GPS

Global Proxy Solicitation

Will Activist Investing Awaken the Sleeping Giants?

Will Activist Investing Awaken the Sleeping Giants?

November 2015

The foot soldiers of corporate activism have conducted guerrilla warfare for several years now, while the sleeping ranks of big institutional investors have hardly stirred.

But strategies and tactics are changing and the anticipated surge of high-end activism in the Australian market may not be too far off.

US activism at the big end of town is now into its fifth year and lapping at the shores of the UK and European markets, with an occasional flourish in Japan for good measure.

The key to unleashing the forces of change will actually come from within the Australian market, just as they did in the US and as is currently playing out elsewhere.

Pershing Square Capital's Bill Ackman says that activism's time came when US index funds started backing activist campaigns. Prior to that, corporate activists in the US were confined more to lower and midcap opportunities. His view is also shared by Australian market watchers.

In a research note to clients in April this year, a team at Credit Suisse Australia observed that "the explicit support of the large superannuation funds is required for activism to take hold in Australia."

We agree. Active fund managers have shown plenty of enthusiasm over the last couple of years, but it's always been the silent majority – the large index funds and super funds – that have stayed below deck during the campaigns.

In April 2014, GPS surveyed a group of Australian industry, state, index and quant funds representing **$550** billion AUM to find out their attitude to activist funds in the local market. While only **20%** of them had ever supported an activist campaign, two thirds of the managers we interviewed said they would publicly support an activist campaign to get a change at board level or to help influence a potential transaction.

Moreover, almost half (45%) said they would be prepared to enlist the support of an activist investor (as partner) to achieve these goals.

Lucky them.

Using a formula that includes assessing a company's cash, net debt to EBITDA, return on equity(%) return on invested capital (%) and price versus book value, GPS identified **32** immediate activist targets with a collective market value of **$865** million among listed smaller cap companies. Plainly, there's a lot of activist potential.

A current activist challenge in the market launched in mid-June was by Sandon Capital analyst Campbell Morgan who authored a critique of BlueScope Steel (ASX:BSL) which, in classic US activist fashion, succinctly argues that BlueScope should off-load its Port Kembla blast furnace plus a range of surplus assets to realise substantial cash for shareholder distribution. Sandon presented its work to several BSL institutions who agreed with the findings.

Call it a coincidence if you like, but by 24 August BlueScope Chairman Mr Graham Kraehe had flagged that the company would undertake a strategic review of steelmaking operations – including a review of the blast furnace operation in question.

AMP Capital China Growth Fund (ASX-:AGF) is also under pressure from global activist investor LIM Advisors to implement initiatives that will close the NAV gap. Interestingly, another AGF investor, London-based Metage Capital, appears to have got the ball rolling earlier this year when it circulated a comparative analysis of AGF. Although a proxy fight was averted LIM Advisors has publicly stated that it's keeping a close watch on the AMP fund leading up to a June 206 unitholder meeting to vote on the renewal of AMP's management contract.

But it's not always the case that a proxy fight ensues when an activist starts exert-ing some influence. Hong Kong-based Janchor Partners – run by expatriate Australian John Ho, expressed a view to Medibank Private's board only a couple of months after it listed, seeking a change at the top.

By late November, Medibank Private's board announced that the company's CEO would step down. Some institutional investors were dismayed. Market sources say it was pressure from Janchor, who own **5%**.

John Ho told the Financial Review that he was looking for the board to strategically engage with stakeholders, including policy members, government and shareholders.

So who's next?

Credit Suisse says "We believe it's only a matter of time before the largest superannuation funds embrace activism. Aussie stocks that could be the target of partnered campaigns by hedge fund activists and pension fund activists include BHP Billiton, Caltex, CSR and Woolworths."

Below all this, the Aussie landscape continues to shift and while activism is still confined mainly to small and the occasional mid caps, it continues to manifest itself in surprising ways.

Stocks Attractive to Hedge Fund Activists and Pension Fund Activists
Companies that provide an economic and ESG activist opportunity

Company	Economic Opportunity	Potential ESG issue
BHP Billiton	Re-structure or divest capital-intensive, poor performing Petroleum assets. Petroleum makes up 28% of core company valuation. Divesting coal provides further capital return potential.	Environmental concerns centred around coal assets, which make up 7% of core company valuation.
Caltex	Re-leverage balance sheet. Has Net Debt / EBITDA of 0.5x vs US peer at 1.5x. Divest infrastructure assets.	Industry may receive pressure to raise clean fuel requirements.
CSR	Re-leverage balance sheet. Zero Net Debt on balance sheet vs US peer Net Debt to EBITDA of 3.2x.	Remove asbestos liability from balance sheet, potentially raising debt. Liability valued at c$360m.
Myer	Close down poor performing stores. Refocus brand.	Management / board dis-closure could be improved.
News Corp	Has $2bn of net cash on balance sheet. Could potentially divest education subsidiary (Amplfy) which is losing cash.	Founder owns only 13% of the shares but controls 40% of the vote.
ResMed	Has net cash on the balance sheet, can increase current buy-back.	c40% of customers are female, but has only one female member on the board.

Rio Tinto	Re-leverage balance sheet further. Net Debt / EBITDA at 0.8x vs US peers of 2.3x. Divesting coal assets provides further capital return potential.	Environmental concerns centred around coal assets, which make up 4% of company valuation.
Wesfarmers	Re-leverage balance sheet. Net Debt / EBITDA is low vs. international peers at 1x.	Exposed to fossil fuels – coal.
Woolworths	Hotels business ($200m EBIT) enjoys limited synergies within Woolworths. The liquor business ($700 EBIT) may also be	Hotels business includes gaming machines, which is a social concern. Can potentially address further social issues by divesting liquor as well.

Source: Company data, Credit Suisse estimates

July 2015 was a particularly colourful month for activism and dissident shareholder behaviour.

On 24 July the Financial Review headlined "AusNet Bid for TransGrid in Tatters" as China's State Grid Corp, backed by fellow offshore traveller Singapore Power, voted off AusNet (ASX:ANV) director Tony Iannello, rejected an equity raising proposal, and delivered a "strike" against the company's remuneration report – at the shareholder meeting! They also wrecked AusNet's ambitious **$9** billion plan to bid for NSW power grid owner TransGrid.

That's highly unusual, as dissident or activist action is usually signalled well in advance. Also of interest is the fact that the dissidents were two foreign investors with over **60%** of the voting power between them.

"Truly shocking" was how retiring AusNet director Ian Renard put it; adding that the vote against Mr Iannello was also a vote against the board, which backed him. In a wonderful understatement, Mr Renard was quoted as saying "I've had no experience of this in all my professional experience."

Meanwhile, across town copper explorer CuDeco Ltd (ASX:CDU) founder and chairman Mr Wayne McCrae found himself the target of three of his significant investors, China Oceanwide International Investment Co, Sinosteel Equipment & Engineering and New Apex Asia Investment Ltd. They requisitioned a section 249d board spill to dump Mr McCrae. (These three had been in funding discussions with Mr McCrae, but clearly the talks didn't go too well). Mr McCrae resigned of his own accord a few days later.

At the start of July, a mini-vortex of activism was brewing in WA. Perth-based Echo Resources (ASX:EAR) attracted the attentions of Miss Mei Yen Tan and Mrs Sarah Cameron, who requisitioned not only a shareholder meeting under section 249d, but also a notice under section 249f to dump managing director Ernst Kohler. Under Section 249f, the requisitionist gets to run the meeting, which affords several advantages, including keeping the incumbent board on the blind side during much of the proxy voting period.

Mr Kohler, after failing to arouse any interest from the Takeovers Panel to act against the requisitioners, lobbed his own 249d to dump yet another board member.

But we digress.

Activist Insight's Josh Black observes that some of the strategies that activist investors have adopted over the past few years include deep operational dives into companies with regular, stable cash flows, takeover offers (not to mention completions), and even becoming the CEOs of companies when the incumbents of the corner office aren't up to scratch.

"Private equity used to do these things in spades. That they do less of it now is at least partially because activist investors have set a new floor in stocks – usually getting to the companies first…" he says.

"Over there", things are heating up, and index funds are queuing for some of the action. Amid a boom of hostile takeovers not seen since before the GFC, nearly **$US108** billion in potential deals were rejected in a single weekend in mid-June, according to London's Financial Times.

The rejections mean the number of hostile deals launched by US companies since the start of 2015 have doubled since the same period last year, to **40**.

Jim Head, Morgan Stanley's co-head of M&A says the takeover battles are becoming more hostile because nobody wants to be left alone with nobody to consolidate. "That's why we're seeing a lot of unsolicited bids" he told the FT.

Another significant factor is the availability of cheap cash. According to Chris Ventresca, global head of M&A at JPMorgan, cheap financing has been an enormous incentive to strike deals now.

In a note to its US clients, consultant firm Bain & Company recently wrote:- “Arguably, the single best way to ruin a CEO’s day is to report that an activist is on the phone and has just taken a position in the CEO’s company’

Bain said that more and more CEOs are getting this call, as activist investing has exploded in recent years. Bain says it has examined more than **400** activist engagements and found that the targets are getting larger and the industries more diverse.

In a cautionary note that equally applies to the Australian market, Bain said “We also found that activists’ attention is not just limited to so-called laggards; it includes a number of high performing companies as well. In short, few, if any management teams are immune to an activist challenge”

Credit Suisse Australia’s Hasan Tevfik summarizes that Australia’s big funds are not yet quite at the critical mass needed to influence a change of investment strategy away from pure indexation to activism but he expects the combined efforts of hedge fund activists and pension activists will play leading role in pressuring reform in the corporate sector.

“We think this will change and the biggest funds will formalize their activist strategies as they grow in size. The age of Activism in Australia is still ahead of us.”

The giants are stirring and more than a few CEO’s will face a ruined day by the time they’re fully awake.

ENDS

For more information, or to discuss how we help Boards respond to Shareholder Activism, please contact:

Murray Williams
P: 02 8022 7911
E: mwilliams@gpsproxy.com.au

Andrew Thain
P: 02 8022 7940
E: athain@gpsproxy.com.au

Global Proxy Solicitation

Copyright notice:

Complete or partial use subject to copyright and prior permission from Global Proxy Solicitation Pty Limited.