# Optimistic activists

*The Deal Newsweekly*
By Ron Orol
October 31, 2008

With the global economy declining, struggling corporations had been hoping that a diminished M&A marketplace would provide them some relief from the wrath of activist hedge fund managers.

That hasn't happened. Although activists themselves are coping with diminished returns, they haven't gone away. They're merely adjusting their strategies to the new market realities.

Pressing companies to buy back stock, provide special dividends or screaming for higher deal premiums are all off the table -- at least until markets recover. Instead, established insurgents who agitate for share improvement are employing a long-term governance and operational approach that involves finding highly qualified director candidates. Meanwhile, corporate and distressed activists as well as hybrid buyout shop activists are also on the rise as the companies become cheaper.

"Institutions are telling me that they know that it would be foolish and irresponsible right now to take a company's war chest of cash and give a significant chunk of it to one investor," says Damien Park, president of Hedge Fund Solutions LLC, a Philadelphia-based consulting firm. "But there are major economic shifts taking place that are all creating opportunities for activists, particularly the long-term operational activist."

Companies with weak management are attracting activists seeking to change boards and executives, focusing on profit and loss statements rather than cash on the balance sheets that can be handed to investors. Bulldog Investors' Phillip Goldstein expects that trend to continue in the coming months, as CEOs are no longer able to hide behind improving share prices. "One group has so far escaped unscathed -- boards of directors, the very people responsible for these financial problems," says Goldstein. "There is too much collegiality on boards, not enough skepticism."

Hedge Fund Solutions estimates that one in 10 companies in the U.S. are trading below their cash/share value. There are similar valuations in Europe and Japan, where activism is on the rise. In the U.S., Park counts 50 campaigns in October, 57 in September and 54 in August.

Still, fund managers must weigh whether they have the means to pursue these opportunities, particularly when their passive holdings may be losing value and limited partners are pulling out. "As long as you can stay in, you will come out on the other side," says one activist manager. "But if you get forced to sell at the bottom, it's a killer."

Most established activists typically have two- or three-year lockup periods. As a result, they are more likely to have the capital on hand to continue pursuing opportunities. Institutional investors are less likely to lead an activist campaign, as OppenheimerFunds Inc. did at Take-Two Interactive Software Inc., or back an activist seeking to drain the company of cash. But

institutional investors are becoming more supportive of insurgents looking for long-term governance improvements. Corporate and public pension funds, once backing up insurgents seeking cash distributions, are now less likely to take such a stance. "I'm getting calls from corporate investor relations officials and CEOs saying, 'We feel less pressure from the activists because we don't think they'll get institutional support for their financial engineering activism,' " Park says.

Robert Rosen, managing partner at RLR Capital Partners LP, says his approach for forcing change during a market downturn is to make collaborative private suggestions to management rather than agitate aggressively for change. "We are now suggestivists, not activists," Rosen says. "There are lots of opportunities, but you have to be careful about the time frame you need for the value improvement you expect to see. This is a great time to build a portfolio of companies for future activism."

Operational activists, such as Trian Fund Management LP's Nelson Peltz, try to improve a firm's corporate governance and enhance profitability. They gain the trust of institutional investors through their background as operators. Their long-term approach to companies is expected to withstand the downturn. Others may not fare so well. "Unless they have a track record, [activist investors] aren't going to succeed at this approach," says David Katz, partner at Wachtell, Lipton, Rosen & Katz in New York. "The larger funds won't be affected -- Harbinger, [Carl] Icahn -- but some of the marginal players will disappear. There will be a shakeout."

Also, expect more highly skilled director candidates. Dissident investors with strong reputations are able to attract candidates with the experience needed to gain the approval of skeptical institutional investors. "We are seeing well-qualified board nominees," Park says. "No more 28-year-old analysts."

The Children's Investment Fund Management (UK) LLP got four directors on the board of embattled railroad company CSX Corp., in part due to their thick resumés. One nominee, Tim O'Toole, manages the London Underground Ltd., while another nominee, Gil Lamphere, has been on the board of many public companies including three railroads. Carl Icahn named strong candidates to Yahoo! Inc.'s board, including Harvard Law School professor Lucian Bebchuk and investor Mark Cuban. Jana Partners LLC's industry-expert candidates helped facilitate a $1.8 billion sale of Cnet Networks Inc. to CBS Corp. in May.

Deal-related activism is also on the decline. According to RiskMetrics Group Inc., not only are there fewer deals, but there are fewer activists pressing for a better price when transactions do happen. There are exceptions. Pershing Square Capital Management LP's William Ackman stands to receive a return in excess of 30% for a short-term holding in Longs Drug Stores Corp., a company that, partly due to his activism, agreed to be purchased by CVS Caremark Corp. for $2.9 billion. Ackman says he doesn't plan to tender his Longs shares because he thinks the bid undervalues the company's real estate. Meanwhile, Walgreen Co. offered and later withdrew a $75 per share offer for the company. Ackman also is returning his attention to Target Corp., where he has a 10% stake through a vehicle set up specifically for his campaign to force the retailer to sell its real estate.

Harbinger Capital Partners doesn't plan to take over Leap Wireless International Inc., but it turned its passive 14.8% stake in the $1.8 billion telecom into an activist stake on Oct. 14. According to a Securities and Exchange Commission filing, Harbinger expects to engage in discussions with Leap on "near-term and long-term" ideas about management and operations. Analysts have long expected Leap to merge with MetroPCS Communications Inc., which bid for it last year, but the prospects for a near-term deal have dimmed.

Corporate activism is on the rise, too. Companies such as InBev SA and Microsoft Corp. are using the activist toolbox to get things done. InBev launched an expedited proxy contest using a written consent solicitation to push Anheuser-Busch Cos. to the negotiating table. Bud eventually accepted a $60 billion offer from InBev. Before Icahn and other insurgents got involved, Microsoft in April threatened a proxy contest to seize control of the board of Yahoo! as part of its takeover attempt.

Many activist investors are turning to their distressed investing funds to buy fallen corporate debt. "The distressed market had been quiet for a long time due to the ability of corporations to refinance maturing or defaulting debt," says Evan Flaschen, partner at Bracewell & Giuliani LLP. "But with the refinance market now shut down until further notice, there is more stressed and distressed debt out there for activists to buy at a discount." He cites homebuilding and related companies such as WCI Communities Inc., Hovnanian Enterprises Inc. and Masonite Holdings Inc. as targets for distressed activists who perceive longer-term value in a depressed industry. Debt securities of financial institutions, such as Washington Mutual Inc., are also in play.

Some other strategies are on the decline and may disappear forever. Many activists have until recently been using opaque, cash-settled equity swaps to pull the strings of target corporations in the shadows. Activist funds have used the strategy to enter into contracts with bank derivatives dealers to hike their economic position in companies but at the same time remain below the regulatory radar until the time comes for taking an insurgency campaign public.

TCI took the derivatives route in its CSX campaign. Investment bank derivatives dealers, who have been either unwitting or knowing partners to activists' use of swaps, are rewriting internal guidelines making clear that the shares they buy to offset swap deals with activist fund managers are not being voted for the purpose of supporting the insurgent's proxy contest, says Frank Zarb Jr., partner at Katten Muchin Rosenman LLP in Washington.

The SEC may draft new rules requiring activists to consider synthetic shares obtained through swaps as equivalent to equity for the purpose of the agency's Schedule 13D 5% disclosure rule. That would end the use of swaps in activism.

Blackstone Group LP chief executive Stephen Schwarzman said in an Oct. 28 speech that "this kind of environment is tailor-made for making absolute fortunes in the private equity business." But Clifford Press, managing partner at Oliver Press Partners LLC in New York, says activists with capital could be better positioned to take advantage of the economic downturn because they can build large minority positions while valuations are low and realize gains when the market strengthens. On the other hand, private equity shops need to complete the buyout to get involved,

a much higher hurdle and one that requires debt financing, a difficulty right now. "Activists don't have to go over the threshold of the buyout to make their returns, so this kind of situation is better suited for the activist," Press says.