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LAW AND CAPITAL MARKET

How hedge funds change the M&A market

Who triggers the change and who benefits from it? - It depends on constant dialogue with the most important investors

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At the end of September 2018, Thyssenkrupp announced that it would be splitting into Materials and Industrial Solutions. This, the largest reorganisation in the 200-year history of the company, was however not driven by Thyssenkrupp itself but largely by activist shareholders, the Cevian and Elliot hedge fund, supported or tolerated by the Krupp foundation as a controlling shareholder. Triggered by poor business development, the announcement was the end point of a campaign, as it has so far been perceived, mainly in the USA. Nevertheless, Thyssekrupp is by no means an isolated case. Last year, there were 726 campaigns around the world by funds described as activists, of which 138 were in Europe. At least in Europe, a further rise is expected in future.

Falling exchange rates are a lure

Falling exchange rates make investments more attractive. Rises in exchange rates due to changes in business are easier to achieve. Index funds are controlling more and more shares. Whilst they are passive investors, they are however increasingly interested in governance and operational matters because higher prices of the company managed in each index also lead to higher income from administrative fees. This particularly applies to the three largest providers of index or ETF funds: BlackRock, Vanguard and State Street.

In addition to the campaigns for changes to governance, changes to capital structure, distribution of capital to shareholders through dividends or share buy-backs, more and more campaigns are directed towards M&A activities. Globally in 2018, there were 253 campaigns by hedge funds related to M&A - a record number. Based on the volatile markets, a further rise is forecast for the current year.

There are three different types of M&A related campaigns: The sale or splitting off of business fields or splitting up into two independent companies - examples of this are Thyssenkrupp but also Telecom Italia, where Elliott started a boardroom battle in 2018 over the sale of the landline network which led to a change in management; the improvement or prevention of a transaction already announced - a prominent example of this in 2017 was the planned merger of equals between Clariant and the Texan Huntsman; the activist investor White Thale doubted the strategic sense in this and the transaction was cancelled; lastly, sale by actively searching for a bidder.

Activists often justify the demand for a sale using the argument that an industry consolidation is taking place and the company is too weak on its own. A prominent example of this was the takeover of the US organic store chain Whole Foods in 2017 by Amazon. Jana Partners, one of the largest activist hedge funds in the USA joined Whole Foods and, in the face of the price war in the US foods sector, demanded a sale. Within a few months of the campaign, Jana made a profit of around 300 million dollars.

Their approach

Disappointing market trends, low returns, no stringent business model or an announced transaction which has not been positively received - all of these are starting points for activists. In the USA, an activist can utilise three different forms of leverage to accomplish changes: first of all, they can carry out PR work, starting with a letter to the board, press campaigns or searching for support from other shareholders. Secondly, they can start a campaign against the re-election of board members. In the US, they are generally re-elected every year. Thirdly, in the context of M&A, further leverage can arise if the transaction requires the agreement of the shareholders, such as for a merger or the issuance of more than 20 % of new shares. In the Huntsman/Clariant case, activists bought shares in Clariant because consent was required with a 75% majority.

In Germany, PR campaigns work in the same way as in the USA. In the Thyssenkrupp case they were also successfully applied. The possibilities for influence over the supervisory board elections, however, is much lower in Germany since the supervisory board is currently voted in for five years and committees with staggered terms tend to be rare. Nevertheless, the Corporate Governance Code bill now recommends terms of only three years. When an election is imminent, the activist can only request that supervisory board members are voted out. In order to get a resolution matter onto the agenda of a general assembly, shareholders must hold 5% share capital. If this threshold is not exceeded, activists barely have any threat potential. Questions which concern the strategy and the operational activities may not be placed on the agenda to be voted on but may only be discussed in the context of the agenda point regarding the discharge of the management and supervisory boards. In the case of Thyssenkrupp, the activists effected changes in the supervisory board; the chairs of the supervisory and executive boards resigned from their posts.

Communication counts

The general assembly only votes on M&A transactions in two cases: the transaction is implemented according to the Umwandlungsgesetz [Reorganisation of Companies Act], that is, in the form of a merger or split-off/spin-off (Osram, Innogy, Uniper). In these cases, a 75 percent majority is required. Or it falls into the category of the unwritten responsibility on the part of the General Meeting, which the Federal High Court of Justice developed in the "Holzmüller" and "Gelatine" landmark rulings. The transaction must make a significant change to the company. The criteria are a change of 80 % or more for sales, equity or assets. When it comes to sales, even when exceeding these limits, agreement is not deemed necessary provided that it does not fall short of the statutory corporate purpose.

The most important means of attack is also the most important means of defence: communication. Companies should foster constant dialogue with their most important investors. It is not just strategy and business models, but also M&A projects which should be explained and validated. The dialogue with investors can be used as a sounding board. This can result in ideas for value-creating transactions which the management did not previously have on the agenda. If they do not entertain these ideas themselves, an activist will do it.

Barbarians have marched in

It is difficult to validate with investors before major M&A transactions, because they are subject to ad hoc obligations and strict confidentiality needs to be observed. Ultimately, wherever possible, transactions should be structured in such a way that they do not require agreement from shareholders thus giving activists no way in.

"Barbarians at the gate" was the title of a book and film about the takeover battle over the tobacco and food conglomerate RJR Nabisco in 1988. With the mother of all buyouts, it was the start of the rise of KKR into one of the largest financial investors. This, too, related to the separation of businesses which supposedly did not go together: food and tobacco. Triggers for the transaction were the low share price due to the conglomerate effect, despite the good results. This transaction was ushered in, not by activists but by the CEO who, together with financial investors, wanted to turn the poor performance to his benefit by way of a management buyout. The rest is history - the "barbarians" marched in.

Was that bad for the shareholders? In part, yes, because the transferees avoided sharing as much as possible of the profit from the restructuring with the shareholders. If companies are undervalued and not protected against major shareholders or other mechanisms, this will result in changes. The large quantity of capital that can be invested will find a way. The question is only who will trigger the change and who will profit from it.

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