PORTFOLIO

The Untapped Market That's Ripe for Activists

Submit

Illustration by Yarek Waszul.

A former Canadian pension fund CIO wonders why more investors aren't doing private equity–style plays in a certain stock market.

By Terri Troy July 30, 2018

What do I mean by active investing? I am not talking about investment managers actively managing a portfolio within a tracking error range (no matter how large) around an equity market index, such as the TSX or the S&P 500.

I am not talking about investing in **factor-based strategies** where stocks are grouped based on certain characteristics, such as value, growth, minimum volatility, or momentum.

I am talking about investors applying private equity techniques to the public market domain to target 20 percent-plus returns while improving governance.

This strategy appeals to many pension plans including OPTrust, one of Canada's largest pension funds, with approximately $20 billion in assets. "We believe an active approach to investing adds value over the long term," says **director Wei Xie**. "Applying the private market approach — a space that we've had historical success in — to the public markets is an interesting idea that is worthy of further exploration. It also aligns with our broader philosophy of engagement where we could influence change on issues that are important to us beyond investment returns."

Private equity is one of the highest-returning asset classes. According to Goldman Sachs Asset Management's most recent strategic long-term assumptions for Canada, private equity is expected to return, on average, 8.7 percent annualized versus 5.6 percent annualized for U.S. stocks and 4.9 percent for the Canadian equity market. Top-quartile **private equity managers earn significantly higher returns** than the average ones and their respective public market managers.

A successful private equity manager will buy an underperforming company and make it better by changing all or some of the board members, replacing some or all of the senior management, improving operations to make it more efficient, optimizing its capital structure, and/or improving its growth prospects by changing its strategy.

This is done in the public equity markets by activist investors. I would argue that Canada is their perfect market. "Canada is the most shareholder activist–friendly jurisdiction in the Western world," says Walied Soliman, an attorney specializing in shareholder activism and chair of law firm Norton Rose Fulbright's Canadian practice.

In Canada an investor with 5 percent of a company's shares can request a special meeting of the board, compared with a 10 percent threshold in the U.S. This gives activists in Canada the ability to enact change without locking up too much capital. Important matters do not have to wait until the annual general meeting. Canadian directors must stand for election each year, whereas U.S. board terms can be staggered, making it more difficult to make significant changes in short order.

Furthermore, an investor can accumulate up to 10 percent of a public Canadian company's shares without having to disclose the holding. In the U.S. this "early warning" **threshold is 5 percent**. Secrecy is a valuable tool for activist managers, allowing them to be proactive.

And in Canada a shareholder can solicit votes from 15 other investors without issuing a proxy circular, allowing a relatively small owner to gather powerful allies and demand positive change. This can be done behind closed doors, without having to declare the strategy to regulators.

So if this is so easy, why aren't more institutional investors doing it?

Large index-based investors like a BlackRock or a Vanguard may own significant percentages of a company's shares but are passive in nature. Mutual fund companies and large buy-side managers run multiple strategies and do not tend to invest the time and resources required for activist investing. But they can be quick to support specialists' campaigns to help improve shareholder returns.

“Activist funds allied with asset and pension fund managers are transforming the landscape of shareholder involvement,” wrote David Beatty, founding member of the Canadian Coalition of Good Governance, in a 2017 McKinsey & Co. **article**.

Many successful activist investors do only activist investing. Having this sole strategy helps them stay focused. Also, many investors do not wish to get involved in messy situations that may result in their names being in the newspapers — headline risk. Some U.S. activists routinely appear in the press when making what incumbent boards see as hostile overthrow attempts.

Pershing Square’s **activist strategy with CP Rail**, in which CEO Bill Ackman managed to replace the existing CEO and drive significant returns for shareholders, is probably the highest-profile Canadian transaction in this model.

Up north there is often a “Canadian way,” or a more collegial method, to get significantly improved performance. Of course, disagreements will happen, and players can find themselves defending their strategies and tactics in the press. But this is often a last resort, not part of the kind of up-front strategy some American activist hedge funds utilize. For example, in late 2015, Toronto-based PointNorth Capital — then Oxford Park — initiated board and strategic changes at Extendicare, a health care real estate investment trust. Long before the proxy contest came to a vote, the board and PointNorth amicably agreed on five new board members and a new chair for Extendicare.

“The level of activism we’re starting to see in the Canadian REIT sector is unprecedented,” says Wes Hall, executive chairman of proxy and M&A firm Kingsdale Advisors, adding that REIT investors have been frustrated for a long time.

PointNorth — founded by John Bitove, Phil Evershed, and Barry Goldberg — has found success in activism. With $300 million in assets, the firm sees no need to limit its investable universe and excludes only resource commodities.

In a tenser engagement than it had with Extendicare, PointNorth in 2017 acquired 10 percent of Edmonton-based Liquor Stores, the largest public alcohol retailer in North America. The activist fund was ultimately successful in changing six board members after receiving significant institutional and retail shareholder support — and **pushback from Liquor Stores**. The investment firm targets returns of 25 percent or more, which it achieved with Extendicare and expects from Liquor Stores. Since the changes in the board, Liquor Stores (now Alcanna) has sold its money-losing U.S. business, deleveraged its balance sheet, commenced the overhaul and upgrading of its Canadian business, diversified into cannabis, and attracted $140 million at a 50 percent premium to the market.

In addition to PointNorth, there are a few local names doing activism in Canadian fiirms.

West Face Capital invested in Maple Leaf Foods in 2011 and eventually sought and received a board seat. The investor then worked with the company through a key strategic period for Maple Leaf Foods.

Toronto's Smoothwater Capital Corp. "works to effect change in targeted companies, often collaboratively with institutional and other like-minded investors who hold material positions but are not able to take on the time-consuming and costly activist role," its website says. The company started activist investing in 2016, and together with Hennick & Co., it took Equity Financial Holdings private the following year.

Sandpiper Group, a real estate private equity firm based in Vancouver, focuses its activist strategy on real estate, specifically underperforming REITs. Samir Manji, CEO of Sandpiper, says that "some of the greatest opportunities are in mispricing in the public space." Sandpiper enjoyed a recent success by changing board members at Granite REIT and is now seeking change at Agellan Commercial REIT.

As a former allocator, I must confess that I never spent much time researching the activist space. Though I was aware of the high-profile activist transactions that were reported by the press, I did not appreciate how compelling an opportunity this is in Canada until I studied it. I believe more investors will adopt this strategy once they become aware of the overwhelming potential benefits.

Canadian activist fund managers offer global investors significant return potential while improving governance at their underlying portfolio companies. This strategy fits neatly into the theme of impact investing. Activist investors target 20 percent-plus returns, a significant premium above Goldman Sachs' expected long-term returns of 5 to 6 percent for Canadian and U.S. stocks.

Where many pension plans have shifted toward passive investing using index funds or factor-based methodologies, activist investing provides a nice complement in the form of a core-satellite approach.

For those investors who wish to minimize market exposure and benefit from the alpha generated by activist investing, market beta can be **hedged out**. Shorting can also be used to enhance the activist's strategy where it is difficult to effect the changes needed to improve performance.

In contrast to private equity vehicles where investor capital is locked up for ten-plus years, some activist managers offer this strategy in a long-only mandate, charging fees only on invested capital. This eliminates the early negative returns produced by paying fees on committed capital that has yet to be deployed. Long-only public equity investing entails no, or relatively short, lockup periods. And crucially, there is no need to pay hedge fund–level fees for long-only activist services.

Terri Troy recently retired as CEO/CIO of the Halifax Regional Municipality Pension Plan. She is president of Troy Advisory Services.