

Activist funds set their sights on microcaps

Smaller companies find themselves subject of attention as search grows to unlock share price gains



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AUGUST 28, 2016 by: **Stephen Foley** in New York

Famous activists such as [Daniel Loeb](#) and Bill Ackman may be retrenching and mounting fewer campaigns against large-cap companies, but there is one area where hedge fund managers are still finding lucrative opportunities: microactivism.

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Since the start of the year, 61 micro-cap companies, those with a market capitalisation of \$50m to \$250m, have found themselves on the receiving end of attention from activist funds — companies ranging from a Canadian software vendor to a US luxury hotels group to a [British tool hire business](#).

While their battles with activists contain as many poisonous public letters and aggressive legal tactics as the blue-chip

showdowns of recent years, they are more likely to be played out away from the headlines.

And because the companies are less well researched by analysts, have access to fewer corporate advisers, and are less likely to follow corporate governance best practices, the potential for unlocking big share price gains may be greater than at

Activist funds which have targeted microcaps for decades are being joined by newcomers inspired by the famous players but without their financial firepower, and even some of the big names are moving down the market-cap scale.

“The inefficiencies that allow for good stock picking increase as you move ever lower down the scale, but as you move lower you face the problem of low trading volumes and of being able to deploy institutional-scale capital,” says Mick McGuire, the Ackman protégé who has demanded change at groups such as [Bank of New York Mellon](#) and [Macy’s](#) in recent years.

His hedge fund, Marcato Capital, has launched a smaller spin-off, with seed investment of just \$75m, that is targeting small and micro-cap companies.

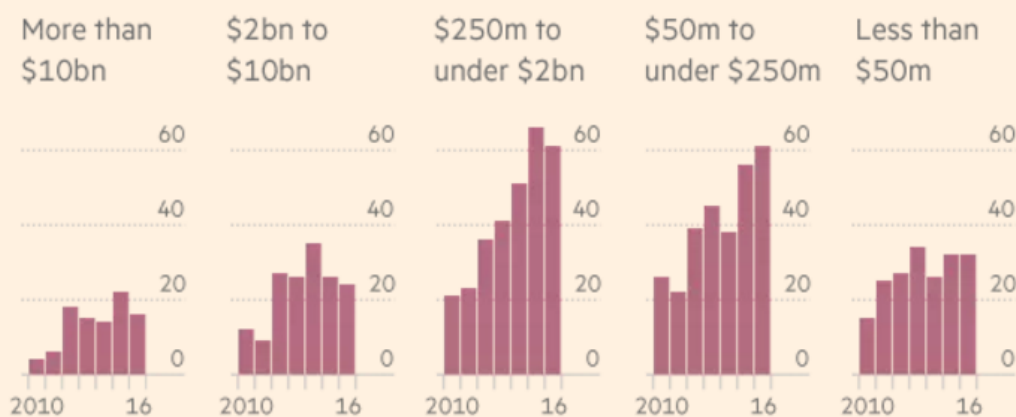
“Smaller companies do not have the resources for a large finance staff or business development team or for Goldman Sachs or for McKinsey,” Mr McGuire says. “There is an opportunity for activists to add value in a legitimate way.”

The number of new micro-cap targets this year compares with 56 by this point in 2015, according to Activist Insight’s global figures, and it is the only segment still growing.

By contrast, 16 new \$10bn-plus companies have been targeted so far in 2016, compared with 22 in the same period last year, ending several years when the swelling size of activist funds — and the swelling ambitions of their managers — led them to go after bigger companies.

Activism declines in all but smallest companies

Number of targets by market cap, year to end-July



Source: Activist Insight

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Investors [pulled money](#) from activist funds in the first quarter of this year after a run of disappointing performances. Activists returned 1.65 per cent in the first half of 2016, on top of just 1.15 per cent for the whole of 2015, compared with an S&P 500 total return of 3.8 per cent and 1.4 per cent, respectively.

At the most recent annual investor day for his fund, Third Point, Mr Loeb told clients that he was [giving up activism](#) for the time being, while stocks looked overvalued and there were better investment opportunities in the debt markets.

Mr Ackman — nursing a 33 per cent decline in the value of his fund, Pershing Square, since the start of last year — has sold positions in [Mondelez](#), owner of Cadbury chocolate; Zoetis, the animal pharmaceuticals company; and [Canadian Pacific](#), a railway business.

And [Carl Icahn](#), who for the past two years has urged [Apple](#), the largest company in the world, to return more cash to shareholders, sold out in April. In a regulatory filing this month, he said: “Current market valuations do not provide an opportune time to embark on large new investments.”

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Icahnism is not dead... There is opportunity in microactivism for years to come

David Neuhauser, Livermore Partners







David Neuhauser, whose \$100m fund Livermore Partners has targeted undervalued energy companies, says “Icahnism is not dead” and shaking up poorly governed companies remained a lucrative enterprise.

“A \$200m company is too small for him,” Mr Neuhauser says. “At that size, Mr Icahn could buy the whole company. But for those of us who want to carry the baton, there is opportunity in microactivism for years to come.”

Some of the most vitriolic activist cases have involved micro-cap companies this year. At Hill International, a construction consultancy, shareholders were told that their annual meeting was being cancelled, hours before a vote that New Jersey activist fund Bulldog Investors believed would put its representatives on the board.

Recent micro-activist campaigns

Selected companies

<p>YuMe</p>  <p>Mobile video ads Market cap: \$116.5m Total return*: -3.1% Activist: Viex Activist concern: Misaligned pay/spend</p>	<p>Vaalco</p>  <p>Oil explorer Market cap: \$60.1m Total return*: -35.6% Activist: Lone Star Activist concern: Poor capital allocation</p>	<p>Madalena Energy</p>  <p>Oil explorer Market cap: \$58.7m Total return*: -51.7% Activist: Maglan Activist concern: Falling share price</p>
<p>Edgewater Tech</p>  <p>Business software Market cap: \$109.7m Total return*: 11.2% Activist: Severl Activist concern: Strategy</p>	<p>FBR & Co.</p>  <p>Investment bank Market cap: \$95.6m Total return*: -31.9% Activist: Voce** Activist concern: Growth strategy</p>	<p>Speedy Hire</p>  <p>Tool hire Market cap: \$256.9m Total return*: -9.6 Activist: Toscafund Activist concern: Merger talk failure</p>

Total return for the S&P 500 and FTSE All-Share are 8.8% and 15.4%, respectively

* Past year to Aug 25 ** Subsequently have liquidated its holding

Sources: Activist Insight; FT research

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At Ashford Hospitality Prime, owner of the Ritz-Carlton hotel in St Thomas in the Caribbean, Sessa Capital took its fight for board seats to court. It lost the case, but AHP split the role of chairman and chief executive this month.

Ajay Khorana, global head of Citi's financial strategy and solutions group, says small-cap campaigns are far more likely to escalate into a proxy fight. "Activists are no more likely to obtain board seats at small-cap targets," he says. "This may reflect target management's smaller perceived cost of fighting an activist when the company is small enough to stay off the front pages."

Where microactivism may retain an advantage over large-cap situations is in the ability for hedge funds to push for a sale of the company, since by definition there are more buyers for small companies than for large ones.

Last month, Mr McGuire's spin-off fund scored an early success when Epiq Systems, a Kansas legal software company, agreed a \$626m takeover bid, and Mr McGuire expects more sales. "These companies are bite size, at a time when the strategic goals of larger companies include tapping the cheap debt markets to fund bolt-on acquisitions," he says.

"Our goal is to get a transaction," says Phil Goldstein, co-founder of Bulldog Investors. "If you separate investors into two types, we tend to be the bird-in-the-hand type."

Jury remains out on effects of megacap activism

The advent of megacap activism, with Carl Icahn targeting Apple and Nelson Peltz eyeing [General Electric](#), brought a new intensity to the academic debate over whether activist hedge funds are good or bad for the long-term health of companies — and though large-cap [activism](#) may be subsiding, the debate is not, **writes Stephen Foley**.

In the latest intervention, researchers from Texas A&M University find “strong evidence” that activism strengthens the prospects of target companies.

Edward Swanson and Glen Young, of the university’s business school, have supplemented the usual, equivocal measures of shareholder return and share price performance with data on what short sellers, financial analysts and institutional shareholders are thinking in the years after an activist intervention.

Their paper, presented at this month’s meeting of the American Accounting Association, found that two years after the arrival of an activist, short interest in a companies’ shares has declined and analysts’ recommendations have improved, suggesting more confidence in the outlook for the company.

“If, as its critics contend, activism actually destroys shareholder value . . . one might expect short selling to increase and analyst recommendations to be less positive after the intervention,” they write.

And they find that long-term investors make up a larger proportion of the shareholder register two years after an activist shows up. “After an activist intervention, we find an increase in ownership by long-term, ‘dedicated’ institutional investors and a decrease in transient ownership. These ownership changes are inconsistent with activism encouraging managerial short-termism.”