Runners and Raiders

Companies are Under Attack Again, This Time from Activist Hedge Funds that Want to Enrich Shareholders, Not Chief Executives

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Gordon Gekko is back. But this time he's running a hedge fund. Nearly 20 years after Michael Douglas personified the corporate raider in Wall Street, companies around the world are again under attack from a new breed of assailant known, disarmingly, as activist hedge funds. They should be afraid, very afraid.

That at least is the warning from some leading US business advisers. They predict that the assaults by activist hedge funds will drive some companies to take actions that would be against long-term shareholders' interests. The more apocalyptic suggest they could undermine the very competitiveness of the US economy.

Nonsense, say others. The hedge funds are only doing what good investors should - encouraging managements to act in shareholders' interests. Good companies with good managements pursuing good strategies have nothing to be afraid of.

One striking feature of the new wave of assaults, according to the critics, is how similar the plots are to the last wave. In some cases, even the actors are the same. The most audacious sally so far has been the attempt to win control of the Time Warner board by an investor group led by Carl Icahn. Icahn, 70, made his name taking control of TWA with a hostile bid for the airline in 1985 and is said to be one of the models for Gekko. (Gekko's sneering quip "If you need a friend, get a dog" is one of Icahn's favourite gags.)

Some of the critics are also the same, notably Marty Lipton, a leading US corporate lawyer. Lipton made his name defending companies from raiders such as Icahn and invented the "poison pill" to help them do so. Lipton says there has been a huge increase in investor activism from hedge funds seeking corporate change of one kind or another. "For every situation that goes public, there are probably 10 that don't. There is an avalanche of letter writing by activist investors requesting companies to change strategy, to change management, to spin off a division or put the company up for sale."

In addition to Time Warner, other recent targets have included McDonald's, Heinz, Tyco and The New York Times. No company appears too big. Nor is the phenomenon restricted to the US. The latest company to find itself in Icahn's sights is KT&G, South Korea's largest tobacco and ginseng group. After taking a stake in the company, an investor group headed by Icahn tried to persuade the former state monopoly to spin off its ginseng arm, sell real-estate assets and install three Americans on the board. When KT&G failed to respond, Icahn showed his teeth by making an indicative Dollars 10bn

offer for the company, and in March its shareholders voted to put a member of Icahn's group on the board.

KT&G is unusual for an Asian company in that 60 per cent of its shareholders are foreign. Most large companies in the region are controlled by government or families and can shrug off activist shareholders. But in Europe there has been a significant increase in the proportion of public company shares held by foreign investors. This makes them much more vulnerable to moves by activists - or more responsive, depending on your point of view.

The most dramatic example was last year's rebellion of shareholders in Deutsche Borse, who blocked its proposed acquisition of the London Stock Exchange and ousted its chairman and chief executive. The UK and US-based hedge funds behind the revolt were famously dubbed "locusts" by Franz Muntefering, now Germany's deputy chancellor. There has since been a wave of similar cases including the current fight over the future of VNU, the Dutch publisher.

Paul Frentrop of Deminor, a European shareholder rights group, says many European companies are particularly attractive targets because they tend to be smaller than their US counterparts, making it easier for funds to build up big stakes. He estimates that half of the large non-financial companies in the Netherlands are under shareholder pressure of some sort. "Everyone is under siege."

So why is the new outbreak happening now? On one side of the equation, a huge amount of money has flowed into hedge funds which, finding returns more difficult to generate in traditional strategies, have turned their attention to activism. On the other side, there are good profits to be made from activism because, as in the 1980s, many companies are undervalued by the market, partly because they are not managing their assets as efficiently as they could.

In an analysis of 31 companies targeted by activist investors, Citigroup's financial strategy group found that their stocks delivered returns 8 per cent above the market in the weeks following the public announcement of the campaign.

Michael Klein, head of global banking at Citigroup, says corporate profits have been buoyant since the stock market bubble burst in 2000 but cautious managements have not spent aggressively and many are now sitting on excess cash. "Some chief executives may find the regulatory climate restraining and, with reduced use of employee share options, may be less incentivised to create long-term shareholder value."

One of the common features of many activist campaigns is pressure to return cash to investors, partly for fear that it will be spent on big acquisitions that may do more for a chief executive's imperial ambitions - and pay - than for shareholders. Barry Rosenstein, who runs San Francisco-based hedge fund Jana Partners, says: "Often managements own very little stock and have a strong interest in making a company bigger."

Nobody denies that there are companies that could release value to shareholders by handing back cash or selling off operations. But, Klein says: "Some activists are actually mimicking the ways of the old corporate raiders, forcing short-term return of capital without creating long-term value."

Other critics argue that the plans put forward by some activist hedge funds could leave their targets with too much debt when the credit cycle turns. But Rosenstein argues that the distinction between short-term and long-term shareholders is illusory. "Activists generally seek to cause the stock price to reflect a company's true value, which is in the best interest of supposed 'short-term' and 'long-term' investors alike."

He also points out that hedge funds are often long-term shareholders. Last year Rosenstein teamed up with Icahn to press the management of Kerr-McGee, a US oil and gas company, to make disposals and use the proceeds to buy back shares. Although the shares have since doubled, Jana retains its stake because it expects further growth from a revitalised company, says Rosenstein.

For companies worried about the new activism there is no shortage of advice. In a report entitled "Hedge funds at the gate", Citigroup found that activist hedge funds tended to "attack" quickly and usually after modest declines in performance. It recommends that companies be proactive in response to the potential threat. "A well-thought-out offence may be the best defence," which sometimes means pre-empting the activists' proposals.

Funds that seek to put the company up for sale are more difficult to fend off. "In these cases, developing a strong defensive posture is the appropriate strategy to ensure a company is not pressured into a sale that may not be in the best long-term interest of its shareholders," says the report. All advisers say it is vital for companies regularly to monitor changes in hedge fund and institutional investors holdings. However, this is more difficult in some countries with less stringent disclosure requirements.

Frentrop says the generally weaker rules in European countries, including the ability of an activist investor to count holdings split between different funds separately, allow large stakes to be built up secretly. The German government recently announced plans to tighten its rules to require investors to report stakes as soon as they exceed 3 per cent of voting rights, down from the existing 5 per cent.

In the US, the Securities and Exchange Commission is under pressure to ensure that its existing rules are enforced, including those on funds "acting in concert". Some observers believe that the scale of the new activism should not be overstated and that Icahn's limited success in his Time Warner campaign was significant. "Success always breeds imitators but we have yet to see a broad pattern of activist success," says Klein of Citigroup.

At the same time, there are signs that investors who have not historically taken activist positions are starting to adopt the tactics used by activist hedge funds. The investment management arm of Morgan Stanley, the Wall Street bank, recently launched a public

campaign to end the two-tier share structure of The New York Times Company, which gives the Sulzberger family control of the influential media group.

This was the first time that Morgan Stanley's investment arm had ever taken such a public position, and Rosenstein believes it reflects the lessening stigma associated with activism. "As a result, in instances where managers' or boards' actions are egregious you have seen shareholders who historically have never been public in opposition to a board not hesitating to press their views."

For Lipton, the lessening stigma is partly a consequence of the efforts by some academics and unions to shift the nature of US companies from a "director-centric management system" to a "shareholder-centric" one. This movement, best illustrated by the work of Professor Lucian Bebchuk at Harvard, threatens to replace the "imperial chief executive" with the "imperial shareholder", says Lipton. Combined with the reaction to the wave of corporate scandals at the end of the stock market boom and media coverage of soaring executive pay, their efforts "provide wonderful cover" for activist shareholders. Lipton fears it could ultimately lead to US companies becoming more like UK companies in terms of the active role of shareholders. This, in his view, would be "a disaster" for US companies and "for the economy as a whole".

Many UK chief executives would disagree, even in private, though few would go as far Gordon Gekko did 20 years ago. Proclaiming investor greed to be good, he declared that the efforts of raiders would help not only badly managed companies but also "that other malfunctioning corporation called the USA".