The attributes of a successful activist

Active ownership in emerging markets is gaining greater momentum – and achieving results. Mike Lubrano explains what it takes to drive change.

When the word 'activism' is mentioned in financial circles in the US, UK and other advanced capital markets, it is usually firms like Bill Ackman's Pershing Square and Dan Loeb's Third Point that enter the conversation.

Colourful hedge fund managers like Ackman and Loeb are manna from heaven to the usually desiccated landscape of financial journalism. The editors at the *Financial Times* and the *Wall Street Journal* may not permit their reporters to titillate readers with tabloid headlines, racy pictures on page three or blow-by-blow reports of last night's brawl at the hockey game – or at least not yet. But at least some readers get a rush from coverage of the no-holds-barred efforts of hard-core activists to muscle onto corporate boards and carry out proxy battles to force fundamental changes in direction at, and even break up, public companies. Bill Ackman's tearful televised presentations on Herbalife and Dan Loeb's decidedly uncivil open letters excoriating under-performing CEOs may not always have their intended impact, but they are undeniably entertaining and circulation-enhancing.

Most fund managers in advanced markets that seek to influence corporate behaviour actually get results working privately and collaboratively with issuers, rather than conducting the boardroom battles and shareholder meeting contests that provide the media with a dose of excitement. As engaged minority shareholders, this class of investors identifies possible shortcomings in capital allocation, capital structure, corporate governance, domestic and international capital market strategy, group structure and transparency. They work with controlling shareholders, the board of directors and management to address these shortcomings. This very much engaged and proactive – if less publicly confrontational – breed of fund managers is also showing it can earn excess returns for investors. It is this more behind-the-scenes approach that is proving best adapted to emerging and frontier markets in Asia, Africa, Eastern Europe, Latin America and the Middle East.

The shorthand used by fund managers who pursue such an approach varies. Relational Investors, a pioneer in this space in the US, refers to what it does as 'active engagement of corporate leadership'. ValueAct Capital and Blue Harbor Group, two other fund managers based in the US, respectively call it 'constructivist' and 'collaborative active ownership'. Nalanda, a fund manager focused on the Indian market calls what it does 'passively active' investing. The RWC Focus Funds in Europe and the UK use the term 'constructive activist' and Cevian Capital, probably the best-known European fund manager of this type, describes its approach simply as 'active ownership'.

We at Cartica adopted the tag line 'active ownership in emerging markets' because we feel it succinctly describes what we do – we take seriously the role of shareholder as owner and actively engage with controllers, managers, boards of directors and sometimes other stakeholders in ways that are best suited to emerging markets conditions, all in the interest of creating value for all shareholders.

Active ownership suited to emerging markets

Most publicly listed companies in emerging markets share some of the characteristics of the small and mid-cap companies that have been attractive targets of active ownership fund managers in the US, UK and Europe.

Concentrated ownership with a majority of shares held by a single controlling shareholder or group, rather than atomised shareholding, is the dominant pattern in virtually all emerging markets. Usually a founder and/or family members hold executive positions and have enough combined shareholding to exercise effective control of the shareholders meeting and elect a majority of the board of directors. A small number of outside institutional investors generally hold the bulk of the public float. Corporate governance may be underdeveloped and non-transparent. Even operationally world class and internationally competitive emerging markets firms can have surprisingly inexperienced investor relations teams – if they have any staff dedicated to this function at all – and sub-standard disclosure practices (such as poorly detailed reporting compared to advanced market peers and/or no quarterly investor calls). Consequently, sell-side coverage is usually very limited, exposure to international investors almost non-existent and liquidity constrained.

For the active owner, a concentrated ownership pattern in a company whose governance can stand improvement and that has thus far done a poor job of explaining itself to the financial markets presents opportunities to create value for investors. Concentrated ownership carries with it the potential for personal and intense interaction with the ultimate decision makers and the key outside investors. Companies that have thus far done a sketchy job of facing the markets (especially international investors) present an opportunity for active owners to influence governance and disclosure practices to increase transparency, market interest, liquidity and (hopefully) improve multiples and valuations.

Executing an active ownership strategy in emerging markets

The evidence from both advanced and emerging markets demonstrates that a special combination of skills and experiences (and personality types) is required successfully to add value and achieve excess returns through an active ownership strategy. Doing this in a single market, across a region or on a global emerging markets basis (as in the case of Cartica) adds increasing layers of demands on a fund manager.

In-depth fundamental analysis hardwired to a concrete engagement agenda

Active ownership is predicated on the fund manager understanding each portfolio company better than the market does. It is a deep-value strategy that requires intensive in-house research and painstaking due diligence at every step of the process, from idea generation to investment to engagement to exit. An active ownership investor's research process needs to look behind the numbers to identify the reasons behind a company's under-valuation, formulate a possible engagement agenda to address them, and, perhaps most importantly, assess the chances for success and

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> potential upside of such a strategy. This can't be done from a Bloomberg terminal alone. The staff need to have direct and intensive interactions with controllers, board members, managers, other stakeholders and sometimes even regulators to really understand what needs to be done to unlock unrealised value – and whether these steps are achievable. The luggage (and sometimes digestive tracts) of the staff of active ownership fund managers suffer extensive wear and tear.

Powers of persuasion

As noted earlier, concentrated ownership is the rule in most emerging markets. One can rarely run, or even threaten, a proxy battle to push management to make changes. The active ownership investor needs to rely first and foremost on staff capacity to convince those in the target company with the power to effect change that the steps the active owner is advocating will help the company achieve better operational performance and enhance shareholder value.

Persuasion usually requires evidence. Active ownership fund managers must marshal convincing data and practical examples from comparable companies and markets if they hope to get their points across. The peer comparisons identified by the active owner in its research process can provide a useful entry point for opening discussion with controllers and management. A well-reasoned analysis of the opportunities to enhance value, including an estimate of the upside based on peer comparisons, is a by-product of the active ownership manager's intensive research and due diligence process that may well be welcomed by the company as valuable and free consulting advice.

If evidence alone were enough to convince intelligent people of the rationale for change, then active ownership investing would be a far simpler task and the world itself would be a very different place. Not surprisingly, controllers and managers generally react to suggestions from investors the same way they do when they hear: "We are from the government and we are here to help". It is a challenge to build the sort of relationship with controllers and managers that fosters frank discussion and open-minded consideration of suggestions for change.

The controllers and managers of some, perhaps even most, listed companies in emerging markets may not be open to productive dialogue with active owners. Not everyone is constitutionally suited to building the kinds of relationships of trust that are essential to the kind of collaborated approach that active ownership requires. Some personalities 'click' better with certain people than others. Some personalities repel like oil and water. Active ownership investors need the interpersonal skills and experience accurately to gauge the potential receptivity of key players to the kind of engagement it proposes.

The courage to escalate when required

Active ownership investing is a 'carrots and stick' approach with the preference leaning distinctly towards the carrots, especially in emerging markets. In the best of circumstances, controllers and managers come to appreciate the active shareholder as a provider of invaluable perspectives that they wouldn't want to live without. There may be disagreements and even some occasional head-butting, but the relationship continues because it is mutually beneficial. But, while it is usually important for the openness of the company–shareholder dialogue to focus on the benefits of collaboration, controllers and managers must sometimes be reminded that cooperation is not cooptation. Active ownership fund managers are 'watching the store' for themselves and other minority shareholders and can't be expected to sit idly by when it looks like controllers or managers are about to destroy or misappropriate shareholder value.

Active ownership investors, alone or together with other shareholders, often have sufficient votes to elect one or more member of the board of directors (election of directors is by cumulative vote in many emerging markets). Indeed, in some jurisdictions (Chile and Brazil for example) the votes of minority shareholders are required for the election of independent directors. Active ownership fund managers are logical parties to play the role of informed minority shareholder anticipated by such regulatory regimes. Other statutory rights, for example rights to request a special audit or to place items on the shareholder meeting agenda, exist to be used in defense of minority shareholders' interests.

A sudden and noisy exit by an active ownership investor sends a signal to the market that things are headed in the wrong direction. The implicit threat of such an event may sometimes prove enough to dissuade controllers and management from taking the wrong course. In the most serious of cases, where the actions contemplated or consummated by controllers or management are egregious or patently illegal, active ownership investors may find themselves with no alternative but to take a page from the book of the classical 'activists' mentioned at the beginning of this article and sue in court, even in countries where such efforts are (so far) uncommon.

Extensive country knowledge, networks and 'street cred'

Superficially, public securities markets in most emerging markets share the same basic components as in more advanced economies:

- legal/regulatory frameworks consistent with International Organization of Securities Commissions (IOSCO) principles;
- professional intermediation through secure electronic trading and settlement platforms;
- corporate governance regimes along the lines of the OECD Principles of Corporate Governance;
- accounting regimes in accordance with internationally accepted standards; and
- independent external audits conducted in accordance with international practices.

But experienced international investors know that these similarities can be deceptive. There are critical differences in market practices, corporate behaviours and shareholder rights and treatment across markets, especially emerging markets. To be effective in such markets, active ownership investors need to know what lies beneath the thin veneer of rules and institutions and understand intimately the interests and dynamics that drive markets and motivate company behavior. Experience is really the only teacher, and it is a teacher that doesn't flinch from more than occasional application of the ruler across its students' knuckles.

Even a solid understanding of the business culture and norms of communication in a market won't get you far without a network of trusted partners on the ground. People and institutions that leverage the active ownership investor's experience and contacts are indispensable to conduct integrity checks and understand how the individuals behind potential investee companies are regarded in the market. These networks can also be invaluable reputational agents, demonstrating the active ownership investor's credibility in the local market, 'selling' cooperation with active owners to companies as a long-term value-adding proposition, and building personal bridges to controllers and managers to assure those that need convincing of the investor's honorable intentions.

The guts to run a very concentrated portfolio

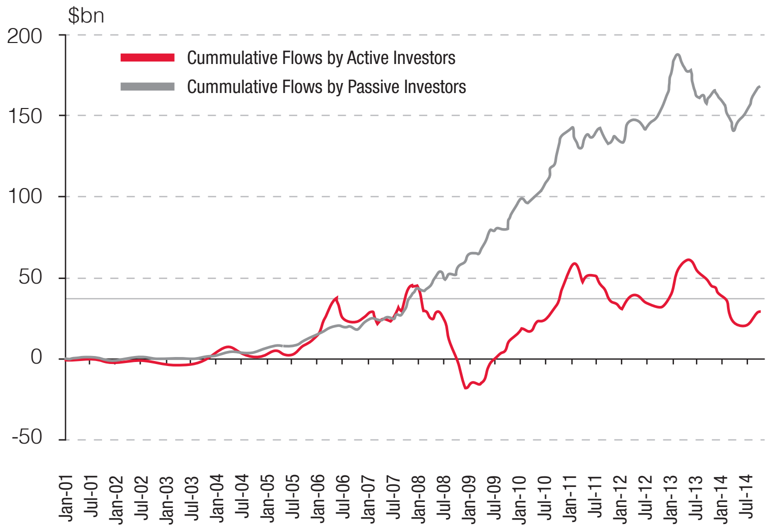
Active ownership funds are by their nature highly concentrated because the research process is so intensive, and because devising and executing engagement strategies requires continuous and direct interaction with companies. As a consequence, their performance is highly uncorrelated to country, regional or global indexes. Active ownership managers must have the intestinal fortitude to weather the periods when general market movements leave them behind. Investors in such funds need to remember they are buying alpha, not beta.

Active ownership as a public good

As in advanced markets, active ownership investors represent a distinct

Figure 1: Dedicated EM equity flows by investor type

Source: EPFR Global, Fund Flows Database, Morgan Stanley Research. Data as of 24 September 2014.



minority of active (as opposed to passive) investment strategies.

As illustrated by Figure 1, the funds that have flowed into emerging markets so far this century have been increasingly invested in passive, largely indexed, portfolios.

Nevertheless, active ownership investors are a critically important species in the broad ecosystem of emerging markets investors. The markets need, and indeed their regulatory regimes often explicitly presuppose the existence of minority shareholders whose investment style is the antithesis of passive. Active owners can thus have an outsized impact on capital market development.

There is no doubt that efforts in recent years by regulators, stock exchanges and international organisations to improve general standards of governance and transparency of public companies, such as the OECD Principles of Corporate Governance, the IOSCO Principles and International Financial Reporting Standards (IFRS), have had important benefits for investor confidence and capital market development in emerging markets. ICGN's own central role as a forum to develop and share best practice across the globe has also played a key role in improving governance and transparency in all markets – developed and emerging.

However, it requires real life private actors with 'skin in the game' to ensure more than compliance on paper, and to provide regulators and standard setters with a reality check. Active ownership fund managers don't make money by getting their portfolio companies to implement the full panoply of general best practices. They must be selective. To earn excess returns, they are laser-focused on identifying and implementing the changes that will yield the greatest improvements in operational performance and valuation in their portfolio companies.

In the process, they provide companies, investors, standard setters (including the ICGN) and regulators with examples of what works (and occasionally what doesn't work) in particular markets and types of companies – free of charge.

ABOUT THE AUTHOR

Mike Lubrano is Co-Founder and Managing Director, Corporate Governance at Cartica Capital, an emerging markets fund manager with approximately US$2.8 billion in assets under management. Cartica runs a concentrated, long-only portfolio of publicly-traded equity securities, acquiring significant stakes and employing an 'active ownership' approach.