Activist Investing

Interview preparation summary · HF track

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INT.HC.1.a · The activist model, targets and economics

Explain the activist model and screen for targets: tell a company that is cheap for a good reason from one where engagement can close a valuation gap, using underperformance, conglomerate discount, capital allocation and governance signals.

An activist fund buys a concentrated stake, usually a few percent of a listed company, because it believes the value is higher than the price and that it can change what the company does. That last part is what separates it from a long-only or long-short equity fund (see Hedge Fund Stock Pitches), which accepts management as given. A target is found by screening for a gap and then asking whether the gap is fixable. The common signals are a valuation discount to peers, years of share price and return on capital underperformance, a conglomerate discount where unrelated divisions trade as one, poor capital allocation (hoarded cash, expensive acquisitions, returns below the cost of capital), and weak governance (a long-serving board, pay unlinked to returns, no independent challenge). The key skill is to split the discount into the part the market has earned, such as lower growth or a weaker franchise, and the part that engagement could remove. Use the earnings-quality checks from Equity Valuation and Earnings Quality before building a case on reported numbers. A company that is cheap because its business is declining is a value trap, not a target. Say which of the levers could be moved by a shareholder.

WORKED EXAMPLE: SCREENING TARN FOODS FOR A CAMPAIGN

Tarn Foods plc is an invented packaged-food group with 300m shares at 3.00, net debt of 180m and EBITDA of 180m. Listed peers trade at a median of 8.5 times EV / EBITDA. Tarn has grown 1% a year against 4% for peers, has an EBITDA margin of 15% against 19%, and a return on invested capital of 6% against 11%. How much of the valuation gap could an activist hope to close?

Answer: At the peer multiple the shares would be worth 4.50, but after a fair discount of one turn the fixable value is about 3.90, 30% above 3.00, which is 0.90 a share. That fixable part, not the headline gap, is what the campaign must deliver.

> **Interview tip:** Always split a valuation gap into earned and fixable parts, and say which signals show the fixable part is real. Quoting only the headline discount is the usual mistake.

INT.HC.1.b · The activist model, targets and economics

Build an activist thesis and value-creation plan, quantifying operational, capital-allocation, strategic and board-level levers (including operational and ESG improvements) in a sum-of-the-parts or bridge to a target value.

The thesis states what the company is worth, why it trades below that, and the specific actions that would close the gap. Build it from levers that can each be priced. Operational levers are margin, cost, working capital and pricing. Capital-allocation levers are returning excess cash, stopping poor acquisitions and lifting the dividend or buyback. Strategic levers are selling or spinning off a division, merging with a buyer, or simplifying a conglomerate. Board levers are new directors, a new chief executive or a change in pay. For a company with several divisions, a sum of the parts values each at the multiple of its closest listed peers, deducts capitalised central costs and net debt, and compares the total with the market capitalisation. Then subtract the costs of getting there, such as separation costs, tax leakage and stranded costs, and weight the outcomes by probability, because a campaign rarely delivers everything. Operational and ESG activism follow the same logic: a governance or environmental change is a lever only when it can be tied to cash flow, risk or the multiple. Compare the plan with what management already promises, as in Hedge Fund Stock Pitches, and be honest about what the board could do by itself.

WORKED EXAMPLE: A SUM OF THE PARTS FOR MARLOWE INDUSTRIAL

Marlowe Industrial Holdings is an invented conglomerate with 200m shares at 3.60 and net debt of 250m. Precision engineering has EBITDA of 90m and peers at 9.0 times, logistics 60m at 7.0 times, and legacy printing 30m at 4.0 times. Central costs of 20m are capitalised at 7.0 times. Break-up costs would be 40m. Logistics revenue is 750m at an 8% margin and could reach 10%. What is the plan worth?

Answer: The break-up is worth 4.60 a share (28% upside) after costs, but the probability-weighted value is 4.11, an upside of 14%. That is the figure to size the position on.

Interview tip: Show the full sum of the parts, then take off the costs and weight by probability. A thesis that stops at the headline discount is not a plan.

INT.HC.1.c · The activist model, targets and economics

Work out the economics of an activist position: concentration, holding period, probability-weighted returns, campaign costs and how the fund is paid when a campaign succeeds or fails.

An activist position is large and slow. Funds hold perhaps 10 to 15 positions and each may be 8% to 15% of the fund, so one failed campaign matters for the whole year, and the stake may be hard to sell without moving the price. The holding period is often two to four years, so a good gross return can still be a modest annual one. Costs are real and are normally borne by the fund: lawyers, proxy advisers, communications and a proxy contest can cost millions, while the benefit of a rise in the share price goes to every shareholder in proportion to what they own, which is the free-rider problem. To judge a campaign, list the outcomes (success, partial, failure), assign probabilities and price returns, subtract costs and annualise over the holding period. Fund fees are usually a management fee on assets whatever happens and a performance fee on gains above a high-water mark, so a success pays the manager far more than a failure, although a failure still earns the fee on assets. Link this with sizing in Risk and Portfolio Construction: the loss in the bad case must fit the fund's limit. Say whether the expected return clears the hurdle the investors expect.

WORKED EXAMPLE: DOES A CAMPAIGN AT BRIGHTWATER CLEAR THE HURDLE

A fund with 1,000m of capital considers a 120m position (12% of the fund) in an invented company, Brightwater Water plc, for a campaign lasting 3 years. The three outcomes are success (probability 40%, share price up 60%), partial (35%, up 20%) and failure (25%, down 20%). Campaign costs are 6m. The fund charges a 1.5% management fee and a 20% performance fee. Does the position clear a 10% a year hurdle?

Answer: The expected annual return is 6.6%, below the 10% hurdle, so at these odds the campaign needs a higher chance of success, a bigger payoff or a shorter timetable. A success adds 6.6% to the fund and a failure costs 3.0%.

Interview tip: Annualise before you judge a campaign, and say what success probability would be needed. Quoting the 60% upside alone overstates the return.

INT.HC.2.a · Campaigns, defences and the pitch

Describe campaign mechanics in sequence, from building a stake and disclosure thresholds (UK and US in outline) through private engagement, public letters, proxy contests, board seats and settlements, and judge the votes needed to win.

A campaign usually runs as a ladder, and each step costs more and is harder to reverse. The fund first builds a stake quietly, buying until a disclosure rule forces it to say so. In the US a holder must report a stake above 5% in a filing within days, and the UK requires notification of holdings from 3% with further steps (check the current thresholds and timing; these are outline figures). Derivatives and groups of holders may count. Disclosure often lifts the price, so the cost of building a bigger stake is partly set by how much can be bought before then. Next comes private engagement with the chair and chief executive, then, if that fails, a public letter or presentation to rally other shareholders, then a proxy contest or a requisition of a meeting to nominate or remove directors. Most campaigns end in a settlement, where the company adds directors or agrees to a review or buyback. Winning depends on the votes of institutions and index funds, who often follow proxy advisers, so work out the votes cast, not the shares in issue. A majority is of votes cast, which turnout reduces. Differences between UK and US procedure matter and should be named.

WORKED EXAMPLE: BUILDING A STAKE IN CORVALE AND COUNTING THE VOTES

Corvale Group is an invented company with 200m shares at 10.00. A US fund can stay below 5% and a UK fund below 3% (illustrative thresholds). The fund builds 4.9% at an average of 10.30 and, in the UK case, 2.9% at 10.15. On disclosure the price goes to 11.50. Separately, a contest costing 6m has a 50% chance of lifting value by 20%. At the meeting the shareholders are the activist (4.5%), two long-only funds backing it (8.0% and 6.0%), index funds (20%), insiders (7%) and others (54.5%, with 55% voting and 40% of those voting for the activist). Does it win?

Answer: The contest has a positive expected value of 3.8m, and the activist wins with 50.49 votes against a need of 37.74 only if the index funds back it. Without their 20% it has 30.49, so the proxy advisers decide the result.

Interview tip: Count votes cast, not shares, and say who is the swing vote. A campaign plan that ignores the index funds is not a plan.

INT.HC.2.b · Campaigns, defences and the pitch

Explain defence tactics (poison pills, staggered boards, advance notice rules) and the legal line for an activist (acting in concert, market abuse and inside information), saying which rules belong to the UK and which to the US.

Boards defend with tools that make a campaign slower or costlier. A poison pill, common in the US, lets other holders buy shares cheaply if any holder crosses a trigger such as 15%, which dilutes the holder who crossed it. A staggered or classified board elects only a third of directors each year, so an activist needs two meetings to win control. Advance notice rules set a window in which nominations must be filed, and dual-class shares can leave control with insiders. In the UK, boards face tighter limits: the Takeover Code stops a board from frustrating an offer without shareholder approval, listed company directors generally face annual re-election, and holders of 5% can requisition a meeting and can remove directors by ordinary resolution (outline, to be checked). The legal line matters more than any tactic. Funds that work together may be treated as a group acting in concert, so their holdings add up for disclosure and, in the UK, for the 30% mandatory bid threshold. Using or passing on inside information, or trading when told confidential facts in a private meeting, can be market abuse. The practical rule is to keep a record, wall-cross only with care and take legal advice. See Legal Terms and Documentation (Hedge Funds) for the wider vocabulary.

WORKED EXAMPLE: A POISON PILL AND A CONCERT PARTY

An invented company, Ellory Instruments, has 100m shares at 20.00 and a pill that triggers at 15%: once any holder passes the trigger, every other holder may buy one new share per share held at half the market price. An activist crosses the trigger with 15m shares. Separately, in a UK company two funds that agree to vote together hold 16% and 15%. What happens in each case?

Answer: The pill cuts the activist from 15% to 8.1% and costs it 68.9m of value, so an activist stays below the trigger or negotiates its removal. In the UK case the concert-party stake of 31% is above the 30% bid threshold.

Interview tip: Name which rules are UK and which are US, and treat the legal line as a constraint on the plan, not an afterthought.

INT.HC.2.c · Campaigns, defences and the pitch

Structure an activist pitch, the white paper, from situation and diagnosis through plan, valuation bridge and response to management, and test it the way a portfolio manager or fellow shareholder would.

A white paper is the document an activist uses to convince its own investment committee and then other shareholders. It follows a fixed order. First state the situation: the company, the share price record against peers and the gap. Second, the diagnosis: why value is lost, with evidence from reported numbers, capital allocation and governance. Third, the plan: each lever, who must act on it and a timetable. Fourth, a valuation bridge from the current price to a target, with each step priced and the costs deducted, so a reader can see how much depends on which lever. Fifth, why management has not done it and what it would say in reply, with answers prepared. Sixth, the risks and the downside if nothing changes, and an ask: board seats, a review or a buyback. A good paper separates levers the board controls from those that need a buyer, because the latter are less certain. Readers test it by asking what the market already knows, whether the numbers use the company's own reported data, whether the plan is credible and whether the activist is paid by outcome. Keep the argument factual: an accusation that cannot be sourced can create legal risk. Link the numbers to the checks in Equity Valuation and Earnings Quality.

WORKED EXAMPLE: A VALUE BRIDGE FOR A WHITE PAPER ON DUNMORE BRANDS

Dunmore Brands is an invented consumer group with 150m shares at 6.00. The draft white paper proposes a margin plan adding 24m of EBITDA valued at 8.0 times, a return of 45m of excess cash, a sale of a non-core division at 30m above the value the market gives it, and 18m of one-off costs. Build the bridge and say which steps depend on the board alone.

Answer: The bridge reaches 7.66, 27.7% above the price, with about 88% of the uplift within the board's control. A reader will trust the paper more if it shows the result with and without the division sale.

> **Interview tip:** Show each lever in pence or cents per share, deduct costs, and separate what the board controls from what needs a buyer.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.