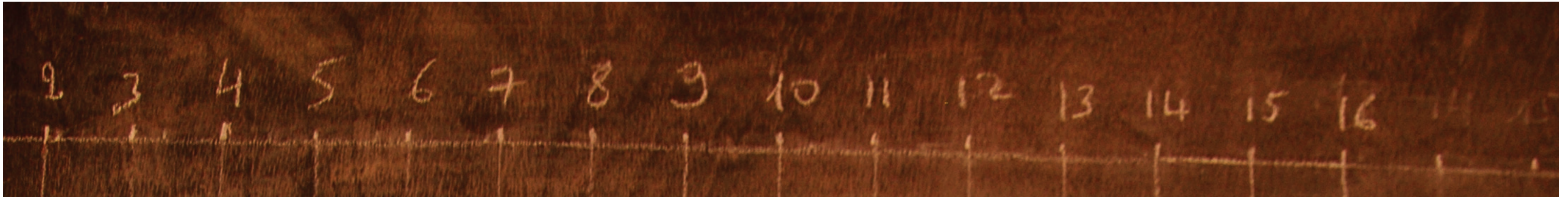

Value Investing: Activist Investing

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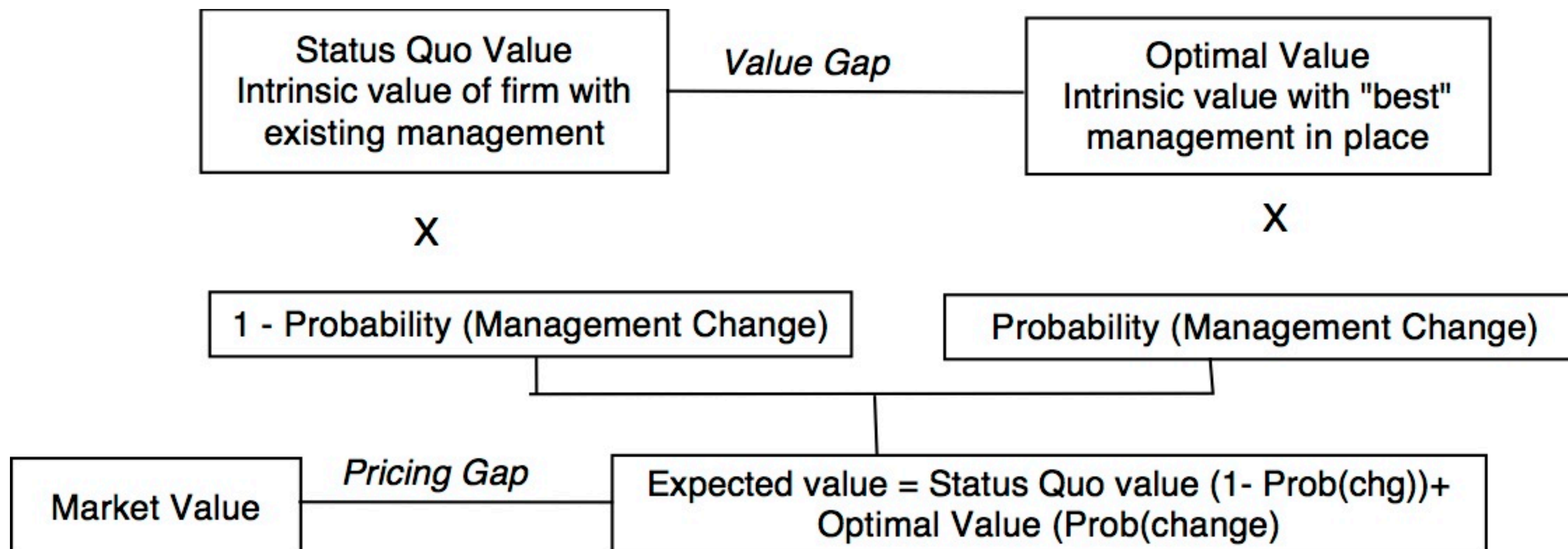
Classes of Activist Investors

- Lone wolves: These are individual investors, with substantial resources and a willingness to challenge incumbent managers.
- Institutional investors: While most institutional investors prefer to vote with their feet (selling stock in companies that are poorly managed), a few have been willing to challenge managers at these companies and push for change.
- Activist hedge & private equity funds: . A subset of private equity funds have made their reputations (and wealth) at least in part by investing in (and sometimes buying outright) publicly traded companies that they feel are managed less than optimally, changing the way they managed and cashing out in the market place. A key difference between these funds and the other two classes of activist investors is that rather than challenge incumbent managers as incompetent, they often team up with them in taking public companies into the private domain, at least temporarily.

Activist Value Investing

Passive investors buy companies with a pricing gap and hope (and pray) that the pricing gap closes.

Activist investors buy companies with a value and/or pricing gap and provide the catalysts for closing the gaps.



(1) How well do you manage your existing investments/assets?
a. Cost cutting
b. Asset divestitures
c. Tax management
d. Working capital management

(2) Are you investing optimally fo future growth?
a. If ROC < WACC, invest less
b. If ROC > WACC, invest more

(3) Is there scope for more efficient utilization of exsting assets?

Growth from new investments
Growth created by making new investments; function of amount and quality of investments

Efficiency Growth
Growth generated by using existing assets better

Cashflows from existing assets
Cashflows before debt payments, but after taxes and reinvestment to maintain exising assets

Expected Growth during high growth period

Stable growth firm, with no or very limited excess returns

(4) Are you building on your competitive advantages?
a. Augment existing advantages
b. Find new barriers to entry

Length of the high growth period
Since value creating growth requires excess returns, this is a function of
- Magnitude of competitive advantages
- Sustainability of competitive advantages

(5) Are you using the right amount and kind of debt for your firm?
a. Change mix of debt and equity
b. Match debt to assets
c. Make your products less discrtionary
d. Reduce fixed costs

Cost of capital to apply to discounting cashflows
Determined by
- Operating risk of the company
- Default risk of the company
- Mix of debt and equity used in financing

With young growth firms, start of the life cycle: Focus on (2)
With established growth firms, later in life cycle: Focus on (2, (4) and (5)
With mature firms, middle of life cycle: Focus on (1), (3) and (5)
With declining firms, end of life cycle: Focus on (1) and (5)

1. Asset Deployment: Why assets may be deployed in sub-optimal uses…

- Ego, overconfidence and bias: The original investment may have been colored by any or all of these factors.
- Failure to adjust for risk: The original risk assessment may have been appropriate but the company failed to factor in changes in the project's risk profile over time.
- Diffuse businesses: By spreading themselves thinly across multiple bsuinesses, it is possible that some of these businesses may be run less efficiently than if they were stand alone businesses, partly because accountability is weak and partly because of cross subsidies.
- Changes in business: Even firms that make unbiased and well reasoned judgments about their investments, at the time that they make them, can find that unanticipated changes in the business or sector can make good investments into bad ones.
- Macroeconomic changes: Value creating investments made in assets when the economy is doing well can reverse course quickly, if the economy slows down or goes into a recession.

Redeploying assets: Shut down or divestiture

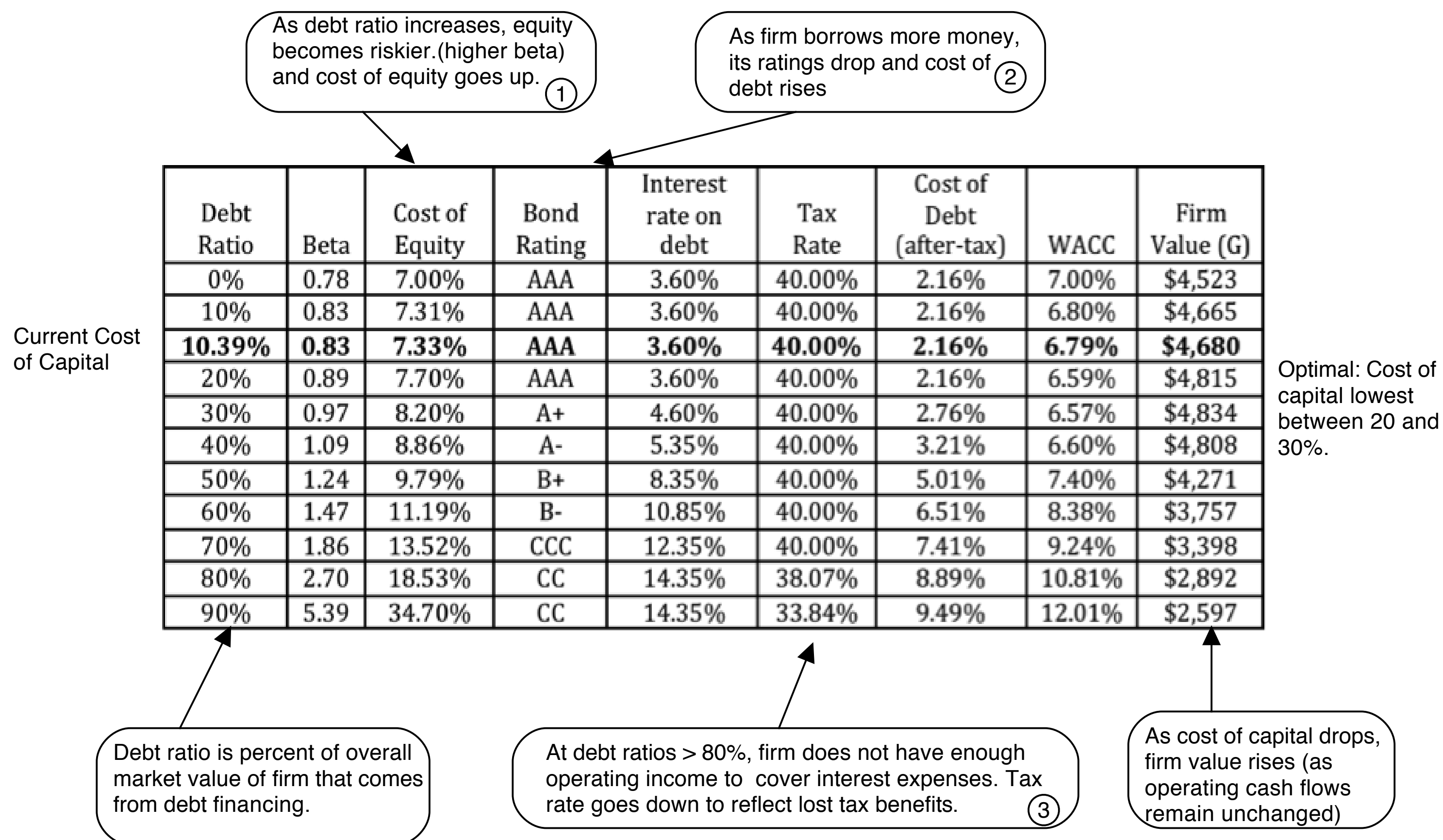
- Shut down: If an investment is losing money and/or the company can reclaim the capital it originally invested in an investment that earns less than its cost of capital, you should shut it down.
- Divestiture: Divesting bad businesses will enhance value if and only if the divestiture value > continuing value of the bad business. The market reaction to asset divestitures is generally positive, but more so if the motive for the divestiture and the consequences are transparent.
- Spin offs and split offs: A business that is being under or mis valued by the market can be spun off or split off from the company.

2. Capital Structure/ Financing

Advantages of Debt	*Disadvantages of debt*
1. Tax Benefit: Interest expenses on debt are tax deductible but cash flows to equity are generally not. *Implication: The higher the marginal tax rate, the greater the benefits of debt.*	**1. Expected Bankruptcy Cost**: The expected cost of going bankrupt is a product of the probability of going bankrupt and the cost of going bankrupt. The latter includes both direct and indirect costs. The probability of going bankrupt will be higher in businesses with more volatile earnings and the cost of bankruptcy will also vary across businesses. *Implication:* *1. Firms with more stable earnings should borrow more, for any given level of earnings.* *2. Firms with lower bankruptcy costs should borrow more, for any given level of earnings.*
2. Added Discipline: Borrowing money may force managers to think about the consequences of the investment decisions a little more carefully and reduce bad investments. *Implication: As the separation between managers and stockholders increases, the benefits to using debt will go up.*	**2. Agency Costs**: Actions that benefit equity investors may hurt lenders. The greater the potential for this conflict of interest, the greater the cost borne by the borrower (as higher interest rates or more covenants). *Implication: Firms where lenders can monitor/ control how their money is being used should be able to borrow more than firms where this is difficult to do.*
	3. Loss of flexibility: Using up available debt capacity today will mean that you cannot draw on it in the future. This loss of flexibility can be disastrous if funds are needed and access to capital is shut off. *Implication:* 1. *Firms that can forecast future funding needs better should be able to borrow more.* 2. *Firms with better access to capital markets should be more willing to borrow more today.*

Cost of capital as a tool for assessing the optimal mix

Exhibit 7.1: Optimal Financing Mix: Hormel Foods in January 2009

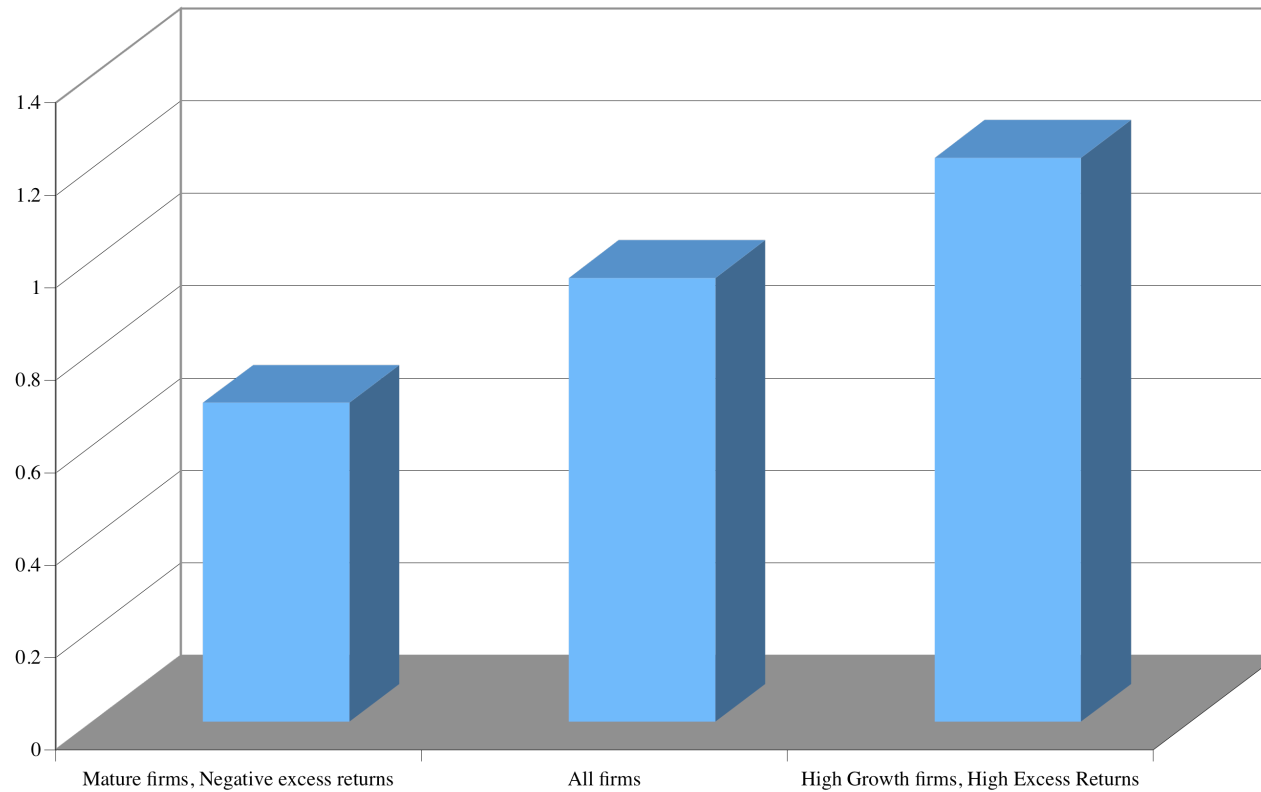


Debt Ratio	Beta	Cost of Equity	Bond Rating	Interest rate on debt	Tax Rate	Cost of Debt (after-tax)	WACC	Firm Value (G)
0%	0.78	7.00%	AAA	3.60%	40.00%	2.16%	7.00%	$4,523
10%	0.83	7.31%	AAA	3.60%	40.00%	2.16%	6.80%	$4,665
10.39%	**0.83**	**7.33%**	**AAA**	**3.60%**	**40.00%**	**2.16%**	**6.79%**	**$4,680**
20%	0.89	7.70%	AAA	3.60%	40.00%	2.16%	6.59%	$4,815
30%	0.97	8.20%	A+	4.60%	40.00%	2.76%	6.57%	$4,834
40%	1.09	8.86%	A-	5.35%	40.00%	3.21%	6.60%	$4,808
50%	1.24	9.79%	B+	8.35%	40.00%	5.01%	7.40%	$4,271
60%	1.47	11.19%	B-	10.85%	40.00%	6.51%	8.38%	$3,757
70%	1.86	13.52%	CCC	12.35%	40.00%	7.41%	9.24%	$3,398
80%	2.70	18.53%	CC	14.35%	38.07%	8.89%	10.81%	$2,892
90%	5.39	34.70%	CC	14.35%	33.84%	9.49%	12.01%	$2,597

Ways of adjusting financing mix

- Marginal recapitalization: A firm that is under (over) levered can use a disproportionately high (low) debt ratio to fund new investments.
- Total recapitalization: In a recapitalization, a firm changes its financial mix of debt and equity, without substantially altering its investments or asset holdings. If under levered, the firm can borrow money and buy back stock or do a debt for equity swap. If over levered, it can issue new equity to retire debt or offer its debt holders equity positions in the company.
- Leveraged acquisition: If a firm is under levered and the existing management is too conservative and stubborn to change, there is an extreme alternative. An acquirer can borrow money, implicitly using the target firm's debt capacity, and buy out the firm.

3. Dividend policy



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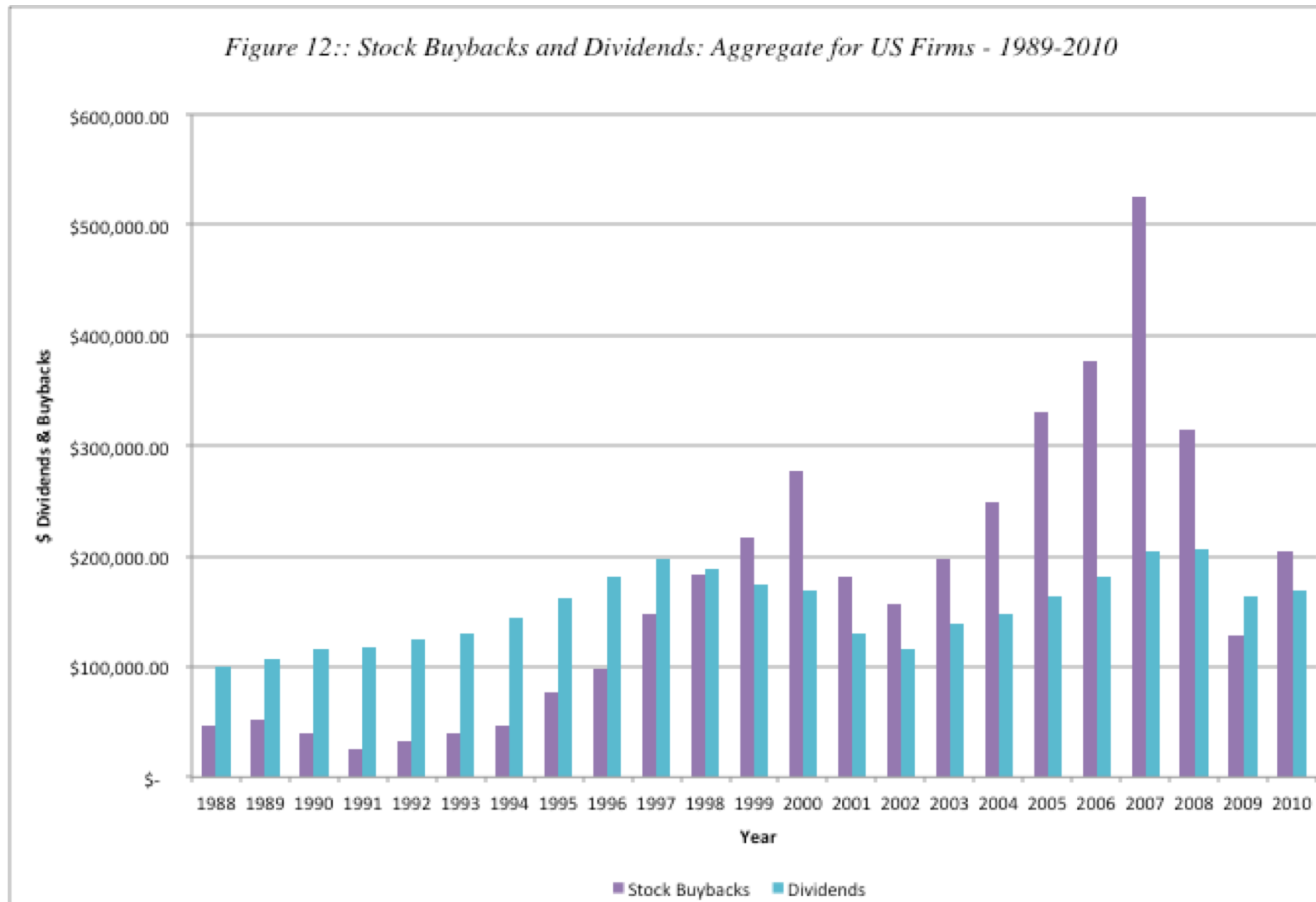
If you have too much cash…



4. Corporate Governance

- To value corporate governance, consider two estimates of value for the same firm:
  - In the first, you value the company run by the existing managers, warts and all, and call this the status quo value.
  - In the second, you value the company run by "optimal" management and term this the "optimal" value.
- To the extent that there are at least some dimensions where the incumbent managers are falling short, the latter should be higher than the former. The price at which the stock will trade in a reasonably efficient market will be a weighted average of these two value:
  - Expected value = (Probability of no change in management) (Status quo value) + Probability of change in management) (Optimal value)

Mechanisms for corporate governance change

1. Proxy contests: Investors contest incumbent managers for proxies they then use to elect their nominees for directors and change policy.
2. Hostile acquisitions: Hostile acquisitions are more likely to be mounted on poorly managed, poorly run firms and are far more likely to be successful.

Determinants of Success at Activist Investing

1. Have lots of capital: Since this strategy requires that you be able to put pressure on incumbent management, you have to be able to take significant stakes in the companies.
2. Know your company well: Since this strategy is going to lead a smaller portfolio, you need to know much more about your companies than you would need to in a screening model.
3. Understand corporate finance: You have to know enough corporate finance to understand not only that the company is doing badly (which will be reflected in the stock price) but what it is doing badly.
4. Be persistent: Incumbent managers are unlikely to roll over and play dead just because you say so. They will fight (and fight dirty) to win. You have to be prepared to counter.
5. Do your homework: You have to form coalitions with other investors and to organize to create the change you are pushing for.