unlock value, and in fact recent research has suggested that by improving governance structures company valuations can be improved as well.

Other Factors Relevant to Activist Investing

— Market Capitalization

While activist investing spans the market capitalization spectrum, historically the focus had been on small to mid-cap sized companies as targets. This was likely a function of their management teams tending to be smaller and perhaps less experienced, and as such more amenable to suggestions from activists with regard to capital allocation decisions.

In addition, stocks in a smaller company may trade in more inefficient markets, and so their valuations could potentially offer a significantly higher upside versus a larger cap company.

More recently, however, activist hedge funds have been targeting larger entities. According to FactSet SharkWatch, of the 241 activist campaigns aimed at boosting a company's financial returns or securing board seats last year, 21% were aimed at those with market values of over $1 billion, up from 7% in 2009.

— Board Structure

The structure of a company's Board of Directors is an important consideration for an activist hedge fund in terms of the ability to influence or control strategic decision making. Ideally there will exist a separation of management roles in terms of a company's CEO and its Board, with the Board maintaining ultimate seniority and control over strategic CEO actions. In addition, the level of shareholder representation in the nomination of a company's directorship is important as well.

The Role of Activist Hedge Funds in an Institutional Portfolio

Broadly speaking, we believe an allocation to a set of activist managers may be an effective way to enhance the diversification and potential return of an institution's hedge fund portfolio, and in some instances to reduce overall risk levels as well.

Activist hedge funds are typically sub-categorized as event driven or long/short equity allocations. In this way they may be used as part of a long-biased event driven allocation, to diversify an existing credit/distressed event driven allocation, to diversify or enhance the return profile of a long/short equity allocation, or perhaps as an equity substitute or complement to an existing long-only equity allocation.

In addition, many activist funds are increasingly being viewed as a substitute to an allocation to private equity. Because of their nature as longer-term investors that involve some aspect of direct 'involvement' in facilitating the enhancement or creation of company value, there is a natural association between the two strategies.

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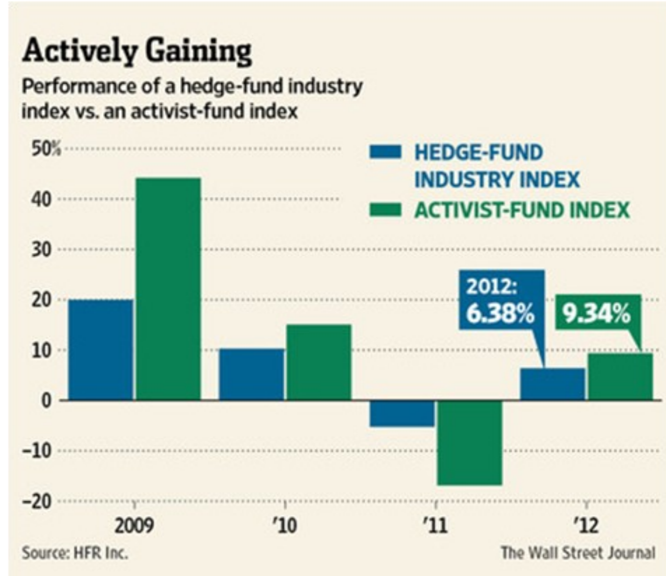

Blue: HFRI Fund Weighted Composite Index
Green: HFRX Activist Index

A Typical Activist Hedge Fund Portfolio

- Concentrated – 8-10 core positions and long-biased
- Average positions size 5% to 15% of total portfolio, depending upon manager conviction
- In addition to core positions managers may have several smaller 'farm team' or 'toehold' positions in stocks where they see future potential but have not yet fully committed to the thesis. By establishing a toehold the manager may gain access to information/knowledge to either help strengthen or perhaps debunk their view of the opportunity
- Most activists will implement hedges by shorting indices or baskets of stocks. These positions are generally targeted towards reducing systemic risk and not considered as protection against specific portfolio positions. In some instances, however, the hedge fund manager may view a specific company as significantly overvalued by the market, and in these cases a strategic short may be employed to capture alpha from a stock's decline
- Activist investment horizons vary but are typically longer than those of traditional long/short managers, as uncovering the value in a stock may take time. Holding periods generally range from six to 36 months, and many activist hedge funds will try to match their liquidity terms to their investment horizon. In this way, although the underlying assets that comprise the investment are public equities and hence highly liquid, lock-up periods may be longer than those of traditional long/short equity funds

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In XX's view, however, there are significant differences that may make an allocation to activist hedge funds over private equity more attractive for some investors. These include:

— Leverage

PE firms will typically use leverage as part of their strategy when taking over a company or supporting a start-up, while activist hedge funds generally will not.

In addition, when investing in a public company PE shops typically seek to take them private to 'fix' the issues behind the scenes, with the goal of an IPO or sale as the exit from the investment. Alternatively, the stocks activist funds target typically remain public for the life of the investment.

— Liquidity

PE firms on average target a 10 to 12 year capital commitment, while for activist hedge funds the cycle would be much shorter, perhaps in the range of 12 months to three years. In this way the liquidity profile for activist hedge funds is more attractive then that of private equity.

In addition, returns from capital allocated to PE are often not realized until several years into the life of the investment (generally five to seven years). This is known as the J-curve effect, a reference to the shape of investment returns in private equity when plotted over time. Historically there is a tendency for private equity funds to deliver negative returns in early years, and then stronger gains in the later years as the companies underlying the investment mature.

For activist hedge funds there is no inherent dynamic in the strategy that would imply a similar J-curve pattern to performance.

In Conclusion

We view the current economic and market environment as attractive for activist hedge funds. Given the muted expectations for global growth, high corporate cash balances, high levels of private equity capital, and the increasingly favorable light in which activist managers are viewed by media, investors, and corporate management (usually…), the opportunity set is robust.