Small but dutiful: How to pursue change without filing

By Paula Schaap   Updated 12:19 PM, Aug-14-2015 ET

In the month leading up to its annual meeting, MGM Resorts International (MGM) said it had hired Evercore Partners Inc. to explore strategic alternatives, including possibly establishing a REIT to hold its properties. That move likely had a lot to do with the decision made by one of the company's investors: Land and Buildings Investment Management LLC, a real estate-focused activist, withdrew its slate of four director candidates just before the May 28 shareholder meeting.

With only a 0.8% stake in the company, the investor likely didn't have the torque to pull off its proxy contest. Still, Land and Buildings hasn't gone away. On Aug. 3, the activist urged its fellow investors to ask on MGM's second-quarter earnings call the next day why the company's chairman and CEO Jim Murren hadn't returned the phone call of Gaming and Leisure Properties Inc.'s (GLPI) CEO Peter Carlino.

"Presumably," Land and Buildings founder Jonathan Litt wrote, "Carlino was interested in acquiring MGM's real estate."

And that is one way Land and Buildings' small stake could ultimately work to its advantage.

Filing a Schedule 13D with the Securities and Exchange Commission is required when a beneficial owner of a security amasses a 5% stake. By keeping its interest below that level, an investor will sacrifice a certain amount of activist street cred and publicity, advisers on both sides of proxy fights said.

But being able to fly under the radar may also help the smaller stakeholder to better gauge the response of institutional investors, as well as to field inbound inquiries about the company or its assets, those advisers note.

That competitors may have been trying to sound out MGM Resorts is the kind of intelligence potential buyers may be more ready to review with investors when they know the campaign isn't in the public eye.

"A well-advised company will understand that they're in the same boat with a 4.9% stake-it may make it easier for an activist to speak to others or to take incoming calls from journalists or other companies," said one legal adviser.

ACTIVISM AT U.S. public companies has been on an upswing, along with the improving economic outlook. And small stake activism is also on the rise. Of the 148 public activist campaigns announced as of Aug. 3, 34.5% of them were from a shareholder with less than a 5% stake, according to FactSet. Because most of proxy season occurs during the first half of the year, it's hard to project how many more campaigns will be launched going forward. However, it is notable that in all of 2014, smaller stakeholders accounted for 34.5% of 163 total activist campaigns.

Year-over-year results for the same time period in 2014 had under-5% stakeholders at 32.3%, according to FactSet, while the year before the percentage stood at 26.8%. (2012 as of Aug. 3 was 22.3%, while 2011, it was only 14.8%.)

Some of those stakes could have gone above 5% later, but weren't at the level to trigger a 13D filing when the investor made an announcement of its intentions for the company.

The advantage of not taking the full 5% stake in a company, said Steve Wolosky, who heads the activism practice at Olshan Frome Wolosky LLP, is the ability to work behind the scenes.

On the other hand, Wolosky noted, if one of the items on the investor's agenda is board representation, management may ask whether they shouldn't be talking to a larger shareholder. Which means it's incumbent upon the small stake investor "to understand the rest of the shareholder base," he said.

That, according to Glenn Welling, founder of Engaged Capital LLC, is as much a part of his firm's strategy as running a financial projection or a peer comparison.

"Its unquestionably easier to act as a catalyst for change when you own 9% to 10% of the company," he said. However, since the fund views itself as being a representative for all shareholders, when it owns less of the company, relationships with institutional investors are all the more important, he added.

Engaged is a smaller fund-a few hundred million in assets according to a person with knowledge of the firm-and its portfolio is concentrated on smaller cap companies.

Being under the 13D threshold also helps with liquidity, Welling noted. Regulatory rules require an amended 13D for every 1% an activist raises, or drops, the investment in a particular equity. "Investors can be much more nimble in adding to or taking away from their position when they're under 5%."

This proxy season Welling clocked in with a number of settlements in which companies agreed to install dissident directors, including at diet products company Medifast Inc. (MED) and industrial manufacturer TriMas Corp. (TRS).

Engaged had to go through a proxy fight with Rovi Corp. (ROVI), the digital entertainment technology provider, but ultimately got two of its three candidates on the seven-person board.

Welling's biggest win this year was at Silicon Image Inc. (SIMG). Only a month after Welling sent management a letter arguing that the chipmaker was undervalued by 48% to 116%, the company sold itself to Lattice Semiconductor Corp. (LSCC) for $606.6 million, a 41% premium to Silicon's stock price on the day Welling revealed his stake.

Each of those campaigns was waged with less than a 1% stake in the company.

Though there are many examples of smaller funds mounting campaigns at companies with a similarly diminutive market caps-the traditional targets of activist investors-another change in the landscape is under-5% stake holders waging campaigns at megacap companies. Taking on the behemoths means, by necessity that the stake is smaller, but that is happening more often. As of June, the median market cap of companies that were targeted with proxy fights was $518 million, more than double the $255 million in 2014, according to ISS Special Situations Research. The median market cap of targeted companies was $141 million in 2013 and only $24 million in 2012.

This year there was eBay Inc. (EBAY), currently at a $34.3 billion market cap, where Carl Icahn said he wanted board representation and was pushing for a spinoff of its Paypal Holdings Inc. (PYPL), something that became a fact in July. Starboard Value LP has taken a less than 5% stake in Macy's Inc. (M)--without much in the way of public filings or press releases. Starboard CEO Jeff Smith has said he wants to see the $22.7 billion market cap retailer consider a REIT structure for its property.

The biggest campaign so far this year is Jana Partners LLC's effort to convince semiconductor giant Qualcomm Inc. (QCOM)-market cap of $98.3 billion-to consider separating its chipmaking business from its licensing division. With only a 0.27% stake, Barry Rosenstein's fund wrangled a settlement and got two nominees on the Qualcomm board; the company has already started to review its alternatives.

Successful campaigns at the biggest companies where the investor can't depend on his stake to win the argument, brings another important matter that advisers to both activists and companies stress: the credibility factor.

Wolosky pointed out that the best campaigns happen when the fund is clearly in for the long term. He said investors "have to assess risk, you have to assess cost of capital, what will other shareholders say?"

That assessment, Wolosky noted, can lead to a conclusion that "the upside is not so great," just because the stock price goes up a few percent.

As another industry adviser observed, "People have different reputations, like ValueAct has a more constructive reputation, and deservedly so." Also, "if it's someone from Blackrock that owns 1% and is upset about something at the company," he says, they might get a different reception than an investor nobody ever heard of.

Still, that doesn't mean a small stake activist won't get a hearing, the adviser said.

The advice might be, he suggested, "Don't ring the fire alarm. But you can meet with them and see what they have to say."

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