

CORBIN

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Shareholder Activism

Over the past several years, so-called “shareholder activist” strategies have achieved remarkable prominence in the hedge fund industry. Although the practice of combining buy-side investment management with the promotion of shareholder-friendly corporate change is many decades old, activism’s emergence as a widespread dedicated hedge fund strategy is of more recent vintage. Given our interest in the topic, combined with requests from our clients and friends for opinions on this subject, we felt it appropriate to dedicate a section of our letter to shareholder activism. As it happens, we feel reasonably well positioned to contribute something to the topic: Our first investment with a manager who would today be called an activist was in the mid-1990s, and, more recently, we have included a dedicated activist investment book in our Fort Tryon Equities Fund, which we launched at the beginning of last year. We have had a chance to observe these strategies for many years – both from an outside perspective and through our own investment activities – and have developed views on a number of issues relevant to activism.

The ultimate goal of this discussion is to focus on two questions which have important ramifications for the future of such strategies:

- 1) Why has activism emerged as a popular investment strategy, and are the conditions which have led to its emergence sustainable?
- 2) What are the key elements of successful activism; i.e., are certain approaches more (or less) likely to produce successful investment results over time?

Throughout our treatment of the second question, we will use real-life case studies from recent activist situations to illustrate our points, marrying our investment views to actual events with which many of our readers are already familiar.

Why Has Activism Emerged Now?

As noted above, activism is hardly a new development. Owners of corporate equity have enjoyed access to the most basic “activist” tool since the advent of the first corporate shareholding structure 600 years ago: The right to vote on corporate initiatives and personnel according to their shareholdings.¹ U.S.-based investors have pursued targeted value-creation approaches to investing since the 19th century, and governance-related conflicts have existed in Europe for centuries before that. Focusing on more recent time periods, it is instructive to note that, contrary to the received wisdom about the aggressiveness and nimbleness of hedge funds

¹ Stora Kopparbergs Bergslags Aktiebolag, a Swedish mining and forest products company, was arguably the oldest corporation in the world. In 1998 it merged with a Finnish competitor, Enso-Gutzeit Oy. For a fascinating history of mining, forestry and corporate evolution, see www.storaenso.com.

relative to traditional asset managers, members of the latter group successfully pursued activist strategies decades before most of today's hedge funds were founded.²

What *is* new, however, is the emergence of a large number of dedicated “activist” hedge funds, and the emergence of activism as a dedicated investment *strategy*, as opposed to an opportunistic investment *tool*. Estimates vary, but we know of at least 20 hedge funds employing principally activist strategies on a global basis – the vast majority of them founded in the past 5 years.³ These funds in aggregate manage a substantial amount of capital, and consume a disproportionate amount of media attention by virtue of the outspoken approach that many of them take.

Why has activism assumed a dedicated hedge fund structure, and why has it done so in recent years? We believe the rise of hedge fund activism arises from the confluence of several economic and governance factors, along with factors related to equity markets generally and the hedge fund industry in particular. The four main factors include:

1. Liquidity (“Because That’s Where the Money Is”). Page one of the standard activist playbook involves returning unused cash to shareholders explicitly (via a dividend) or implicitly (via a share repurchase), funded either by corporate cash or by new borrowings. This strategy thrives (in fact, depends) on underlevered balance sheets, and, not coincidentally, the corporate sector in recent years has been historically liquid. Why? During the 2001-2002 recession, many corporations in the U.S. and abroad adopted a deeply conservative fiscal posture, substantially restraining their capital expenditures, cutting costs across the board, and paying down debt. Since early 2003, the combination of fiscal restraint, increases in revenues and a general reluctance on the part of management teams to make new capital investments have left corporate balance sheets, particularly in the U.S., with record levels of cash and liquid securities and historically low levels of borrowing. By the end of 2005, the net cash balances of the S&P 500’s nonfinancial companies had risen to a record \$647 billion, or a whopping 43% of outstanding long-term debt (also a record).⁴ One has to go back to at least the mid-1980s to find a comparably strong balance-sheet posture, and these underlevered balance sheets have become the favorite and most obvious target of activist investors.

² In fact, “traditional” value managers like Private Capital Management, Third Avenue Capital Management and Mutual Shares, among many others, have successfully employed activist strategies via traditional long only fund vehicles for decades. Hilary Rosenberg’s excellent book on distressed investing, “The Vulture Investors” (1992), features detailed accounts of how the latter two managers have used active corporate engagement to benefit their clients over many decades.

³ There is a much larger number of funds which employ activist techniques (letters to management, proxy contests, etc.) but whose principal business is traditional long/short stock picking. In fact, several of the industry’s most famous/notorious “activist” funds have come to be identified with activities which in reality represent a very small portion of their investment portfolios.

⁴ Source: Standard & Poors, Business Week. The 43% statistic implies that these companies could retire almost half of their total debt immediately with cash on hand. An easy way to relate to this statistic is to sum together the value of your mortgage, auto loans, student loans, and all other debt, and imagine half of that amount sitting in your bank account. Few American consumers find themselves as strongly positioned as the country’s corporations.

- 2. Regulation and Governance.** The corporate scandals of the early 2000s spurred substantial regulatory reforms, such as Regulation Fair Disclosure and the Sarbanes-Oxley Act, which have enhanced the powers of shareholders at the expense of management teams and corporate boards. More generally, and in marked contrast to the fawning, CEO-idolizing business culture of the 1990s, malfeasance at major corporations like WorldCom, Enron, Tyco International and others dramatically reduced the reputational standing of executives and boards and increased public acceptance of activist programs aimed at those players. More importantly, many traditional investors, including most of the large state pension plans, have come out strongly in favor of improved governance practices, and the presence of these very large, like-minded shareholders has substantially strengthened the hand of activist hedge funds – even in cases where governance-related recommendations represent only a fraction of activist platforms much more focused on bottom line profit considerations.
- 3. Operations and Technology.** Many activist managers specialize in operational as well as financial improvements. The rapid advances in technology in the last several decades (in areas like process automation, client relationship management, and logistics) have created an opportunity for activists to propose efficiency-enhancing tools as a way of improving corporate profitability. These new technologies have effectively expanded the toolkit of the activist manager, and have spawned a cottage industry of efficiency-consulting firms to help activists and companies tailor specific programs to improve profitability.
- 4. The Investment Environment.** Perhaps the most powerful forces supporting the rise of dedicated activist investing have nothing directly to do with either activists or the companies in which they invest. Rather, they pertain to dramatic changes in the investing environment and the investment business over the past several years. As many professional investors have lamented to us recently, the “easy money” trade of the early 2000s – going long value stocks and short growth stocks with a net long bias – has been substantially realized, as markets have risen roughly 75% off their lows and the historically vast valuation gap between value stocks and growth stocks has narrowed. Even so-called “special situations,” formerly a powerful source of low-correlation profits for specialists focusing on spin-offs, recapitalizations, and other extraordinary corporate events, have become more crowded and shorter-lived. Many major equity markets today exhibit a high level of informational efficiency: Few broad swaths of grossly skewed valuations, individual stocks that are well-researched by a large number of savvy hedge funds, and single-stock volatility that has returned to historically low levels. Faced with this environment of slimmer profit opportunities, many hedge fund managers have gravitated towards activist approaches, which, though more labor-intensive, offered a playing field rich with target companies (for the reasons described above) and, until recently, relatively devoid of competing “smart money.”

Interestingly, of the four factors described above, two of them (regulation/governance and technology) can be viewed as secular and sustainable in nature, whereas the other two can be viewed as cyclical and potentially transitory. The “easy money” strategy of returning cash to shareholders can last only as long as does the extraordinary level of corporate liquidity, a phenomenon which is almost by definition cyclical in nature.

Similarly, the ability of hedge funds to make relatively easy money in activist situations relates inversely to the number of investment dollars adopting the strategy – and this number has increased very dramatically in the last few years. These fact patterns suggest that, while money will certainly continue to be made, less will be made, and by fewer hedge funds.

The foregoing paragraph should not be interpreted as a negative view on the future of activist techniques or of activism as a whole. On the contrary, we think activist *tools*, in the hands of elite investors, are powerful vehicles for enhancing investment returns, and we view dedicated activist *strategies* as potentially quite attractive in a particular format, which we will describe at the end of this section. For now, we turn to a discussion of the factors which we think will drive sustainable value-added from activism in the future.

Keys to Success in Activist Investing

Corbin has been investing for many years in managers who pursue activist-oriented investment strategies. However, we do not view activist investing as an attractive “asset class” or strategy in and of itself; rather, as with all strategies, we seek to understand and analyze the advantages accruing to specific investment techniques and skill sets deployed by hedge fund managers. As such, we differentiate strongly among different activist approaches. We believe that not all activist situations and approaches are created equal, and that several key factors are likely to differentiate the successful players from the unsuccessful ones over time. A few key themes arise from our analysis:

1. The availability of activist tools does not in any way reduce the requirement that successful activist-oriented managers be excellent business analysts and stock pickers first and foremost. (*Case studies: Blockbuster, Inc. and McDonald’s Corp.*).
2. Activists should bring to the table a range of strategic, operational and technological tools. Simple “financial fixes” can work well in specific situations, but can be greatly enhanced via other tools. (*Case studies: KT&G and the financial exchanges*).
3. Activist tactics can be successfully deployed against asset-rich or franchise-based businesses but present a poor risk/reward tradeoff in the context of people-driven businesses. (*Case studies: BKF Capital Group and Kmart Corp.*).
4. Hostile activism as a stand-alone strategy may face stiffer challenges in the future; sustainable activism should begin from a collaborative premise and should involve the use of value-creation tools beyond standard hostile tactics.

The over-arching theme of all these observations is that, in most cases, activism is best viewed (and used) as an investment *tool* rather than a stand-alone *strategy*. Most of the attractive aspects of activism (increased control over the timing and magnitude of investment results, potential to create value at target companies, potential for large and uncorrelated returns) can be effectively realized in a traditional long/short equity context. In fact, many of the most prominent “activist” hedge funds are in reality high-quality long/short stock-picking funds which use activist techniques on a selective basis to enhance their returns.

Dedicated activist strategies can also be quite attractive, but, in our view, only in a particular investment format – specifically, a concentrated, principally non-hostile format in which a wide range of tools (financial, operational, strategic, etc.) is available to the manager.

We will now discuss these observations in detail, using real-life case studies from recent stock-market history to illustrate our points.

1. Be a Stock-Picker First, and an Activist Second

One of the less-remarked-on characteristics of the world’s most successful “activist” investors is that their activism is a powerful tool to enhance and accelerate the returns associated with great stock-picking. Activism, when pursued properly, combines a wide range of financial, strategic, operational and governance tools which can create value in a business. But even this powerful toolkit is seldom potent enough to avoid the damage associated with poor investment selection (defined here as either buying a structurally compromised business or paying too much for a good business). Many of the most successful activists that we interact with consider themselves stock-pickers first, with their activist tools representing an attractive means of increasing their returns, and, importantly, accelerating the realization of those returns (which is simply another way of increasing returns). In contrast, activist tools deployed against a structurally compromised business may limit or decelerate investment losses but rarely reverse them, and overpaying for a decent business simply subtracts from any subsequent returns generated by activist programs. In summary, we believe that *investors should use activist tools as a way of enhancing and accelerating great stock-picking returns, rather than as the sole source of those returns.*

Below, we review two recent situations – one in which a successful activist program was unable to overcome a structural decline in the target business, and one in which the activist program itself went largely unheeded but was substantially buttressed by great stock selection, with outstanding investment results.

The Importance of Stock-Picking, Part I: Blockbuster, Inc.

The case of Blockbuster, Inc. (“BBI”) offers a clear object lesson in the challenges posed to activist strategies by the presence of structural business risks. BBI is a well-known operator and franchiser of entertainment-related stores (including movie, video game, and television series rentals) in the United States and internationally. Despite BBI’s position as the No. 1 video rental chain at the end of 2004, its stock had lost half its value amid a host of issues that led to a 40% earnings decline.

Among the challenges facing BBI were the multiple threats posed by alternative rental formats for entertainment content – specifically, mail-order movie rentals, video-on-demand, and cut-rate retailing through competitors like Wal-Mart. Trading at 11 times earnings and boasting a widely recognized brand, the company attracted a large and historically successful activist investor, which disclosed a 5% stake in BBI’s shares in December 2004. The investor immediately

backed BBI's attempt to acquire Hollywood Entertainment, believing that a merger with its largest competitor would improve BBI's competitive positioning by achieving economies of scale.

In March 2005, Blockbuster withdrew its bid, citing delays in obtaining regulatory clearance for the deal. Despite this setback, the activist began a new campaign calling for cost-cutting and an increase in dividends, ultimately assuming three seats on the company's Board of Directors. However, the ongoing decline in the store-based video rental industry, driven by the continued shift to alternative rental formats, proved too difficult a hurdle to surmount. As a result, in August 2005, the company withdrew its financial estimates for the year. By the end of 2005, bankruptcy concerns loomed, and the company stated that in 2006 it would further reduce costs and lower capital expenditures.

Despite the activist fund's efforts and its presence on the Board, BBI has continued to wrestle with the changing competitive landscape and a general industry slowdown. Notwithstanding a 25% rally in the shares in the last few weeks, BBI stock remains roughly 30% below its level at the time the activist investor disclosed his stake over two years ago.

The Importance of Stock Picking, Part II: McDonald's Corp.

The recent history of McDonald's Corp. ("MCD") serves as a good example of the successful integration of astute stock picking with shareholder activism. MCD's is the largest fast-food retailer globally and one of the world's best-known brand names, but in mid-2005, MCD's shares were trading at a 52-week low, depressed by factors including slowing same store sales growth, a tougher competitive environment, the impact from Hurricane Katrina, and renewed concerns over mad cow disease.

In September of that year, an activist hedge fund disclosed a 4.9% stake in MCD's stock and presented a complex, broad-reaching restructuring plan to unlock shareholder value. The fund's proposal included an IPO of a 65% stake of the company-owned stores, heavy new borrowing against the company's real estate, and a substantial share buyback. After MCD's management rejected these proposals, the fund publicized a similar but more modest value-enhancement program. In January 2006, MCD announced a share buyback that was roughly 1/13th the size articulated in the initial proposal, along with a small increase in the number of franchised stores over the subsequent three years.

Even though these initiatives barely scratched the surface of the fund's proposals, the investment has turned out to be very profitable for the fund and its investors, as MCD's stock rose steadily in late 2005 and 2006.

Why? Several factors, having little to do with the fund's initiatives, drove the stock's performance during this period. Same store sales exceeded Wall Street expectations each month and margins improved thanks to profitable offerings such as upscale salads, white-meat chicken, and coffee. The shares also benefited from the successful IPO and tax-free swap of Chipotle Mexican Grill.

This case study illustrates how great stock selection drives investment returns even in the absence of a fully-realized activist program. While the activist program for MCD went largely unrealized, the activist fund astutely took a large position in one of the world's premier business franchises at a mere 14 times depressed earnings; today, with improved business results, MCD trades at a more typical premium multiple of 17 times (greatly improved) earnings.

2. Bring Your Tools (the More, the Better)

We believe that a dedicated activist strategy should be driven by a collection of skills and tools available to the activist manager. No manager can be a master of all trades, but within the activist space we prefer managers who enjoy a combination of value-creation capabilities. There are dozens of relevant tools, but generally they can be aggregated into four broad categories:

1. **Financial:** Share repurchases, debt repayment, dividend changes, separation of non-core businesses, management buyouts, leveraged buyouts
2. **Strategic:** Acquisitions, changes in business strategy and corporate mission
3. **Operational:** Changes in operational strategy (productivity-enhancing equipment, enterprise software systems, etc.)
4. **Governance:** Changes in Board structure, management compensation, separation of Chairman and CEO roles, etc.

The availability of multiple value-creation tools gives the activist manager added flexibility in dealing with the inevitable surprises and setbacks involved in any business initiative. Additionally, it facilitates constructive dialogue with management teams, whose willingness to engage activist investors is often directly related to the new value-creating opportunities they see in the activists' proposals. Thirdly, managers with multiple skill sets can deploy those skills against a larger and more diverse group of investment opportunities – a key factor in sustaining success over time as the investment landscape changes. And finally, by using different tools in combination, the activist investors can turn good investment outcomes into great ones.

Below we discuss two relevant case studies – one in which activist managers created significant value principally using financial tools, and one in which the activists created extraordinary gains by complementing a financial restructuring with a powerful strategic insight.

Bring Your Tools, Part I: KT&G

The seven-month long campaign by two prominent activist investors in the Korean tobacco company KT&G illustrates the value of bringing financial solutions to the table in an activist campaign. KT&G is South Korea's largest tobacco company, with 70% market share in a country where about a quarter of the population smokes. KT&G also has a large ginseng business, valuable real estate holdings, and over \$1bn in cash and investments.

In January 2006, two prominent activist investors disclosed a joint filing position in KT&G based on a classic financial-restructuring platform: KT&G's core tobacco business was trading

at a significant discount to its peers, and this value could be realized if the company's non-core holdings, including the ginseng business and its real estate holdings, were stripped away, and the proceeds returned to shareholders in the form of an ongoing stock dividend and a stock repurchase. When KT&G management proved resistant to these proposals, the activists stepped up their involvement, winning a board seat and ultimately making an unsolicited bid for the company. When KT&G rejected the bid, claiming it was not in the best interests of the company, the activists intensified their campaign.

In August 2006, bowing both to the pressure of the activist investors and to the common sense of their proposals, KT&G announced a buyback of 12 million shares (7.5% of its outstanding stock) and a dividend increase of 40%. This equated to a return of \$2.9 billion of cash to shareholders, the biggest buyback in KT&G's 107-year history. These concessions were reportedly the largest ever offered by any Korean company to fend off a takeover. Two weeks later, the activists ended their official alliance as KT&G investors, leaving each of them individually with less than 5% of the company and effectively ending their activist campaign. By that time, KT&G's stock had rallied over 31%, providing an example of a successful investment outcome generated from an activist campaign focused on the internal financial structure of a target company.

Bring Your Tools, Part II: Deutsche Boerse and the Financial Exchanges

The radical transformation and revaluation of publicly-traded financial exchanges in the last several years bears testament to the value creation that can be generated by using multiple activist tools in combination.

In the early 2000s, the world's publicly-traded financial exchanges languished in relative investment obscurity. Many of these companies were newly public, having previously operated as private mutual companies, and their business – the aggregation, management and processing of securities transactions – was both unglamorous and poorly understood. Wall Street coverage was virtually nonexistent. Additionally, many national bourses outside the U.S., though corporate in form, were still managed as quasi-public trusts, with profit motives taking a backseat to providing a utility-like national service. Reflecting these factors, many exchanges traded at multiples of 9-11 times earnings, a steep discount to general market averages.

In 2004, several activist hedge funds began to closely examine the financial exchanges. What they saw were existing business fundamentals and opportunities for improvement that made the stocks seem deeply undervalued. Their insights covered three key areas:

- 1. Financial structure:** Most of the exchanges had excess cash, enviable revenue stability, and substantial economies of scale. The presence of these factors meant that the companies could dramatically enhance profitability by returning capital to shareholders (i.e., via a more efficient capital structure).
- 2. Operations:** Reflecting their long history as mutual companies, and in certain cases also reflecting nationalistic considerations, many exchanges were operated less for profit maximization than for the provision of low-cost services to their clients. Given the near-

monopolistic structure of the industry, the activists saw an opportunity to boost profitability through firmer pricing and cost controls.

- 3. Strategic Combinations:** The activists realized that merging exchanges could drive massive economies of scale in operations and trading, reduced trading and settlement costs, and enhanced liquidity and price discovery. In addition, opportunities to streamline technology abounded, starting with the development of compatible trading platforms.

With these insights in mind, the activist investors embarked on a campaign to focus the investment community on the value embedded in the exchanges, and to promote fundamental changes in the three areas described above. The activist campaign, which initially was conducted outside the public sphere, focused on the management teams and Boards of the exchanges, the sell-side analyst community, and other buy-side investors, including other hedge funds and traditional managers.

The results of this campaign were far-reaching, but the most public episode was the 2005 battle over Deutsche Boerse (“DB”), the German national stock exchange. In December 2004, DB had bid 530 pence per share for the London Stock Exchange. In January 2005, several prominent European activist funds challenged the bid, stating that it was not in the best interests of the company’s shareholders, and advised that management instead consider a share buyback, which they believed would create more value.⁵ In February, after meeting stiff resistance from an entrenched management team and Board, the activists sought the ouster of the company’s Supervisory Board, openly criticizing the Chairman and Chief Executive for ignoring their views and calling for new leadership.

The battle over DB ultimately ended in a victory for the activist hedge funds and their investors: The Company’s CEO and several Board members stepped down, and the company more than tripled its dividend and authorized the repurchase of 10% of its outstanding shares. Over the course of 2005 and 2006, DB’s stock rose more than 200%.

Beyond this particular event, the DB battle further highlighted the value of the exchange business. As markets began to recognize the high-growth, high-return potential of these businesses and increasingly understood that they would be managed for profit, valuations more than doubled, with most exchanges today valued at a premium level of around 20-30 times earnings. And from a strategic perspective, a spate of merger announcements, including the New York Stock Exchange Group’s acquisition of Euronext and NASDAQ’s bid for the London Stock Exchange, have created further value for investors in the space. By combining financial proposals with operational and strategic insights, the activist funds helped to transform the market’s understanding of the industry, achieving substantial investment returns in the process.

⁵ The activists’ objection to the proposed merger was less about the combination itself, which certainly offered synergies, than about the bid price, which they viewed as too high relative to the accretive benefits of repurchasing stock.

3. The Importance of Target Selection

Although recent years have seen activist campaigns across a broad swath of industries and business types, we do not think all situations are created equal when it comes to activism. In fact, target selection is one of the most critical decisions facing the activist investor, and certain types of businesses lend themselves better to activism than others. Specifically, businesses whose intrinsic value lies in their physical assets or their brand name make better targets than those which are highly dependent on people generally, and a few key people specifically. Serious activist engagement often comes with some instability at the corporate level – either from changes implemented at the company or, often, from friction between the activist entity and the company’s management. While this tension may ultimately result in value creation at the company, the attendant disruption often imposes financial costs. And the potential damage increases exponentially when an activist program becomes hostile – either by design or through the natural course of events. Businesses whose value lies in hard assets or durable public brands are less likely to be crippled by such turbulence, whereas turmoil can exact a very serious value-destruction toll in businesses which depend on a few key individuals.

To illustrate the importance of target selection, we examine two relevant cases below: One in which activism against a people-dependent business created a large investment loss, and one in which an aggressive activist program in a brand-driven, asset-supported business led to a successful investment outcome.

Target Selection, Part I: BKF Capital Group

The ongoing saga of BKF Capital Group (“BKF”) is a prime example of a business – in this case, asset management – which lent itself poorly to activist intervention. BKF is a holding company whose principal asset is an investment management firm called John A. Levin & Co., which until recently managed over \$12bn in value-oriented long only and hedge fund assets.

BKF’s business was the quintessential people-driven enterprise: The corporate management team, led by founder John A. Levin, was also the team that produced the firm’s “product” (investment returns), and the brand value of the company was directly tied to the individuals running the business. There were effectively no “hard assets” in BKF’s business; the company’s assets, as the saying goes, rode down the elevator at the end of each business day.

BKF had for years been a target of complaints from external shareholders, mostly focused around expense management and governance; in essence, several large shareholders felt that employee compensation and other expenses were too high, leaving too little for BKF’s outside owners, and that the Board was insufficiently focused on changing these practices.

In 2004, as BKF management failed for the third straight year to accept a shareholder vote against the company’s poison pill provision, a large and historically successful activist hedge fund disclosed that it had accumulated a 6.5% stake in BKF. Several other hedge funds had also disclosed significant holdings, and the stage was set for a final showdown between the dissident investors and BKF’s executive team. The activist funds publicly criticized the management team and questioned the compensation paid to key portfolio managers, including Henry Levin, the son

of the company's founder (who was also one of the key portfolio managers at the company). These broadsides led to a deep and emotional defense of the company by John A. Levin and the other members of the management team. After one of the more heated and public proxy contests in recent memory, the large hedge fund won 3 seats on BKF's board in June 2005.

Unfortunately, while the activist's attempt to gain control over the company was nominally successful, the new powers in the company were unable to reach an accommodation with management on a host of issues, and soon afterwards John A. Levin announced he was leaving BKF to start another firm (and retaining the right to solicit up to 20% of BKF's clients). This departure was soon followed by the departure of Henry Levin and his portfolio-management partner, triggering the termination of the company's event-driven hedge fund, which managed 18% of the company's assets, and produced 44% of its management and incentive fees in the first half of 2005.

As the company's key money managers headed for the exits, assets quickly followed, falling from a peak of over \$12bn in 2005 to \$4.5bn on 12/31/05. Compounding investors' woes, the departed management team members quickly sold their large equity stakes in BKF, putting additional downward pressure on the stock price. As assets plummeted, so did BKF's stock price, and the company ultimately was delisted from the New York Stock Exchange. Today, according to its most recent regulatory filing, BKF has "no operating business and no assets under management." The stock recently traded at roughly \$3.50 per share, implying losses of up to 80% for the various activist hedge funds.

The BKF story demonstrates the importance of target selection in activist investing. Businesses that are highly dependent on a few people may suffer materially from the disruptions associated even with a relatively friendly activist campaign. And when such a campaign becomes hostile – as is possible in any activist situation – the damage to the underlying business can be significant and permanent.

Target Selection, Part II: Kmart Corporation

The story of Kmart Corporation ("KMRT", now known as Sears Holdings Corp.) is arguably the best-known activist situation, and also one of the most complex. While KMRT is certainly much more than just an example of good target selection, this aspect of the story contrasts nicely with the BKF situation. Although the KMRT story has since evolved to encompass Sears Holdings Corp. (the name of the entity created by the 2004 merger of Kmart Holdings and Sears, Roebuck & Co.), our focus will be principally on the initial emergence of KMRT from bankruptcy in 2002-2003.

The KMRT activist story goes back to 2002, when the struggling old-line retailer (then known as the Kmart Corporation) was forced into bankruptcy by a host of financial and competitive problems. In January of 2003, a prominent hedge fund emerged as the controlling stakeholder in the company. At the time, the move was quite controversial: KMRT's bankruptcy was triggered by crippling financial problems, and fundamentally the retailer was losing market share to competing business formats. Many market observers wondered aloud what value could be

wrung out of a tarnished brand that was competing directly with Wal-Mart, the juggernaut of the mass-retailing industry. Moreover, with a “financial guy” leading a bricks and mortar retailing business for the first time, critics fretted about the impact of the anticipated operational and financial adjustments on KMRT’s already fragile business franchise. And there was no shortage of adjustments. In his first two years of control over the company, the hedge fund’s principal (who had also assumed the role of KMRT’s Chairman) implemented a host of changes, including significant debt reduction, the closing of many of KMRT’s weaker store locations, extensive cost-cutting, format changes within surviving stores, and the sale of 68 store locations to Sears, Roebuck & Co. and Home Depot. This period of rapid change also saw fairly significant turnover in senior management at KMRT.

While some critics focused on the poor financial performance and competitive positioning of the KMRT business and fretted over the multiple uncertainties attending the changes at the company, they arguably missed the larger story: KMRT was extremely asset-rich and had a number of recognized brand names (such as Martha Stewart, Footstar and the like). Most importantly, the company enjoyed hard-asset protection by virtue of its substantial real estate holdings, which were estimated at up to \$2 billion in value, and a tax-loss carryforward asset valued at \$4 billion.

The assets provided a powerful investment floor underneath the hedge fund’s investment, while KMRT’s brands conferred a powerful going-concern value on the business, even in the face of the substantial changes implemented as part of the activist program. Put in more specific terms, the hedge fund’s investment in KMRT cost less than \$1 billion and gave it a 50% stake in one of the nation’s largest retailers, which consisted of over 1,500 stores producing nearly \$25 billion in total revenues in 2003. Those revenues suggested very strong staying power for the business, even in the face of corporate change.

There have been many subsequent developments in the KMRT story, but this early chapter demonstrates how a business supported by brand value and hard assets – as opposed to individual professionals – can sustain its value even in the presence of a very aggressive activist transformation. While the jury is still out on the long-term competitive outcome in the “bricks and mortar” retailing business, the market’s decision has been to unambiguously recognize the value created through this situation: Since KMRT’s emergence from bankruptcy less than four years ago, an investment in its stock would have returned over 1,200%.

4. Hostile-Only Activism

Several hedge funds have launched high-profile hostile engagements of various corporate Boards and management teams, executing their strategies through a combination of activist tools. Such tools include calling for extraordinary shareholder meetings and proxy votes, and authoring colorful, aggressive public letters to the company. The initial success of these tactics – focused as they were on relatively sleepy, unwitting executive teams – has spawned a boom in public, hostile activism reminiscent of the corporate raider phenomenon two decades ago.

We view the use of hostile tactics as an indispensable tool of the activist investor – but we view it principally as a *defensive* tool, one whose existence serves as a deterrent to indifference or

heel-dragging by corporate management teams and an inducement to collaborative value creation. To understand the problem with hostile-only approaches one need only study the history, and demise, of corporate raider activities in the 1980s. Many factors contributed to the decline of this trend, but prominent among them were proactive countermeasures taken by corporations once the tactics and goals of the raiders became widely known. Through the adoption of poison pill defenses and similar countermeasures, corporations gradually raised the cost and lowered the success rate of hostile attacks.

The very success of today's hostile activists has begun to generate a similar backlash. The entities that provide advisory services to companies – from law firms to investment banks to information services like Shark Repellent – have recognized the hostile trend and have begun to market various “solutions” to their clients.⁶ As an example, we recently had the opportunity to review an extensive document presented to the Board of Directors of a publicly-traded company. The presentation was given by several senior executives of a bulge-bracket investment bank at the request of the Board – this despite the fact that the company had attracted no hostile activists.

The presentation reviewed the company's financial metrics from the perspective of a hostile activist, focused on “soft spots” that such an activist would be likely to attack, and reviewed a host of potential countermeasures, including staggering the Board, instituting a supermajority provision for amending corporate by-laws, ensuring that Directors can be removed only for cause, and many others – up to and including a preemptive management-led buyout. We have reviewed similar materials from corporate law firms which describe “counterattacks” against activists, including tactics designed to ensnare hedge funds in regulatory violations and expose them to various charges of securities fraud. With materials such as these playing more widely in corporate board rooms, it seems clear that the potential targets of public, hostile activism are learning the game and working preemptively to buttress their position – thereby likely raising the cost, extending the duration and lowering the success rate of future hostile activist interventions.

Additionally, and importantly, resistance to hostile interventions may arise from sources other than the target companies themselves. Highly public, highly hostile activism enjoys substantially less support, both publicly and in terms of shareholder votes, from the very large institutional money managers who have lent crucial backing to more constructive activist campaigns in recent years.

None of this is to say that hostile actions will not continue to add value in certain situations – and, as noted above, we believe these actions to be essential tools in the activist toolkit. But we question the sustainability of hostile-only strategies as the tactics of such managers become well-known and their targets harden.⁷ On a more philosophical level, we believe here, as elsewhere, that, while relatively simple strategies can earn extraordinary returns when first introduced, their very success plants the seeds of their demise as the “trade” becomes widely adopted. We believe

⁶ Though services like Shark Repellent also have obvious useful applications for activists seeking to assess the strength of a company's takeover defenses, the company's mission statement, in part, is to “[assist] major investment banks, legal professionals, corporate insiders, asset managers and institutional investors in defending their clients from unsolicited takeover bids.”

⁷ At the risk of belaboring the point, we are referring here to hostile-only *strategies* – that is, activist strategies encompassing a very narrow set of tools and tactics. Hostile *tools* will continue to be a powerful component of the investment toolkit for both dedicated and non-dedicated activist managers.

the long-term money is to be made with managers who bring durable intellectual capital – in this case, fundamental business analysis and stock-picking talent – to the strategy and can use that capital to evolve and maintain profitability after the easy, early money has been made.

Corbin’s View: Keys to Success in Dedicated Activist Strategies

The foregoing points illustrate our view of what it takes to successfully manage a dedicated activist investment portfolio. Over the years, Corbin has made investments with a handful of dedicated activist funds, and describing the characteristics shared by all of them is perhaps the best way to encapsulate our views on this subject. (Please note that a much larger number of our managers use activist tools in the context of a broader set of investment activities). Consistent with our thoughts above, Corbin’s activist managers share the following characteristics:

- 1) They are, first and foremost, talented stock-pickers who have successfully managed equity-based hedge fund portfolios for many years at successful firms
- 2) Expert knowledge and ability to employ financially-oriented activism is but one of the tools available to them; in addition to these techniques, they bring substantial strategic, operational or governance tools to their target investments
- 3) They are careful in selecting their targets, and their portfolios consist overwhelmingly of businesses whose value derives principally from branding, hard assets or other sources not associated with individual executives
- 4) They approach their investments from a collaborative perspective and seek to engage companies in a constructive dialogue in an attempt to create value in an expedited, non-public fashion – but they are prepared to aggressively defend their positions when necessary
- 5) Lastly, they implement their portfolios in a highly concentrated fashion. Activism, when conducted diligently, is (and should be) an extremely time-consuming process. Our managers invest the majority of their assets in a small number of situations, allowing them to take the time necessary to produce favorable results at their target companies.

Our last note on dedicated activist strategies concerns return expectations. Because most dedicated activist strategies are implemented on a concentrated, long-only or heavily net-long basis, they can produce very high volatility and offer relatively little protection in the event of an “extreme beta” event, i.e., a selloff of risk assets irrespective of underlying value. These risks can be acceptable and make sense in the context of the activist approach, but investors should require a high rate of return from such managers as compensation for the additional risk, and should size their investments appropriately (as Corbin does through our risk-budgeting process).

If you’ve made it to the end of our letter, we thank you for your time and attention. As always, please feel free to call or write us with any questions or comments.

Sincerely,

Corbin Capital Partners

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PAST PERFORMANCE IS NOT NECESSARILY INDICATIVE OF FUTURE RESULTS

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