ACTIVISM Gets Granular

Activist investors in Canada are increasingly focusing on detailed operational decisions. Whether this is a positive development depends on whom you ask

BY SANDRA RUBIN

"IF YOU GOOGLE 'HOW TO COOK PASTA,' THE FIRST STEP OF PASTA 101 IS TO SALT THE WATER."

Caustic observation of a judge on *Chopped*? Not even close. Try business advice from an activist hedge fund in the middle of a fight for board control.

In the rough-and-tumble world of proxy contests, it's probably safe to assume no target has ever before been criticized for failing to salt the pasta water, handing out too many free breadsticks or neglecting to ask customers if they'd like to order wine. Yet that formed part of an extraordinary 294-page report Starboard Value LP released last fall on how to boost the value of Darden Restaurants, Inc., parent of the Olive Garden chain.

Activist investors like Starboard are transforming traditional notions of shareholder activism by looking beyond the universe of returns and challenging operational decisions.

"Getting into details about things like whether they're salting the water is indicative of the fact that hedge-fund investors are increasingly sophisticated," says Daniel McLeod, a partner at Blake, Cassels & Graydon LLP in Calgary. "They can take a look at any number of factors in making their case for change, things that go beyond the traditional strategic considerations. They're actually criticizing how the company is running the business rather than just its performance."

Kingsdale Shareholder Services warned in a recent report that activists are "arriving at boardroom doors armed with white papers; engaging headhunters to increase the credibility of their board nominees; and becoming more adept in using the media to advance their cause." The report adds, "Increasingly they are demonstrating they know the ins and outs of a company better than the board might."

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Yes, you can expect saltier pasta and fewer breadsticks next time you go to Olive Garden. Starboard succeeded in throwing out all 12 members of Darden's board, replacing them with its own slate.

It turns out that fiddling with the ingredients of a target company's operational focus can be a recipe for success for funds agitating for change. But some warn that in the longer term, it may yet turn out to be bad for business.

The older-style shareholder activist, typically an institutional investor fighting for a seat at the boardroom table, has been shoved aside by the new generation of mainly US-based hedge funds that generally push for a whole new board and changes in senior management.

"They try to get at governance as their strategy," says Carol Hansell, the founder and senior partner of corporate governance law firm Hansell LLP in Toronto. "There are more of those funds being created than any other type, and they are performing generally better than other funds."

By 2013, an estimated 100 hedge funds had adopted activist tactics as part of their investment strategies. And it's not hard to see why they make boards of under-performing companies so nervous.

For starters, hedge funds are powerful, controlling nearly US$3 trillion in global capital by the end of last year, about 10 per cent in activist or event-driven funds. They are superbly capitalized so when they pick a fight, the so-called "new sheriffs of the boardroom" are prepared to see it through.

Pershing Square Capital Management, Icahn Enterprises L.P. and JANA Partners LLC are just some of the American names that regularly show up in the Canadian business news.

Third Point LLC may soon join their ranks. Over the summer, the hedge fund raised US$2.5 billion in two weeks to shore up its war chest, according to the *Wall Street Journal*, and was reportedly looking at TransCanada Corporation as a possible break-up candidate.

DANIEL MCLEOD
> BLAKE, CASSELS & GRAYDON LLP

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Third Point is just one of an increasing number of cash-rich American funds on the prowl north of the border. With the strong American dollar and continuing commodities slump bumping Canadian energy stocks sharply off their peak, Canada's oil patch is seen as a particularly ripe hunting ground.

In Alberta, as many as 10 companies were quietly engaged with activist shareholders in the lead up to Christmas, several practitioners say.

"Alberta right now is a frothy place for US activists to look for positions," says one who asked not to be identified. "These are big companies with good assets and they're in industries that people understand and that have done well in the US.

"So there seems to be a focus on Alberta right now — all soft and under the radar."

With money so cheap and many Canadian companies either sitting on cash or investing in the future in markets that aren't yet paying off, many practitioners expect hedge fund activism to tick up this year. Hansell is among them.

"There is money around now that has activism as its mandate, and it's out there looking for opportunities where there might currently be a downtick in performance," she says. "It could be industry based. Sectors that are in trouble create opportunities for people to try to move in, particularly on the smaller companies."

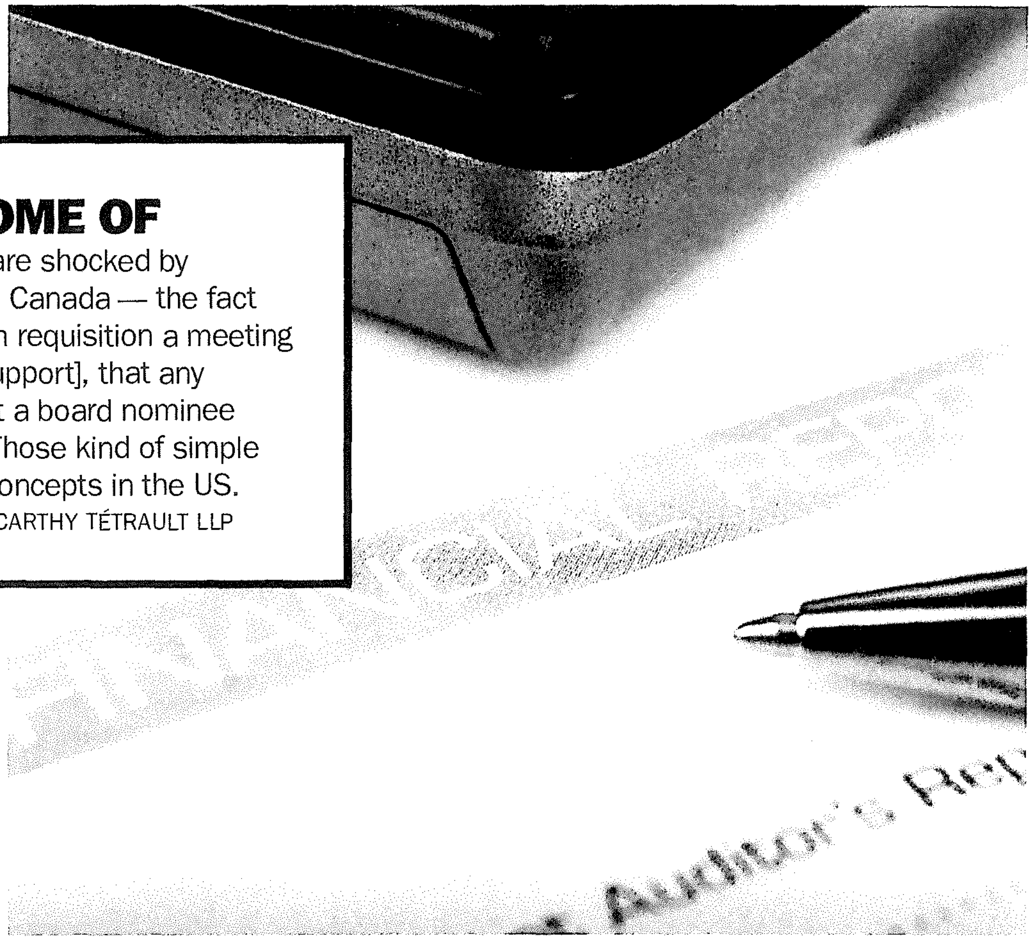
A lawyer who spoke on condition he not be named says some corporate lawyers are not averse to helping grease the wheels a bit. "They'll find a story in the newspaper that says the CEO of a mining company just got fired, and they'll look for somebody who might have an interest in turning the board over.

"Then they'll call the guy who was fired, or the fund will call him, and say: 'We think this was a travesty of justice and we can help you get your company back. We will put money behind attacking this board and putting you back in place.' So they help manufacture some sort of a crisis — I'd call that corporate ambulance chasing."

Canada is seen as especially vulnerable to this kind of action because the regulatory regime is more favourable for activists than in the United States. Funds can build a position and don't have to unmask until they hit the 10 per cent threshold, for example, whereas in the US, they are required to disclose their stake at 5 per cent.

Tim McCafferty, a partner at McCarthy Tétrault LLP in Vancouver, says Canada is not as activist friendly as some people seem to think.

McCafferty says the landscape is different in Canada, rather than more wel-



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coming. "I think some of our US colleagues are shocked by what can happen in Canada — the fact any shareholder can requisition a meeting with 10 per cent [support], that any shareholder can get a board nominee on the proxy card. Those kind of simple rules are startling concepts in the United States.

"But things people forget about are that this is Canada, so we've also got a much more restrained judicial system, we've got loser-pay regimes – which they don't have in the US – and our securities regulator is not in this game in the same way as in the US. So it's easy to say Canadian companies are sitting ducks, but that's a fairly superficial analysis. There are safeguards up here."

That said, he adds, "if you have an activist who wants to do capital-A activism, they're going to find a way to do it — north or south of the border."

With taking a stake in an under-performing company, then agitating for boardroom change proving to be such a lucrative business line, specialty hedge funds are setting their sights on larger and larger targets. Yahoo!, Apple, Microsoft, Sony, P&G, DuPont and PepsiCo are among the corporate giants that have found themselves in activists' sights.

As the game gets bigger, the blueprint for successful shareholder activism is also being rewritten.

With large public companies controlled by institutional investors, activist campaigns are being designed to appeal directly to them, says Toronto-based Orestes Pasparakis, Co-chair of the Canadian special situations team at Norton Rose Fulbright Canada LLP.

"The only thing that really resonates with the institutions is good analytics. So activists are coming out more and more with white papers that seek to analyze not just the business but also the proposals they are making to increase the value of the business. The papers have comparables, forecasts, multiples — the kind of analyses you'd expect from an investment bank."

In fact, some of the large US funds employ professional analysts, traders, bankers and senior partners on par with investment banks. Armed with their white paper and a toehold position in the target's stock, he says, the activist funds typically start meeting quietly with the institutional shareholders to see whether the institutions will support their plan.

"They do it quietly because they want to get a sense of where people are," says Pasparakis. "They want to be able to tweak their thesis so it resonates with other shareholders, so throughout that process they'll refine the thesis and refine the white paper, then they'll go to the board and say: 'Here's our plan.'

"If the board says no, then the activist will likely leak it – we've seen West Face Capital do it [in the proxy battle for Maple Leaf Foods] and many others do it as well – so that the media picks it, and people start to talk about the white paper."

If all this happens before the activist starts a proxy contest, discussing the contents of the white paper with other shareholders does not constitute a solicitation and there is no need for the activist to spend money putting out a circular.

Pre-proxy campaigns and the heavy use of analytics in the proxy fight are now "just part of the roadmap," says Pasparakis. "So compa-

PHOTO: SHUTTERSTOCK

nies are having to hire investment bank 'fight teams' to respond to the analytics."

As activists gain more clout, it has given rise to a phenomenon Pasparakis calls "a sheep in wolves' clothing" — shareholders who may challenge the board but don't have either the moxie or the money to fund a campaign through to the end.

Norton Rose has been warning clients not to automatically settle with anyone who claims to be an activist, "just because they look like an activist and talk the activist talk.

"It takes a big investment of time, energy and money to mount a campaign and you don't have to run for the hills just because someone who sounds scary emerges from your shareholder base. If they're proposing something you don't think is right, go a few rounds. See if this is somebody fishing to effect change on the cheap."

How do you separate the sheep in wolves' clothing from the wolves in sheep's clothing? Pasparakis says it's easy. "You punch them in the nose a few times and see if they actually have teeth."

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> ORESTES PASPARAKIS, NORTON ROSE FULBRIGHT CANADA LLP

A lot of them do, especially large American hedge funds that have been looking north with new interest since Pershing Square Capital Management's success in overturning the board of Canadian Pacific Railways.

But American activist funds have a mixed record in Canada. CP shares jumped to more than $225 last year from under $49 before Pershing launched its proxy battle — for a compounded annual return of roughly 67 per cent. However, things don't always work out so well, or at least so quickly. Talisman Energy has slumped by a third since Carl Icahn took a stake and seats on the board in 2013.

Martin Lipton, a founding partner of Wachtell, Lipton, Rosen & Katz in New York, has been among those sounding the yellow light on the emergence of activist hedge funds, saying they may be good for the share price but bad for the business. With their short-term focus on squeezing out profits to bolster the company's share price and their own bottom line, he believes they divert money that should go into strengthening the business in the long term.

Yet the strategy is so successful, he says on *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, that activist funds have become a new "asset class" that is attracting investment and support from traditional institutional investors.

Lipton points to the Ontario Teachers' Pension Plan aligning itself with Pershing Square in the CP board challenge and to Valeant Pharmaceuticals partnering with Pershing Square on the proposed takeover of Allergan as examples of institutions getting into bed with activists.

Unlike in the US, Canada's institutional investors traditionally gave activism a wide berth, preferring to avoid the risk and stay out of the headlines. But as activist hedge funds reach out to them with well-researched proposals backed by analytics, they have been increasingly willing to play a supporting role.

That dynamic is skewing the outcome of proxy contests, says Ed Waitzer, who leads the corporate governance group at Stikeman Elliott LLP in Toronto. "In most widely held companies, the top 10 or 15 shareholders hold between 30 per cent and 50 per cent or more of the stock, so that's all you need. If you can get them onside, there's lots of cheap money available and lots of opportunity to create short-term value accretion.

"And you can do lots of things to increase short-term stock price. The question is whether those things are consistent with long-term sustainability."

Waitzer believes in many cases, they are not. The difficulty, he says, is that activist investors often do successfully identify under-performing companies where there are legitimate reasons to be questioning the company's management.

While the emergence of an activist may or may not be bad for a given business depending on the situation – and he says Pershing's Bill Ackman "got lucky" on CP because demand for rail transportation "went up dramatically" – he's convinced it's bad for the long-term health of the capital markets in Canada.

Waitzer says Valeant and Pershing teaming up on the hostile bid for Allergan, and their strategy for creating more value from the Botox maker, is an example of what he finds troubling. (Stikeman Elliott was involved in the battle, although Waitzer himself was not.)

"Part of the way Valeant and Pershing were proposing to create value is by cutting research and development from something like 20 per cent to 5 per cent, and cutting the tax rate from 30 per cent to 3 per cent. Allergan basically said that amounts to burning the furniture to generate short-term stock performance. If you don't do R&D in a pharmaceutical company, you're not going to be sustainable in the long term. And if you are clearly avoiding taxes, sooner or later countries are going to do something about it, which they're starting to do.... so these strategies create a lot of short-term value — whether that's a good thing is the debate."

Waitzer believes the timeline of a company's business plan, whether a board is more concerned with long-term or short-term performance, is "*the* fundamental question of corporate governance. It's a question of what kind of system we want to have."

The focus for the past 20 years has undeniably been on generating short-term financial value, says Waitzer, and as a result the vast majority of wealth created hasn't been creating more wealth. "It's just been shifting wealth by taking advantage of information asymmetries, shifting wealth to people who have informational advantages over others.

"We're in this era of financial capitalism where the focus is very short term, when at the end of the day most stakeholders are disadvantaged and as a result public trust in our institutions has diminished dramatically. My argument is we should be focusing on longer-term sustainable capitalism."

The large institutional investors need to take the lead if things are going to change and, instead of teaming up with activists, he says, they should take back activism.

"Institutional investors should be saying to themselves we're in it for the long haul, so why would we sacrifice long-term performance and market sustainability for a short-term pop? Maybe the game shouldn't be to beat the market but to make the market a better place. But if you're a portfolio manager, you get paid for beating the market because you're evaluated on your quarterly performance, or annual performance."

Compensation metrics are starting to shift to longer term, he says, with the Canada Pension Plan Investment Board and McKinsey & Co. among those warning about "the plague of short-termism," trying to convince institutions to refocus and manage their portfolios with the longer term in mind.

Waitzer says he goes in and talks to institutional investors "all the time" about the need to shift their thinking. "Part of what I've been arguing to the institutions is if you accept the logic that you own the market and you're in for the long term, then you should be the activists instead of relying on short-term activists. You almost have a duty, a fiduciary duty, to collaborate.

"There are 20-25 very large pension funds or wealth funds that own a very significant portion of global financial assets, and they should all be getting together and sitting down with the big issuers and talking about what we need to do to make the system work.

"Do quarterly earnings make sense anymore? Do existing compensation structures make sense anymore? Does guidance, which focuses people on short-term results, make sense anymore? If they did that, the world would change a lot quicker — and some of them are beginning to."

CAROL HANSELL
> HANSELL LLP

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Patricia Olasker, a senior partner in Toronto at Davies Ward Phillips & Vineberg LLP, is not convinced by the argument. In fact, when it comes to shareholder activism, she's not convinced differentiating between hedge funds and institutions is a meaningful distinction.

People try to categorize shareholders as long-term versus short-term, says Olasker, "but to me that's a bit of a mug's game. All shareholders are fundamentally short term. One is investing for returns — and whether that means five minutes or five years, treating shareholders differently creates all kinds of artificial distinctions."

Olasker acted for Pershing Square in its battle with CP and again on the proposed acquisition of Allergan by Valeant. She calls the latter "a very interesting development in the world of activism, where the activist is actually the instigator of an M&A transaction and effectively a co-bidder.

"It's also a particular brand of activism that is very noisy, very public and very litigious — very different from the day-to-day activism we're used to seeing here in Canada where most of the activism is quiet, behind the scenes and never makes headlines."

As well-funded activists increasingly tackle market laggards and complacent boards, she says they are winning support among institutional investors and regulators with good reason.

Olasker takes issue with the idea that institutional investors may have more of an interest in the long-term sustainability of capital markets, and that that interest is not shared by results-oriented hedge funds. "I would have thought probably nobody cared more about that than fund managers – and a hedge-fund manager is a fund manager – what they do is not much different from a Canada Pension Plan or a Caisse de dépôt. The difference is they make fewer investments, so they're more focused, and have an inclination to get very involved in monitoring those investments and engaging with management when they think management goes off the rails.

"I actually think they perform a critical function in the capital markets. If the world was full of passive institutional investors, I think there would be very little discipline on management to keep an eye on decision-making with a view of what's best for the shareholders."

Sandra Rubin is a Toronto-based writer and strategic consultant.