

Unlocking value: the role of activist alternative investment managers



Simmons & Simmons



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1 Executive Summary

Since the late 1990s, a new actor has entered the corporate governance landscape. Activist managers of alternative investment funds - including hedge funds, focus funds and certain other investment vehicles - have proven adept at effecting change in even the largest corporations while generating exceptional returns for fund investors. Between 2009 and 2014, activist hedge funds grew their assets under management 269% to almost \$120 billion, according to Hedge Fund Research (HFR, 2014). Citi estimates that returns to activist hedge funds globally (net of fees) increased a cumulative annual rate of 19.4% over the five years to 31 December 2013, delivering performance significantly superior to the wider alternative investment industry (Khorana et al, 2014).

The rise of shareholder activism among hedge funds and other alternative investors is timely. In the wake of the recent financial crisis, policy makers are stepping up efforts to promote improved engagement by shareholders with the companies in which they invest. Those efforts recognise a role for shareholders in shaping the long-term success of companies in a way that benefits the economy as a whole, as well as investors themselves.

In the United Kingdom, the Financial Reporting Council (FRC) introduced the voluntary Stewardship Code in July 2010 (revised September 2012), which “aims to enhance the quality of engagement between asset managers and companies to help improve long-term risk-adjusted returns to shareholders” (FRC, 2014). In April 2014, the European Commission (EC) issued a proposal to amend the European Union Shareholder Rights Directive (2007/35/EC) to include legally binding provisions aimed at encouraging long-term shareholder engagement (EC, 2014). In the United States, the Dodd-Frank Wall Street Reform and Consumer Protection Act (12 USC § 5301 et seq), passed in 2010, introduced a range of corporate governance measures, including expanded rights for shareholders to nominate company directors and a requirement for companies to have a non-binding ‘say-on-pay’ vote on executive compensation. Comparable measures have been implemented in other jurisdictions.¹

Activist alternative investment managers offer a distinct model of shareholder engagement. They typically hold a concentrated and long-biased portfolio made up of meaningful minority stakes in portfolio companies. While invested, they may adopt a variety of engagement tactics, ranging from private communications with management to taking the company or its directors to court. The aim is to achieve profitable changes to the strategic direction, capital structure and/or governance of portfolio companies. Whereas ‘traditional’ institutional investors (such as pension funds and mutual funds) that adopt an activist stance tend to do so in response to perceived underperformance of a portfolio company, alternative investors typically make investments with an activist strategy already in mind.

Simmons & Simmons and the Alternative Investment Management Association (AIMA) undertook this joint research to assess the development and current state of shareholder activism by alternative investors, investigate the impact of such activism and identify

¹ For example, a voluntary Stewardship Code was introduced in Japan in February 2014 “to promote sustainable growth of companies through investment and dialogue” (Financial Services Agency, 2014).

certain trends and implications for future developments.² We analysed a unique dataset compiled with assistance from Activist Insight, reviewed the empirical research to date, and consulted both activist and passive investment managers.

Among the key findings of this research are:

- ▶ ***Alternative investors generally make proficient activists:*** By comparison with traditional institutional investors, activist alternative investors are generally more willing to engage in activist strategies, more successful in achieving changes in the management of portfolio companies and more frequently able to drive profitable improvements in those companies.
- ▶ ***Activism by alternative investors appears to produce long-term improvements in portfolio companies, on average:*** The empirical evidence to date indicates that, on average, activist engagement by alternative investors is correlated to improvements in the share price, operating performance and productivity of targeted companies for several years following the engagement, including after the fund exits.
- ▶ ***Alternative investment activism leads to greater alignment of interests:*** Activist alternative investors seek higher standards of corporate governance, which improves alignment of interest between management, shareholders and all other stakeholders and ultimately leads to improvements in the efficient allocation of capital and resources in the economy overall.
- ▶ ***Activist alternative investment managers are relatively longer-term investors and are frequently structured as to provide 'patient capital':*** Alternative investment funds hold activist investments for longer periods than is common in purely trading-oriented strategies - holding periods average 1.8 years for investments, while specialist activist funds have investment horizons averaging almost two years. The average market-wide holding period of stocks is around three months. As a consequence of the relatively long investment horizons, activist funds often employ structural characteristics designed to retain capital for the duration of activist campaigns.
- ▶ ***Alternative investor activism is having a collateral impact on companies not yet targeted by an activist:*** The increased likelihood of engagement by an activist alternative investor is leading company managers and boards to make pro-active changes to corporate policy that, in general, appear to increase shareholder value and longer-term profitability of yet-to-be-targeted firms.
- ▶ ***Activist alternative investment managers are influencing institutional shareholders:*** Large institutional shareholders are becoming increasingly supportive of activist alternative investors: by investing ever greater sums in activist funds; by supporting activist proposals and, in some cases, by joining forces with activists.

² AIMA and Simmons & Simmons would like to acknowledge and thank the author of this research, Jon Malik.



Many are also borrowing from alternative investor activism to adapt their own investment strategies.

- ▶ ***Activist alternative investment managers make use of a variety of tactics but are mostly collaborative in approach:*** While high-profile proxy contests, lawsuits and other public activist tactics tend to generate headlines, most activism by alternative investors takes the form of behind-the-scenes interventions and other “soft” strategies, such as seeking board representation with management support. Collaborative engagement also appears more likely to achieve success than more assertive approaches, particularly outside the United States.
- ▶ ***Activism by alternative investors is evolving:*** As alternative investor activism matures, it is evolving in scope and strategic approach. For instance, alternative investors have become more likely in recent years to take activist positions in large or well-performing companies, and are becoming increasingly global in focus.

2 What is Alternative Investor Activism?

2.1 Alternative Investor Activism Defined

Literature on *shareholder activism* dating from the early 1980s has offered a number of definitions of the term.³ Among the more thoughtful was suggested by Gillan and Starks (1998, pp. 11-12), who call a shareholder activist “an investor who tries to change the status quo through ‘voice,’ *without* a change of control of the firm.” They were referring to the second of three primary options available to dissatisfied shareholders identified by Hirschman (1971): simply sell their shares, hold their shares and voice their dissatisfaction, or hold their shares and do nothing. Hirschman called these three activities: “exit,” “voice” and “loyalty.” However, Gillan and Starks also distinguish shareholder activism from a change of control, an option theoretically available to existing shareholders as well as to outsiders and management insiders. They situate shareholder activism on a continuum of vocal responses to corporate performance, between the market for corporate control at one extreme, and “active” shareholders simply trading in and voting their shares at the other.

The terms “*alternative investors*,” “*alternative investment funds*” and the like describe a loosely defined and heterogeneous class of investor types. Although the distinction between “traditional” and “alternative” investors is not always entirely clear, the latter is often considered to include the universe of investment strategies and vehicles that remain after deducting the former. For example, Bookstaber (2003, p. 19), who is cited in *AIMA’s Roadmap to Hedge Funds* (Ineichen, 2012, p. 12), approaches the analytical distinction between traditional and alternative investors this way:

The hedge funds/alternative investments moniker is a description of what an investment fund is *not* rather than what it is. The universe of alternative investments is just that—the universe. It encompasses all possible investment vehicles and all possible investment strategies minus the “traditional” investment funds and vehicles.

A similar approach is, to varying degrees, taken in the regulatory frameworks of several jurisdictions.⁴ In practical terms, alternative institutional investors are often understood to include hedge funds, private equity funds, exchange-traded funds and sovereign wealth funds, as well as other, even less clearly defined, investment vehicle and strategy types (see, e.g., Çelik and Isaksson, 2013, p. 96).

The alternative investors that have proven most likely to engage in shareholder activism are hedge funds and certain other investor types. Indeed, much of the research and public debate on shareholder activism by alternative investors has focused on “hedge funds,” another term for which there is no global definition.⁵ We prefer the broader class of “alternative investors” for two main reasons. First, the approach to shareholder activism

³ For surveys of this literature, see Gillan and Starks (2000; 2007) and Karpoff (2001).

⁴ For instance, the European Union Alternative Investment Fund Managers Directive (2011/61/EU, Art. 1(a)) defines “alternative investment funds” by exclusion of funds requiring authorisation pursuant to the EU’s UCITS Directive (2009/65/EC). The UCITS Directive covers “traditional” institutional investors, such as pension funds and mutual funds, although a number of alternative investors also now organise themselves as UCITS funds (see, e.g., Prequin, 2013b).

⁵ Ineichen (2012, p. 13) adopts the following working definition of a “hedge fund” in *AIMA’s Roadmap to Hedge Funds*: “A hedge fund constitutes an investment program whereby the managers or partners seek absolute returns by exploiting investment opportunities while protecting principal from potential financial loss.”

common to activist hedge fund managers is also adopted by certain other alternative investors, including some private equity firms and individual investors. And second, some activists that are frequently described as hedge funds disagree entirely with the classification as they never short the stock of their portfolio companies or otherwise “hedge” their activist investments. Recognising the difficulties of a narrow view to alternative investor activism, Becht et al (2010) refer to the distinctive style of activism common to certain hedge funds, “focus funds” (generally, funds that hold relatively concentrated portfolios) and other alternative investors as “New Activism” (see also, Becht et al, 2014; Franks, 2014).

2.2 Activism by “Traditional” and “Alternative” Investors

Mutual funds and institutional investors including pension funds have utilised activist approaches in the United States since the mid-1980s (Gillan and Starks, 1998; 2007). Their size and professionalism gave force to the practice of shareholder activism that had up until then been largely confined to a small number of individual “gadfly” investors, who being “too few (and too new)” experienced limited success (Eisenhofer and Barry, 2013, p. 3-1). Large institutional investors in Europe and other regions of the world also turned increasingly activist from the late 1980s, though generally less frequently and energetically than their United States counterparts (Arnold and Breen, 1997; Gillan and Starks, 2003).

Despite these developments, most “traditional” institutional investors remain overwhelmingly passive, and a number of studies have shown that when such investors do pursue an activist agenda, they usually do not achieve substantial benefits for shareholders.⁶ By contrast, activist alternative investors are generally both more readily activist and - despite the economies of scale available to large institutional investors - more effective as activists. Hedge funds and other alternative investors enjoy regulatory, structural and organisational advantages that appear to make them better suited to activism than pension funds and mutual funds. Those advantages in turn lead to decisive differences in strategic approach.

The regulation of alternative investment funds has generally been designed with different objectives and priorities than the regulation of traditional institutional investors. Alternative investment funds, which are primarily distributed to sophisticated institutional investors, are not restricted by regulation that is designed and targeted primarily to protect retail investors.⁷ As such, activist alternative investors (among other things): (i) are not required to diversify their investments and typically hold highly concentrated holdings in a small number of companies, enabling them to acquire substantial voting leverage in, intensively monitor, and effectively engage with the management of portfolio companies; (ii) can use leverage and derivatives to extend the reach of their holdings; (iii) are able to “lock up” investor capital for a number of years, and employ other structural

⁶ Gillan and Starks (2007) and Klein and Zur (2009) provide surveys of this research.

⁷ Illig (2007) and Kahan and Rock (2007) discuss in detail the regulatory context of shareholder activism by mutual funds, pension funds and hedge funds in the United States. The Organisation for Economic Co-operation and Development (OECD) (2011), p. 33 summarises relevant legal frameworks, professional codes and disclosure requirements in 26 OECD member countries.

liquidity management techniques in order to execute often lengthy activist strategies; and (iv) highly-incentivise fund managers to pursue absolute returns.

As for incentives, almost all mutual funds and pension funds charge fees based primarily on a flat percentage of the fund's assets under management (AUM), due in part to regulatory constraints (Kahan and Rock, 2007).⁸ Such compensation structures may not provide adequate incentives for fund managers to engage in costly activist campaigns regardless of potential upside for the fund. Since pension funds and mutual funds also generally hold relatively small investments in portfolio companies, they suffer from "free rider" problems: an activist bears all the costs of pursuing an activist campaign, but any benefits are shared with passive shareholders (Black, 1990). And those other shareholders may include direct and indirect competitors of the activist fund, particularly as returns to pension funds and mutual funds are typically measured against an index (Kahan and Rock, 2007).

By contrast, hedge funds and other alternative investors usually charge a performance-related fee in addition to a management fee (Ineichen, 2012). The performance-based element of hedge fund compensation is substantial, averaging 17.1% of profits earned in 2013, according to Preqin (2014b). Performance is mostly measured as the total (absolute) return to the fund, rather than against a benchmark (Ineichen, 2012). In addition, alternative investment fund managers frequently invest their personal wealth in the fund (*ibid.*). The resulting package is designed to highly-incentivise fund managers to generate outperforming returns. And because activist alternative investors typically take substantial minority stakes in target companies, and are judged by their absolute returns (i.e., regardless of gains to competitors), they are able to mitigate much of the "free-riding" problem experienced by mutual funds and pension funds (Kahan and Rock, 2007; Clifford, 2008).

Mutual and pension fund managers may also be vulnerable to conflicts of interest arising from their business and political ties, which can deter such funds from engaging in any, or at least the most confrontational, activist initiatives. Since many mutual fund management companies are affiliated with another financial institution, such as an investment bank or an insurance company, managers of such funds may be reluctant to antagonise present or future clients of their affiliated institution by pursuing activist initiatives (Kahan and Rock, 2007). Unaffiliated mutual funds, through their reliance on the management of corporate pension plans as an important revenue stream, may also be reluctant to engage in activism that may deter current or potential corporate clients (*ibid.*). Corporate pension fund managers themselves are generally considered to be controlled by their sponsors (Black, 1990; Illig, 2007). And public pension funds, whose boards of trustees typically include elected politicians and employee representatives, may be discouraged from more assertive activism for political reasons or influenced by political or labour interests (Black, 1990; Kahan and Rock 2007).⁹

These differences in regulatory, structural and organisational frameworks go at least part of the way toward explaining key distinctions in strategic approach generally employed by

⁸ In the United States, for instance, mutual fund managers are subject to the Investment Advisers Act of 1940, which limits their capacity to receive compensation related to the performance of the fund.

⁹ See also, Romano (2001), Woidtke (2002) and Davis and Kim (2007).

traditional and alternative investors. Kahan and Rock (2007, p. 1069) describe mutual fund and pension fund activism as “incidental and *ex post*” - such fund managers that turn activist tend to do so only after realising that portfolio companies are underperforming. They describe hedge fund activism as “strategic and *ex ante*” - activist managers of hedge funds (and other alternative investment funds) first decide if a company would benefit from activism, and then either take a position and become activist or, in some cases, quickly increase a pre-existing stake (Amess et al, 2007). Activist alternative investors therefore position and prepare themselves to target companies in which they determine the greatest gains can be achieved through activism.

Some commentators argue that, at least traditionally, mutual fund and pension fund activism generally seeks different objectives and focuses on different types of companies than hedge fund activism. Kahan and Rock (2007), for example, suggest that traditional institutional investors tend to identify a particular issue and seek to effect a relatively small change across a range of companies, while activist hedge funds tend to pursue big changes at a small number of companies, and that hedge funds usually focus on persuading target companies’ managements and boards to change specific aspects of their business operations and strategies (such as selling non-core assets or the entire company, buying back shares or paying special dividends), whereas traditional institutional investors tend to seek changes in corporate governance structures and policies (such as separating the roles of CEO and Chairman). Brav et al (2008a), Klein and Zur (2009) and others report that activist hedge funds tend to target undervalued companies that are relatively profitable and financially healthy, while earlier activism by traditional institutional investors focused on companies with poor operating performance.

Such distinctions, of course, are generalisations and there have been cases, even in the past, of “traditional” institutional investors pursuing “alternative investor-style” activist strategies (Amess et al, 2007). For example, the Hermes UK Focus Fund, a UK focus fund formerly owned by the corporate pension scheme of British Telecommunications (and since, 2012, part of activist hedge fund manager RWC Partners), was acquiring stakes in companies for the purpose of activism and adopting other strategic techniques common to alternative investor activism as early as 1998 (Becht et al, 2009; Jones and Oakley, 2012). London Business School professor Julian Franks (2014) argues that the objectives of activism engaged in by traditional and alternative institutional investors appear to be converging, and points to increasing willingness of traditional fund managers, such as Standard Life, L&G and M&G in the UK, to challenge management and boards of portfolio companies (Sullivan, 2013).¹⁰

In a few recent cases, traditional and alternative institutional investors have jointly led activist approaches. Between 2012 and 2013, for example, the California State Teachers’ Retirement System and Relational Investors took joint action urging the Timken Company to split (De La Merced, 2013). In other cases, traditional institutional investors have spoken out publicly in support of activists. T. Rowe Price, for instance, publicly supported Carl Icahn’s opposition to a \$25 billion buyout bid for Dell in 2013 (Francis, 2013; Guglielmo,

¹⁰ For further examples of individual and traditional institutional investors engaging in shareholder activism of the kind currently most common to alternative investors, see, e.g., Cheffins and Armour (2011b) (which examines cases of such shareholder activism in U.S. public companies in the first half of the twentieth century) and Barber (2007) (which analyses the shareholder activism of the California Public Employees’ Retirement Association).

2013). And, crucially for the success of alternative investor activism, industry participants report that pension funds and mutual funds are increasingly supportive of alternative investor activists behind the scenes (Thurm and Benoit, 2012; Ryan, 2013; Gelles and De La Merced, 2014). That activists are increasingly able to effect changes at large companies with only a small proportionate shareholding is further evidence of that support (section 3.3.3).

2.3 Alternative Investor Activism and Private Equity

Like other alternative investment vehicles, private equity (PE) funds have significant performance-based compensation linked to absolute returns. They are generally unexposed to the conflicts of interest to which mutual funds and pension funds may become subject, and typically take strategic *ex ante* positions in target companies with the aim of making operational, managerial and strategic changes (see, e.g., Belivacqua, 2006; Klein and Zur, 2009). While there are key strategic and structural distinctions between PE and activist alternative investment funds, the latter are more aligned to PE funds, in both strategy and structure, than many other alternative investment vehicles.

Classic PE buyout firms aim for “corporate control” (i.e., voting and frequently, board control) and a profitable exit (such as by means of an initial public offering (IPO) of the portfolio company or its subsequent sale), while activist investors seek “corporate influence” and profit from a minority stake in target companies (Armour and Cheffins, 2012, p. 18). PE buyout funds traditionally acquire controlling interests either in private companies, or in public companies that are then taken private (Gatti and Battistini, 2006, p. 158). As controlling shareholders, traditional PE firms achieve changes in portfolio companies by working closely with, or taking active control over, the management of those companies, while activist funds typically rely on persuading management and boards of target companies - together with other shareholders - of the effectiveness of their proposals (*Ibid.*, p. 158). As controlling shareholders, traditional PE firms are also generally not subject to the free-rider problems experienced by minority shareholder activists (Armour and Cheffins, 2012). Classic PE funds hold illiquid securities (private equities). Activist alternative investors frequently target quoted companies but, since activist strategies take time to execute, they take relatively illiquid positions in liquid securities (public equities). Still, PE fund strategies tend to take longer to implement, resulting in holding periods in portfolio companies of typically three to five years (Prequin, 2013a), compared with between 1.8- and 2-years on average for activist hedge funds (see section 4.4 below).

Despite the analytical usefulness of thus distinguishing PE and activist strategies, there have been cases of takeovers by activist alternative investment funds, shareholder activism by PE firms, and both cooperation and competition among activist funds and PE firms (Amess et al, 2007). Some fund managers may from time to time use either classic PE or activist strategies (Katelouzou, 2013). The markets for control and influence may, therefore, best be considered points on a continuum rather than wholly distinct (Armour and Cheffins, 2012).¹¹ Indeed, activist funds, with their focus on such issues as the strategy, capital structure, operations and governance of portfolio companies, are generally more strategically akin to PE than many other alternative investment funds. The nuts and bolts of alternative investor activism therefore involve skills common to PE, such as detailed

¹¹ The markets for control and influence may, in some senses, also be complementary. Franks (2014) notes that, as activist engagement often results in a takeover involving the target company, the market for influence can be seen to support the market for control. Thomas H. Lee, the PE fund manager, made a similar point at a speech in 2007: “I’d like to thank my friends Carl Icahn, Nelson Peltz, Jana Partners, Third Point ... for teeing up deals because they’re coming in there and shaking up management and many times these companies are being driven into some form of auction” (Sorkin, 2007).

preparatory research and due diligence. While classic PE managers are management experts and hedge fund managers were always the “numbers guys,” many activist hedge fund managers come equipped with PE backgrounds or other management-focused experience (Gatti and Battistini, 2010, p. 159; Boyson and Mooradian, 2012; Bessemer Trust, 2013).

Similarities in strategic approach have further led to convergences in the structure of activist alternative investment funds and PE funds. Traditional hedge fund structures, for example, are suited to trading in highly liquid securities, while classic PE funds are designed for long-term investments in illiquid securities (Mamtani et al, 2009). Hedge funds are traditionally open-ended with an indefinite life, while PE funds are typically close-ended with a specific lifetime (*Ibid.*). During that lifetime, PE managers are not affected by short-term capital redemptions and can therefore focus on longer investment horizons. Activist hedge funds and other open-ended funds, on the other hand, need to implement contractual mechanisms to control redemptions or face capital withdrawals during the course of an activist campaign. Yet activist alternative investors are more strategically aligned to PE funds than many other alternative investment vehicles. Indeed, a number of structural tools used by activist alternative funds, which are discussed in section 5 below, blur the lines between PE, hedge funds and other fund types.

2.4 Alternative Investor Activism and Other Investment Strategies

Alternative investor activism both draws on and extends other investment strategies. As further explained in section 3.3.1 below, activist alternative investors typically take a value-oriented approach, using diligent analysis of corporate fundamentals to identify companies that are underpriced by the market. But unlike classic value investors, activists are also willing to take a “hands on” approach to unlock value, and to do so as a core element of their strategy (Bratton, 2007). Although some value investors, like Warren Buffett’s Berkshire Hathaway, may in egregious cases take action to protect their investments from value-destroying actions, their objective is generally to protect an investment (*ex post*) rather than pursue activist intervention *ex ante* (Katelouzou, 2013).

Some activist strategies resemble opportunistic event-driven plays. Indeed, activism is often classified within the wider group of event-driven hedge fund strategies, since activist funds profit from corporate events. Like merger arbitrageurs, for instance, activist funds may buy (or short) shares in a potential takeover target (and/or short or buy the potential acquirer), but activists will also try to influence the deal, such as by pressing for better terms or blocking the deal (*Ibid.*; Brav et al, 2008a). Or they may take a stake and then press companies to engage in a transaction (Katelouzou, 2013). In other words, while other event-driven strategies aim to profit from predictions surrounding the probability of an event occurring, activist strategies are predicated on their ability to drive events.

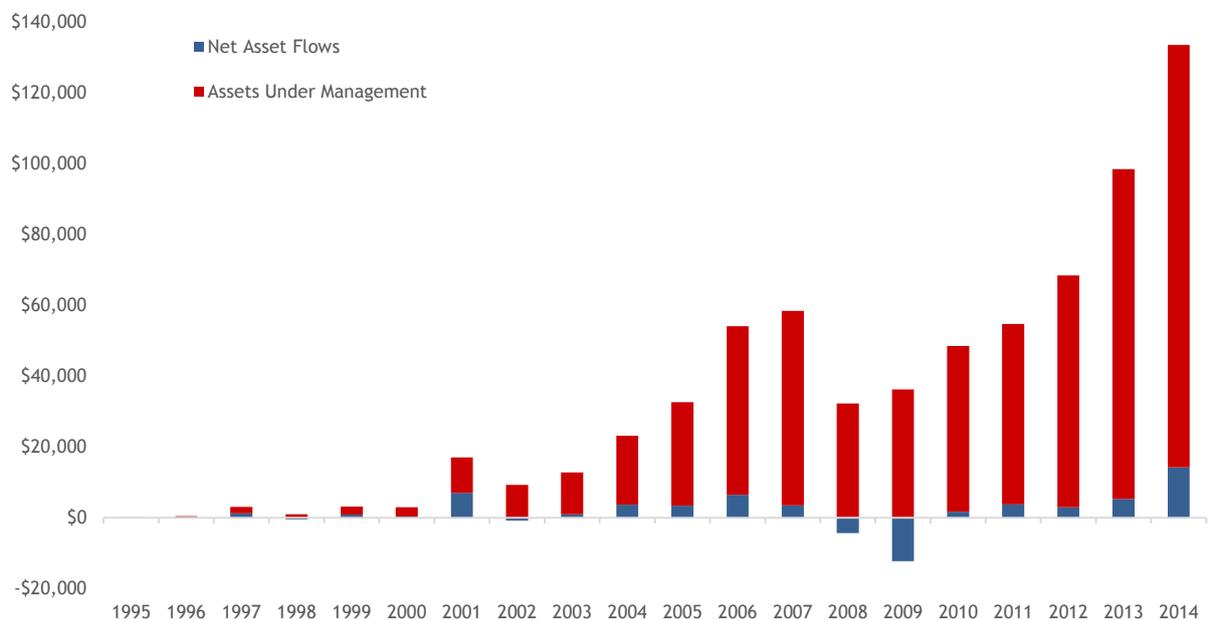
3 The Activist Universe

3.1 The Development of Alternative Investor Activism

Shareholder activism by alternative investors was not unheard of before the late 1990s, but it was an infrequent and unusual practice. Early activists include Greenway Partners, a hedge fund that used shareholder proposals to urge restructuring, takeovers and sales of U.S. public companies, including US Shoe, Woolworth and Unisys, during the mid-1990s (Lipton, 1997; Cheffins and Armour, 2011a). Steel Partners, one of the most prolific activist fund managers today, also made initial activist efforts in the mid-1990s (*Ibid.*). In Europe, the UK Active Value fund launched activist campaigns in the mid-1990s targeting a range of UK companies, including Scholl and Liberty (Burgess, 2010b; Buchanan et al, 2012).

Yet, by the end of 2000, hedge funds engaging in activism were managing only \$2.7 billion worth of assets worldwide, according to Hedge Fund Research (HFR) (Figure 1). Inflows to activist hedge funds then increased dramatically - investors allocated an additional \$7 billion to activist hedge funds in 2001 alone - and their assets under management (AUM) grew to almost \$55 billion by 2007. Greenwood and Schor (2009) document an increase in activist events initiated by hedge funds in the United States from just eight in 1995 to 141 in 2005 (Figure 2). According to Becht et al (2014), publicly-announced activist engagements by hedge funds, focus funds and other alternative investors in North America, Europe and Asia grew from 48 in 2000 to 381 in 2007, before dropping off through the end of 2010 (Figure 3).

Figure 1: Activist Hedge Funds: Assets Under Management and Net Asset Flows (\$ millions)



Source: HFR (2014)

What explains this dramatic growth in activism by hedge funds and other alternative investors from the late 1990s through the start of the recent financial crisis? For one thing, the wider alternative investment industry experienced a boom during the 1990s that lent credibility and financial firepower to the sector (Briggs, 2007; Buchanan, 2012). HFR (2014) estimates that the combined AUM of all hedge funds increased from less than \$40 billion in 1990 to almost \$540 billion by 2001, more than £1.8 trillion by the end of 2007. With this

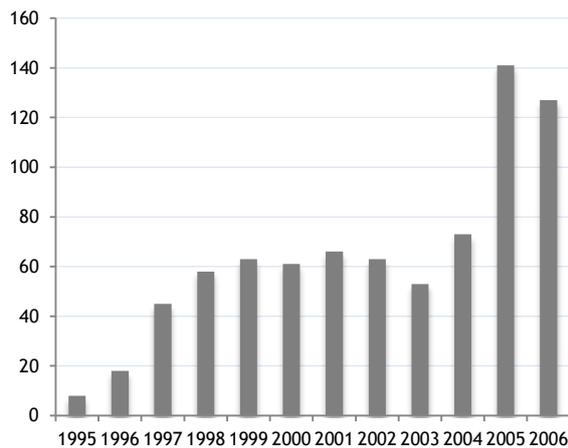
growth also came increased competition - a particular problem for an industry focused on arbitrage - leading many fund managers to seek higher returns through new strategies, including activism (Briggs, 2007). As a reporter for *The Wall Street Journal* explained in 2005:

When there were far fewer funds, there was just a small pool of money that could sit on the sidelines, betting on the outcome of merger deals and make decent returns if the bet was right. Today, there are so many hedge funds -- anywhere from 6,500 to as many as 8,000 -- that such passivity no longer works well enough.

So instead of just taking bets on the outcome of others' moves, they themselves are becoming the catalyst for change in the corporate world (Sender, 2005).

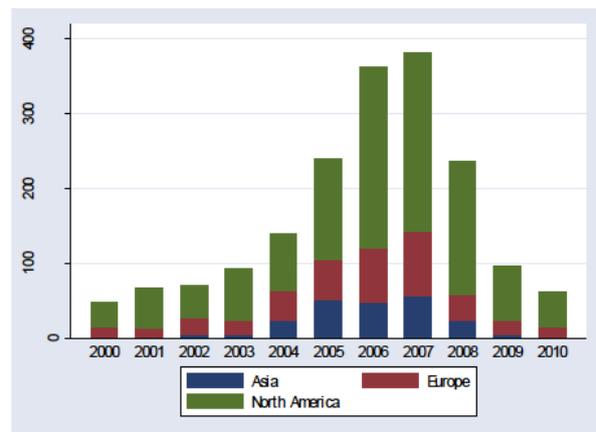
The dotcom crash at the turn of the century and subsequent corporate scandals at companies like Enron, Tyco and WorldCom were a further boon to shareholder activists. In the wake of the dotcom crash, an abundance of companies were trading at prices well below recent peaks, prompting a resurgence in value-based investment strategies (Armour and Cheffins, 2012). Even as share prices rebounded in the early 2000s, activists were increasingly able to identify ostensibly undervalued companies (*Id.*).

Figure 2: Activist Events by Hedge Funds in the United States (1995-2006)



Source: Greenwood and Schor (2009), p. 365

Figure 3: Activist Engagements by Hedge Funds in North America, Europe and Asia (2000-2010)



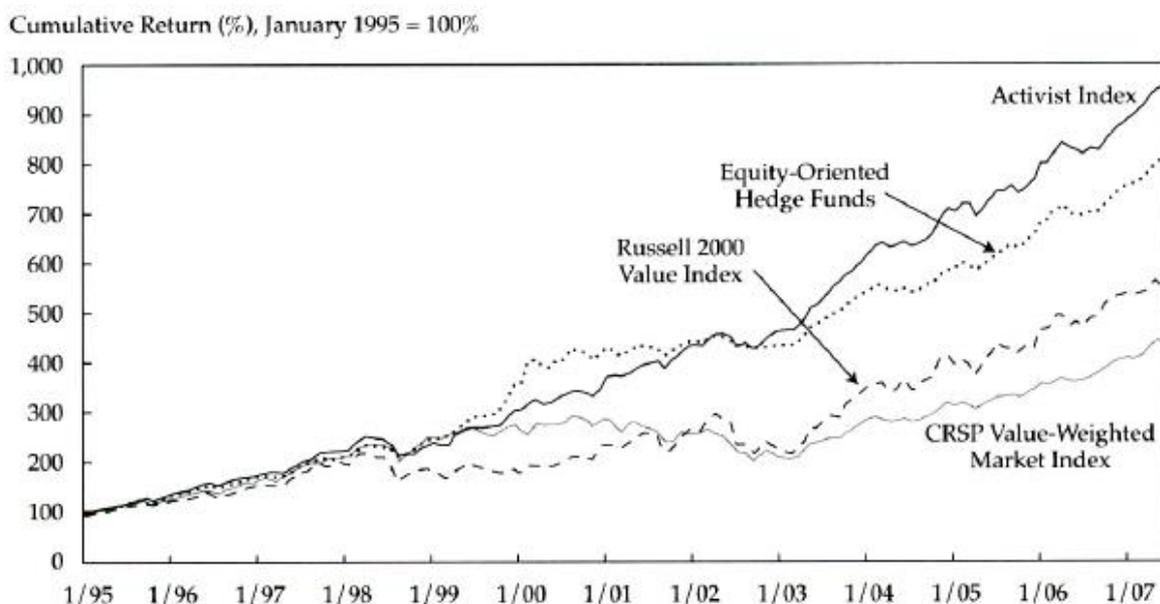
Source: Becht et al (2014), p. 36

Corporate earnings also grew from the early 2000s, but still-cautious executives tended to reserve rapidly accumulating cash stockpiles rather than make investments or increase wages (*Ibid.*). In 2005, Standard & Poor's (S&P) 500 companies held higher levels of cash as a proportion of stock market value than at any time since the early 1980s (Shearer, 2006). In 2006, cash as a percentage of long-term debt at those companies was almost 40% (*Ibid.*). Meanwhile, interest rates remained low in the mid-2000s and debt was cheap and plentiful (Cheffins and Armour, 2011a). The combination of high corporate cash holdings, low interest rates, and cheap and available debt played into the hand of activists arguing for cash to be returned to shareholders (*Ibid.*). "This is arguably exactly the wrong time to sit on cash," wrote a journalist for *The Wall Street Journal* in October 2005. "Because interest rates are low, the return on companies' cash is paltry. With rates likely to go up, the chance to grab debt this cheap is passing. And that's what this wave of hedge-fund agitation is about: They want companies to pay out their cash or take more risk" (Eisinger, 2005). The availability of cheap debt also made it easier for activists to borrow to finance campaigns and helped fuel a roaring market for mergers and acquisitions (M&A) in the mid-2000s (Armour and Cheffins, 2012). A widening range of potential buyers made it easier for

activists to persuade the boards and management of target companies to sell underperforming divisions or the whole company (*Ibid.*).

The turn-of-the-century corporate scandals brought renewed attention to the way companies were being managed, making governance-related activist proposals more compelling to shareholders and boards of directors (*Ibid.*; Briggs, 2007). Legislation enacted in the wake of those scandals - notably the Sarbanes-Oxley Act in the United States and a major reform of the Combined Code on Corporate Governance (now the UK Corporate Governance Code) in the UK - reinforced the principle of management accountability to shareholders, through new measures such as increased disclosure requirements (Buchanan et al, 2012).¹² Carl Icahn, one of the most visible activist alternative investors, described the change of mood following the Enron and other scandals: “there has been a sea change in investor attitudes concerning the role of entrenched corporate managements. Shareholders want to hold them accountable” (Pulliam and Peers, 2005).

Figure 4: Cumulative Returns to U.S. Activist Hedge Funds and Other Indices (January 1995-July 2007)¹³



Source: Brav et al (2008b)

And, of course, there were the returns that these funds produced. Activist funds achieved outstanding results from the late 1990s right through to the start of the recent financial crisis. Brav et al (2008b) estimate returns to U.S. activist hedge funds between January 1995 and July 2007, just before the onset of the recent financial crisis. They find that, from mid-1998, activist hedge funds significantly outperformed both the CRSP Value-Weighted Market Index and the Russell 2000 Value Index (a benchmark for small/value companies, which dominated the portfolios of earlier activist alternative investors, in particular). They

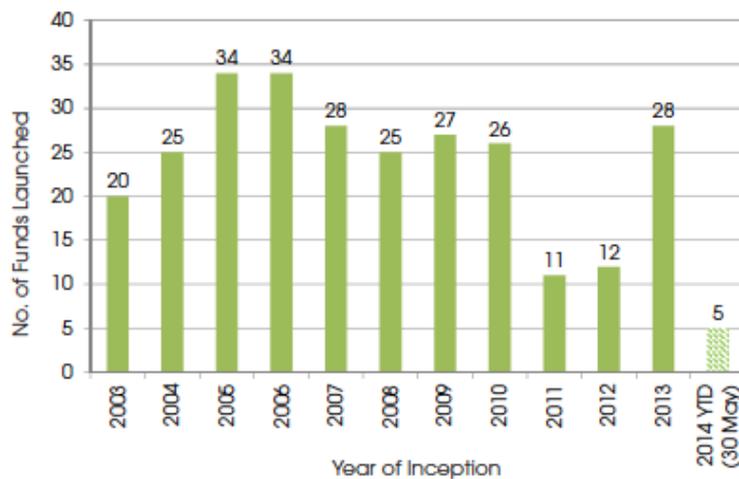
¹² Other regulation further encouraged the practice of activism. Briggs (2007), for example, discusses a raft of regulatory changes and judicial decisions that increased the effectiveness of hedge fund activism in the United States. For instance, in 1999, the United States Securities and Exchange Commission (SEC) added a new Rule 14a-12 to the proxy rules, which effectively allows unlimited communications among shareholders before any proxy statement is filed with the SEC (*Ibid.*). As a result, abandoned solicitations need never result in a proxy statement and, by the time an actual proxy statement is finally prepared, a number of negotiations may already have been settled or otherwise concluded (*Ibid.*). These include the addition of a new Rule 14a-12 to the proxy rules in 1999, which effectively allows unlimited communications among shareholders before any proxy statement is filed with the

¹³ Brav et al (2008b) match a sample of 236 U.S. activist hedge funds with returns data from two data providers updated through the end of 2005 and June 2007, respectively. Cumulative returns of all sampled activist funds are aggregated into a value-weighted “Activist Index.”

also find that activist hedge funds outperformed other equity-oriented hedge funds from 2003 (Figure 4). In the years 2005-2007, when HFR began compiling its HFRX Activist Index of returns to global activist hedge funds, that index showed annual returns of 26.3%, 17.8% and 5.0%, compared with 2.7%, 9.3% and 4.2% for all hedge funds. In comparison, the S&P 500 achieved annual returns of 4.9%, 15.8% and 5.5% over the same period. The most successful activist funds wildly outperformed the market.

During the early and mid-2000s, the interests of activist alternative investors, mutual funds and institutional shareholders seemed increasingly aligned on a wide range of issues, not least governance-related proposals. Alternative investor activists also found growing support for their proposals from influential proxy advisory firms, notably Institutional Shareholder Services (ISS) in the U.S., whose positions on shareholder proposals many institutional shareholders adopt automatically (Briggs, 2007). Regulatory changes also helped to spur activism along, and market forces created an environment where activist proposals for companies to distribute cash, say, or sell underperforming divisions appeared to make good economic sense. The first wave of shareholder activism by alternative investors reached its peak in 2005 and 2006. Almost 70 new activist hedge funds launched in those two years, according to Preqin (2014c) (Figure 5).

Figure 5: Activist Hedge Fund Launches



Source: Preqin (2014c)

Then came the financial crisis, and activist funds fared especially poorly. Collectively, activist hedge funds suffered worse returns in 2008 than hedge funds employing any other strategy, except for funds focused on certain emerging markets (HFR, 2014), and they underperformed the S&P 500 (see section 3.2.3 below). Investors fled activist hedge funds in 2008 and 2009, withdrawing almost as much capital in those two years as they had invested in the previous four (HFR, 2014). The resulting liquidity crisis led to several activist funds being wound up (*The Economist*, 2010; Armour and Cheffins, 2012). Those that survived were far less likely to enter new investments. Becht et al (2014) report a decline in new activist engagements by alternative investors in North America, Europe and Asia from a peak of 381 in 2007 to 236 in 2008, and down to 62 in 2010. While the authors do not find a corresponding increase in exits by activists from existing investments, their results show that activist engagements were far less likely to result in an actual outcome after late 2007.

With often a heavy long bias and highly concentrated portfolios, activist funds were particularly exposed to the stock market downturn (Ahmed, 2010). And the small- and mid-cap companies that dominate most activist portfolios suffered larger share price declines

than large-cap companies (Armour and Cheffins, 2012). Some funds may also have overreached themselves by taking large positions that relied on campaigns that were difficult to win (*Financial Times*, 2008). In the event, some of the activist funds that had done exceptionally well before the crisis suddenly were among the worst performers.

In many ways, a reversal of the same market forces that favoured alternative investor activism during the “boom” years of the early and mid-2000s also helped to reverse the fortunes of activists during the subsequent period of “bust.” The credit crisis made it harder for activists to borrow to finance campaigns or persuade boards and management - now focused on liquidity and survival - to gear up company balance sheets (Burgess, 2008; Zenner et al, 2010; Armour and Cheffins, 2012). Constrained debt markets also contributed to a decline in M&A markets, meaning that prospective bidders for all or part of a target company were harder to come by (Greenwood and Schor, 2009; Armour and Cheffins, 2012). Becht et al (2014) find that activist campaigns resulting in a takeover of the target company declined internationally from more than 60 in each of 2005 and 2006 to just five in 2010. Traditional institutional investors, too, appeared less willing to back confrontations with individual management or boards in the context of general market uncertainty (Gribben, 2008; Armour and Cheffins, 2012). As Patrick McGurn, special counsel to the parent company of ISS, explained in 2008: “concerns about the market and economy trumped concerns about individual management or boards” (Gribben, 2008).

Since 2009, however, alternative investor activism has picked up once more, and to a far greater extent than before. Many of the familiar drivers of earlier growth have resurfaced again - high levels of corporate cash, relatively low leverage and subdued payouts; easing credit and M&A markets, together with plenty of cheap debt; a post-crisis environment receptive to corporate governance agendas, with the introduction of a range of legislative and policy changes targeting governance improvements, such as “Say on Pay” (among other provisions of Sarbanes-Oxley) and the UK Stewardship Code intended to encourage shareholder engagement (see, e.g., *The Economist*, 2010; Armour and Cheffins, 2012; Cembalest, 2014; Khorana et al, 2014). In addition, the second wave of hedge fund activism has benefited from greater familiarity and experience among investors in activist funds, other large shareholders of targeted companies, management and directors of those companies, influential observers and the activists themselves. With added experience, capital and rivals, activist funds have also become more ambitious, targeting larger, often well-performing companies and new geographies.

3.2 Activist Funds and Fund Managers

Just over 400 activist hedge funds worldwide were tracked by Preqin (2014c) as of 30 May 2014. Collectively, activist hedge funds accounted for \$111.2 billion worth of assets at the end of June 2014, according to Hedge Fund Research (HFR) (2014). In pure dollar terms, activists remain a fairly minor constituent of the wider alternative investment management universe - activist hedge funds accounted for less than 4% of the \$2.8 trillion in assets managed by the industry at the end of June 2014 (*Ibid.*).¹⁴ Yet the largest funds pack significant financial firepower, Preqin (2014c) estimates that the five biggest activist hedge funds have a combined \$50bn in AUM.

¹⁴ By comparison, the estimated global AUM of pension funds, mutual funds and private equity (PE) funds was, respectively, \$32 trillion at the end of 2013, \$29 trillion in September 2013 and \$3.5 trillion in June 2013 (Towers Watson, 2014; ICI Global Research, 2014; Preqin, 2014a).

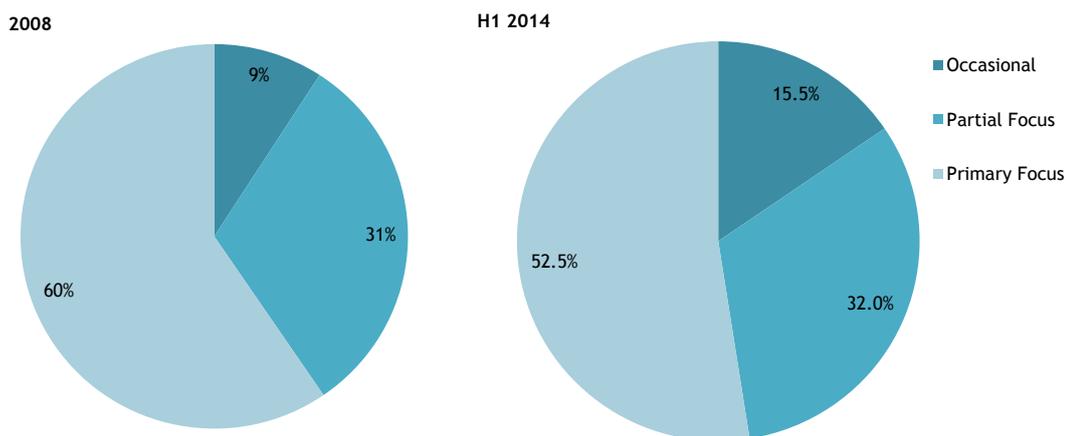
3.2.1 “Pure-play” and occasional activists

Activist alternative investors vary in the degree to which they focus on activist strategies. Activist Insight identifies three broad groups:

- ▶ *Primary focus*: investors that specialise exclusively in activism;
- ▶ *Partial focus*: investors that specialise in activism among other strategies; and
- ▶ *Occasional activists*: investors focused on other strategies that sometimes make opportunistic activist plays.

All three groups have attracted an increasing number of funds and assets in recent years. Some of the most prolific activists are only partially focused on the strategy. Alternative investors with a primary activism focus constitute more than half of all positions among the current activist alternative investor universe (Figure 6).

Figure 6: Proportion of New Positions by Hedge Fund Activism Focus (2008 vs H1 2014)



Source: Activist Insight; AIMA / Simmons & Simmons

Industry participants corroborate this trend. Marc Weingarten of law firm Schulte Roth & Zabel reports “seeing many more hedge funds which would never call themselves activists trying the strategy now when they’re stuck in a position where they think they can unlock value” (13D Monitor, 2013, p. 2). High returns experienced by specialist activist funds are also drawing an increasing number of occasional activists from outside the alternative investment industry. According to a recent report by Citi (Khorana, 2013, pp. 4-5), “the outperformance of “pure-play” activist funds has also led many traditional investment managers to adopt a more active stance with respect to their investments. As a result, the number of “occasional activists” has risen sharply and the activist shareholder playbook is gradually becoming a standard part of the asset manager’s toolkit.”

Infrequent activists may not be as proficient in the practice of activism as their more experienced counterparts, however. Boyson and Mooradian (2012) analyse U.S. hedge fund activism before 2006 and find that “experienced” activists (based on fund managers’ prior experience of activism and the industry of companies targeted by the fund) earn significantly higher returns than less experienced activists. They also find that companies

targeted by experienced activists have significantly higher stock returns and modestly higher operating performance for up to three years after the activist engagement compared with those targeted by less experienced activists. In a study of alternative investor activism in Europe between 2000 and 2008, Becht et al (2010) report significantly higher short-term stock returns in targets of funds that are exclusively activist than in targets of funds that engage in activism among other strategies. In addition, funds that are not specifically designed for activism may face structural challenges, such as liquidity constraints, when engaging in activist campaigns (Williams, 2014).

3.2.2 Regional Headquarters & Regional Focus

About two-thirds of activist hedge fund managers were headquartered in North America at the end of May 2014, according to Preqin (2014c); 15% had headquarters in Europe and 14% in Asia-Pacific (Figure 7). Preqin estimates that 21% of all hedge fund managers are located in Europe, indicating that activist hedge funds are proportionately under-represented there (*Ibid.*). Nevertheless, some of the largest and most prolific activist fund managers are based in Europe.

Figure 7: Regional Headquarters of Activist Hedge Fund Managers (30 May 2014)

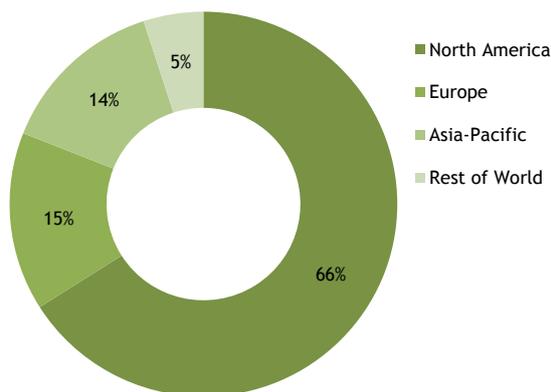
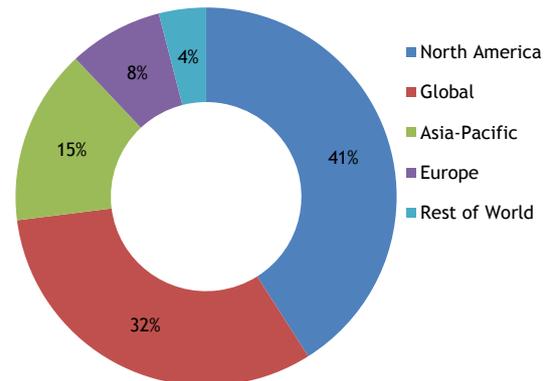


Figure 8: Activist Hedge Funds by Main Regional Focus (30 May 2014)



Source: Preqin (2014c)

Figure 8 provides a breakdown of activist hedge funds by regional focus. According to Preqin (2014c), 41% of activist hedge funds focus entirely on North America, with 15% focused only on the Asia-Pacific region and 8% with a specific preference for Europe. Almost a third have a global focus.

3.2.3 Performance of Activist Alternative Investors

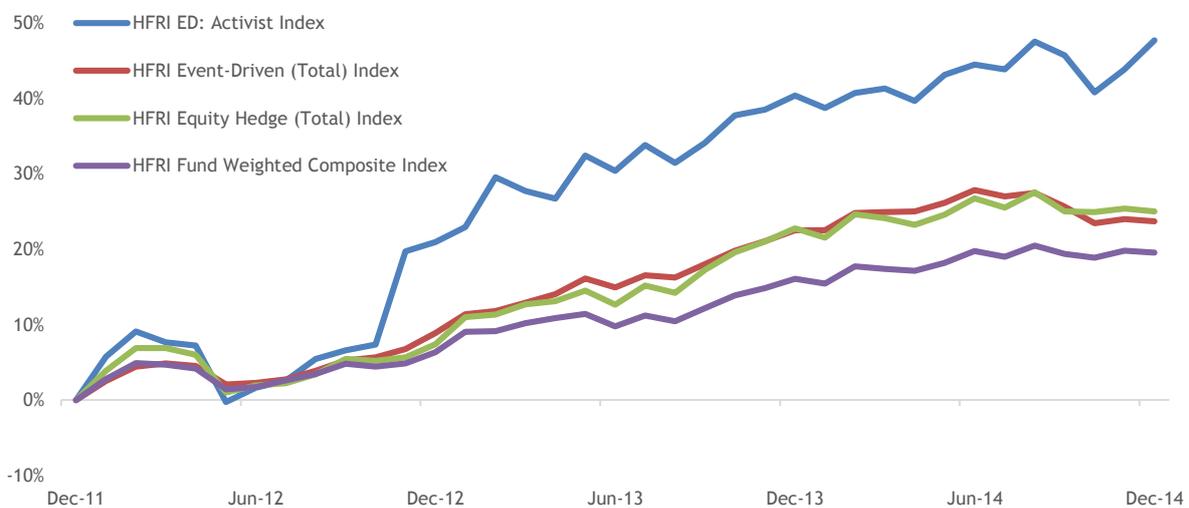
The second wave of alternative investor activism is delivering exceptional returns by most metrics. Activist hedge funds have outperformed hedge funds as a whole on each of one-year, three-year and five-year annualised bases through 31 December 2014, according to data compiled by Hedge Fund Research (HFR) (Table 1). On HFR data, activists have also achieved higher returns than hedge funds focused on general event-driven and equity-hedge strategies in each of those periods through 31 December 2014.

Table 1: Net Returns to Activist Hedge Funds and Other Hedge Funds (%) (31 December 2014)

	1 yr.	Annualised	
		3yr.	5 yr.
HFRI ED: Activist Index	5.21	13.87	7.82
HFRI Fund-Weighted Composite Index	2.99	6.13	4.54
HFRI Equity Hedge (Total) Index	1.83	7.72	4.81
HFRI Event-Driven (Total) Index	0.97	7.34	5.99

Source: HFR (2014)

Figure 9: Cumulative Returns to Activist Hedge Funds and Other Hedge Funds (3 years to 31 December 2014)



Source: HFR (2014)

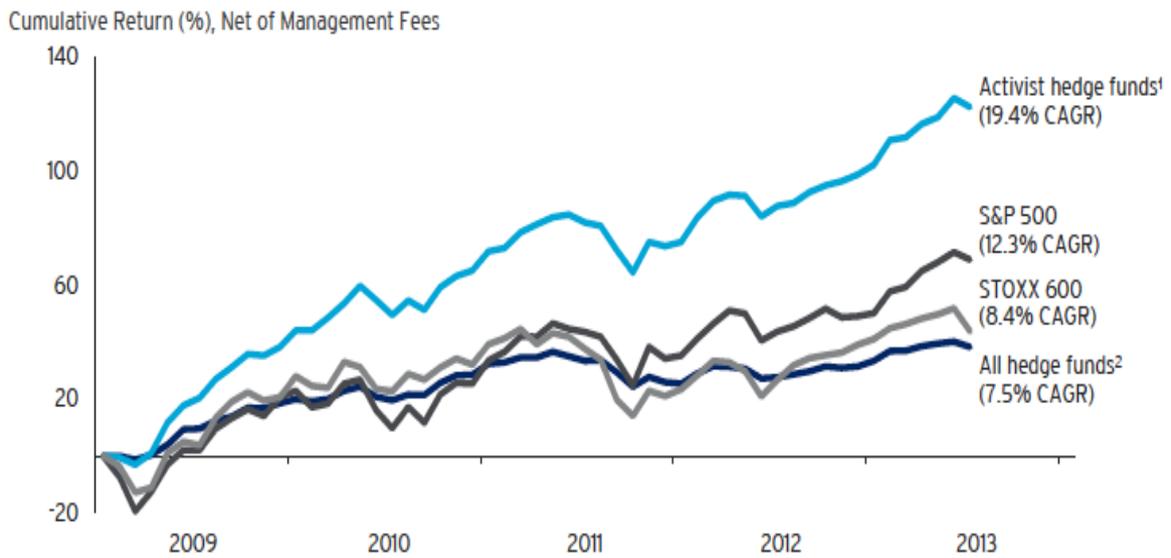
With equity prices at record levels, the most recent returns to activist hedge funds compare less favourably to stock market indices. However, over longer-term horizons, activist hedge funds appear to have outperformed both stock market indices and the wider hedge fund industry. Between March 2004 and June 2014, activist hedge funds generated gross returns of 267.7%, according to data provider Novus, more than double the returns of the S&P 500 and the HFRI Fund Weighted Composite Index (Figure 10). Novus estimates that cumulative annualised gross returns to hedge fund activists between March 2004 and June 2014 were 13.6%, compared with 7.8% for the S&P 500 and 5.5% for the HFRI Fund Weighted Composite (Altshuller, 2014). Global activist hedge funds have also significantly outperformed stock market indices over the four years to 2013, according to research by Citi (Khorana, 2014) (Figure 11).

Figure 10: Cumulative Returns to Activist Hedge Funds and Other Indices (1 March 2004-31 June 2014)¹⁵



Source: Novus (Mellin, 2014)

Figure 11: Cumulative Returns to Activist Hedge Funds and Other Indices (2009-2013)¹⁶



Source: Citi (Khorana et al, 2014)

¹⁵ Novus aggregates returns from the publicly disclosed long portfolios of 60 activist managers into a single market value-weighted portfolio. Their aggregated portfolio contains both activist and passive investments held by those managers.

¹⁶ Citi aggregate returns data on 17 activist funds from three industry data providers and the funds themselves.

The outsized returns to activism appear to come with additional risk - activist hedge funds exhibit higher levels of volatility than other hedge fund indices and the S&P 500 (Table 2).

Table 2: Volatility of Activist Hedge Funds and other Indices (31 December 2014)

	Annualised Std Dev (%)	
	3 yr.	5 yr.
HFRI ED: Activist Index	10.46	11.88
HFRI Fund-Weighted Composite Index	3.92	5.19
HFRI Equity Hedge (Total) Index	5.81	7.56
HFRI Event-Driven (Total) Index	3.88	5.19
S&P 500	9.1	13.01

Source: HFR (2014)

There are at least three reasons for the high levels of volatility associated with activist returns:

- ▶ Activist funds tend to hedge less than many other hedge funds and other alternative investors, have longer investment horizons (see section 4.4) and hold highly-concentrated portfolios, leaving them more exposed to idiosyncratic shocks.
- ▶ Activist returns are often lumpy and unpredictable. It can be difficult to judge the timing and quantum of returns to an activist campaign, and a large proportion of those returns may come all at once, particularly on the occurrence of an activist “outcome,” such as a restructuring of a target company or declaration of increased dividends.
- ▶ Activism appears to be a “win-lose” proposition to a substantial degree. Research discussed in section 6.2 below indicates that returns to activism depend significantly on the ability of the activist to achieve an “outcome,” and that some outcomes are generally more profitable than others.

The headline returns to activism do not appear to be shared by all, or even a majority of alternative investors. For example, a recent study of global hedge fund activism by a team at Citi (Khorana et al, 2014) found that 52% of targets showed negative excess returns over both one and two year periods, meaning that the large average improvements were driven by a relative minority of activist efforts that resulted in outsized share price gains. Research by JP Morgan Asset Management notes that the average activist return is three times larger than the median activist return (Cembalest, 2014). Similar skewed results are consistent across all studies of returns to activist hedge funds and other alternative investors (see, e.g., Brav et al, 2009).

3.3 Targets of Activist Hedge Funds

A company may become a target of an activist alternative investor for a variety of reasons but generally most targets exhibit two characteristics: (1) they show good operating performance but are fundamentally undervalued; and (2) the activist perceives some change in the capital structure, strategy and/or governance of the target that, if implemented, has the potential to “unlock” value for shareholders.

3.3.1 Valuation and Operating Performance

Like traditional value investors, activist alternative investors tend to target companies that are undervalued by the market based on corporate fundamentals. Relative to comparable firms, activist targets tend to have high book-to-market ratios (Brav et al, 2008a; Greenwood and Schor, 2009; Klein and Zur, 2009; Boyson and Mooradian, 2011; Brav et al, 2013a), low Tobin's q (Brav et al, 2008a; Boyson and Mooradian, 2011; Hamao et al, 2011; Bebchuk et al, 2013; Brav et al, 2013a) and underperforming returns on assets (ROA) (Hamao et al, 2011; Bebchuk et al, 2013) prior to the activist engagement. In two-thirds of the cases of U.S. hedge fund activism analysed by Brav et al (2008a), the activist publicly stated that it believed the target was undervalued. Brav et al (2008a), Boyson and Mooradian (2011) and Greenwood and Schor (2009) also report that the stock performance of target firms in the year prior to disclosure of an activist intervention lags considerably behind the market. Hamao et al (2011) and Bebchuk et al (2013a) observe negative abnormal returns in the two and three years prior to activist engagement, respectively.¹⁷

Targets of alternative investor activism tend to show slow top-line growth compared with their peers, but are equally or more profitable (in terms of return on assets (ROA)) and have stronger cash flows (Brav et al, 2008a; Klein and Zur, 2009; Boyson and Mooradian, 2011; Brav et al, 2013a). Klein and Zur (2009) also find that activist targets have a relatively low risk of bankruptcy (measured by Altman's z-score).¹⁸ In a review of the academic literature, Brav et al (2009, p. 208) conclude that "overall, these characteristics suggest that hedge fund activists target companies that have stable but undervalued businesses generating sound cash flows, rather than firms that have either operational problems or uncertain business prospects." This view is corroborated by statements from activist fund managers themselves. Triun Partners' stated strategy, for example, involves targeting "best in class" companies, which are market leaders with high barriers to entry (Triun Partners, 2014).¹⁹ This stands in contrast with earlier forms of shareholder activism, which tended to focus on companies with poor operating performance (Gillan & Starks, 2007; Brav et al, 2008a; Klein and Zur, 2009). Klein and Zur (2009) also report that firms targeted by activist hedge funds tend to have higher earnings than firms targeted by PE funds and other "entrepreneurial" (strategic ex ante) activists.

3.3.2 An Activist "Game Plan"

Of course, the characteristics described in the previous section are generalisations. Some companies targeted by activists, such as Apple and Hess Corporation, would certainly not be universally described as either fundamentally undervalued or slow growth firms. A report on international hedge fund activism between 2006 and 2013 by a team at Citi (Khorana et al, 2014) found that, although on average targeted firms displayed significant stock price underperformance and value-to-EBITDA multiples below their industry peers, over a third of companies targeted by activist hedge funds actually experienced stock price outperformance. The findings of that report also suggest that the trend of activists targeting well-performing companies is intensifying, particularly in the U.S., where 56.7% of activist campaigns against S&P 1500 companies in 2013 involved those that had outperforming share prices. They conclude that "the low-hanging fruit of underperforming firms was largely

¹⁷ Similarly, Clifford (2008) finds that targets of activist hedge funds experience significantly lower market-adjusted stock price returns in the period 13 months through one month before disclosure of the activist investment than companies targeted by hedge funds with a passive agenda. Klein and Zur (2009) appear to be alone in reporting strong stock performance of targets (12.3% abnormal return) in the year prior to disclosure of an activist intervention.

¹⁸ Clifford (2008) finds that firms targeted by activist hedge funds tend to be more profitable in terms of ROA and return on equity (ROE) but have lower book-to-market ratios than firms targeted by passive hedge funds.

¹⁹ Triun contrasts this goal with traditional PE firms, which it claims "tend to target third-rate companies; otherwise strategics would buy them" (Triun Partners, 2014).

picked in the first wave of shareholder activism, and we are now seeing a second wave of activism unfold where activist investors are setting their sights on well-performing firms” (*Id.*, p. 7).

It appears that, now more than ever, the only essential characteristic of an activist target appears to be the potential for increased value through some change, as perceived by the activist - what might be called an activist “game plan.” In the case of Apple, the game plan was (and, at the time of writing, still is) primarily to encourage the company to return some of its large cash reserves to shareholders (Icahn et al, 2014). Elliott Management’s activist intervention in Hess was largely directed at pressing the company to spin off its U.S. shale assets (Sider and Warner, 2013).

The critical element of an activist game plan can, at least in some cases of activism, lead to an approach to valuation that is rather different to that of the traditional value investor. Jeff Smith of Starboard Value (13D Monitor, 2012) explains the distinction between the approach his firm takes to identify investment opportunities and traditional value investment analysis:

Unlike traditional value investors, valuation is only one component of our process and what we deem to be undervalued may actually look expensive to another value investor. Most value investors are analyzing companies based on their existing business and trying to project out future financial results based on management’s existing business plan. Those investors excel when they are more confident than the market that management will be able to execute on its stated business plan. We are different. We analyze companies existing business plans and compare them to what, we believe, may be a better alternative business plan. If our analysis shows that our alternative business plan has a substantially higher expected return (risk-adjusted present value) then we have a potential investment opportunity.

Or consider Carl Icahn’s open letter to Tim Cook, Chief Executive of Apple of October 2014, in which the activist argues that Apple (then the world’s largest company by market capitalisation by some margin) was trading at less than half its true value and that the situation could be remedied by accelerated and larger share repurchases (Icahn et al, 2014).

Activist investors therefore look for companies that the manager believes are appropriate for the implementation of one or more value-enhancing “objectives,” which, as described in section 4.2 below, tend to fall within established general categories. Clearly not all activist objectives are appropriate for every target, which might explain why studies attempting to identify generally applicable target characteristics other than those described in the previous section have been inconclusive. For example, a company like Apple that has large cash reserves might be a target for an activist calling for increased dividends or share buybacks, but it does not follow that most activist targets have high levels of cash. Academic studies have offered inconsistent findings of the capital structure of the average activist hedge fund target,²⁰ as well as other characteristics, such as their levels of investment, governance features, institutional ownership and analyst coverage.²¹

²⁰ For example, Brav et al (2008a) find that activist targets have lower cash-to-asset ratios, are slightly more leveraged, and pay significantly lower dividends than comparable firms, while target firms in the sample constructed by Boyson and Mooradian (2011) had similar leverage and cash-to-asset ratios to peers, but a lower payout ratio. Clifford (2008) and Klein and Zur (2009) find that companies targeted by activists have lower or similar levels of cash, and statistically indistinguishable payout ratios to sample control firms, while more than a third of the targets in the sample of Bratton (2010) were “cash rich” (defined as a cash to total assets ratio of 0.15 or greater plus a cash to debt ratio of 0.50 or greater).

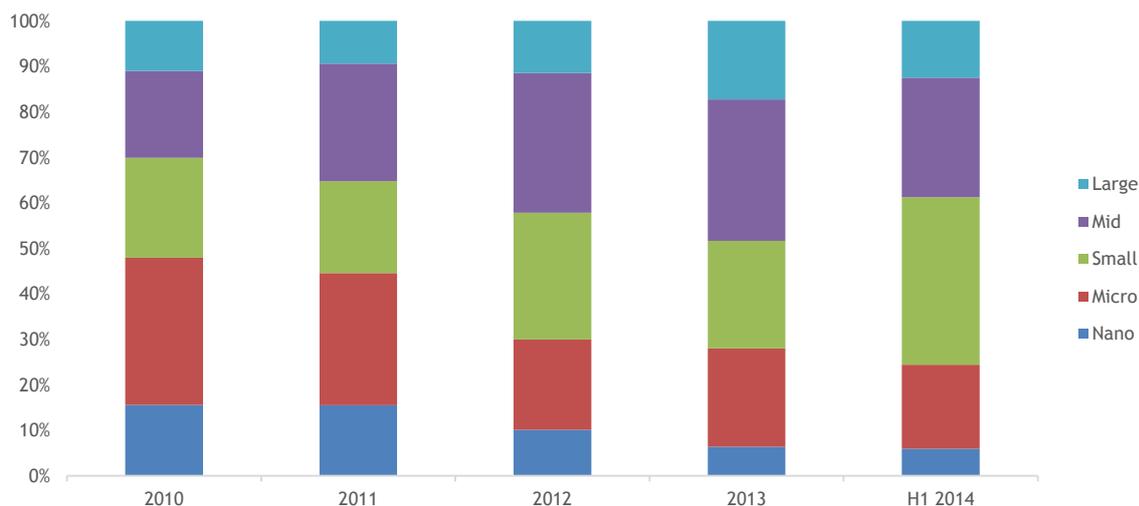
²¹ See, e.g., Coffee and Palia (2014), which surveys studies of U.S. targets of hedge fund activism.

3.3.3 Market Capitalisation

With a few notable exceptions, early activist alternative investors tended to target small- and mid-cap companies (Bratton, 2007; Brav et al, 2008a; Clifford, 2008; Klein and Zur, 2009; Greenwood and Schor, 2008; Bratton, 2010; Boyson and Mooradian, 2011). The obvious conclusion was that this was because activist investors were generally unable or unwilling to assume the idiosyncratic portfolio risk required to take meaningful stakes in the largest companies (Brav et al, 2008a, p. 1752).

Increasingly, however, activist funds are engaging with larger companies, as shown by Figure 12 below.²² Although activist investments in the largest companies have fallen off in the first half of 2014, fully 15% of activist targets during that period had market capitalisations of more than \$2 billion. In some cases, activists have achieved significant successes despite relatively small shareholdings. ValueAct Capital Management, for instance, secured a seat for its President on the board of Microsoft in August 2013 with just 0.8% of the company’s shares (Vardi, 2013b). Ralph Whitworth of Relational Investors was appointed as a director of Hewlett Packard in late 2011, and later interim chairman, although his fund held a stake of only 1.5% in H-P (Benoit, 2013a; Foley, 2014).

Figure 12: Market Capitalisation of Companies Targeted by Activist Alternative Investment Funds



Source: Activist Insight; ALMA / Simmons & Simmons
 Market capitalisations: Nano: ≥\$0<\$50 million; Micro: ≥\$50 million<\$300 million; Small: ≥\$300 million<\$2 billion; Mid: ≥\$2 billion<\$10 billion; Large: ≥\$10 billion

Activist funds certainly have more capital than ever before with which to make more ambitious investments (Weingarten and Rosewater, 2014). But activist successes at the largest companies have largely relied on growing support from non-activist shareholders and proxy advisory firms, as well as greater understanding of activism by target company management and boards (Thurm and Benoit, 2012).

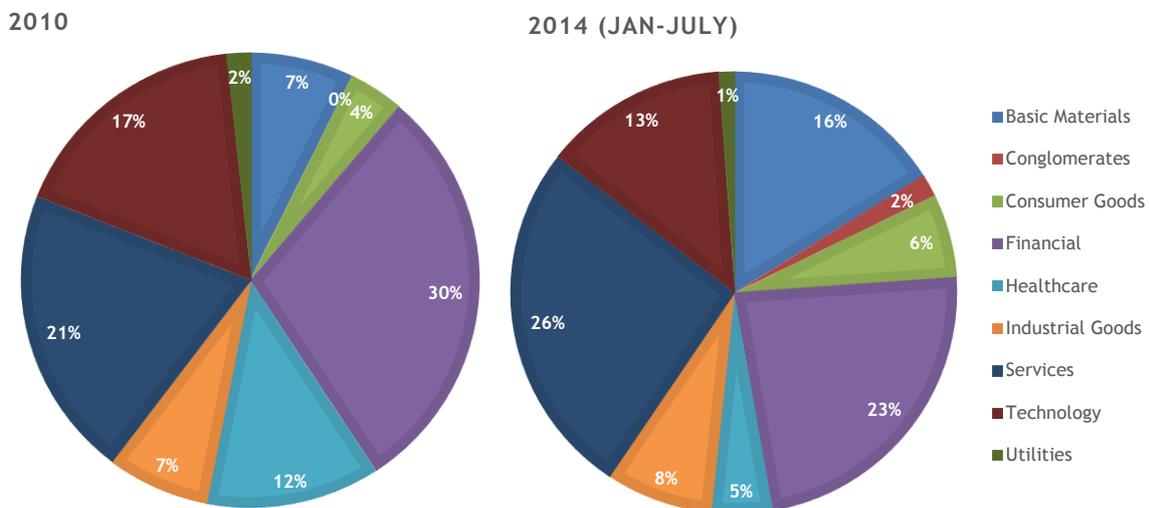
Activist engagement with larger companies has not come at the expense of smaller and medium-sized targets. 63% of companies targeted by activists in the first half of 2014 had market capitalisations of between \$300 million and \$10 billion, according to Activist Insight.

²² Other research shows a similar trend. Data provider FactSet SharkWatch (2013), for example, found that activist campaigns aimed at companies with market capitalisations greater than \$1 billion increased from 7% in 2009 to 30% in early 2013. According to McKinsey (Cyriac et al, 2014), U.S.-listed companies targeted by activists in 2013 had an average market cap of \$10 billion, compared with \$2 billion at the end of 2010.

3.3.4 Industry

Activist alternative investors target companies in a range of industries, and as a whole do not display any clear preference for any particular sector (Figure 13). Some individual managers focus on particular sectors - Triam Fund Management, for example, tends to target consumer products and financial companies - while others remain industry generalists. In very broad terms, industries that are most attractive to activist funds at a particular time appear to show dynamics that favour their constituent companies having some or many of the characteristics that activists look for (see sections 3.3.1 and 3.3.2 above). The U.S. technology sector, for instance, has remained popular to activists in recent years, not least because several technology companies have large cash balances, minimal debt levels and relatively low payout ratios (see Moody's Investor Service (2014)).

Figure 13: Industry Focus of Activist Alternative Investment Funds (% of New Campaigns Initiated)



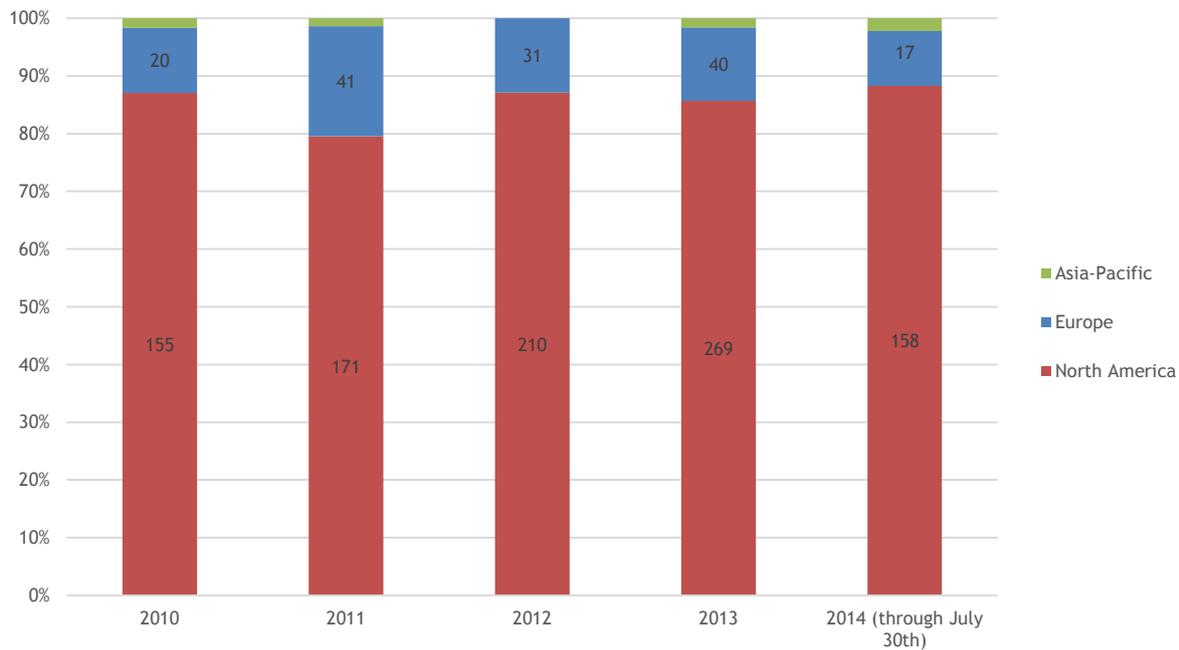
Source: Activist Insight; AIMA / Simmons & Simmons

3.3.5 Geographical Location

A large majority of companies targeted by activist alternative investors are based in the United States - 84% of activist engagements by alternative investors recorded by Activist Insight in 2013 involved American listed companies. After the U.S., British and Canadian listed companies are the next most likely to attract activists, respectively accounting for 9% and 2% of activist engagements by alternative investors in 2013.

On a proportionate basis, the regional dispersion of activist investment has remained fairly constant in recent years. In each of the years 2010 to 2013 and in 2014 through 30 July, companies listed in North America have received between 80% and 90%, and European listed companies between 10% and 20%, of activist engagements from alternative investors globally (Figure 14). Yet as overall alternative investor activism has grown, an increasing number of activist targets are based outside of the U.S.

Figure 14: Regional Exchange Listing Location of Targets of Activist Alternative Investment (% of New Campaigns Initiated)



Source: Activist Insight; ALMA / Simmons & Simmons

3.4 Investors in Activist Funds

Preqin provides data on institutional investors with a stated preference for activist hedge funds. This data shows that institutional investment in activist hedge funds is dominated by a narrow selection of investor types. As of 30 May 2014, private and public pension funds, foundations and fund of hedge funds accounted for 81% of investors with a preference for activist hedge funds, despite making up only 59% of the hedge fund investor universe as a whole (Figure 15).

Investors with an appetite for activist hedge fund allocations also show a much stronger preference for direct investments compared with the hedge fund investor universe as a whole: just 3% of investors commit to activist hedge funds solely through funds of hedge funds, compared with 29% of all hedge fund investors (Figure 16). According to Preqin (2014c), investors willing to take on the risk of investing in activist hedge funds are likely to be more established hedge fund investors and as a result are likely to be able to have a portfolio of single-manager funds. In addition, Preqin notes that there are not many activist-specific funds of hedge funds, so investors looking for exposure to activist hedge fund strategies are more likely to invest directly (*Id.*).

Figure 15: Investors with a Preference for Activist Hedge Funds by Investor Type (30 May 2014)

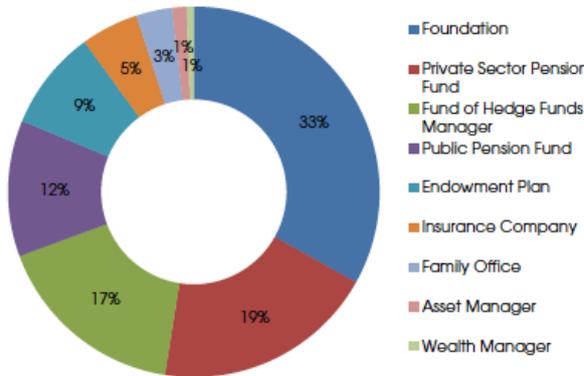
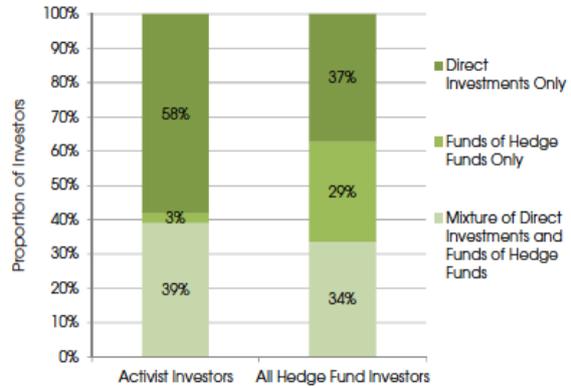


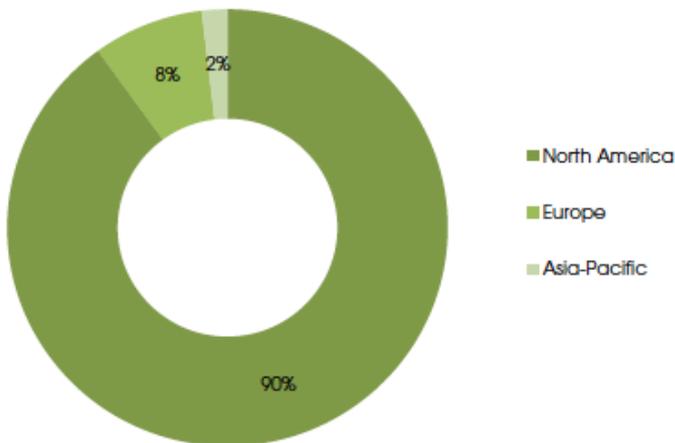
Figure 16: Method of Investing in Activist and All Hedge Funds (30 May 2014)



Source: Preqin (2014c)

In terms of geographical distribution, investors based in North America account for 90% of institutional investor interest in activist hedge funds (Figure 17). The proportion of investors in activist hedge funds based in North America substantially exceeds the proportion of North American-based activist hedge fund managers (Figure 7), suggesting that activist hedge funds have yet to generate widespread appeal globally.

Figure 17: Investors with a Preference for Activist Hedge Funds by Investor Location (30 May 2014)



Source: Preqin (2014c)

4 Activist Strategies

4.1 Stakebuilding and Extension Tactics

4.1.1 Size and Timing of Accumulations

Activist alternative investors tend to hold meaningful non-controlling stakes in target companies, which are frequently increased over the period of engagement. Activist alternative investors also tend to hold concentrated portfolios and take larger percentage stakes in target companies than mutual funds, activist pension funds and other “traditional” institutional shareholders, which typically maintain diversified portfolios (see, e.g., Brav et al (2008)). They also generally maintain larger holdings than passive investors (Clifford, 2008).

Table 3 below shows the initial shareholdings and maximum shareholdings during the period of engagement (expressed both as percentages and dollar value at cost) in the cases of American hedge fund activism between 1994 and 2011 studied by Brav et al (2013a).²³ Those results are broadly comparable to those reported by other studies of U.S. hedge fund activism (Brav et al, 2008b; 2009; Clifford, 2008; Greenwood and Schor, 2009; Boyson and Mooradian, 2011).

Table 3: Percentage Shareholdings and Capital Committed: U.S. Activist Investments 1994-2011

	Initial Shareholding		Maximum Shareholding	
	% Ownership	Capital Committed (\$ million)	% Ownership	Capital Committed (\$ million)
5 th percentile	5.0	0.9	5.2	1.1
25 th percentile	5.4	4.4	7.0	5.8
Median	6.4	13.5	9.5	18.6
75 th percentile	9.4	41.3	14.0	54.7
95 th percentile	21.8	185.1	31.0	244.9
Average	9.0	55.4	12.9	70.0

Source: Brav et al (2013a)

Activist holdings appear to be smaller in percentage terms outside of the U.S. Becht et al (2010), for example, found the average disclosed stake size in European targets of activism between 2000 and 2008 to be 6.1% (median 5.0%) rising over the period of activist engagement to 9.7% (median 7.0%). Activist holdings in Japanese companies analysed by Hamao et al (2011) averaged 6.8% (median 5.3%) rising to 9.9% (median 7.4%) over the period of engagement.

Of course, activists may also take smaller undisclosed holdings. Using a database of private activist interventions in Europe, Becht et al (2010) report undisclosed stakes averaging 2.7% (median 2.3%), rising to 3.5% over the period of engagement (median 2.9%).

²³ Disclosed figures on activist shareholdings do not capture the effect of derivatives and other “decoupling” techniques that do not require disclosure (see section 4.1.2 below).

Gantchev and Jotikasthira (2013) document the trading behaviour of U.S. activist hedge funds between 2000 and 2007. They find that almost all hedge fund purchases of target company shares are executed in the open market in a small number of large trades. On average, the activist hedge funds they analysed purchased 4.25% of the target's outstanding shares in the two months before disclosure of the activist engagement, over 1% on the date they cross the 5% disclosure threshold, and over 1% more until the public announcement of their activist intentions. The authors report a significant price run-up in the 60 days before an activist campaign, especially in the 10 days between the date on which the activist's holdings cross the 5% threshold and the 13D filing date, which coincides with the accumulation of the hedge fund's position. Bebchuk et al (2013c) confirm that U.S. activist hedge funds make use of the ten-day period for permissible filings, with the majority filing their Schedule 13D between seven and ten days after they have crossed the 5% threshold and nearly 20% filing on the tenth day itself. Of course, these patterns do not account for undisclosed holdings, which may arise either because an activist may engage a target company with less than a 5% shareholding or due to the use of derivatives and other "decoupling" techniques (see section 4.1.2).

4.1.2 Use of Derivatives and Other "Decoupling" Techniques

The extent to which activist funds employ derivatives as part of their investment strategies is not fully known, since many derivative positions do not need to be disclosed. Their use is, however, thought to be fairly widespread. For example, in 16.1% of the cases of U.S. hedge fund activism analysed by Brav et al (2008), hedge funds reported derivative positions in the target companies, with the most common types being options, warrants, convertible debt and convertible preference shares. Taking into account derivative positions that are not disclosed, the true proportion of activist holdings involving derivatives is probably considerably higher.

Derivatives are not the only means by which activist hedge funds can extend the reach of their holdings. Through share loan agreements, for example, an activist borrower can acquire voting rights but no economic ownership, while the lender retains economic ownership without voting rights. The activist's voting strength can thus be varied through the course of the activist engagement. An activist fund can, for example, borrow shares just before the record date for a shareholder vote, and then return the shares afterwards. The first publicly reported instance of this "record date capture" strategy was executed in the United Kingdom by activist fund Laxey Partners (Hu and Black, 2006). At British Land's 2002 annual general meeting, Laxey Partners, which owned an interest of about 1% in the company, proposed to oust its Chairman (*Ibid.*). In the days before the record date for the vote, Laxey borrowed shares representing a further 8% of British Land from Hermes, Barclays Global Investors and Scottish Widows, increasing the fund's voting weight to 9% (Scannell, 2007). In the event, Laxey's proposals were ultimately unsuccessful, but the practice has since been replicated (*Id.*; Hu and Black, 2006).

Hu and Black (2006) use the term "decoupling" to describe situations in which a shareholder's economic ownership is separated from their voting rights, either because they hold more votes than shares or their economic interest exceeds their voting rights. Several

commentators, regulators and lawmakers have expressed concern about the effects of such practices, which undermine the basic “one share, one vote” principle of corporate governance. In an extreme case, an investor can vote despite having a negative economic ownership, which gives the investor an incentive to vote in ways that reduce the company’s share price. Decoupling techniques can also be used to avoid a range of regulatory requirements, including rules on disclosure of significant shareholdings, mandatory bids, recapture of “short-swing” trading profits and vote buying (Hu and Black, 2006; 2007; 2008). On the other hand, there are likely to be a number of benefits arising from the use of decoupling techniques, such as increased efficiency through reduced transaction costs (Hu and Black, 2008; Brav and Matthews, 2011).

Hu and Black (2008) describe 82 publicly reported cases of decoupling by hedge funds, other investors, companies themselves and their executives between 2001 and 2007 worldwide, of which the majority took place in Europe. Katelouzou (2013) finds 17 publicly reported cases of decoupling by activist hedge funds in Europe between 2002 and 2010. Of these, only four involved the fund holding more votes than shares (through share lending and one case of short selling), suggesting that the more common practice of decoupling by activist funds is to boost the fund’s economic interest over its voting stake, primarily by using derivatives. Of course, the true prevalence of such techniques remains only partly known.

4.2 Activist Objectives and Outcomes

An activist’s “objectives” - their strategic goals going into an investment - cannot always be clearly distinguished from the “outcomes” of activism - the changes in a target company that result from the activist’s engagement. In some cases, activists make their objectives clear, perhaps in the press, in regulatory filings or in proxy communications. Some academics have also been given access to the private records of activists with which they can test the link between objectives and outcomes (see, e.g., Becht, 2009). In many cases, however, an activist’s intentions are not made clear to the outside world. Those intentions may change during a course of a campaign or may be compromised through negotiation with the target company’s management or board.

To the extent that they can be ascertained, the objectives of alternative investor activism generally fall within four broad groups,²⁴ each related to:

1. *Improving capital efficiency* - proposing changes to reduce excess cash, increase or reduce leverage and/or deliver higher payouts to shareholders (such as through increased dividends, special dividends or share repurchases), or suggesting that the company undertake (or refrain from undertaking) an equity issuance, debt restructuring or other recapitalisation ;
2. *Changing the company strategy* - pressing the company’s management and board to cut costs, improve operational efficiency, or pursue initiatives to enhance tax efficiency, restructure the business, sell or spin-off a division, questioning the

²⁴ See, e.g., Bratton (2007) and Brav et al (2008a).

company’s growth strategy, or discouraging or pressing for better terms on a pending acquisition by or from the company;

3. *Selling of the target company* - usually involving selling the company or its main assets to a third party, but occasionally the purchase of all of, or a controlling interest in, the company by the activist; and/or
4. *Improving corporate governance* - such as seeking representation on the board, proposing the rescission of “poison pills” and other takeover defences, calling for the dismissal of the chief executive or chairman, seeking changes to executive compensation, or pursuing other governance-related changes.

These objectives are not mutually exclusive (or at least not all of them are) and one activist might target multiple issues (Brav et al, 2008a).

Activism focused on the first three objectives is sometimes called “*operational activism*” or “*strategic activism*,” while activism focused on the fourth objective is sometimes called “*governance activism*” (see, e.g., Bebchuk, 2013b). Cevian Capital, for instance, describes itself as an operational activist (Kerr, 2008). Governance changes are frequently sought by activist funds as a step towards achieving operational or strategic changes (see, e.g., Katelouzou (2013); Gantchev Costs; Bebchuk, 2013b).

According to data on global activism provided by Activist Insight, governance-related proposals account for more than half of the objectives of activist alternative investors (Figure 18). In many cases such proposals will be pursued in order to facilitate other changes. In about a third of cases, for example, the activist seeks representation among the board of directors of the target company (Figure 19). Objectives related to a target’s strategic direction account for about a quarter of cases. This suggests the concerns that activism by hedge funds and other alternative investors is primarily about “financial engineering” (see, e.g., Surowiecki, 2013) are not well-founded.

Figure 18: Proportion of Activist Hedge Fund Objectives by Type (31 July 2006-30 July 2014)

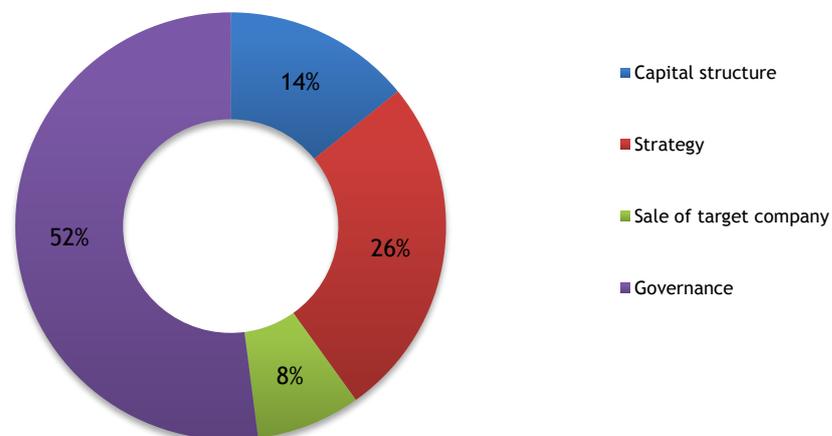
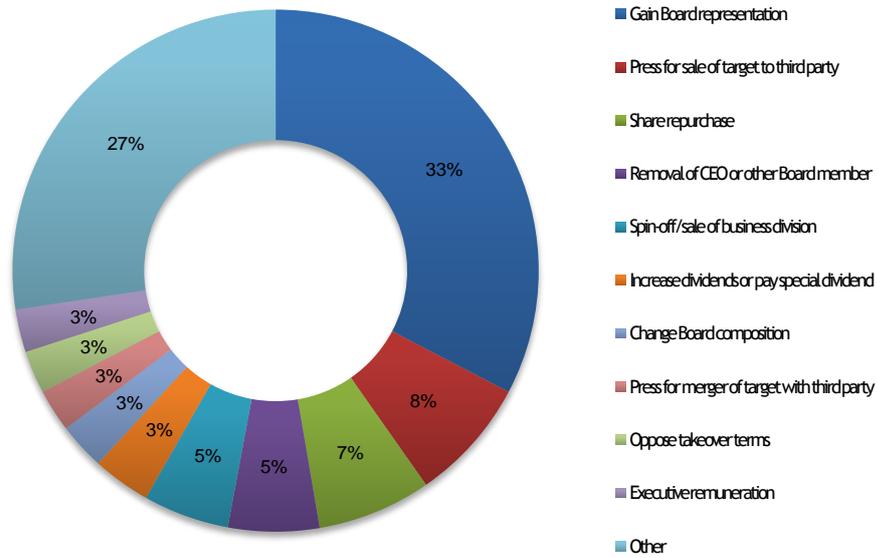


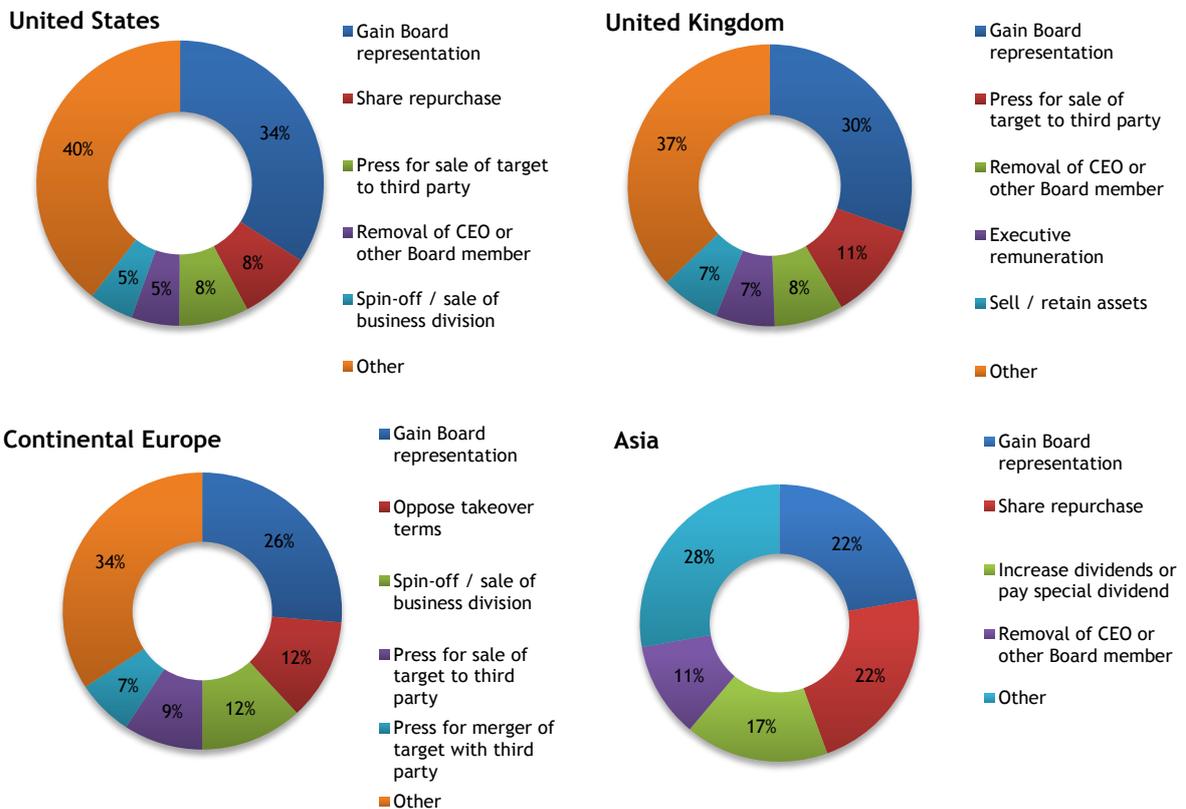
Figure 19: Most Common Activist Hedge Fund Objectives (31 July 2006-31 July 2014)



Source: Activist Insight; AIMA / Simmons & Simmons

There is some regional variation among the objectives most commonly pursued by activists (Figure 20). Proposals for share repurchases appear to be more prevalent in the U.S. and Asia than in Europe, while activists are more likely to seek board representation in the U.S.

Figure 20: Most Common Activist Alternative Investment Fund Objectives by Regional Location of Target (31 July 2006-31 July 2014)

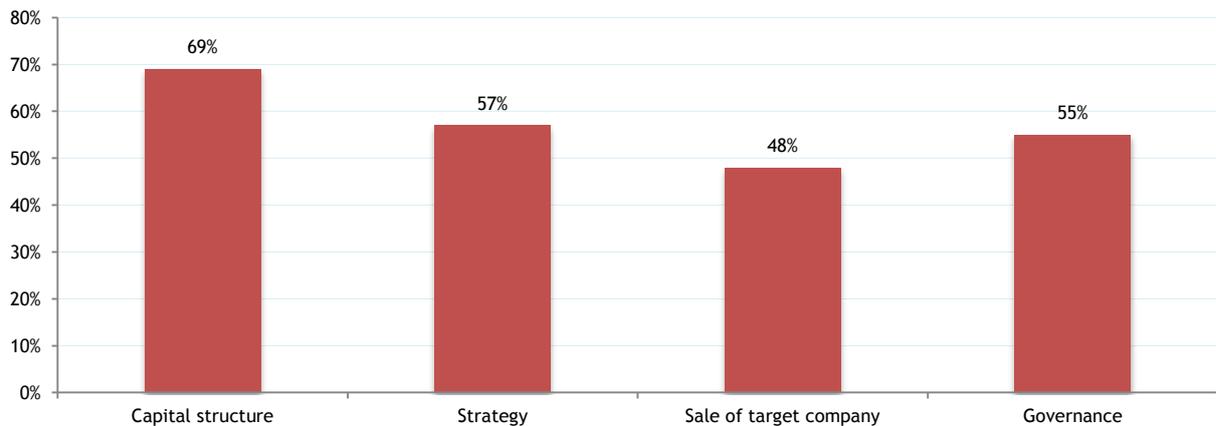


Source: Activist Insight; AIMA / Simmons & Simmons

Activist alternative investors appear on the whole to be quite successful in achieving their objectives. They were successful in 57% of the cases recorded by Activist Insight, partially successful in 13% of the cases, and unsuccessful 30% of the time.²⁵ Proposals relating to the capital structure of target companies (such as proposals to reduce excess cash or undertake a capital restructuring) are the most likely to result in successful outcomes, achieving a success rate of almost 70% (Figure 21). Other studies of alternative activism have found comparable results on the success of hedge funds in achieving their stated goals. For instance, Klein and Zur (2009), Boyson and Mooradian (2011) and Brav et al (2013a) each report success rates for U.S. hedge fund activism of around two-thirds, while Becht et al (2014) find that activist campaigns by alternative investors in North America, Europe and Asia yield on average 0.75 outcomes each.²⁶

According to Activist Insight data, alternative activism targeting companies in the United Kingdom is the most likely to succeed (62% success rate), followed by Canada (61%), the United States and continental Europe (53% each), while Asian activism is the least likely to succeed (46%). Becht et al (2014) looked at activism occurring between 2000 and 2010 and found that North American activism was the most likely to succeed (56% success rate), followed by Europe (46%) and then Asia (just 17%). Hamao et al (2011) supports the view that alternative investor activism in Asia is generally the least successful, reporting that hedge fund activists in Japan were successful in 38% of the sampled cases.

Figure 21: Most Successful Objectives (Percentage of Successful Cases) (31 July 2006-30 July 2014)

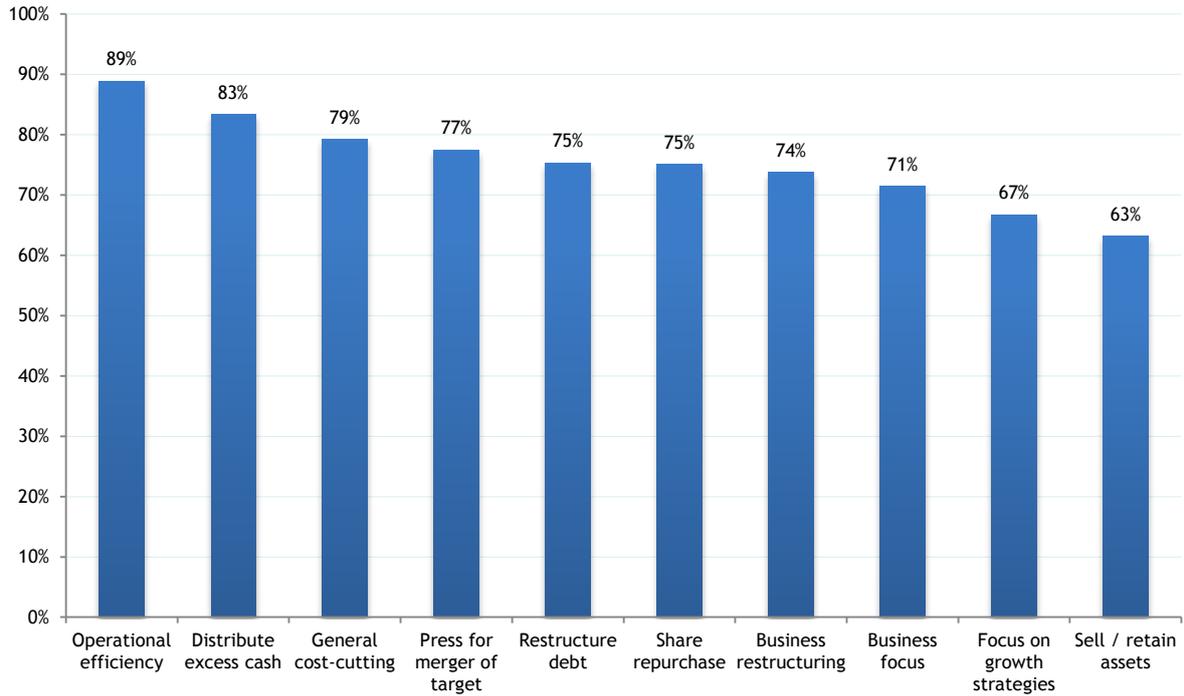


Source: Activist Insight; AIMA / Simmons & Simmons

²⁵ Activist Insight defines an activist campaign as “successful” if all of the activist’s stated demands are met (such as the election of the whole slate of the activist’s nominees to the target company board), “partially successful” if some but not all of the activist’s stated demands are met (such as the election of some but not all of the activist’s board nominees) and “unsuccessful” if none of the activist’s stated demands are met (such as the election of none of the activist’s board nominees).

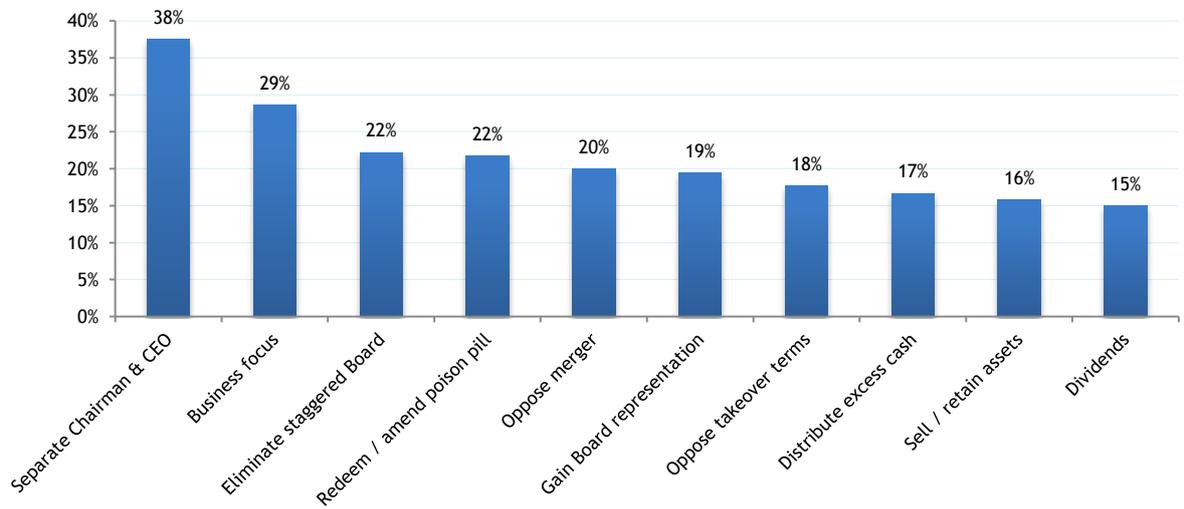
²⁶ In other words, while some activist campaigns produce more than one outcome, and some campaigns do not produce any outcome, Becht et al (2014) report an average rate of 75 outcomes for every 100 campaigns.

Figure 22: Most Successful Objectives (Percentage of Successful Cases) (31 July 2006-30 July 2014)



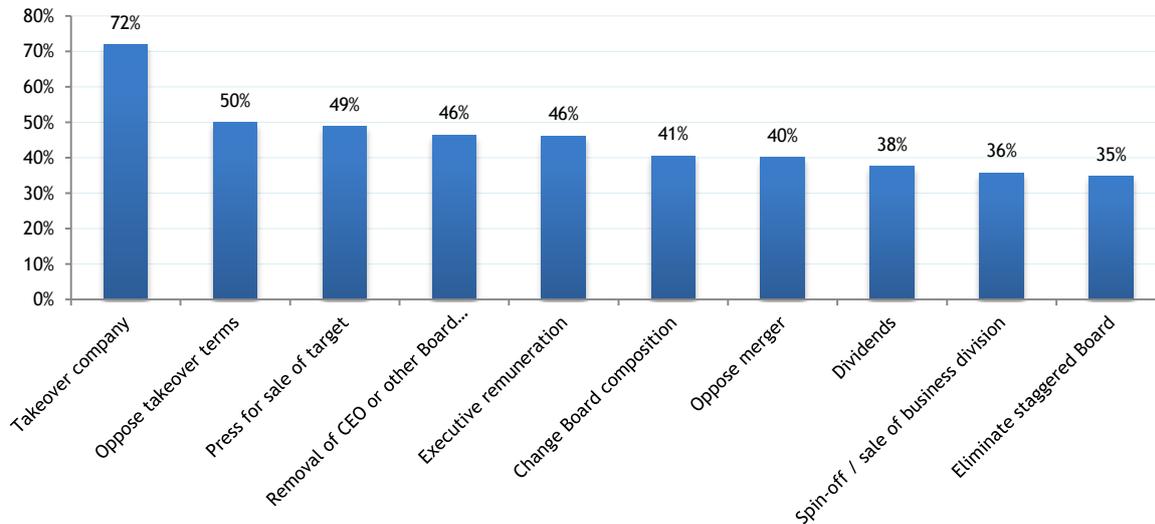
Source: Activist Insight; AIMA / Simmons & Simmons

Figure 23: Most Partially Successful Objectives (Percentage of Cases that are Partially Successful) (31 July 2006-30 July 2014)



Source: Activist Insight; AIMA / Simmons & Simmons

Figure 24: Most Unsuccessful Objectives (Percentage of Cases that are Unsuccessful) (31 July 2006-30 July 2014)



Source: Activist Insight; AIMA / Simmons & Simmons

It makes intuitive sense that an activist fund manager's success in achieving an outcome should be closely correlated to the fund's returns. Becht et al (2014) report that when activist engagements do not result in a positive outcome, the target company's shares produce negative or only slightly positive returns over the period 20 days before disclosure of the activist stake to the date the activist exits. In addition, several studies have shown that some disclosed objectives and outcomes tend to produce greater returns than others, although the results of such studies are inconsistent. For example, Brav et al (2008), Greenwood and Schor (2009), Becht et al (2010) and Becht et al (2014) each identify the greatest abnormal returns either where the activist discloses its intentions to press for a sale of the target company or the activist campaign results in the target being sold. Boyson and Mooradian (2011) report that disclosures of governance-related objectives produce the greatest returns. Klein and Zur (2009) find the highest statistically significant returns where the activist states that it intends to acquire the target or seek changes to the composition of the board of directors.

4.3 Engagement Tactics

The following are the tactics most commonly employed by activist alternative investors to engage with the management and directors of target companies:²⁷

1. Private communications (letters, meetings, etc.) and informal proposals
2. Seeking board representation²⁸ without a proxy contest or confrontation with the existing management or board
3. Making formal shareholder proposals
4. Publicly criticising the target's current strategy, management and/or board

²⁷ See, e.g., Brav et al (2008a); Becht et al (2009); Katelouzou (2013).

²⁸ Seeking board representation may be considered both an objective and tactic where it is an important step in activist engagement but not its ultimate goal (c.f., e.g., Brav et al (2008a); Katelouzou (2013); Bebchuk (2013); Gantchev

5. Launching a proxy contest to replace one or more directors, including the chief executive, chairman or the entire board
6. Litigation against the target or its directors
7. Seeking control of the target, such as via a takeover bid

Activist engagement tactics thus fall along a continuum between approaches that aim for collaboration with incumbent leadership of the target company (such as private meetings with management) and highly confrontational approaches (such as a takeover bid). A number of activist fund managers use the term “*constructivism*” to distinguish collaborative approaches from the aggressive tactics commonly associated with hedge fund “activism” (see, e.g., Vardi, 2013a). Some fund managers focus primarily or wholly on constructivist tactics (Kerr, 2008; Foley, 2013; Benoit, 2013b). Such managers often take relatively long-term stakes in target companies, aiming to work in cooperation with management over a period of years (see, e.g., Kerr, 2008).²⁹ In other cases, an activist alternative investor will begin with a co-operative approach and then, if their demands are not complied with, shift to a more assertive stance (see, e.g., Boyson and Mooradian, 2011; Brav et al, 2013a; Gantchev, 2013).

The most intimate study of activist engagement by an alternative investor is a clinical study of the Hermes UK Focus Fund by Becht et al (2009), although it is limited to the activities of a single fund manager. They found that Hermes met repeatedly over the course of engagements with target companies’ executives (about 10 times per campaign on average and in one case almost 50 times), including meeting with the chief executives, chairmen and chief financial officers, and often other executives, such as the head of investor relations, the senior independent director, the chairman of the executive remuneration committee and non-executive directors. In more than half of the campaigns studied, Hermes also sent representatives to visit the headquarters and operations sites of target companies. The fund manager only once posed a question at or added an item to the agenda for an annual general meeting, and it planned just one extraordinary general meeting. Hermes twice successfully blocked a rights issue and twice initiated a press campaign to support its agenda, but it never participated in litigation against a target company or attempted a takeover. The Hermes study provides a rare glimpse into the private activities of an activist fund manager. The engagement was more private and co-operative than most, and reflective of an approach that appears to be more common in Europe than the U.S. (as discussed below).

Activist alternative investment funds are generally more willing than other investors to adopt the more expensive and assertive tactics, such as public pressure and proxy contests (see, e.g., Partnoy and Thomas, 2007; Kahan and Rock, 2007; Becht et al, 2014). Still, while public engagements often receive media attention, they do not appear to constitute the dominant approach even in the U.S. Negotiation and seeking board representation with the consent of the incumbent directors and management make up more than half of the cases of U.S. hedge fund activism analysed by each of Brav et al (2008; 2009; 2013a) and Gantchev (2013). Attempts to take control of a target or litigation directed at the company appear to be the least common approaches (Brav et al, 2008; 2009; 2013a). Figure 25 summarises the results of a study of U.S. hedge fund activism between 1994 and 2011 by Brav et al (2013a).

²⁹ In the early 1990s, similar engagement strategies by other institutional investors came to be known as “relationship” or “relational” investing (see Eisenhofer and Barry, 2013, pp. 3-66-3-68).

Figure 25: Frequency of U.S. Activist Hedge Funds' Tactics (1994-2011)

Tactic	% of Events
“Non-Hostile” Tactics	78.9
1. Hedge fund intends to communicate with the board / management or stake is for investment purposes only	43.1
2. Hedge fund seeks Board representation without a proxy contest or confrontation with the existing management / board	12.9
3. Hedge fund makes formal shareholder proposals, or publicly criticizes the company and demands change	22.9
“Hostile” Tactics	21.1
4. Hedge fund threatens to wage a proxy fight to gain board representation, or to sue the company	6.5
5. Hedge fund launches a proxy contest in order to replace the board	8.5
6. Hedge fund sues the company	3.0
7. Hedge fund intends to take control of the company	3.1

Source: Brav et al (2013a)

Brav et al classify the first three of their identified tactics as “non-hostile” and the fourth to seventh tactics as “hostile” (see, Brav et al, 2008; 2013a). Their results suggest that, even in the U.S., activist hedge fund tactics are non-hostile almost 80% of the time. Bebchuk et al (2013) also classify as “adversarial” just over 20% of the cases of U.S. hedge fund activism that they analyse. Similarly, Boyson and Mooradian (2011) report that most U.S. activist hedge fund activity relates to negotiations with target company management and directors, rather than more aggressive tactics. In their study of 418 activist campaigns by U.S. hedge funds between 1994 and 2005, 270 (65%) involved the activist disclosing an intention only to communicate with the target company’s management or board or hold the stake for investment purposes, in 49 (12%) such intentions were later replaced by an intention to press for some change in the target, and 99 (24%) involved disclosures of an intention to press for change from the outset.

The significance of cases from those studies where activists disclose an intention to communicate or hold the stake for investment purposes should not be overstated, since this may not always mean that communications with management or directors are actually taking place. Such disclosures might be made, for example, if a campaign is simply not continued beyond an early stage. Data compiled by Brav et al (2013a) shown in Figure 26 suggests that when U.S. hedge fund activists do disclose an intention to press for change in the target company, they are also quite likely to disclose an intention to pursue a “hostile” tactic. That data still does not indicate that the use of such tactics amounts to a dominant force among U.S. hedge fund activism, however. In addition, such studies, which rely on public disclosures, are likely to underestimate the private, “behind-the-scenes” activism that by definition is less aggressive. The incidence of such private activism is likely to be substantial (see, e.g., Becht et al, 2010; Katelouzou, 2013).

Figure 26: Frequency of U.S. Activist Hedge Funds' Tactics (1994-2011)

Objective	% Initially Hostile	% Ex-post Hostile
Capital structure	20.5	45.5
Business strategy	26.3	62.6
Sale of target company	22.6	56.5
Governance	24.1	59.0

Source: Brav et al (2013a)

Events are classified as "Initially Hostile" if they had begun hostile and "Ex-post Hostile" if they turned hostile. Percentages sum up to more than 100% because one event can have multiple objectives.

Outside of the United States, shareholder activism is even more likely to be private and "constructivist." Katelouzou (2013) analyses 432 activist campaigns by hedge funds in 17 countries excluding the U.S. between 2000 and 2010 and finds that what she terms "aggressive activism" occurs only about 30% of the time (Figure 27). Of the 164 campaigns she analyses that involve a mixture of "quiet," "soft" and "aggressive" tactics, 138 (84%) involved an escalating strategy from less to more aggressive tactics, while in the remaining 26 (16%), activist funds started an aggressive engagement at the outset and switched to a more co-operative approach after failing to secure the desired results. Based on proprietary data collected from five European activist alternative investment funds, Becht et al (2010) suggest that a substantial proportion of the total amount of activism by some European funds is likely to be private. Industry observers support the view that aggressive tactics by activists are likely to be less utilised outside of the U.S. For example, Maarten Wildschut, lead portfolio manager of RWC's European Focus fund told the *Financial Times* in late 2013 that: "Aggressive activism in Europe has been tested over the past two years and broadly failed. If you are immediately hostile, you will not get co-operation from the company's board" (Marriage, 2013). Nevertheless, activists have and continue to successfully use hostile tactics in Europe and elsewhere.

Activism employing hostile tactics tends to produce higher short-term returns in target company shares than non-hostile approaches in the U.S., Europe and Japan (Brav et al, 2008a; 2009; Becht et al, 2010; Boyson and Mooradian, 2011; Hamao et al, 2011; Brav et al, 2013a). This may be because hostile campaigns are more likely to target changes that are resisted by management and that would not otherwise have happened (Brav et al, 2008a).³⁰ On the other hand, hostile campaigns are usually significantly more expensive. Gantchev (2013), for example, estimates that the average cost of an activist campaign ending in a proxy contest runs to more than \$10 million. With regard to the proprietary data of five European activist alternative investment funds, Becht et al (2014) suggest that the net returns to funds employing purely private activist tactics is generally higher than those pursuing public campaigns. Hostile campaigns also typically require a larger stake in the target company to pull off (Brav et al, 2008; 2009; Boyson and Mooradian, 2011; Brav et al, 2013a). Brav et al (2013a) estimate that, on average, a hostile campaign requires the activist to invest almost \$20 million more than a non-hostile campaign, although the difference can be significantly larger. In general, cooperative activism also appears to be significantly more successful (Brav et al, 2008; 2009; Boyson and Mooradian, 2011, Becht et al, 2014). According to Brav et al (2008), non-hostile campaigns are successful 30% more often than hostile campaigns.

³⁰ Bebchuk et al (2013) show that adversarial campaigns tend to produce improvements in the operating performance of target companies up to five years following the intervention, suggesting that such changes are generally justified. Hamao et al (2011) report that superior returns to companies targeted by hostile activists compared with non-hostile activists in Japan are maintained over the fund's holding period.

Figure 27: Frequency of Activist Hedge Funds' Tactics Outside of the U.S. (2000-2010)

Tactic	% of Events
“Gentle Activism”	29.8
1. Quiet persuasion (behind the scenes)	9.5
2. Communication (letter / meetings)	13.9
3. Informal proposals / Business plans	6.3
“Soft Activism”	39.5
4. Public criticism or demand for change	27.3
5. Board representation (no reported management confrontation)	5.0
6. Formal shareholder proposal	7.2
“Aggressive Activism”	30.7
7. Against shareholder resolution recommended by management / Proxy contest for reasons other than the composition of the Board	5.3
8. Board representation against management’s will	3.6
9. Against re-election or pressing for removal of key executives	2.4
10. Threatening to remove Director(s), pursue litigation or launch a takeover bid	4.8
11. Suing the company	4.3
12. Seeking Board control	6.1
13. Launching a takeover bid for the target company	4.2

Source: Katelouzou (2013)

Of course, there are other, unquantifiable advantages and disadvantages to taking a collaborative or confrontational approach. For instance, hostile campaigns are often highly public and the activist can use that attention to put further pressure on target company management and directors. Conversely, such publicity may also expose the fund manager to reputational damage in the case the campaign fails. Some major shareholders, whose support the activist may need to win in more than one campaign, may also be less willing to back activists employing the most aggressive tactics (see Alexander 2014). Further, in a collaborative process, activists often enjoy regular access to management and corporate information. In contrast activists are generally cut off in times when the campaign is more hostile (Bessemer Trust, 2013).

4.4 Investment Horizon and Exit

Contrary to claims that activist alternative investors are primarily focused on realising short-term profits (see, e.g., Lipton, 2013), most activist funds have relatively long investment horizons. The average holding period of activist funds tracked by Activist Insight is more than seven calendar quarters (Table 4) for exited investments with the holding period

substantially longer for investments currently held. This implies an emerging trend towards longer holding periods among activist alternative investors.

Table 4: Average Holding Periods for Exited Investments of Activist Alternative investment Funds

Activism Focus	Average Holding Period (days)
Primary Focus	723
Partial Focus	616
Occasional	511
Total	655
Activist's Approach	Average Holding Period (days)
Collaborative	703
Confrontational	621
Mixed	630
Total	655

Source: Activist Insight; AIMA / Simmons & Simmons

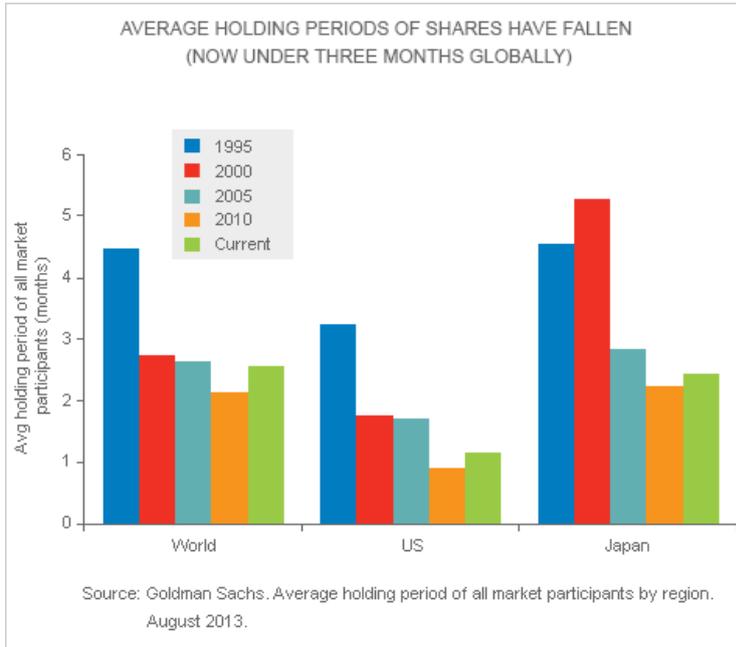
Average holding periods stated as mean duration of all exited investments by activist alternative investment funds on the Activist Insight database

Activist Insight's data on holding periods is comparable to that of earlier studies of activism by alternative investors. U.S. activist hedge funds studied by Brav et al (2013a), for example, had an average investment horizon of 581 days, with a median of 348 days. The average holding period in the sample of international alternative investor activism by Becht et al (2014) is slightly over 1.5 years, with an average of 710 days for investments in Asian companies, 640 days for European companies and 515 days in North America.

Alternative investors specialised exclusively or partially on activism appear to have longer investment horizons than occasional activists, with primary focused activists holding their investments for about two years on average. In addition, activists engaging primarily in collaborative tactics generally have longer investment horizons than those adopting confrontational tactics. Other studies have found similar results. For example, in the sample of Brav et al (2013a), hostile investments were held for 325 days on average (median 179 days), while the average investment horizon for the whole sample was 581 days (median 348 days). This suggests that collaborative approaches are typically less focused on short-term solutions (such as a one-time share buyback) and more appropriate for activist strategies dependent on longer-term engagement, perhaps requiring ongoing interaction with directors and executives of the target company. Some activists that focus on constructivist strategies set explicit longer-term investment horizons in their investment strategies. Cevian Capital, for instance, typically expects to invest for three to four years (Kerr, 2013). Blue Harbor Group's stated investment strategy involves a two- to three-year horizon.

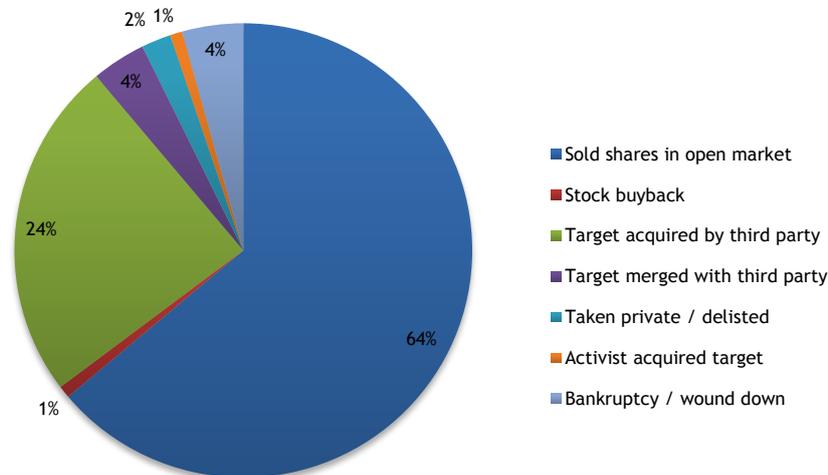
Activist alternative investors therefore hold stocks for considerably longer time periods than the average equity investor. In contrast, research by Goldman Sachs finds that the average holding period of shares globally is less than three months (Figure 28).

Figure 28: Average Holding Periods of All Equity Market Participants Globally (August 2013)



At the conclusion of an activist campaign, the sale of target company shares in the open market is by far the most common exit strategy, accounting for almost two-thirds of the activist hedge fund exits recorded by Activist Insight (Figure 29). In 30% of cases, the target was acquired or merged with a third party, taken private or otherwise delisted. Other exit options are also available although less common, including a repurchase of the activist’s shares by the target company or a takeover of the target by the activist.

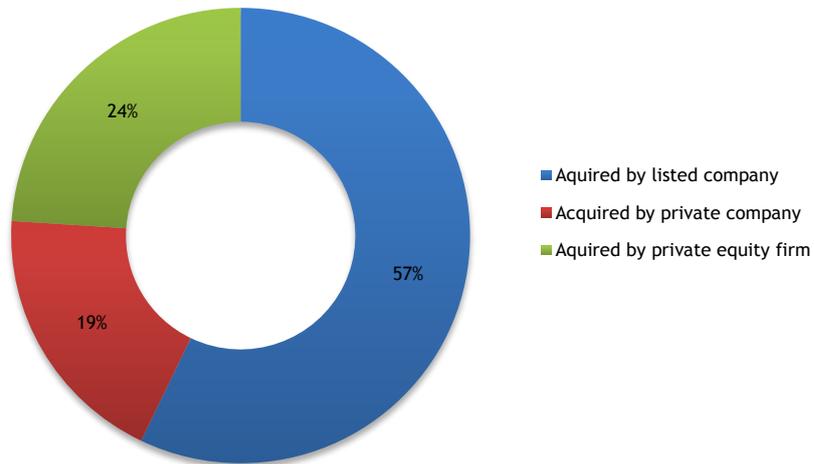
Figure 29: Activist Alternative Investment Fund Exits



Source: Activist Insight; AIMA / Simmons & Simmons

Figure 30 shows the proportion of targets sold to third parties following activist engagement that are acquired by each of listed companies, private companies and private equity (PE) firms.

Figure 30: Buyers of Activist Alternative Investment Fund Targets



Source: Activist Insight; ALMA / Simmons & Simmons

5 Structural Characteristics

The distinctive nature and requirements of activist strategies impact the structure of the funds that deploy them. In particular, activist alternative investment funds:

1. ***Often hold highly liquid securities (public equities) but, like some passive longer-biased managers, take relatively illiquid positions.*** Activist strategies take time to execute, resulting in holding periods averaging over 1.5 years (section 4.4). Activists may also become subject to regulatory restrictions that limit their ability to trade target companies' shares. Activist funds tend to have concentrated positions in a few companies (section 4.1.1), which means that liquidity constraints in one or a few of a fund's positions can quickly become a liquidity problem for the fund's investors.
2. ***May need to raise new capital quickly.*** For example, activist managers frequently seek to amass positions relatively quickly before crossing regulatory blockholding thresholds that trigger disclosure requirements (section 4.1.1), and may need to rapidly increase their positions further at a critical stage.

To better align the liquidity (redemption) rights offered to investors with the liquidity of their underlying assets, activist funds often extend liquidity management tools widely used among other alternative investment vehicles:

- ▶ ***Lockups:*** Activist funds typically have longer lockup periods than other alternative investment funds (Clifford, 2008): 12 months on average in 2013, compared with 6 months for all hedge funds (Prequin, 2014c). Some activist funds, such as Cevian Capital, have lockup periods of 3-5 years (Ahmed, 2010), nearing the investment period of a traditional private equity (PE) fund. Lockups may be "hard" (absolute), "soft" (where redemption is subject to a penalty) or a combination of both (e.g., a hard initial lockup and soft lockups thereafter) (Nissembaum & Bianchini, 2005). In activist funds, lockups are often rolling, where capital not withdrawn at the end of one lockup period is rolled over to another (Breslow, 2005).
- ▶ ***Redemption Frequency & Notice Periods:*** Where rolling lockups are not used, activist managers tend to restrict redemption frequencies more strictly than other hedge funds (redemption frequencies were 2.5 months on average in 2013, compared with 1.7 months for all hedge funds) and require longer redemption notice periods (46 days in 2013, compared with 41 days for all hedge funds) (Prequin, 2014c).
- ▶ ***Gates & Suspensions:*** Activist fund documents may also incorporate fund-level gates (which enable fund managers to limit redemptions up to an agreed percentage of the fund's NAV, typically 10-20% depending on the redemption frequency and often subject to an annual "clean-up call"), investor-level gates (which allow managers to limit redemptions by each investor up to an agreed percentage of that investor's investment in the fund in each redemption period) and rights to suspend redemptions in certain circumstances (which, in practice, are only exercised as a very last resort).

Activist funds may also adapt liquidity management mechanisms traditionally used by other investment vehicles that hold illiquid or hard-to-value assets (e.g., distressed investments and private placements):

- ▶ **Side pockets:** Activists can use side pockets to permit a fund manager to designate a position that it wants to hold for a longer time period (e.g., where the strategy depends on a particular event, like a shareholder vote or a merger) as a “special investment.” Activist funds can also permit a special investment to be designated by the manager at any or a particular time (e.g., if a position becomes subject to regulatory resale restrictions). Side pockets, also known as “special investment accounts,” track special investments, once designated, in an account separate from the fund’s other (more liquid) assets. They are structured like a private equity (PE) fund within a hedge fund (but without many of the investor protections that PE investors would typically demand, e.g., the ability to remove the fund manager, position limits, clawbacks, etc.). New investors do not share in special investments, existing investors exiting the fund remain invested in the side pocket until the underlying assets are realised or the side pocket is otherwise dissolved, and performance compensation is payable only on realised gains (or gains deemed to be realized).
- ▶ **Synthetic side pockets:** Synthetic side pockets are achieved by sequestering less liquid assets in a newly created subsidiary (SPV). The redeeming investor is granted an ownership interest in the SPV as payment “in kind” with a value equivalent to the investor’s share in the fund as of the redemption date. When the SPV sells all or part of the target company’s stock, the proceeds are distributed to the owners of the SPV. Other rules of side pockets are respected (for example, performance fees are paid only once underlying assets realised or deemed to be realised, and new investors do not share in the SPV after it has been created).

As an alternative to side pockets and SPVs, activists (along with other funds seeking to target relatively illiquid assets) may use a separate structure outside their main fund, except for a *de minimis* portion of such investments for which there may be limited capacity in the primary fund vehicle (JP Morgan, 2014).

One response has been the increasing adoption by activists (and other hedge funds holding less liquid assets) of **hybrid vehicles**, which combine elements of the traditional hedge fund model with PE-like features (JP Morgan, 2013). Such structures come in a variety of permutations but fall within two broad categories:

- ▶ **Fixed term:** As with PE vehicles, fixed-term hybrids have finite subscription periods (but may have subsequent closings occurring within a limited timeframe after the initial closing, with later investors paying an interest charge), closed-end terms, specified investment periods and distribution waterfall profit allocations (*Ibid.*; Efron & Grofman, 2009). A 1.5- to 3-year term would be typical, perhaps with a 1-year investment period during which recycling committed capital would be allowed (JP Morgan, 2013) and an option to extend (Efron & Grofman, 2009). Because fixed-term hybrid structures do not provide hedge-fund style liquidity, they tend to charge lower fees (e.g., 1.25% based only on invested, not committed, capital during the life of the fund) (JP Morgan, 2013). Fixed-term hybrid funds provide a preferred return for limited partners followed by a profit split for the sponsor, with the preferred return dependent on the fund’s return profile. Carried interest tends to range from 16%-20% (*Id.*).
- ▶ **Evergreen:** Evergreen hybrids have rolling lockups (typically, an initial hard lockup of 1-3 years, which may be followed by a soft lockup) and rolling subscriptions (*Ibid.*). Because evergreen hybrids constrain liquidity, they tend to charge lower fees than standard, open-ended hedge funds (typically, 1-1.75% depending on the length of the lockup period) (*Ibid.*). Hedge fund performance compensation (annual incentive allocation based on realised and unrealised net capital appreciation subject to loss

carry-forward and/or a GP give-back provision) generally ranges from 15%-20% (with the carried percentage tending to decrease inversely to the length of the lockup) (*Ibid.*).

For investors, hybrids provide greater transparency than side pockets and SPVs, and combine many of the benefits of each of the traditional PE and hedge fund models (e.g., access to potentially highly-yielding, less-liquid assets with rolling subscriptions and redemptions (evergreen) and/or shorter investment horizons, together with reduced fees) (*Ibid.*).

Also increasingly prevalent among activist funds since the financial crisis are **co-investment vehicles** (JP Morgan, 2014). Co-investment vehicles help activist fund managers overcome capacity limits (explicit concentration limits in fund documents and/or self-imposed position limits in their risk management guidelines) in order to acquire significant stakes in targets and act on opportunities quickly (by using co-invest vehicles that are sufficiently capitalized to execute the trade) (*Ibid.*). For investors, co-investments offer reduced fees and enhanced transparency, give access to high-conviction ideas and strategies requiring speed of execution and (because co-investments may be offered to allocators not yet invested in a manager's primary fund) an opportunity to perform due diligence on the manager for its primary vehicle (*Ibid.*). Commonplace in the PE industry, co-investments are vehicles that participate in an investment on a commingled basis or on behalf of a single investor alongside, or in lieu of, an investment manager's main fund (*Ibid.*). As a relatively new phenomenon among hedge funds and other alternative investment vehicles, the co-investment structures that are used tend to be idiosyncratic rather than standardised, but certain patterns are evident:

- ▶ **Evergreen hybrid activist co-investments:** Activist funds using co-investment vehicles to present investors with high conviction ideas and overcome capacity limitations tend to use evergreen hybrid structures (described above) with terms of around 3 years (typically, a 1-year investment period and 2-year harvest) and opt-out or veto rights for individual investments (*Ibid.*). Management fees tend to be 0%-1% on invested capital only, performance fees are 10%-15% on realised investments, which may be subject to a high water mark, and 6%-8% preferred returns on contributed capital (when applicable) with hurdle rates typically depending on the risk/return profile of the underlying investments (*Ibid.*)
- ▶ **Single trade activist co-investments:** Used mostly as overflow structures to obviate capacity constraints on single trades or deals, these structures are most often employed by activist managers with shorter-term, trading-oriented structures (*Ibid.*). Single trade co-investments have finite subscription periods, varying redemption rights but are open-ended with an initial lockup, and are structured both as commingled funds and as single investor funds (*Ibid.*). When structured to accommodate a single investor, the fund documents usually provide a time by which the investment will be liquidated and capital distributed in lieu of a traditional redemption feature (*Ibid.*). Run like separate hedge funds, single trade co-investments usually have their own prime brokerage agreements and investment management agreements and offer no recourse to the manager's main fund (*Ibid.*). In such vehicles, management fees are often waived entirely and performance fees are typically up to 10% above a specified benchmark (*Ibid.*).

Additional structures and tools are also used to manage liquidity, including:

- ▶ **"Fast pay-slow pay"** structures in which illiquid assets are held in a single fund structured more like a hedge fund. These funds are open-ended and continuously offered. Redeeming investors are deemed to own a slice of the fund's entire

portfolio. On redemption, the manager determines which part of the portfolio is liquid (for which payment is made promptly after the redemption date, i.e., “fast pay”), and which part is illiquid (for which payment is made as these investments are realised, i.e., “slow pay”). The slow-pay portion of the portfolio remains in the fund (and is diluted by new capital being contributed), but is captured by a memorandum account. Cash is reserved in connection with the slow-pay portfolio to account for future management fees and general fund expenses. Prior to giving effect to redemptions, the fund pays hedge fund-style performance compensation, with performance compensation from the slow-pay bucket paid on a PE waterfall basis. A mechanism for the fund to purchase the slow-pay investments back from the redeemers may also be established. (Efron & Grofman, 2009).

- ▶ **Crossover funds**, which combine PE and hedge fund strategies within a single vehicle and often bifurcate the fee and liquidity structure accordingly (Breslow, 2005).

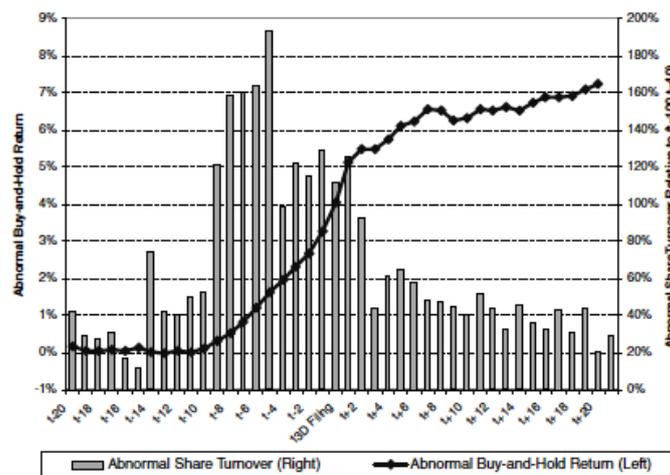
6 Impact of Shareholder Activism by Alternative Investors

Much of the debate surrounding shareholder activism by alternative investors, particularly hedge funds, has focused on whether activists are “good” or “bad” for the companies they target, the shareholders of those companies and the wider economy. Empirical research has shed some light on the real impact of alternative investor activism.

6.1 Short-Term Effects on Share Price and Turnover

A short-term spike in the price and trading volume in the shares of companies targeted by activist alternative investors around the date on which the activist engagement is disclosed is now well documented. In the earliest peer-reviewed research, which analysed U.S. hedge fund activism between 2001 and 2006, Brav et al (2008a) report a run-up in the share price of target companies of about 3.2% between 10 days to 1 day prior to the filing of a Schedule 13D, accompanied by a spike in trading volume. The filing day and the following day see a price increase of about 2.0%. Afterward, the abnormal return keeps trending up to a total of 7.2% in 20 days. They find positive abnormal returns in the period of 20 days before to 20 days after the filing date in 62% of the cases sampled.

Figure 31: Short-Term Impact of Hedge Fund Activism on Share Price and Trading Volume



Source: Brav et al (2008a), p. 1756

The general pattern reported by Brav et al (2008a) is corroborated in subsequent studies of U.S. and international alternative investor activism across various time periods.³¹ Short-term returns appear to be greater where intervention is by an activist fund rather than a passive fund (Clifford, 2008; Drerup, 2013) and by a specialist activist fund rather than an occasional activist (Becht et al (2010).

³¹ Clifford, 2008; Uchida and Xu, 2008; Becht et al, 2009; Brav et al, 2009; Klein and Zur, 2009; Greenwood and Schor, 2009; Becht et al, 2010; Bessler and Holler, 2010; Boyson and Mooradian, 2011; Hamao et al, 2011; Kruse and Suzuki, 2011; Mietzner et al, 2011; Boyson and Mooradian, 2012; Bebchuk et al, 2013a; Bessler et al, 2013; Brav et al, 2013a; Drerup, 2013; Becht et al, 2014; Mietzner and Schweizer, 2014).

6.2 Longer-Term Share Price Effects

An analysis conducted on the Activist Insight database of companies exited by alternative activist managers in 2012 reveals that on average, the share prices of the target companies increased 25% in the subsequent two-year period regardless of the success of engagement. Companies that alternative investment managers exited in 2011 also witnessed significant gains to their share prices, albeit perhaps having been ably assisted by bull equity markets.

Recent research supports the view that, on average, activist alternative investment delivers long-term abnormal price returns (alpha) in the shares of target companies. That performance is not experienced in all, or even a majority, of activist interventions, however, and appears to depend on a variety of variables, including the success or otherwise of activist engagement, the outcome achieved, the tactics employed, and the jurisdiction of the target company.

Bebchuk et al (2013a) study about 2,000 interventions by activist hedge funds in the United States between 1994 and 2007. They find average value-weighted buy-and-hold abnormal returns (BHAR) of 3.5% and 8.7% in the three and five years after activist intervention, respectively. In addition, they observe an equal-weighted BHAR averaging 25.8% in the three years after an activist exits its investment in a target company. The authors conclude that there is no evidence for either long-term underperformance of the shares of activist target companies or “pump-and-dump” tactics by activist funds.

Research on global hedge fund activism between 2006 and 2013 by a team at Citi (Khorana et al, 2013) found that target company stocks outperform market benchmarks, on average, by 15.1% in the year following initiation of the activist campaign, and 33.8% in the two years after the start of the campaign. Excess returns were significantly higher in North America than the rest of the world over both the one and two year periods. However, the researchers also found that 52% of targets studied showed negative excess returns over both the one and two year periods, meaning that the large average improvements were driven by a relative minority of activist efforts that resulted in outsized share price gains.

A number of studies of U.S. activism report that short-term abnormal share price returns in companies targeted by activist funds improve or are sustained over longer periods. Clifford (2008) finds monthly excess returns in a target company’s shares ranging from 1.0% to 1.9% for the periods one, two and three years after disclosure, although the results for the two- and three-year horizons are statistically indistinguishable from zero. Brav et al (2013a) find no evidence of a reversal in the initial excess returns around disclosure of activist engagement in each of the subsequent one, two and three years. Greenwood and Schor (2009) estimate cumulative abnormal returns of over 10% for the period one month before to eighteen months following disclosure, with most of the returns gained in the final fifteen months. However, they also find that longer-term alpha is significantly positive only where targets are eventually acquired. Klein and Zur (2009) also report average alpha of 11.35% over the period 30 days before to one year after disclosure of activist engagement. Boyson and Mooradian (2011) see superior returns in the shares of activist targets compared with matched firms of 14.42% on average over the period one year before to one year after the disclosure date.

In an international study of activism by hedge funds, focus funds and other alternative investors, Becht et al (2014) measure returns during the period 20 days before the disclosed engagement until the fund exits. They find significant positive returns where the activist achieves at least one “outcome” of 18.4% in North America, 9.1% in Europe and 22.8% in Asia. However, they report negative BHAR over the same period where the activist engagement does not result in an outcome in Europe and Asia, with a small gain of 2.0% in

North America. Of course, the ultimate relevance of returns experienced during activist holding periods to the long-term sustainability of a target and its other shareholders depends on whether or not activists stock prices decline after an activist exits.

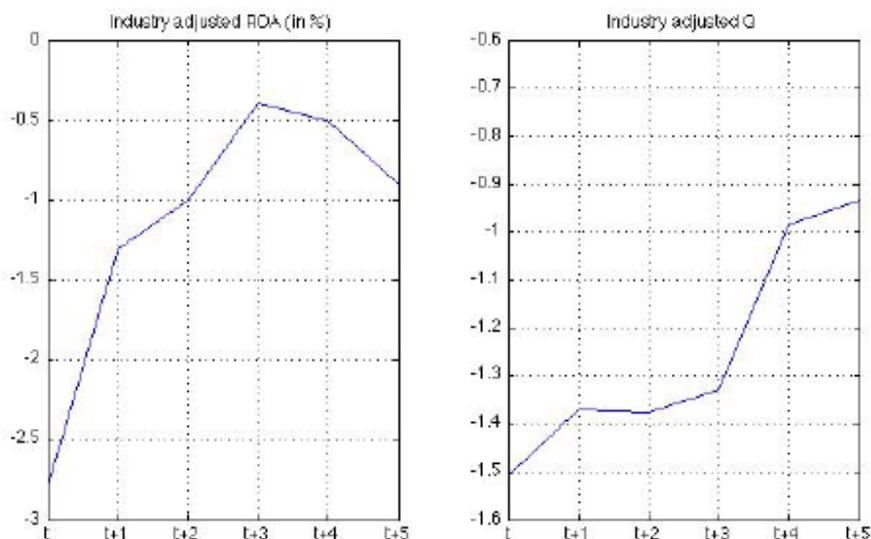
These results may not be universal, however. In separate studies of hedge fund activism in Germany, Drerup (2013) and Mietzner and Schweizer (2014) each find that initial stock price returns around disclosure of the activist engagement are significantly reversed during the following year. Bessler et al (2013) find that only less aggressive forms of hedge fund activism in Germany are followed by future stock market outperformance, while the initially positive returns to more aggressive forms of activism are subsequently reversed. The opposite finding is reported in a study of hedge fund activism in Japan by Hamao et al (2010), which reports that long-run returns on hedge fund activism are experienced only by companies targeted by hostile funds. Meanwhile, Uchida and Xu (2008) analyse the Japanese targets of two activist funds, Murakami Fund and Steel Partners, and find that initially positive stock returns did not revert to zero or negative values in the long run. They find positive alphas from calendar-time portfolio regressions for one year after the event month for the activist investments of both funds.

6.3 Impact on Operating Performance

If hedge fund activism truly creates long-term value in targeted firms, we would expect to see sustained improvements in metrics other than the company’s share price. The majority of studies on U.S. hedge fund activism indicate that, in general, the operating performance of activist targets does significantly improve following the start of an activist engagement, by comparison both to the company’s recent historical performance and its industry peers.

Bebchuk et al (2013a) study approximately 2,000 interventions by activist hedge funds in the United States between 1994 and 2007. They find that the profitability of both the mean and median target company (measured by their return on assets (ROA) and Tobin’s q) is higher on an industry-adjusted basis in each of the five years following activist engagement than in the year the activist intervened (see Figure 32).

Figure 32: The Impact of U.S. Hedge Fund Activism on Target Company Operating Performance over Time



Source: Bebchuk et al (2013a), p. 10

In the sample of U.S. hedge fund activism analysed by Brav et al (2013a), the industry-adjusted ROA of the average target company dips slightly during the year in which the activist engagement begins and significantly improves during the second and third year after the engagement commences. Brav et al (2008a) report a similar pattern for the average target company's earnings (EBITDA/assets and EBITDA/sales), which exceed matched firms (by 2.67% and 8.67%, respectively) two years after the start of the activist campaign. Clifford (2008) finds improvements in the average industry-adjusted ROA and return on equity (ROE) of U.S. targets of hedge fund activists in the three years following activist intervention, peaking in the second year. Boyson and Mooradian (2011) report growth in sales, Tobin's q, ROA and cash flows as a percentage of assets of target companies during the year before and the year following activist intervention. Brav et al (2013b) study approximately 2,000 cases between 1994 and 2007 where the effect of hedge fund activism on U.S. manufacturing plants is observable. They find that, on average, the productivity of plants owned by companies targeted by hedge fund activists (measured by their total factor productivity (TFP), the difference between the actual and predicted output given inputs) significantly improves in the three years following the activist engagement.³²

There is limited evidence on the effect of hedge fund activism on the operating performance of activist target companies outside of the U.S., but there may be some regional variation. In the United Kingdom, Becht et al (2009) reported a small decline in the ROA of companies targeted by the Hermes UK Focus Fund in the year after the fund's engagement followed by significant improvement in the subsequent year. Two studies of Japanese alternative investor activism find no evidence of improved operating performance in targeted firms in the two and three years, respectively, after the activist engagement (Kruse and Suzuki, 2009 and Hamao et al, 2011). Similarly, Drerup (2013) finds no significant change in various measures of operating performance of German companies targeted by activist hedge funds in the one and two years after the activist intervention. However, Bessler and Holler (2010) document small improvements in both the ROA and ROE of German companies targeted by hedge fund activists between the year before and the year after activist engagement.

6.4 Impact on Capital Structure

Several studies of U.S. hedge fund activism show that target firms tend to gradually reduce cash, slightly increase leverage, reduce capital expenditures and modestly increase payouts to shareholders (through dividends and/or share repurchases) up to three years following the activist engagement (Brav et al, 2008; Clifford, 2008; Greenwood and Schor, 2009; Klein and Zur, 2009; Boyson and Mooradian, 2011; Brav et al, 2013a). In general, the scale of such change appears significant but not drastic. In the sample constructed by Clifford (2008), for example, the mean U.S. firm targeted by an activist hedge fund decreased cash levels by 0.94% (median 0.45%), increased leverage by 0.81% (median 1.25%) and increased dividend yield by 0.24% (median 0.00%) in the year following the activist intervention. As would be expected, the magnitude of such changes is likely to be larger when the activist successfully achieves a stated objective focused on the target company's capital structure (see, e.g., Greenwood and Schor, 2009).

Comparable evidence on activism outside of the U.S. is limited and offers mixed results. Hamao et al (2011) find changes in the capital structure of Japanese targets of hedge fund

³² The finding of improved operating performance in U.S. target firms following engagement by activist alternative investors has not received complete consensus in the literature, however. Klein and Zur (2009) and Greenwood and Schor (2009) each find no significant improvements in the operating performance of U.S. targets of activist hedge funds in the year following activist intervention. This may be at least partially due to the shorter time frame of these studies compared with other research.

activism that are similar to the U.S. studies. However, Drerup (2013) and Bessler and Holler (2010) each record no, or insignificant, changes in the capital structure of German targets of activist hedge funds. The impact of alternative investor activism on the capital structure of target companies may, like the impact on operating performance, be subject to regional variation.

Of course, the changes to capital structure generally perceived in the American and Japanese studies are not necessarily appropriate to every company. However, coupled with long-term improvements in share prices and operating performance, it does appear that changes to the capital structure of targeted firms are, on average, beneficial. To test this more closely, Bebchuk et al (2013a) analyse cases where, between the year of engagement by an activist hedge fund and either of the subsequent two years, sampled U.S. target companies: (i) increase leverage within the top 5% of leverage increases among all U.S. public companies in that year; (ii) increase payout yield (including dividends and share buybacks) within the top 5% of payout increases among all U.S. public companies in that year; and/or (iii) increase capital expenditure and research and development (R&D) within the bottom 5% of all U.S. public companies in that year. 19% of the activist interventions they record fall within these categories. As in the overall sample, the study finds improvements in the average industry-adjusted ROA and average industry-adjusted Tobin's q of target companies subject to the sub-sample of engagements during the five years following activist intervention. The authors conclude that their evidence suggests that such engagement tends to produce a positive long-term effect on the operating performance of target companies.

6.5 Impact beyond the Targets of Alternative Investor Activism

As would be expected given the increasing prevalence of alternative investor activism, and its impact on targeted companies, there is a large amount of anecdotal and qualitative evidence suggesting that the strategy is also having a significant effect on companies that have not yet experienced activist engagement. Among the effects most commonly cited by corporate managers and their advisers are closer assessment by management and boards of the company's strategic direction and competitive position, a wider awareness of the characteristics that tend to attract activist investors (see section 3.3.1 above), and a general move towards greater engagement with investors.

As Robert Kindler, global head of Mergers and Acquisitions at Morgan Stanley told *The New York Times* in late 2013, "Boards are preparing for the possibility that activists may come ... Part of it is proactively reviewing areas of vulnerability and seeing whether or not there are things you should be doing anyway" (Gelles, 2013). At an event convened by accounting and advisory firm EY in March 2014, one company executive explained the thinking about shareholder activism at their company this way: "Activists have played a role in our industry, so we have focused on it. What makes the company a target? Would we be a target? Is it revenue growth, margins, governance issues? We ask what prompts an activist to get involved, and we assess our company against these factors" (EY, 2014). A survey conducted by Mergermarket for law firm Schulte, Roth & Zabel in the second quarter of 2014 found that 92% of U.S. corporate executives thought a company's financial performance would be an important catalyst for shareholder activism in the following

12 months, 48% cited an inefficient capital structure as attractive to activists and 48% thought that activists would look to implement strategic or operational changes at targeted companies (Schulte, Roth & Zabel, 2014). In the same survey, 67% of executives at European companies thought shareholder activism would somewhat or significantly increase in the next 12 months.

There is also some quantitative evidence in support of these observations. Gantchev et al (2014) analyse around 1,280 U.S. hedge fund activist campaigns between 2000 and 2011. They find that recent activism in a particular industry predicts a higher rate of future activism in that industry and that industry peers with similar fundamentals to previous targets respond by improving operating performance and making changes to capital structure along the same dimensions as activist targets. The authors also find that such policy changes at industry peers with similar fundamentals to activist targets lead, on average, to high abnormal share price returns and a lower probability of the company actually becoming a activist target. They conclude that the perceived threat of being targeted by an activist hedge fund has a disciplining “spillover” effect that improves the share valuation and operating performance of yet-to-be-targeted firms, making activist engagement less likely. Using a different methodology, Zhu (2013) also finds that the higher the probability a company will become targeted by an activist hedge fund, the more likely the company is to make proactive changes to its operations or capital structure that are similar to those perceived at actual activist hedge funds targets. He notes that hedge fund activism appears to have not only a “corrective” but also a “preventive” disciplining effect on managers.

7 Conclusion

Alternative investment managers have made a particular brand of shareholder activism their own, being more proactive in approach, more dedicated in focus, more varied in tactical scope and generally more effective in delivering results than its earlier forms.

Although the analysis of this new model of shareholder engagement is far from complete, there is now reasonable evidence supporting the view that activist alternative investors overall deliver sustained share price gains, improved operating performance and a more efficient allocation of resources at the companies in which they invest. Further, activist alternative investment managers seek higher standards of corporate governance, which improves the alignment of interest between management, shareholders and other stakeholders.

Institutional investors have noticed this and, as a result, many are allocating new or additional funds to activist alternative investments and changing the way they themselves monitor the management and boards of portfolio companies. Alternative investment managers have therefore been able to extend the reach of their influence despite typically taking a significant but non-controlling stake in companies, through engaging not just with the management of these companies, but also its broader shareholder base. In addition, there is evidence that the threat of activist engagement by an alternative investment fund tends to prompt management of yet-to-be-targeted companies to pro-actively implement profitable policy changes without an alternative investor ever having to invest.

Through the past decade, shareholder activism has developed from a relatively incidental investment strategy among alternative investors to one of the most attractive strategies for managers and investors of alternative investment funds. As a result, activism is no longer exclusively limited to engagements in the United States with influence growing across other global regions, in particular Europe. This global collaboration improves companies and delivers significant gains to shareholders and other stakeholders, all of which ultimately underpins its significance to the broader economy.

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Appendix: Case Studies

Jana Partners and McGraw-Hill Companies: Alternative investment managers are collaborating more with institutions in order to achieve their objectives.

Timeline

August 2011: Jana Partners first file a 13D form disclosing a 2.9% stake in publisher McGraw-Hill, seemingly teaming up with Ontario Teachers' Pension Plan (OTPP) who disclose a lower stake of 2.3%. Jana had built up its stake at between \$40.89 and \$43.77. Together, Jana Partners and McGraw-Hill have a joint holding in excess of 5%.

Jana believes that the shares are undervalued and represent an attractive investment opportunity and state their intentions to have discussions with McGraw-Hill management around the business and corporate structure.

Late August 2011: Jana and OTPP meet with McGraw-Hill management to discuss various issues and present a compelling argument to the Board of Directors. They believe that McGraw Hill is trading at a sizeable discount due to operational challenges and capital inefficiencies caused by a complex conglomerate structure and state that McGraw-Hill should separate its four businesses (education, information and media, S&P ratings and its financial business) and accelerate its share buyback.

12 September 2011: McGraw-Hill announce that the Board has approved a comprehensive growth and value plan with three objectives. The first objective is to separate the business into two public companies. One focused on capital and commodities markets (McGraw-Hill Markets) and the other company focused on education services and digital learning (McGraw-Hill Education). The second objective is to reduce costs to ensure efficient operating structures for the two companies, and the final objective is that the pace of the company's share buyback program will be accelerated.

A tax free spinoff of McGraw-Hill Education to shareholders is expected to be completed by the end of 2012. Management notes that the plan will create two focused and nimble operating companies, which should enhance strategic and financial flexibility and result in two pure play investment opportunities.

January 2012: McGraw-Hill note the productive nature of discussions in their 4Q11 earnings release and credit Jana Partners and OTPP with having constructive input.

February 2012: As of 3 February, Jana Partners and OTPP decrease joint holding to around 4.8% and state their intention to continue holding onto the shares given McGraw-Hill's commitment to continually evaluating opportunities to improve its corporate structure and portfolio of businesses.

Late 2012: In late 2012, McGraw-Hill announce the education unit will be sold off to Apollo Global Management for \$2.5bn (\$1.9bn after-tax which will help finance a share repurchase program). The remaining company will become McGraw-Hill Financial.

At the end of 2014, McGraw-Hill Financial operates from a more strategically sound and streamlined position. Net income and operating income have increased dramatically and this is reflected in a share price that is close to \$90.



Altai Capital Management and SunEdison: Alternative investment manager helps turnaround a struggling company and make it one of the best in its industry.

Background (early 2012): SunEdison - then called MEMC Electronic Materials (“MEMC”), was in the early stages of a restructuring of its two business segments, Semiconductor Materials and Solar Energy, as they experienced significant downturns in 2011. As a result, almost 20% of the workforce was laid off. By mid-2012, its shares were trading at approximately \$1.50, a dramatic fall from the all-time high of \$91.23 in mid-2007 and the company’s debt had been downgraded by two credit agencies. The company was struggling to produce solar panels at a profit as Chinese manufacturers flooded the market. The market value of the company was approximately \$350m.

Timeline

June 2012: Altai Capital announces it is the beneficial owner of 6.8% of the outstanding shares of MEMC. They also state that they have engaged or may in the future engage in discussions with management and the Board of Directors, and may make proposals with respect to potential changes in the operations, management, Board of Directors composition, ownership, capital structure, strategy and future plans of the company. Altai Capital immediately proposes that Steven V. Tesoriere, its co-founder, be appointed to the Board of Directors to a fill a vacancy created by a recent resignation.

October 2012: MEMC announces that Mr. Tesoriere has been appointed to the Board of Directors.

Mr. Tesoriere immediately sets about reconsidering a number of areas including the company’s financial strategy and soon focuses on two large initiatives. First was separating the company’s solar power and semiconductor businesses, believing that a separation would renew focus and attract new investors. Mr. Tesoriere also lobbied for MEMC to place its solar projects into a publicly traded company (a yieldco in industry jargon) in which it would hold a large stake.³³

November 2012: Altai Capital increases its beneficial ownership to 8% of the outstanding shares of MEMC.

May 2013: MEMC becomes SunEdison, reflecting the company’s new focus on solar energy.

May 2014: SunEdison separates its Semiconductor Materials business from its Solar Energy business. SunEdison Semiconductor, Ltd. spins off through an IPO on the NASDAQ and generates \$94m for SunEdison which maintains a stake as the largest shareholder. At the offer price, the Semiconductor business has an enterprise value of approximately \$632m. Other alternative investment managers such as Greenlight Capital begin showing interest in the emerging success story that is SunEdison.

June 2014: Altai Capital decreases its beneficial ownership to 4.6% of the outstanding shares of SunEdison. Mr. Tesoriere will remain on the Board.

July 2014: SunEdison creates their yieldco subsidiary calling it TerraForm Power (“TerraForm”) generating \$500m in the IPO spinoff and \$65m from two private stock sales conducted at the IPO price. Altai Capital participates in the private stock sale and holds a significant stake in TerraForm. At the offer price, TerraForm has a market value of \$2.4bn.

November 2014: SunEdison and TerraForm agree to acquire First Wind, one of the leading developers, owners and operators of wind projects in the U.S., for \$2.4bn. This makes SunEdison the leading renewable energy development company in the world.

Ahmad R. Chatila, the CEO, of SunEdison praises the role of Altai Capital in an interview, “having a constructive dialogue with shareholders in the boardroom is something I think everyone would gain something out of”. Looking back, Mr. Tesoriere says, “it’s clear to us that our participation at the board level helped accelerate a number of initiatives that drove the company’s market value and access to capital.” The company has been widely praised on its turnaround and hailed for its approach to business, not least the piece of financial engineering that cut costs of developing new solar power assets. Investor appetite for SunEdison stock is high with Greenlight Capital now the largest shareholder and hedge funds the largest investor type (50% by Bloomberg estimates). At the end of 2014, SunEdison shares were hovering around the \$20 mark.

³³ The New York Times describes the benefits: “the new entity can tap the stock markets for money to support SunEdison’s projects at a cost of up to a third less than that of bank loans. And yieldcos pay out most of their earnings as dividends, providing their parent companies and public shareholders with steady payouts.”



Pershing Square and Canadian Pacific Railway: Alternative investment manager actively pursues change at an underperforming company and to date the implemented changes are a great success.

Timeline

October 2011: Pershing Square first file a 13D form disclosing a 12.2% holding in Canadian Pacific Railway (including an over-the-counter American-style call option). Much of the position is built between CAD\$46 and \$60. Pershing Square states on item 4 of the filing that they believe that the shares are undervalued and attractive and that they are likely to engage in discussions with management, board and other stockholders concerning the direction of the business.

December 2011: Pershing Square note in a 13D/A filing that they have been engaging in ongoing discussions with representatives of Canadian Pacific Railway concerning changes to their business and operations, management and Board composition but that while the discussions were productive, no assurances were given that any suggestions would be adopted. Shortly after the filing, Pershing Square increases its holding yet further to 14.2%.

January - April 2012: Pershing Square issues a press release announcing its proposed five directors to be nominated to the Board of Canadian Pacific Railway. Speaking in the press release for the announcement, Pershing Square CEO Bill Ackman says, "We've assembled a superlative slate of nominees who share our goal of ensuring that the Canadian Pacific remains independent and strong. With a revitalized board and new management, we will help CP transform from the worst to one of the best performing Class I railroads in North America."

The five nominees consist of Bill Ackman and another Pershing Square employee in Paul C. Hilal, as well as three Canadian business executives. Bill Ackman added, "We believe Canadian Pacific has a unique opportunity to benefit from the leadership of one of Canada's great railroad executives, Hunter Harrison. As transportation experts and analysts have said in recent days, there is no executive who is as qualified to lead a turnaround of CP - to build value for shareholders and to improve performance for the hundreds of Canadian clients and communities it serves."

In February and April, Pershing Square make further announcements about two more nominees, making it seven in all, who will stand for election to the Board of Canadian Pacific Railway. Together the seven nominees have important industry and turnaround experience which should benefit the Board.

May 2012: The seven director nominees proposed by Pershing Square are elected to the Board along with nine incumbent directors who are re-elected. Meanwhile, the current CEO Fred Green resigns following pressure from Pershing Square to replace him with Hunter Harrison.

June 2012: Hunter Harrison, Pershing Square's top choice, is appointed the new CEO of Canadian Pacific Railway signing a four year deal. Harrison, a veteran of the industry, had been the chief executive of rival Canadian National Railway Co. before his retirement in 2009 and is credited with turning around both a dying Illinois Central and Canadian National. Harrison's aim is to immediately address the reputation that Canadian Pacific Railway has as one of the worst-performing of the continent's major railways and vows to trim the operating ratio from a level of 80% to 65% by 2015. Harrison also moves out much of the core of Fred Green's senior team in his first 90 days and aims for a leaner company with better service at lower costs.

June 2013: Pershing Square announce plans to sell 7 million of their 24 million shares (13.8% stake) over the following six to twelve months. Bill Ackman says, "thanks for Hunter Harrison's and the CP team's performance over the last nearly one year, Canadian Pacific's share price has more than tripled since we first invested in CP. As a result, our stake in CP has grown to approximately 26% of the combined assets of our funds. Given that increased concentration, portfolio management considerations have driven our decision to trim our holdings. Even after these sales, we expect to remain CP's large shareholder and for CP to remain one of our largest investments."

At the end of 2014: Pershing Square continues to hold an estimated 8% stake in Canadian Pacific Railway and the two employees still serve on the Board of Canadian Pacific. The company has gone from strength to strength with an operating ratio at 62.8% YTD through the third quarter of 2014 spurred by revenue growth and better cost management. This is reflected in the share price a close to CAD\$224.