Activist investors impeding energy development

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Natural resource development is expensive. New projects in oil, gas and mining all require significant capital investments and companies need to wait five to 10 years before realizing a return.

So Apache Corp.'s recent announcement that it was pulling out of the proposed Kitimat liquefied natural gas project and selling its 50 per cent interest in a soon-to-be-completed Australian liquefied natural gas plant, solely because of pressure from an activist investor, raises questions on the negative impact "value investing" could have on Canada's resource development.

Apache joins companies such as Agrium, CP Rail and Dow Chemical as companies that have been impacted by activist investors. JANA Partners, the activist investor in Apache's case, is a "value-oriented investment adviser specializing in event-driven investing." Through its purchase of $1 billion worth of stock, and getting other large shareholders on side, it convinced management to divest long-term future-paying assets to free up cash that will be used to buy back shares and pay shareholders a dividend.

The problem with this strategy, for Apache shareholders, is the Wheatstone liquefied natural gas project in Australia is nearly complete. Apache and its partner companies have already taken the construction risk. A company purchasing the project will not have this risk, but will gain the advantage of the billion dollars in free cash flow once it starts operating in 2016. As for Kitimat, it is being sold to focus on U.S. shale gas, an overhyped market that has more supply then demand, at a time when global liquefied natural gas demand is estimated to double by 2030, led by Asian demand not U.S. growth.

Many shareholders have the view that activist investors are a panacea to unlock hidden value. In fact, a recent paper by Lucian Bebchuk, Alon Brav and Wei Jiang showed that stocks rose nearly six per cent after activist investors got involved and that the gains were not temporary.

Unfortunately, the study only went to 2007. Since then, a new breed of activist investors, led by companies such as JANA and Pershing Square Capital Management, have come to the forefront. These companies no longer have the low-hanging fruit of poorly managed companies to pick and are targeting large asset-heavy companies, but their record is less success than their predecessors.

CP Rail is often touted as a success story for activist investors. Looking solely at earnings, it would be hard to argue against this point. Company profits rose 28 per cent after Pershing Square gained control. It claims this was done through narrowing the efficiency gap between CP and its rivals — basically faster average train speeds, nine per cent longer trains, and reducing the workforce by nearly 30 per cent.

In reality, the gains came from selling real estate assets, differing capital expenditures, but mostly from increased oil transportation that grew from virtually nothing to 200,000 barrels per

day in 2013, and which is expected to rise to 700,000 barrels per day by 2016. Even without the changes made by Pershing Square, CP still would have increased profits simply by the inertia of previous management decisions.

Companies that have not heeded short-term activism of value investors have also not failed, as many think. Dow Chemical was targeted by Third Point investors who pushed for a separation of its commodity petrochemical and specialty chemical businesses. Dow rejected Third Point's breakup proposal and has begun implementing modest divestitures that will allow it to improve its economic metrics at the same time as it maintains a long-term strategy. The share price is up 20 per cent this year and more than 50 per cent from a year ago.

Another example is Agrium, which successfully defeated a boardroom challenge from JANA in 2013. JANA wanted to split Agrium's fertilizer production operations from its farm products retail unit — a short-term strategy that would have adversely impacted future efficiencies. Agrium convinced shareholders its long-term strategy was the best way forward and the share price is currently up nearly 20 per cent from its 52 week low.

In the world of activist investors, "cash is king," but in the real world, cash reigns equally with "long-term sustainability."

Canadians should look at the example of Apache to see what can happen when short-term objectives trump long-term strategy and realize the dangers companies seeking a quick buck can make to our resource industry.