

VALUE INVESTING: ACTIVIST INVESTING

Private Equity – The Good, The Bad and the Ugly!

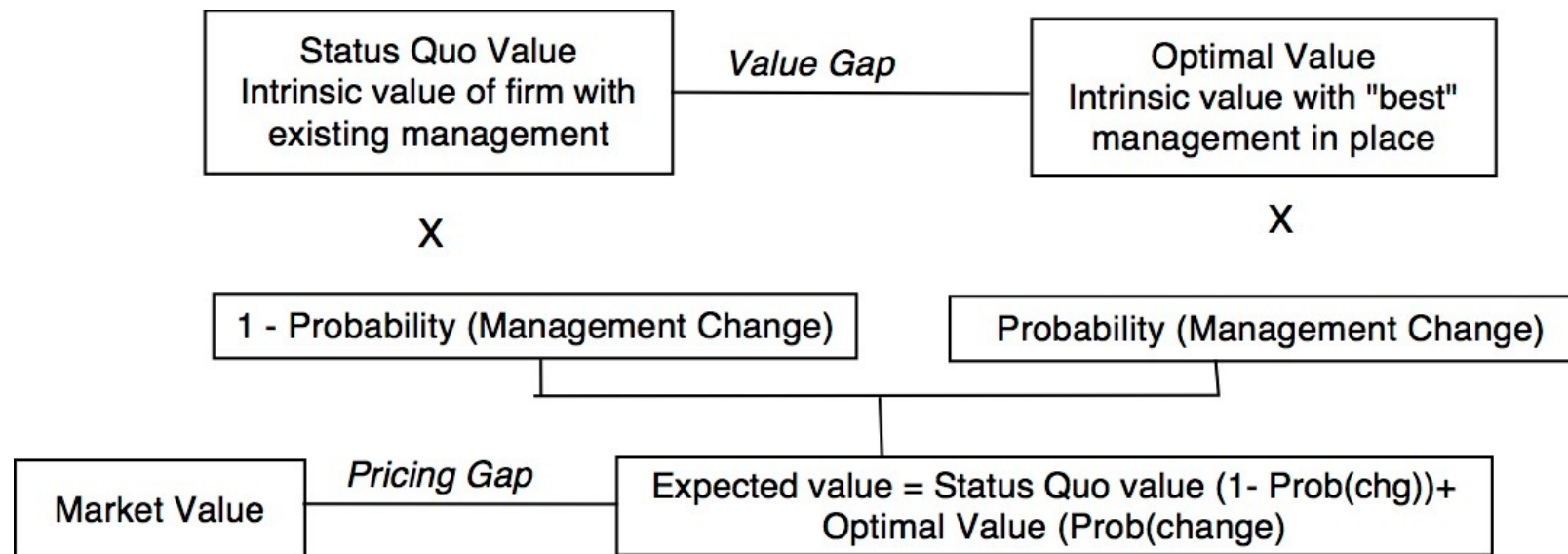
CLASSES OF ACTIVIST INVESTORS

- 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.

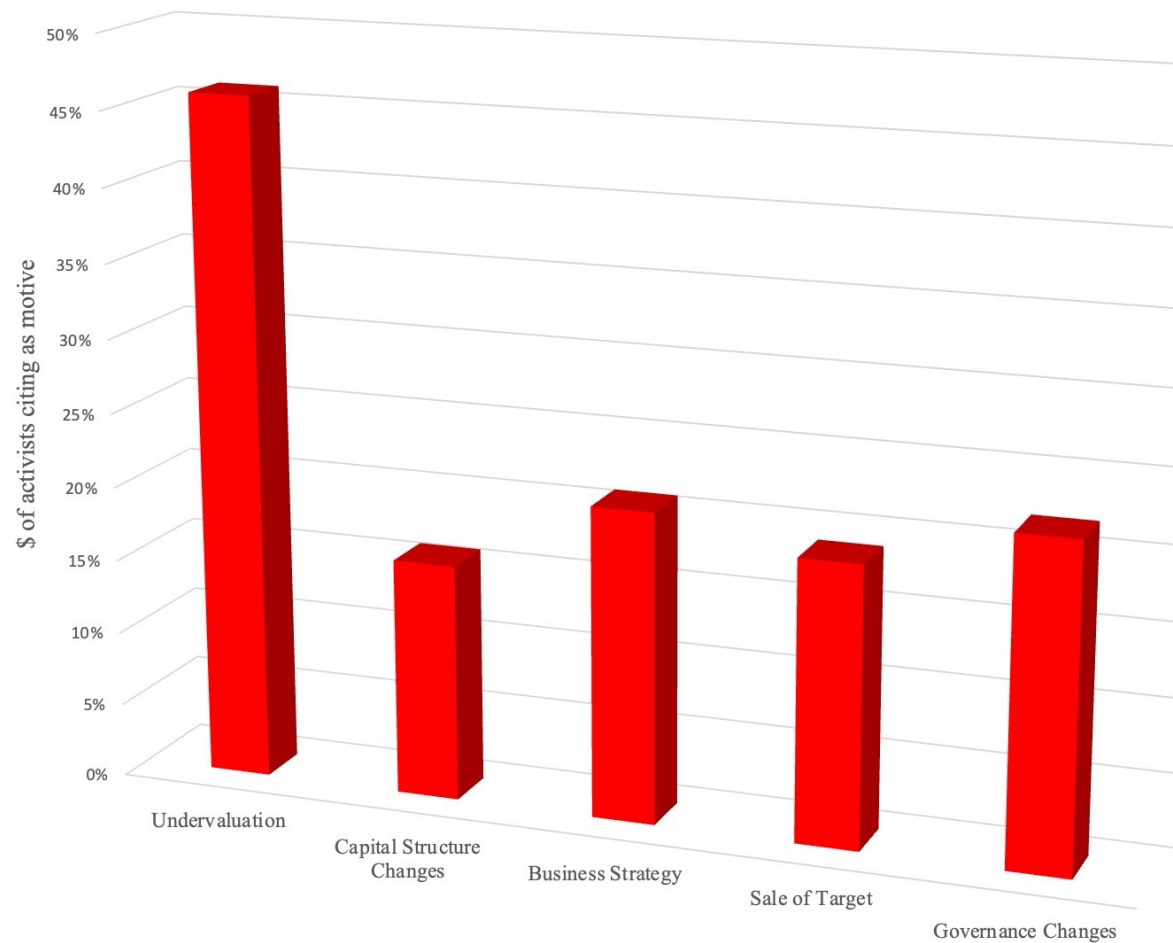
ACTIVIST VALUE INVESTING

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.



AND WHAT ARE THEIR MOTIVES?



You have to be able to buy the target company at the right price.

WHO DO THEY TARGET?

- **Free cash flows:** Given that many buyouts are funded with debt, it should come as no surprise that one of the common characteristics across target firms in buyouts is **large positive free cash flows from operations** that can be used to service and pay down debt.
- **Cheap:** While the objective in a buyout may be fixing up a poorly run firm and flipping it back to the market, at a much higher price, private equity firms improve their odds of high returns, if they can acquire target firms at low prices. Target firms in leveraged buyouts **trade at lower pricing multiples, with enterprise value to EBITDA** among the more widely used metrics..
- **Potential for operating improvement:** One simple, and flawed, measure of the potential for operating improvement is a **comparison of the operating margins or returns on invested capital of the targeted firm to that of its peer group**, and here too, the evidence is supportive of the notion that companies that lag their peer group in profitability and investment returns are more likely to be targeted in buyouts.

And what do they try to do at these firms?

(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 discrntionary
- 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)

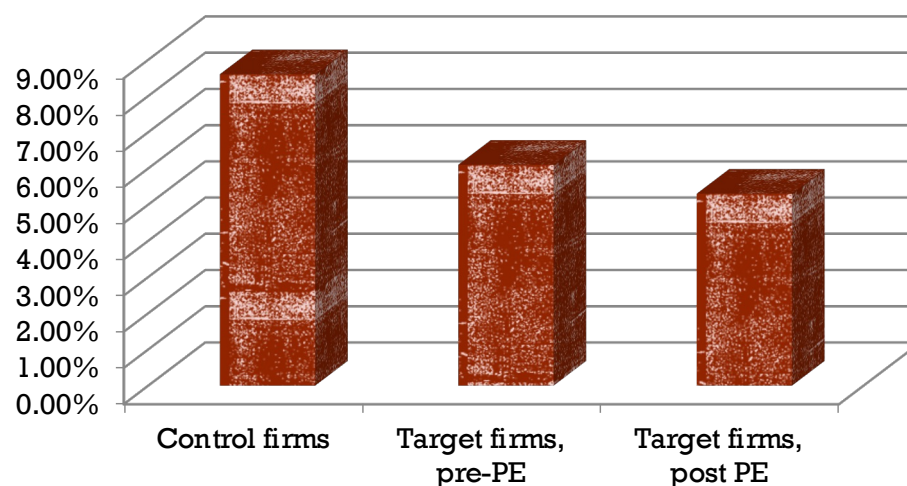
ON THE “GOVERNANCE” PART... THEY PUSH FOR CHANGES

- **Board of directors:** The board of directors at target firms is picked by the equity investors in the buyout deal and therefore is more active in overseeing management.
 - Boards of the targeted firms **tend to become smaller and meet more frequently after buyouts.**
 - More of the **directors are picked for their expertise in the target firm’s business**
- **Top management:** While some of the managers in the target firm are part of the buyout team, there is also a greater push on accountability and compensation:
 - **The likelihood of CEO turnover jumps at firms that have been, increasing 5.5% after the targeting.** One study found that two-thirds of CEO of buyout companies were replaced within four years of buyout.
 - **CEO compensation decreases** in the targeted firms in the years after the activism, with pay tied more closely to performance.

ON ASSET DEPLOYMENT...LESS IN INVESTED BACK INTO EXISTING BUSINESSES...

- The firms that are targeted by PE investors tend to be investing less in their businesses than their peer group even before the PE and there is a **decline in that reinvestment after the PE.**

Cap ex as % of total assets



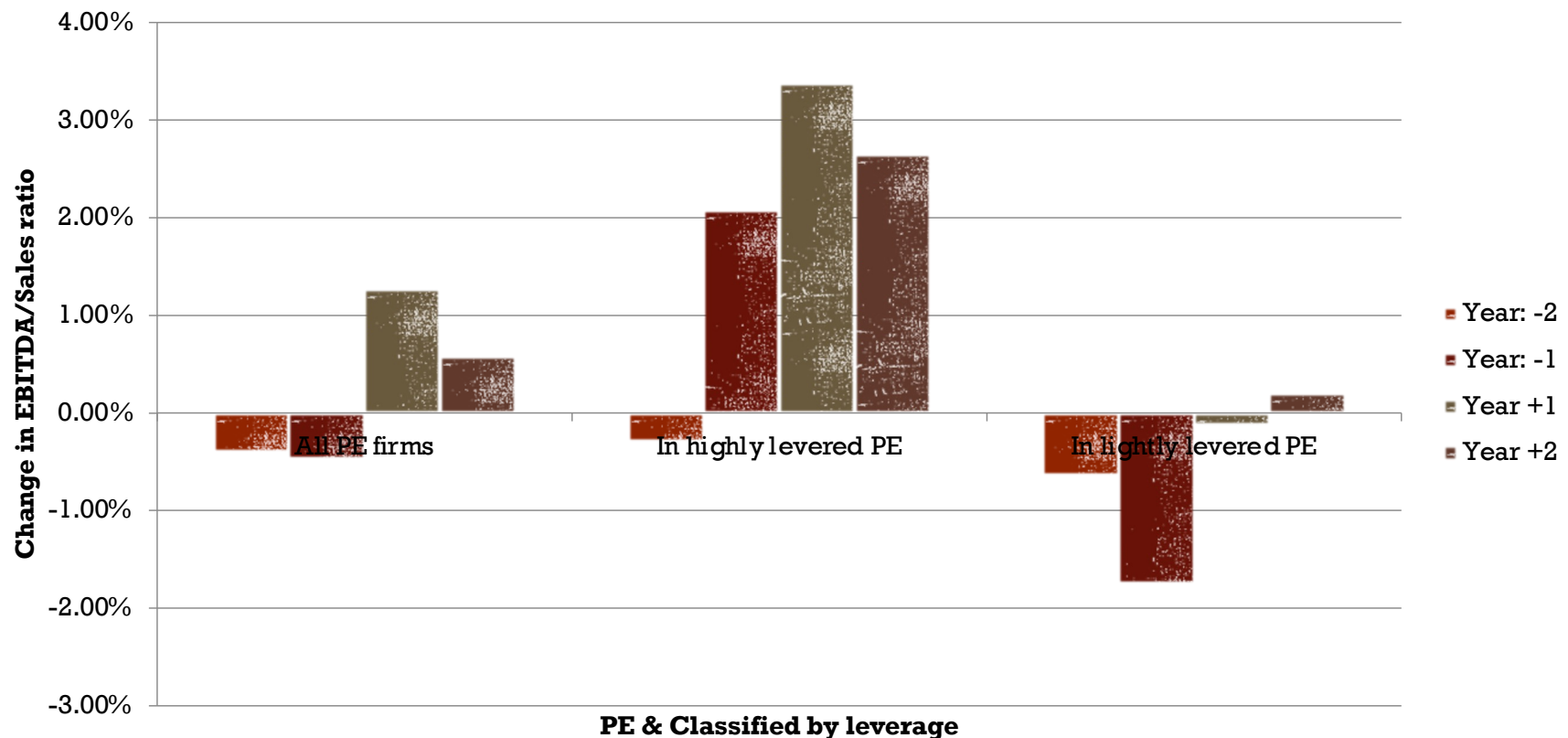
- When growth firms are targeted by PE groups, **there is no perceptible decrease in R&D and other investments after the buyout.**

AND THERE ARE DIVESTITURES...

- There is an **increase in divestitures**, especially in **non-core businesses**, for firms with business sprawl.
- There is **little evidence of wanton stripping of assets for cash**, i.e., the divestitures are generally not overboard are driven by the need to service debt, at least in the aggregate.
- At the same time, **many targeted firms find new businesses to invest in and change their asset mix.**

WITH EFFECTS ON PROFITABILITY...

Profit and PE: Changes in EBITDA/Sales at PE firms - Two years prior & after buyout



Target firms come into buyouts with declining profitability in the two years prior but see improvements in the two years after, and more so in highly levered firms.

ON THE FINANCIAL FRONT... THEY DO BORROW MONEY TO FINANCE THE DEAL.

Year	Excess CF LBOs		Cash Shortfall LBOs		All Firms	
	Mean	Median	Mean	Median	Mean	Median
Year -2	45.30%	40.00%	48.80%	41.70%	47.50%	41.00%
Year -1	41.30%	40.80%	46.80%	44.10%	44.70%	43.20%
Year of LBO	73.10%	69.50%	75.80%	77.50%	74.80%	75.40%
Year +1	74.80%	69.60%	76.70%	78.70%	76.00%	77.60%
Year +2	80.00%	76.00%	84.50%	77.60%	82.70%	77.50%

PE investors use more debt in funding transactions than other public companies.

Default risk increase as debt increases as % of value and cash flows

Existing bondholders/lenders may be adversely affected, if they did not protect themselves.

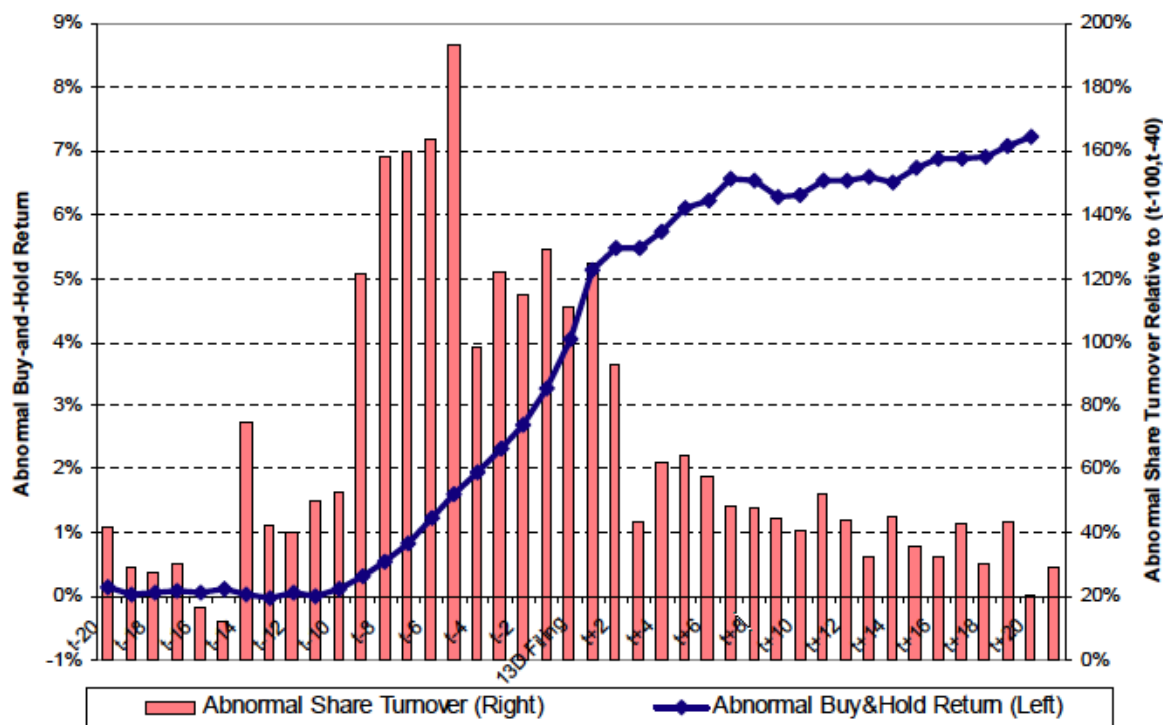
AND ON DIVIDEND POLICY, THEY DO TAKE CASH OUT OF FIRMS..

- Special dividends: While there are some who fear that PE investors pay themselves large dividends right after they take over target firms, special dividends remain rare. A study of 788 private equity targets, tracked from 1993 to 2009 found only 42 instances of special dividends paid to PE investors.
- Asset strips: While there are undoubtedly some PE houses that turn target companies into ATMs, selling assets and drawing cash out of them, they are not the norm.

THEIR SUCCESS RATE IS MODEST...

Activist Demand	# Campaigns	% of Sample	% Success Rate
Strategic and Operating Changes			
Sale of Company to 3rd party	159	31.55%	32.08%
Operating restructuring	69	13.69%	34.78%
Convert to private (from public)	52	10.52%	40.38%
Capital Structure and Dividend Policy			
More dividends & buybacks	78	15.48%	16.67%
Increase debt load	22	4.37%	31.82%
M&A			
Back out of announced merger	63	12.50%	28.57%
Corporate Governance			
Remove CEO, Separate CEO from Board Chair	27	5.36%	18.52%
Reduce executive compensation	20	3.97%	15.00%
Increase disclosure	14	2.78%	35.71%

DO ACTIVISTS MAKE MONEY? WHEN THE TRANSACTION IS ANNOUNCED...



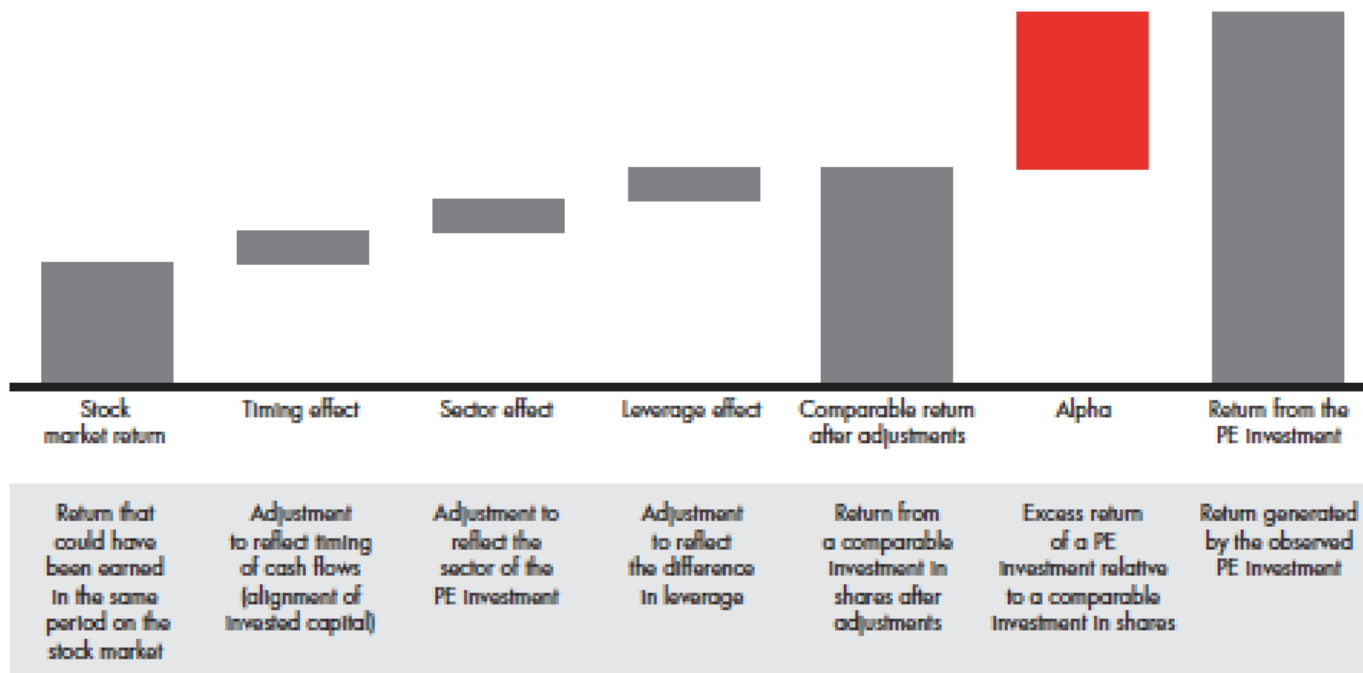
Note: The solid line (left axis) plots the average buy-and-hold return around the Schedule 13D filing, in excess of the buy-and-hold return of the value-weight market, from 20 days prior the 13D file date to 20 days afterwards. The bars (right axis) plot the increase (in percentage points) in the share trading turnover during the same time window compared to the average turnover rate during the preceding (-100, -40) event window.

WAYS FOR PRIVATE EQUITY TO GENERATE PROFITS FROM THE TRANSACTION

- Management fees: When the PE investor runs the company as a private business, the company will pay management fees for the services rendered by the PE investor.
- Make equity stake more valuable before exit: By finding market mistakes, making operating fixed or through financial engineering, try to reap the difference in value at exit (by taking company back public or by selling in a private transaction).
- The **big winners almost always require the second component to be significant**, but fees can sometimes flip the assessment of even bad or neutral investments.

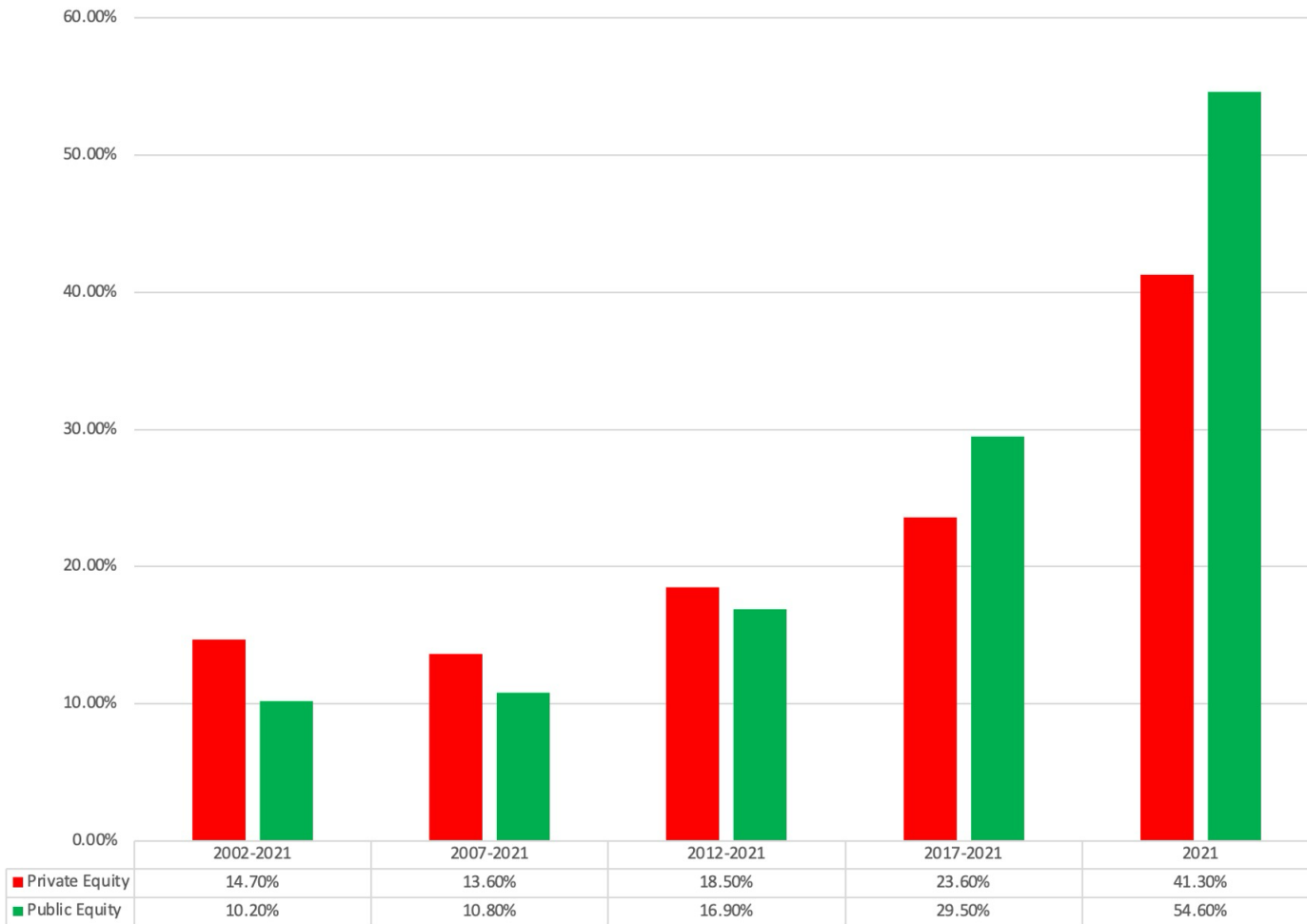
BREAKING DOWN THE RETURNS TO PE INVESTORS

Calculation of alpha for PE (illustrative)

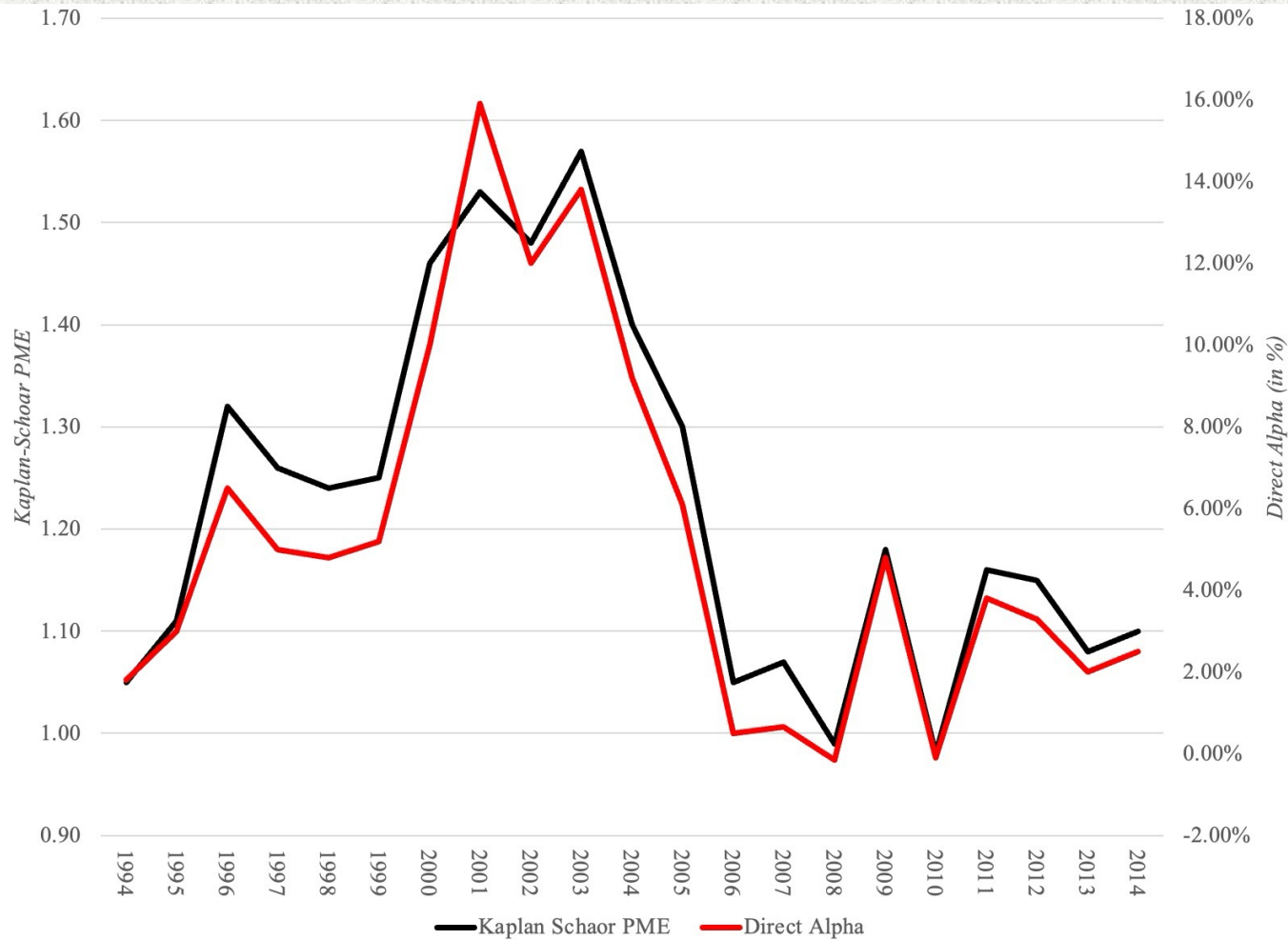


Source: "Private Equity Study: Finding Alpha 2.0," Oliver Gottschalg, HEC-Paris; Golding Capital Partners, November 2011

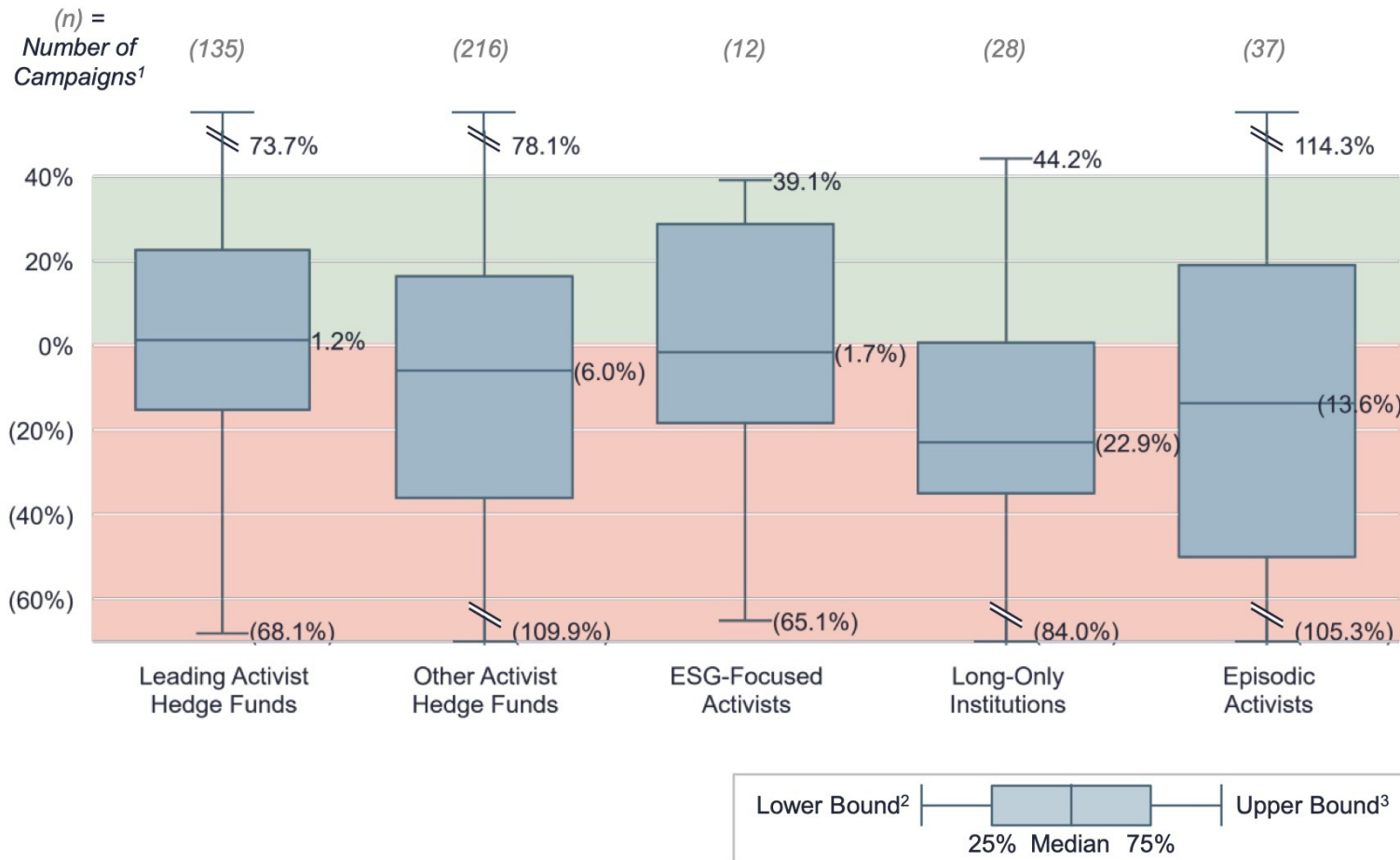
THE RETURNS TO PE INVESTORS ARE DECLINING..



AS ARE EXCESS RETURNS OVER TIME..

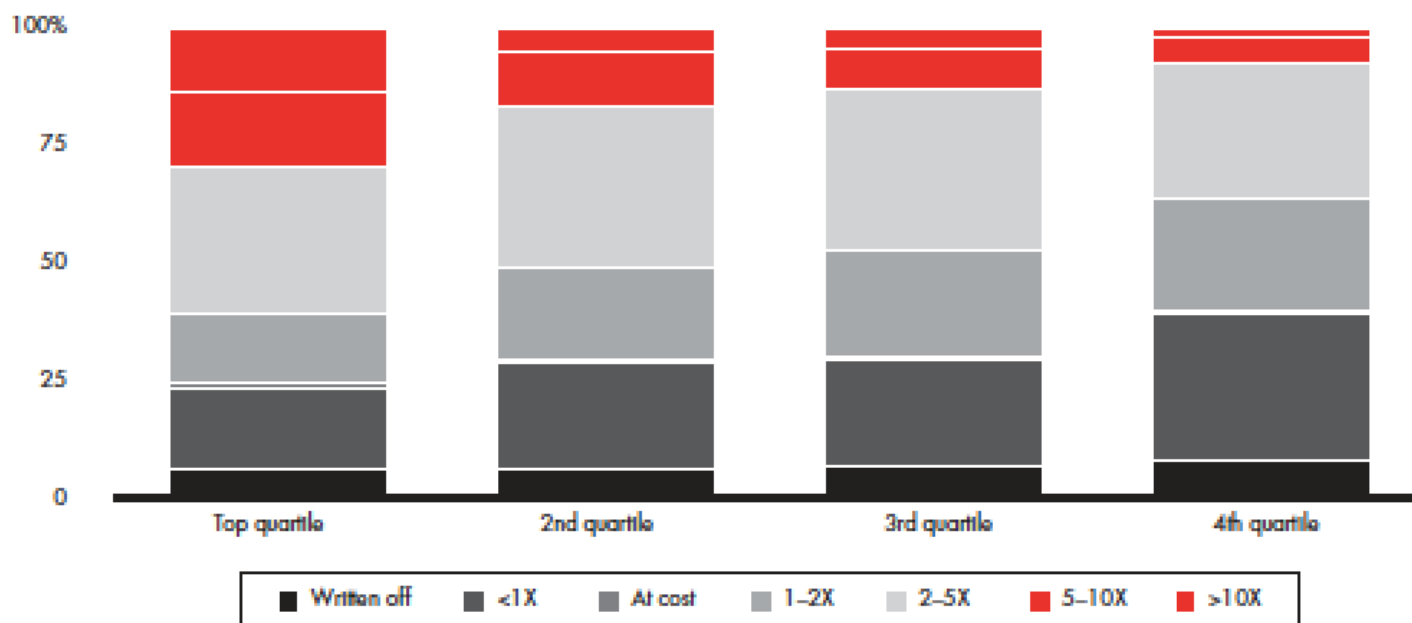


WITH WIDE VARIATIONS ACROSS PE INVESTORS..



AND EVEN THE BEST PE INVESTORS LOSE SOMETIMES... BUT MAKE UP WITH BIG WINNERS

Distribution of gross deal returns for a sample of buyout funds by quartile



Notes: Analysis based on 117 mature buyout funds globally (≥9 years old with at least 10 investments made); funds were classified into performance quartiles based on fund-TVP; total of 2,973 investments (realized and unrealized)
 Source: Perata-HEC Report on Risk-Profile of PE Funds (forthcoming)

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.