Appetite for Activism Driving Rise in Campaigns

The explosive growth of activist investing and this year's proxy season has once again fueled debate over the strategy, highlighted by the media's focus on campaigns bent on forcing big changes at **DuPont**, **Qualcomm**, **Yum! Brands** and other large cap companies.

But considering the fact that 83% of the roughly 5,800 exchange-listed companies have market capitalizations of less than $2 billion – and 65% have a market cap of less than $500 million – small cap and emerging growth companies provide activist investors with the broadest opportunities, whether the goal is to resuscitate a company for the long term or force a quick sale.

Activist hedge funds targeted nano cap, micro cap and small cap companies for 74% of their campaigns in 2014, up six percentage points from 2013, according to the *Activist Investing Annual Review 2015*, a publication released by London-based researcher **Activist Insight** in association with law firm **Schulte Roth & Zabel**.

Last year saw an upswing in the number of activist campaigns against companies, and a steadily increasing flow of capital to activist funds should keep activity brisk in 2015, predicted the report. Activist investors held stock positions valued at $237 billion globally at the end of 2014, it said.

The growth of the strategy has paralleled the trajectory of the market since the financial crisis – some 1,189 campaigns were launched globally over the last five years, growing steadily from 136 in 2010 to 344 in 2014. (Of the 344 issuers subjected to demands in 2014, 75% of the activity occurred in the U.S.) The global review also found that 203 funds subjected a listed company to a "public action" in 2014, nearly triple the number in 2010.

The report acknowledged, however, that the estimate is likely low considering the fact that activist investors say that less than a third of their campaigns go public. In fact,

Activist Insight recorded 708 activist investments in 2014, a 43% increase over 2013.

Short-Term Appetite

While the growth of the number of funds and campaigns suggest that the strategy follows the broader business cycle, Andrew Shapiro, a longtime activist investor and founder of Mill Valley, Calif.-based **Lawndale Capital Management**, said that the real cyclicality tends to show up in the specific tactics that activists deploy.

Cheap capital and booming stock markets typically generate merger and acquisition activity, for example, which creates the opportunity for activists to raise money based on a short-term approach to pursue company sales. Plus, the funds often promise investors liquidity that the strategy inherently fails to provide, he said.

Andrew Shapiro, Lawndale Capital Management

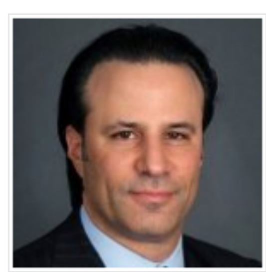
Invariably such "Johnny-come-lately" funds run into periods of illiquidity, Shapiro said. And because an activist strategy in smaller companies requires large positions in a concentrated number of illiquid issuers, he added, many activist investors face nervous investor redemption requests, which forces the funds to dump securities at big losses or halt redemptions. Subsequently, many funds don't last long.

"Investors blame the strategy and swear off of it," said Shapiro, who has focused on small company activist investing for 23 years. "But the blame lies partially with the 'hot money' investor who didn't appreciate the risk and nature of the strategy. While funds attract capital and grow rapidly by promising investors liquidity, an effective activist strategy fund ought not offer that kind of liquidity and smart allocators ought not require it."

Similarly, Adam Epstein, founding principal of Danville, Calif.-based small-cap corporate governance advisory firm **Third Creek Advisors**, said that he's observed arbitrage funds rebrand themselves as activists to take advantage of the capital pouring into activism.

He acknowledged that small issuers are often activist targets – some deservedly so – because it costs less to buy material stakes in the companies while managements and boards vary widely in quality. But a rise in the number of funds employing short-term strategies that call for a company's sale could saturate the market and eventually drive less skilled investment managers out of the business.

"Some of these investors have unsophisticated playbooks – they fire off letter after letter, scream, and demand that every target put themselves up for sale," he said. "While markets need arbitrageurs, yelling isn't really an investment strategy."



Adam Epstein Third Creek Advisors

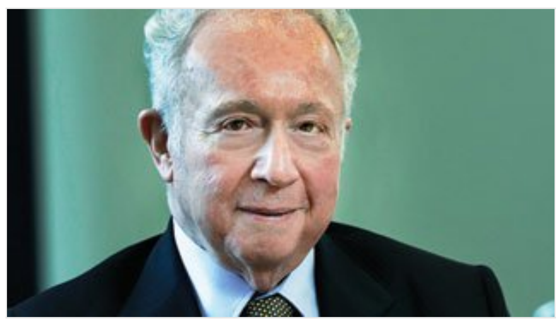
Institutional Interest

Despite the turnover of activist funds that follows illiquid periods, observers suggest that activism will remain a significant part of the market in good and bad times, especially as the funds continue to receive institutional support.

Among others, the **Florida State Board of Administration**, **TIAA-CREF** and the **Illinois State Board of Investments** last year backed successful dissident proxy battles at community website operator **Sparks Networks (LOV)** led by **Osmium Partners**, and convenience store chain operator **Pantry** led by **JCP Investment Management** and **Lone Star Value Management**, according the Activist Insight report.

Mixed results followed each campaign: Sparks Networks has seen its share price fall more than $2 a share to around $3.17, while Quebec-based Alimentation Couche-Tard acquired Pantry in March for $36.75 a share, a premium of more than $20 a share.

The rise in institutional investor interest and assets under management of more than $200 billion in activist funds have cemented activism as an asset class unto itself, suggested longtime anti-activist hawk Martin Lipton, a partner with the **Wachtell Lipton & Katz** law firm, in article penned for the Harvard Law School Forum on Corporate Governance and Financial Regulation in November.


Martin Lipton

"Today, regardless of industry, no company can consider itself immune from potential activism," he wrote. "The additional capital and new partnerships between activists and institutional investors have encouraged increasingly aggressive activist attacks."

Shapiro agrees that activist investing could be considered an asset class given its unique return characteristics and portfolio construction. But he argues that the institutional capital rolling into the sector – the basis for Lipton's assertion that activism is an asset class – is "hot money" that is making unrealistic demands on the strategy.

"Institutional investors are expecting and wanting low volatility and high returns, which cannot come from a concentrated portfolio of a few names," he said. "Activism is a hybrid between private equity and other forms of public market investing."

Clashes Past and Present

Among other campaigns, Shapiro's Lawndale Capital in 2010 began challenging **P&F Industries (PFIN)**, a manufacturer and importer of air-powered tools and builder hardware, to shrink and improve the independence of its board of directors, reduce the salary of the CEO and chairman, and consider the sale of the company. Since then the number of directors has declined to six from nine and the CEO base salary in 2014 was $700,000 compared with more than $938,000 in 2009, according to proxy statements.

Lawndale Capital owns 367,086 shares, or 10.2%, of the company, and P&F Industries' shares were recently trading around $7.15 versus $2.80 at the end of 2010.

Shapiro focuses on small companies largely because of the size of the market, the lack of competition and the potential upside, and he anticipates opportunities in the energy industry due to falling oil prices. Some activists have already started campaigns.

In a press release issued last month, for example, New York-based Lone Star repeated its call for a sale of **Dakota Plains Holdings (DAKP)** after the issuer employed what Lone Star considered to be delaying tactics in response to earlier calls for a sale and to fears of a potential proxy battle. While the Wayzata, Minn.-based transporter of Bakken Crude announced it was initiating a strategic review process, in actuality it had adopted more "shareholder unfriendly" policies, Lone Star alleged.

Lone Star, which owns 4.3 million shares, or 8%, of Dakota Holdings, noted that after it initially called on the board to pursue a competitive auction in December, the company retained "activist defense" advisors. The fund detailed what happened to oil and gas exploration firm **Endeavour International (ENDRQ)**, which also announced a strategic review as a defense tactic to ward off shareholder input. When Endeavour announced there would be no sale in 2013, its shares plummeted 14% in one day and it eventually filed for bankruptcy in 2014.

"As the largest shareholder of Dakota Plains, we believe that the company owns an excellent but undervalued asset, and we are eager for the company to close the current valuation gap by selling the company to its natural owner – an MLP," Lone Star said. The investor said it believes a sale could fetch $3.50 a share, an 80% premium to the share price at the time of the letter, which has grown to 134% as of May 8.

Other investors calling for companies to explore sales include Beverly Hills, Calif.-based **Consac**, which last month sent surf and apparel maker **Quiksilver (ZQK)** a letter urging it to find a buyer. The company's shares have dropped to around $1.59 from more than $8 in the last two years.

In an earlier campaign, Consac called for **Vitacost.com**, an online seller of vitamins and other health products, to explore a sale in early 2014 after it had failed to turn a profit despite revenue growth and high customer satisfaction. Osmium Partners a few months later convinced the company to allow it to appoint an independent director to the board. In July, **Kroger Co. (KR)** agreed to buy the issuer for $8 a share and closed the deal in August.