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Wake up the Raiders: Considerations for Private Equity Going Activist

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What do you do when valuations reach record-high levels, but you have trillions of dollars to spend amid increased competition? The challenge of an "inverse proportion" of dry powder (rising) to attractive deal opportunities (declining)[1] is driving private equity professionals to consider emulating the tactics of shareholder activists in order to generate good returns for their investors.

Embracing shareholder activism creates risk for private equity managers that traditional activist funds do not carry. By understanding these differences and their communications implications, private equity sponsors can manage these risks and effectively capture the value potential of activist strategies.

The appeal of activism for private equity is easy to understand, especially as whatever stigma had once applied to hedge fund activists has all but fallen away. Much like private equity firms, activists are looking to drive stronger returns for investors by effecting operational changes and attracting and retaining high-caliber executives.

In many ways, hedge fund activists are applying portions of the private equity playbook and adopting them to the public markets, including in some cases putting in their own bids for companies that they are encouraging to entertain buyouts. Elliott Management has established a dedicated private equity fund (Evergreen Coast Capital) that towards the end of last year teamed with Veritas Capital to acquire Athenahealth. Trian is another hedge fund activist that publicly touts its "private equity mindset." From an activist perspective, a full acquisition of a company is an effective way to implement operational changes.

And private equity firms are starting to dip their toe in the water of shareholder activism. A number of private equity firms – KKR is among the firms that have been public about their plans – are buying what are known as "toehold" stakes in public companies. These holdings, typically under the five percent public reporting threshold, are sometimes used as a way to approach management and begin a conversation of a buyout. The approach can then spark change, potentially driving a sale to the investor who obtained the "toehold", and also providing the fund with quality returns if a sale to another party results.

But what if the private equity firm is rebuffed or isn't able to effect the change it wants through these "toehold" under-the-radar stakes? Some funds have been exploring an activist approach, which could include pursuing changes at the board level, potentially in partnership with established activist funds.

While so much of shareholder activism today is conducted through private engagement, activism is seen by the public and most journalists as a high-visibility strategy, pitting two parties against each other, with one emerging victorious. The media seeks out and often amplifies conflict, which means that an activist approach is likely to generate persistent coverage far beyond what most private equity firms normally experience for any one investment[2].

This attention will only be exacerbated if private equity and shareholder activism fully collide in the form of a concerted proxy fight against a public company. Not only do such fights generate outsized attention, but the novelty of private equity fully and publicly diving into activism may generate even more attention and could prove costly for all parties involved.

Accordingly, if considering an activist approach, private equity firms should contemplate a few critical issues.

Management relationships can be a competitive advantage (or disadvantage) – Unlike shareholder activists, a private equity firm's ability to work with management teams is a fundamental requirement. Being seen as an aggressor who wants to force change – which could include replacing members of management – can limit a management team's willingness to engage in new buyout discussions, especially in the mid-market or with family owned enterprises who may be more sensitive to perceived outside challengers. Furthermore, in a fiercely competitive field it is highly likely that other private equity firms will draw attention to a competitor's "aggressive" approach in their conversations and meetings with management teams of prospective portfolio companies.

Confusion and hesitancy from limited partners (LPs) – Investors decide where and how to allocate their funds based on an expected strategy and historical precedent. While investors are increasingly comfortable with dedicated activist funds, they may be confused or concerned to see a portion of their private equity allocation pursue this strategy. Furthermore, it is not unheard of in a heated proxy contest for the target to communicate directly with the activist's fund investors, and that certainly could put a publicity shy private equity LP in more of a spotlight than it's used to experiencing.

Greater risk of public failures – While there's often speculation about private equity auctions, purported bidders and estimated valuations, in general only the ultimate winners are announced with clarity; other participants are rumored but all that is certain is that their bids were not as compelling (or the target wasn't). But the higher level of disclosure (and media interest) associated with a proxy contest will lay bare the participant roster for all to see. Given the ability of companies to put up legal obstacles to activists, if investors are unable to convince the other shareholders of the compelling nature of their strategy it will be extremely difficult to dislodge incumbents. And any such losses will be public indeed – again, likely more so than private equity sponsors have come to expect from other transactions they've pursued.

Despite these risks, we believe that private equity will continue to adopt shareholder activism as a value creation tool on a case by case basis and depending on market conditions. As private equity leaders consider this inevitable evolution here are a few tips to keep in mind:

- **Preview as much as possible** – To the extent you can, discuss your appetite for activist-like strategies with LPs – ideally while you are raising the fund from which you might deploy such tactics. Topics to discuss include your perspective on such strategies being implemented in the market, where you think value is created and how you might consider adopting them yourself. Give enough information to let them know it's on your mind, but don't feel compelled to lay out a campaign in any level of detail. If you're suddenly in a public process, a series of surprised LP calls will only limit your ability to succeed.

- **Know your partner** – Activism is a personality driven endeavor. Activist funds are unique – both in terms of their strategies, but also in terms of their public reputations and tendency to engage in a public fight. If you're working with an established activist fund, be sure you know its history and tactics as these inevitably will come up in a contested situation.

- **Know your target** – Due diligence is a constant. However, private equity leaders should consider one additional aspect – the target company board's and management's willingness to engage in a fight. Activists often "test" company leaders in early meetings to get a read on how the leadership would react under pressure.

- **Know the process, build a plan, stay in control** – Before launching any sort of campaign (even before pursuing a "toehold" stake) you should understand the different paths – and the corresponding communications required for the various scenarios – it could take following that initial purchase or meeting. What would happen if it leaked? What if the management team disclosed the approach? If this is a concerted campaign, what are the key milestones? How do you plan for and manage unexpected events or changes in tactics from the target? While it is tempting to cede control of the fight to a seasoned expert by partnering with an activist fund, it is important to maintain control over the process, particularly when the reputation of your business is on the line.

- **Be prepared for the downside** – Know in advance what you'll do if you meet resistance. While many companies are prepared to engage at this point, others may still put up stiff resistance. Consider your options up front and be prepared to call an audible if engagement is not possible.

- **360-degree approach to messaging** – In preparing for any sort of campaign, you should focus messaging not just on the campaign (i.e., convincing the target's shareholders and board) but also proactively talking to prospective and current management team partners as well as your LPs. An activist contest might last for a few months, but your business model needs to endure for the long term. Don't let anyone set the narrative with the audiences that drive your business.

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[1]Correlation does equal causation in this instance. With so much dry powder sloshing about the system, virtually every attractive investment opportunity is being pursued by multiple firms at aggressive rates.

[2]Exceptions, of course, abound – any investment in a high-profile company, especially if it ends badly, is likely to attract media coverage.