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The growth and changing landscape of activist investing in the US

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For the past year, people have speculated activist-style investing would go the way of the Internet boom and bust witnessed earlier this decade. However, despite a weaker economic outlook, shaky credit markets, and a subprime turmoil upending financial markets worldwide, activist hedge funds continue to grow at remarkable rates in both number and in assets under management. Indeed, by all measures, activist investing is showing signs of credence even when other hedge fund strategies, such as quantitative investing, seem to be faltering. Much of their sustainability can be attributed to advantages in the way these funds are structured, while controversial methods of accumulating substantial ownership stakes, tag-team campaigns and new stock exchange rules should continue to foster their growth for years to come.

While many hedge funds have seen investors fleeing for the exits, on a whole, the activist fund has maintained a steady stream of capital inflows. One explanation for this can be ascribed to the fact that these investors have somewhat of a secret weapon: longer lock-up periods.

Unlike most hedge funds that allow investors to withdraw funds on a quarterly or semi-annual basis, activist-style investment vehicles typically require investors to commit to investing in the fund for a period of two to three years. In a poor economic environment, this can be the difference between a fund's success and failure, and has two real tangible benefits. First, activists are less concerned with monthly returns, ongoing redemptions and fund maintenance, which allows for a longer-term outlook on stock picking; and second, a weaker stock market often generates better investment opportunities in fundamentally sound businesses – the Rosetta Stone of an activists' stratagem.

Armed with a greater number of militiamen and enlarged stockpiles of weaponry, activist investors are continuing to wreak havoc in boardrooms across America by being more vocal and by launching more campaigns against the establishment than ever before.

Explosion of Activist Investing

Early this year Carl Icahn, one of the world's most notable activist investors, casually remarked in an interview, *"In today's environment, there are a great number of companies that can use activism…I think we're going to be very active this year."*

Based on the number of activist situations since the beginning of January, it's safe to say Icahn isn't the only one keeping busy. More than eighty activist campaigns have been launched at US companies across practically every industry during the first seven weeks of 2008. And while many of the insurgent names are familiar from proxy ballots a year ago (Nelson Peltz's Trian Fund, Warren Lichtenstein's Steel Partners, Dan Loeb's Third

Point, and Barry Rosentein's Jana Partners), plenty of newcomers are establishing themselves on IR watch lists as "investors of interest," adding to new levels of uneasiness in weekly management meetings and regularly scheduled board meetings.

The growth in activist hedge funds over the past few years has been nothing short of tremendous. Over 75 hedge funds are currently dedicated to an event-driven, activist-style of investing, managing more than $50 billion in assets in the US alone, making these juggernauts a powerful force to be reckoned with. In addition, there are hundreds of institutional and high net worth investors managing many more billions of dollars who are opportunistically adopting activist-style investing techniques in order to press for change in underperforming companies around the globe.

So far this year, US companies confronted with demands from activist investors attempting to influence change to corporate systems, structure and governance has risen by more than 30% over the same period in 2007. And while some ask for improved disclosures around executive compensation schemes and political contributions, most demands are for board representation, hiring financial advisors to evaluate value improvement initiatives, restructuring balance sheets and changing management.

Public Demands Made by Activist Funds
Jan 1st – Feb 15th 2008

Demand	Count
Board Representation:	**48**
Review Strategic Alternatives (including a sale):	**40**
Implement a Share Buyback Program:	**8**
Distribute a Special Dividend:	**3**
Change in Management:	**4**

Source:
Hedge Fund Solutions' Catalyst Equity Research Report

Furthermore, while asset-rich retail businesses and maturing Silicon Valley–based technology companies are currently attracting a disproportionate share of attention from activists this year, very few industry sectors seem immune to the activists' advances.

Discreet Accumulations and Tag-Team Campaigns

For an activist investor, timing is everything. The primary objective is to accumulate enough ownership in a targeted company to influence change while securing a tidy profit. The trick, of course, is to purchase sufficient shares without drawing attention from the target and without attracting too many tag-along investors - unwittingly driving up the stock price and making it too expensive to accumulate additional stock.

Clever activist investors have found new ways of maintaining the element of surprise through the use of complex financial derivatives and by working as teams.

Under SEC regulations, investors owning 5% (or more) of a company's equity are required to disclose their ownership within 10 days of an acquisition. For an activist investor wishing to remain undetected until enough shares are purchased to promote change in a targeted company, this can be a very low threshold.

Unresolved Activist Campaigns (Jan/Feb 2008)

Company	Industry	Activist Investor(s)	Demand
Biogen Idec Inc.	Biotech	Carl Icahn	3 board seats; explore a sale
Brinks Co.	Security	MMI Investments, Steel Partners	Business unit spin-off; $500M share buyback
Charming Shoppes Inc.	Retail	Crescendo Partners, Myca Partners	3 board seats; explore sale; buyback shares
CNET Networks, Inc.	Internet Media	Jana Partners, Sandell Asset Management	7 board seats
CSX Corp	Railroads	The Children's Investment Fund	5 board seats
Dillard's Inc.	Retail	Barington Capital, Clinton Group	Remove dual class voting structure; terminate poison pill
Enpro Industries Inc.	Industrial	Steel Partners	Explore sale; share buyback
Gencorp Inc.	Industrial/ Real Estate	Steel Partners	6 board seats
Motorola Inc.	Communication Equipment	Carl Icahn	4 board seats
New York Times Company	Media	Harbinger Capital, Firebrand Partners	4 board seats
Phoenix Companies	Insurance	Oliver Press Partners	3 board seats; explore sale
Rowan Companies	Oil & Gas Drilling	Steel Partners	3 board seats; explore business unit spin-off
Target Corp.	Retail	Pershing Square Capital	Sell real estate; sell credit card unit
Unisys Corp	Information Technology	MMI Investments	Explore a business unit spin-off
Wendy's International	Restaurant	Trian Fund	8 board seats; business sale

Source: Hedge Fund Solutions' Catalyst Equity Research Report

So, in an attempt to secure adequate ownership without tipping their hand, savvy activist investors have begun using "cash-settled derivative transactions" also known as "swap agreements" in order to accumulate shares without having to disclose the ownership with the SEC.

This is how it works: An activist investor enters into a multifaceted swap arrangement with at least one investment bank whereby the bank buys shares on behalf of the investor, but never actually transfers the full ownership to them. Under the terms of the agreement, the activist agrees to repurchase the shares from the bank at a predetermined time and price, at which point the ownership will have to be disclosed to the SEC.

The big question is who controls the votes attached to the shares that are part of the derivative transaction? In theory, since the activist does not own the shares, they technically don't own the voting rights. However, by establishing a timeframe in the swap agreement to repurchase the shares before the election of directors, the activist can confidently own the votes when it matters most.

One recent example illustrating this phenomenon is with CNET Networks in early January. Two well-known activist investors - Jana Partners and Sandell Asset Management - began purchasing a small portion of the company's equity while simultaneously entering into a variety of swap arrangements with investment banks. Apparently, before anyone realized the serious nature of the activists' intentions, they had accumulated more than 20% of CNET's stock, filed as an investment group with the SEC and declared their intention to obtain control of the board at the upcoming annual meeting. The company countered by installing a poison pill defense mechanism hoping to stop the accumulation of shares by these unwelcome shareholders. But by that time it was too late - the activists had finished accumulating the number of shares they felt were necessary to promote their desired changes.

This example also highlights the tag-team approach to activist investing that has become much more popular over the past year. More than ever, activists are teaming up with wealthy individuals (who often own a large percentage of a company's stock), private equity groups, and other activist investors for the purpose of making buyout offers or instigating value improvement initiatives. A few recent examples include Harbinger Capital and Firebrand Capital at The New York Times; Crescendo Partners and Myca Partners at Charming Shoppes; Steel Partners and Newcastle Partners at Fox & Hound Restaurant Group (and the subsequent follow-on acquisition of Champps Americana), and Barington Capital and Clinton Group at Dillard's Inc.

In the last case, the two activist investors sent a joint letter to Dillard's board of directors demanding cost improvements, management evaluations, changes to compensation arrangements, and radical changes to corporate governance, including (i) the elimination of the company's dual class share structure, (ii) the separation of the Chairman and CEO positions, (iii) the termination of the poison pill, and (iv) an amendment of the company's voting procedures to change from plurality voting to a majority voting standard.

Changing Rules Favoring Activists

Activist investors are masters of the proxy contest and rarely launch campaigns they cannot win. Consequently, one of the most important components of being a successful activist is their overall command of how the shareholder voting process works. In fact, some say having a clear understanding of how shareholders will likely cast their vote - if a proxy contest goes the distance - is the only thing that really matters. If calculated accurately, vote projections can create a sense of security early on for insurgents embarking on a costly crusade to remove directors, and later on, provide increased leverage during negotiations closer to election day.

Many factors can influence the shareholder vote projection, including: (i) the ownership interest of like-minded investors (i.e., tag-along investors who often follow activists into an investment); (ii) the makeup of a company's institutional shareholder base; (iii) the extent to which these institutional investors will be influenced by third-party proxy advisory services (such as RiskMetrics/ISS or Glass Lewis); and (iv) the retail investor base and the associated broker discretionary vote.

During 2008, the New York Stock Exchange is expected to eliminate the broker discretionary vote for the election of directors. If this occurs, the net effect will shift additional power to activists in director elections, particularly at the more than 44% of the S&P 500 companies who have adopted a majority vote election standard.

Until recently, directors of most public companies were elected by a plurality of the votes cast in the election of directors. In plurality voting, the nominees for available directorships who receive the highest number of affirmative votes cast are elected irrespective of how small the number of affirmative votes is in comparison to the total number of shares voted (i.e., all affirmative votes and withheld votes). Under the plurality voting system, a nominee could be elected as a director with one affirmative vote and several million withheld votes. In companies that have adopted the majority vote requirement for directors, nominees are typically required to receive the affirmative vote of at least 50% of the votes cast in order to remain in office for another term.

Hence the importance of the possible amendment of NYSE Rule 452 on discretionary voting in director elections. Currently, if a retail shareholder (often considered an individual investor) fails to vote their shares in director elections at New York Stock Exchange-listed companies, brokers holding those shares (called broker non-votes) are generally empowered to vote them at their discretion because director elections are considered “routine matters” under Rule 452 today. Brokers typically vote these shares in-line with management’s recommendations, including for incumbent directors.

A few years ago, this rule change would have little effect since nearly all companies had a plurality voting system. But today, many companies have adopted a majority voting standard, with the trend still continuing at a rapid pace under pressure from shareholders. The combination of Rule 452 being changed so that director elections are no longer a “routine matter” and the use of a majority vote standard will give disgruntled investors a much better chance at launching successful “just vote no” campaigns to remove incumbent directors.

Special Purpose Acquisition Vehicles (SPACs)

Blank check companies, better known as SPACs – Special Purpose Acquisition Vehicles, are quickly becoming the new darling of the activist investor. SPACs are newly formed companies that raise equity capital through an initial public offering for the sole purpose of pursuing a business combination in a dedicated industry or geographic location. And although the purpose for raising a SPAC is quite different from the goals associated with investing in them, a number of activist investors are exploring the value of doing both.

Within the past few months, two of the world’s pioneers in activist investing – Warren Lichtenstein (Steel Partners) and Nelson Peltz (Trian Fund) - have launched two new acquisition vehicles with a combined value in excess of $1 billion. Lichtenstein’s SP Acquisition Holdings (Ticker: DSP) went public in November 2007 with $400 million in capital and is currently trading close to $500 million in market capitalization, while

Peltz's Trian Acquisition I Corp (Ticker: TUX) launched in January 2008 with $750 million in cash is now trading north of $900 million in value.

The prospectuses for both companies indicate these activists will target businesses that are fundamentally sound but in need of certain financial, operational, strategic or managerial redirection to maximize value. And both groups have 24 months to acquire a single business using at least 80% of their cash.

At the same time, other well-known activist investors have raised dedicated funds to invest into these new acquisition vehicles. For example, Phil Goldstein, the founder of Bulldog Investors who famously - and successfully - sued the SEC over hedge fund registration requirements, recently launched the Absolute Plus Fund. The objective of the fund is to allocate capital into a SPAC where the money is locked-up in a Trust accumulating interest until a deal is approved by more than 80% of the shareholders.

For activist investors like Goldstein purchasing a 20% stake in one of these SPACs is a win-win situation. If the activist doesn't like the proposed acquisition, they can block it and walk away with most of their initial investment plus the accrued interest on the cash while it was sitting in the bank. On the flip side, if the acquisition plan is satisfactory to the activist, the upside potential can be phenomenal.

A New Era

In 2007, CEOs and board members at more than 500 US companies learned about activist hedge funds first-hand when signal flares shot off in IR departments following a routine review of the company's shareholder base. Some of those CEOs took the warning seriously and began to act accordingly, while others dismissed it as inconsequential. Now, barely into 2008, more than eighty companies have felt the pressure of an activist's campaign and many more will be pressed for changes to the status quo before the year is out.

Just a few years ago, the reinvention of the hedge fund manager into an activist investor marked a new era for investing. And now, activist investors are everywhere! From the US to Europe, throughout Asia and into South America and Australia, activist investors continue to grow at significant rates with no slowdown in sight. Who knows what the future holds for these insurgents and the companies they target? But one thing is for certain – activist hedge funds aren't going away anytime soon.

About the Author

Mr. Park is the President and CEO of Hedge Fund Solutions, a Philadelphia-based consulting firm singly focused on providing substantive solutions for companies and investors on issues relating to shareholder activism. He is widely considered an expert on activist hedge funds, speaks at numerous seminars and events, and is often quoted in leading business publications around the world.

In addition, Mr. Park's firm issues a weekly research report called the *Catalyst Equity Research Report*, which highlights US-based companies under threat of attack from activist hedge funds. Individuals interested in obtaining a free copy of the report can do so at the company's website www.hedgerelations.com.

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