

HEDGE FUNDS AND SHAREHOLDER ACTIVISM

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In a corporate governance white paper we published at the beginning of this year (see www.altmangroup.com), we focused on the surge in shareholder activism and in particular on the success hedge funds were achieving in proxy contests they started in 2005. As one of the proxy solicitation firms most heavily involved in the activist arena, in 2005 we tracked 20 instances of shareholder activism involving hedge funds; and, in 15 of those cases the target company conceded or was forced to accept, to some degree, the demands of the dissident shareholder. For anyone who hoped 2005 was an aberration, we have bad news for you.

To date, in 2006, not only has this trend continued but it has reached a point far beyond what we thought likely. So far this year well over 75 instances of hedge fund activism have risen to a level that has landed them on our radar screens. (In fact we have already been retained in 20 contested or activist matters in 2006 – This is more than double the number of contests we were involved in during the previous two years combined.) Of particular note is the very poor success record companies are having in beating back the challenge hedge funds present.

Among the topics we touch on in this article are: Why this continued surge in proxy battles? How long can one expect this to go on for? What should you be looking out for? How should you react if faced with one of these fights?

While there is no easy answer to the last question, as every case is unique, this article will help you focus on the issues that are involved and perhaps provide some guidance as to how to avoid getting in a hedge fund's crosshairs in the first place. We will also look at how these situations develop, some trends we have seen in addressing the other questions above, and raise other topics for your consideration.

First a little background. It is estimated that there are currently about 8,000 hedge funds with assets nearing \$1.5 trillion. We have seen recent predictions that hedge fund assets will reach \$5 trillion by 2008. While this money

will obviously not all be deployed in the stock market, the dollars involved are indeed frightening to vulnerable corporate targets. With some notable exceptions, such as Heinz and Time Warner, hedge fund activism has been heavily concentrated in the small and mid-cap arena. With so much money chasing similar investment opportunities, many hedge funds turn to activism to boost performance and enhance the payouts to the hedge fund's principals.

In addition to the tremendous success they have enjoyed in taking on corporations, hedge funds seem to be having their way with regulators as well. Phil Goldstein, a well-known, long-time activist shareholder, successfully challenged the SEC in court to overturn the requirement that hedge funds register with the agency. (FYI: Mr. Goldstein is now contesting the 13F filing requirement for all institutions. Stay tuned, as success with this legal action could significantly impact every issuer's ability to identify its shareholders.)

For those readers who themselves are the front line for investor inquiries, we think it is safe to assume that you have noticed an increase in the number of calls you are receiving from firms that you have never heard of before. Undoubtedly the tone of at least some of these calls and the demand for information is likely ratcheted up a few notches from the level you are accustomed to when dealing with your typical mutual fund or pension fund manager. This is not always a cause for alarm. While the term hedge fund has a very aggressive ring to it, not all hedge funds are activists. Indeed, there are but a small number of them that really are a cause for immediate concern as a party that might engage your company on the field of battle.

We categorize activist funds into three groups, the first being what we call "Alpha Activists": firms that get into a stock with the planned intent of undertaking an activist approach to boost returns. Activism is one of their primary investment philosophies.

The second group is what we call "One Timers". There are some who are possibly two- or three-timers: but ostensibly they resort to activism only

in instances when they believe it's absolutely necessary to rescue an investment turned sour.

The third category are the "Wolves": the countless number of hedge funds who believe in the activist approach but will only move in as part of a pack when somebody else takes the lead.

In response to a rising tide of client inquiries concerning hedge funds' accumulations in their shares, earlier this year we announced our Hedge Fund Tracking Service to help companies detect such accumulations. Perhaps we should not have been surprised at the large number of calls we received from hedge funds asking if they could subscribe and track the activity of certain activist funds (We obviously said "No!"). This service has become a valuable tool for companies who understand that the real threat from hedge funds is not an investment by one or several funds but rather a broad based accumulation of shares by parties predisposed to vote with an activist fund that may challenge your management and board.

In a typical scenario, an Alpha Activist buys into a position over time and either through a required SEC filing, a surprise letter to the Board (with the attendant press release announcing it to the world) or through "chatter", the wolves find out about the Alpha investment and start to pile in – often snapping up 20% - 30% of the company shares. Depending on who sold out during this run, the reconstituted shareholder base often presents management with no choice but to make concessions and settle a fight, should one develop.

Unfortunately, public companies find that in the overwhelming majority of these situations they find settling to be a better option than going to a full fight. We have been involved in negotiations where even when we believed we would win, our client has attempted to settle rather than go through the time consuming and costly process of a proxy contest. Interestingly many activist funds have also demonstrated a willingness to negotiate for minority representation on a board rather than go through the process of a full fight, even when they appear to have the support lined up for control. Why would a hedge fund do this? In fact many hedge funds propose a short slate for election simply because it improves their chance of winning a vote of confidence from ISS and traditional institutional investors; thereby both increasing the likeli-

hood of success and reducing the chance they will alienate other major owners.

What are hedge funds demanding of target companies? The most common request is for board seats, apparently as the hammer to get the company to respond to the fund's call for immediate action. This action commonly is in the realm of a special dividend or stock buyback or a commitment to explore the sale of the company or particular assets. Increasingly hedge funds are also looking to block or force a company to negotiate better terms for shareholders in a merger.

While we can argue over what constitutes a win or a loss, in the cases we have tracked this year hedge funds have been winning 60% of the time – either through an actual contest or in a negotiated settlement. And it's not just the impact of the wolves that is behind this level of success. Mainstream institutions (who are incidentally also pouring money into hedge funds) and the independent proxy advisors, such as ISS and Glass Lewis, are frequently supporting the opposition – at least to some degree. It is rare to see a big mutual fund or one of the advisors vote in favor of granting full control to the dissident, but supporting 1 or 2 board seats is almost becoming the norm at companies where the stock price is lagging or there are substantive performance or valuation issues.

Hedge funds have never made a secret of the fact that they generally invest in securities for the short-term. They generally target companies where the stock price has underperformed its peers, is significantly below its perceived or actual value, or has otherwise not met shareholder expectations. This helps to explain why hedge funds don't target overvalued companies or companies with generally poor prospects and no undervalued assets.

While the advice we give to clients is specific to their situation and more detailed than provided in this article, here are a few general recommendations:

- Know who your shareholders are, how they perceive management and the company and its prospects and how they vote in non-routine situations. Determine the level of influence that ISS etc. will have on your vote and know what factors go into these firms' recommendations.

- Keep an open line of communication with your long-term shareholders. Not only is it appropriate to do so, but that relationship may be invaluable if you find yourself in a proxy battle.
- Understand the strengths and weaknesses of your IR message. How will your message play if you get into a proxy contest? Are you setting expectations (not necessarily earnings, but business strategies etc.) that will be exploited by a potential dissident?
- Engage the hedge funds. Do not ignore them when they call – it just raises the likelihood that they will ratchet up their pressure and you will end up in a fight. Your openness will also help you with other holders if you need to seek their support.

Understand the mechanisms that are available to the hedge funds and what defenses you have. Consent solicitations, for example, are a powerful resource for an activist fund, if available, but, the strategy to combat them may be quite different than what you would use in a standard proxy fight. There are also procedures involving stock loans or hedging that hedge funds can employ to boost their voting power beyond that represented by the shares they own. Do you know how these mechanisms work?

In short, be prepared. Hedge funds have proven themselves worthy adversaries who are also very skilled in their PR/IR efforts and you do not want to find yourself backpedaling and reacting at every turn.

There is little doubt that hedge fund activism will continue to increase as investors demand high returns for the fees they pay to hedge fund managers, as the assets and clout of these funds grows and as their successes embolden them to continue the activist approach.

You will also want to pay careful attention to possible proxy rule changes that are in the wings. These changes, if implemented, will only serve to increase shareholder activism, the number of proxy fights and present even greater challenges to corporate issuers.

While the picture we paint is not a pretty one, it is the landscape that you must operate in. We believe you are better off acting with full knowledge of how difficult things have become and what op-

tions are available to you, rather than cowering in your office as the wolf pack howls at you and not the moon.

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