# BEHIND CLOSED DOORS:

## THE "FRIENDLY" ACTIVISTS KEEPING A LOW PROFILE

Private equity pros among those pushing a softer constructivist approach, rather than the aggressive headline-grabbing stereotype

BY SAM MACDONALD

Mainstream media outlets are quick to focus on high-profile hedge funds calling for a CEO's head or demanding a company break-up, but the majority of activist investors are using much less dramatic tactics to trigger change at the companies they invest in. Constructive or "friendly" activists take a different approach to the confrontational stereotype many people think of when they hear the phrase hedge fund activism.

As the moniker suggests, constructivists seek to work with companies to improve their operations and boost returns, keeping hostility to a minimum. And when tough actions are required they are careful to try and keep any dirty linen from being aired in public.

Whereas hostile funds generally have a shorter-term approach and often employ short as well as long positions, constructivist funds look at a medium to long-term strategies, usually around five years, after identifying growth potential in underperforming businesses. Non-hostile tactics include hedge funds communicating with boards upon taking a stake to assure them they are looking to collaborate, seeking to make board changes without proxy battles or confrontation, making formal shareholder proposals and identifying growth opportunities.

According to Preqin data, activist hedge funds have made annualised three-year returns of 5.7%; annualised five-year gains of 4.6%; and were up 2.8% last year, 6% in 2014 and 17.8% in 2013. Preqin does not break down the index into constructive and hostile strategies, but a report published by Aima with law firm Simmons & Simmons last year found that most activists take a collaborative approach in their investments.

"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," said the report. It added that "softer" approaches were more likely to achieve success, particularly outside of the US. Softer activist approaches have drawn comparisons with private equity practices due to longer lock-ups and the carried interest-style fees often employed.

### NEW LAUNCHES

A number of former private equity specialists have already launched constructive hedge funds and the industry expects more new entrants to introduce similar propositions. In 2014, Carlyle Group executives Jean-Pierre Millet, Franck Falézan and Benoit Colas left to launch European-focused activist hedge fund firm PrimeStone Capital.

"Typically, capital is locked up for an average of five years; this gives assurance to company management that we have faith in the long-term performance of the business and are not using it as a short-term trade," says Colas.

"We think we will see more constructive activist funds going forward as more private equity-minded people look at the space, but at the moment there are only very few players in the European market."

Colas gives the recent example of a PrimeStone investment in a continental Europe-based industrial company which was underperforming market peers by around 5 percentage points. Working with the board, PrimeStone identified misallocation of capital and a lack of acquisition activity by the firm as the reason for the underperformance and is looking to close the gaps over a five-year period.

While PrimeStone is European mid and small-cap-orientated, there are some firms that are able to take a global view on constructive activism and have been around long enough to see how to relationships can change when company boards go against their wishes.

Alex Roepers' $2.1bn Atlantic Investment Management (AIM) is such a firm, and he says there must be a balance struck between getting the right deal for investors and maintaining relations with company bosses.

"We are constructive and engaged with boards but we have two other objectives: to retain liquidity and to always remain respectful of management because it's a small world, we have been doing this for a long time and we want to continue doing this for a long time," says founder and CIO Roepers.

Even with a constructivist approach, there are times when the fund needs to get tough with its investments. Where management tries to shun Atlantic's requests, which occurs in around one fifth of cases, there has to be a slight change in tack, adds Roepers.

"If constructive efforts with management run aground then we inform them we are running out of patience and if time goes on and the share price remains low we are forced to take our message to the board. In some cases, we may be forced to take things to the firm's AGM – and that requires filing of proposals and that attracts publicity."

## SUITED TO EUROPE

Managers say constructive investment is more suited to European-focused funds because of a difference in board culture between the US and EU countries, largely due to family ownership and smaller pools of shareholders on the continent. RWC's $500m European Focus Fund has made gross returns of 220% since its inception in 2009 and last year made gross gains of 24%. The firm says it is easier to adopt a friendly approach in Europe and that hostile activism approaches to European boards rarely work.

"A constructive approach to active ownership investing lends itself to European companies because of a culture and legislation that allows for various types of limitations of formal shareholder rights, as well as the European universe of companies that have a relatively high degree of ownership concentration – particularly in continental Europe. These factors make confrontational activism less effective and obvious," says RWC manager Antonio Salerno.

While constructive practice can, in theory, be applied to any sector, volatile stocks and heavily regulated industries are areas which constructive firms should avoid, Salerno adds. "We have several investments in industrials, business services and medical technology but are generally not invested in sectors where a company's economics are determined mainly by external factors such as regulation or economic cycles such as utilities, banks, life insurers and construction companies."

## GETTING MANAGERS ON YOUR SIDE

Businesses are notoriously wary of activist investors and as a result, hedge funds can spook company management when they express an interest in buying shares. Funds look to use a variety of different methods to try to reassure management.

London-based Highgate Capital Management says all activist funds can be tarnished with the hostile reputation of some large American investors and it has taken steps to try to mitigate this. Former Worldview Capital partner and chief compliance officer Andrey Kruglykhin leads the firm, alongside ex-JP Morgan executive Pavel Moutchiev and ex-Audley Capital CFO Ahmed Obaydi. Highgate's advisory board includes Julian Rogers-Coltman, who set up a $500m hedge fund seeding platform for Fleming Family and Partners; David Trenchard, former managing director at activist Knight Vinke; and Mattias Bischel, the former board member of Royal Dutch Shell, who was once tipped to become the oil giant's CEO.

"Our approach requires expertise and in-depth industry knowledge in order to establish a productive dialogue with management and other stakeholders. And for each particular transaction we retain a team of experts to perform extensive 'private equity-style' due diligence, so that when we engage with management they appreciate we know what we are talking about," says founding partner and portfolio manager Moutchiev.

The management expertise and credibility required to be successful is highlighted by the launches seen in recent years. In January last year, former JP Morgan pros Doug Braunstein and Jim Woolery launched collaborative firm Hudson Executive Capital. The firm has 14 advisory partners including a host of S&P 500 company CEOs and Mary Schapiro, former chair of the SEC.

Last month, Hudson took a 0.5% stake in US financial services giant CIT Group and called for the lender to be broken up amid underperformance and its increasing size, creating a regulatory burden.

There is a potential investor downside to being classified as an activist, as many endowments and pension funds have an aversion to being involved with a fund which could be seen as aggressive and likely to generate negative press coverage. However, market participants note that in Europe there is more acceptance of funds labelling their strategies as "positive engagement". Investors can be wary of activist investors and say they need to be reassured through the experience of hedge funds' management that their reputations will not be put at risk by investing.

"You really need credibility in the market to influence a management team. You shouldn't be threatening to go public either if they don't do what you are suggesting – it is a credibility and reputation game and you have to build up successful activist campaigns over time," says Paamco managing director Alper Ince.

He adds: "We can get wary of the headline risk managers are carrying, they need a successful media strategy and we need to see how they manage the risk of appearing in headlines, we may get concerned if things get hostile." ■

## OTHER 'SOFT' APPROACHES EMPLOYED BY HEDGE FUNDS

Sahm Adrangi's Kerrisdale Capital has carved a niche for itself with a 'soft activist' approach to its long/short equity fund, which includes publishing detailed investment reports on the firms it is shorting and some long positions it takes. The $400m-plus Kerrisdale Partners Fund was up nearly 17% in 2015 and has provided five-year annualised returns in excess of 40%.

In a research document, published in September last year, Kerrisdale suggested technology firm Allied Minds could be overvalued by 70%; Allied's share price is down -31.9% in the five months since the report. Its research report into tech communications company Globalstar, published in October 2014, claimed the stock was "worth nothing". The firm's stock has since dropped -52.8%. Kerrisdale also published research justifying short positions in cellular technology company Straight Path Communications on October 29, and subsequently its share price has fallen -3.5% to 4 March this year.

"With certain investments, where we've developed a contrarian point of view as a result of deep diligence, we take our research and share that information with the marketplace in order to impact the market's perceptions of what these companies are worth, when we believe that the market consensus is misguided," Adrangi said.