February 2023

Hotel California

By today's standards, the story of US-listed CRM company Salesforce's rise and rise is relatively uneventful. Like many Californian startups that went on to become global technology behemoths, the story starts in a small apartment in 1999 and culminates with founder and CEO Mark Benioff erecting the Salesforce Tower – the tallest building in San Francisco.

Ultimately, Benioff's ticket into the Silicon Valley Hall of Fame was punched when he changed the way software was bought and sold, making it more accessible via cloud infrastructure. However, like many technocrats have come to realise, running a listed company isn't just about great ideas.

From its peak in November 2021 to the end of 2022, Salesforce's share price halved. Over that period, lower levels of growth, high overhead costs and questionable corporate strategy have led not one, two or even three, but five activist hedge funds to take up meaningful positions in the company's stock.

However, hedge funds haven't just piled into Salesforce Tower. A year before one of those activist investors checked into Mark Benioff's digs, they checked out of Twitter HQ, which is about 3kms up the road. This was after a successful campaign to oust Twitter's founder and CEO, Jack Dorsey.

About 50kms southeast of the drama in Downtown San Francisco, in Mountain View, a similar group of investors took up residence in the Googleplex. And, if you travel a further 10kms southeast of the Googleplex, you may find more of the same people at MPK, Meta's head office.

Clearly, California has become something of a hotel for activist investors. But who are they? What do they want? And although they've checked in, will they ever leave?

Characterising the Activist Investor

Activist investors use their shareholding in companies to pressure management into making changes. Typically, activist investors target companies they believe to be mismanaged or companies that could be managed more profitably.

This style of investing started to take shape in the US following the Wall Street Crash of 1929. Black Tuesday and the subsequent Great Depression that followed were believed to be caused in part by a lack of transparency by companies listed on the New York Stock Exchange. Ultimately, investors were misled by companies regarding their true financial state which caused them to make ill-informed investments.

To combat this in the future, the Securities and Exchange Commission (SEC) was formed and mandated with regulating the disclosure of financial information to the marketplace. In part, the formation of the SEC created an environment where shareholders not only had rights, but where these rights were enforceable too.

It wasn't until the 1980s that investors started to use those rights to affect change in companies to generate profit. The term *Corporate Raiders* was popularized by Bryan Burrough in his 1987 book *Barbarians at the Gate*, which details the leveraged buyout of RJR Nabisco, the American tobacco and food conglomerate. Ultimately, the corporate raiders were a group of investors that took sizeable positions in companies and then used their shareholder influence to generate short-term profit for themselves.

An important point to make is that at this stage the role of activist investors in companies was far more benevolent than the kind of shareholder activism that was popularized by the Corporate Raiders. Indeed, up until the 1980s, activist investing was typically carried out by religious and environmental groups that were focused on pressuring companies to make investments that ascribed to their beliefs and values.

The avarice displayed by the Corporate Raiders tainted the reputation that shareholder activism had so far garnered. Ultimately, understanding the intentions of activist investors is as important as understanding why they target certain companies.

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With that being said, there are some key differences between the foremost brand of activist investing seen in the 1980s and the brand that has taken center stage today.

Private Equity vs Hedge Funds

Firstly, back then shareholder activism for profit was only really pursued by private equity firms who had the financial clout to take up significant stakes in target companies. But today, that has changed with several different kinds of investors involved in activist campaigns.

Most notably, hedge funds have become one of the most popular players to launch activist campaigns. In fact, one study estimates that from 1994 to 2018, the number of activist hedge funds in the US has increased from under 10 to over 160.

Secondly, the kind of shareholder activism that hedge funds practice is different to private equity funds. The former tends to seek corporate influence while the latter is seeking control. This makes sense if one considers the kind of target companies that each generally invests in. Private equity funds by their very nature invest in private companies or look to take listed companies private. Generally, they believe that the best way to make changes in a company is by taking control of the company.

On the other hand, activist hedge funds prefer not to take majority stakes in businesses that involve tying up capital for long periods of time. Instead, they prefer taking minority stakes in listed companies, and then pressuring management into making changes, essentially letting the court of public opinion (in this case the stock market) decide if they are doing a good job.

Understanding this distinction helps us understand the kind of behaviour we are seeing in Silicon Valley. Firstly, most of the players involved are hedge funds and secondly, all of their targets are listed companies. To that end, let’s focus this analysis on understanding when activist hedge funds like to get involved and if that can tell us anything about the state of the US tech sector.

The Activist Signals

There are generally four signals that may heighten activist hedge fund interest relating to specific target companies. Let’s look at what they are and some examples.

Signal	Description	Indicators
Operational Underperformance	When a company’s return on capital lags behind the peer group or consistently underdelivers on expectations.	High overhead costs, lagging sales growth, high staff cost.
Corporate Governance Concerns	When a company is implementing questionable corporate governance practices that have or can lead to value destruction.	High management compensation in line with better-performing peers, board of directors with lots of “insiders” vying for the interests of management and not shareholders, autocratic leaders.
Corporate Action Concerns	When a company owns potentially valuable assets that aren’t being used to their full potential. Or, goes on a questionable acquisition spree.	A division of a company is poorly run and could perform better if it were independent. The company has made a spate of questionable acquisitions.
ESG Dissidence	When a company doesn’t have an established ESG policy or it isn’t properly disclosed. This may result in weak share price performance.	A company refuses to disclose its carbon footprint because it doesn’t believe in the popular narrative surrounding ESG.

According to Lazard Asset Management, globally the technology sector was the most targeted sector for shareholder activism in 2022. Keeping the above in mind, let’s have a look at why that may be the case.

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Big Tech: The Activist Investment Case

Brick-and-mortar discount retailers and ESG villains like the big oil companies have been the bread-and-butter targets of activist investors. But recently, they have ditched those targets and focused on a new prize – Silicon Valley. Let's take a look at why.

- Signal #1 - **Operational Underperformance -** For the first time in almost a decade, many of the big tech names have reported slowing growth and weaker earnings. And, a lot of that has culminated in mass staff layoffs over the past couple of months. Google, Microsoft and Amazon alone have cut around 40 000 jobs in 2023.
- Signal #2 **- Corporate Governance Concerns -** In recent years several of the big tech companies have been caught in the cross-fire of corporate governance issues. In particular, the fact that many of the companies are still so heavily controlled by their founders lends itself to these concerns.
- Signal #3 **- Undervalued Assets -** Many of the big tech companies are holding onto very lucrative assets – Alphabet's stake in YouTube, Amazon's Web Services and Meta's subsidiary Instagram are all examples of assets that could be spun out in the future.
- Signal #4 **- ESG Dissidence -** Companies like Meta, Amazon and Twitter have increasingly been under the spotlight for social concerns. Either because of the products that they sell (Meta and Twitter) or the way in which their business is conducted (Amazon).

Ultimately, all four signals that typically attract activist hedge funds are currently screening bright red for many big tech companies, and compared to a couple of years ago, those companies are a lot cheaper to buy now. It's the perfect time for the activists to get involved.

But what are some of the implications of that involvement for the companies that the activists are targeting?

This Could Be Heaven or This Could Be Hell

At the heart of it, we must ask ourselves the question – are activists good or bad for the other investors in companies?

Well, that is a tough question to answer, but on the balance probably not. To understand why, let's consider what may end up unfolding at Hotel California – the good and the bad.

<u>The Good</u>

- **Thinking Long term -** When activists have focused on creating long-term shareholder value by either enhancing corporate governance, reducing operational expenditure or rationalizing the company's asset base this has generally had a positive impact on the long-term performance of target companies. An example of this relevant to the tech sector is eBay. In 2019, two activist investors pushed the company to sell unprofitable business units, a move that has been largely positive for the company's fortunes.

<u>The Bad</u>

- **The Death of Innovation -** The US tech sector is what it is today because companies like Amazon, Meta and Salesforce have innovated their way to the top. However, at what point does the presence of the activists lead the drivers of that innovation to head for the nearest exit?
- **Having a Kodak Moment -** When activists focus on generating short-term shareholder value this has generally had very negative effects on the long-term viability of target companies. This was the case when activist investor Carl Icahn invested in Kodak in 2003. Instead of focusing on innovation, in 2004 the company slashed 15 000 jobs and reduced its operating budget. Shortly thereafter, Icahn sold his position at a profit. Although the short-term gain was great for Icahn, long-term investors were left reeling when the company filed for bankruptcy in 2012.

But Being an Activist is Easy?

These days, it's a lot easier to be an activist investor compared to the 80s when you had to commit a substantial amount of capital to buy a considerable stake in a company, and you had to make actual long-term changes that would generate a return on your investment.

In comparison, activist hedge funds today don't need to commit as much capital to take up sizeable positions in big listed companies, and they don't really need to make actual long-term changes to the businesses they invest in. All they need to do is convince the market that they are doing that and the share price will do the rest.

On the flip side, activists do need to tread with caution. While it's relatively easy to trade in and out of big, listed tech companies, you open yourself up to public scrutiny. Activists that advise big tech companies to adopt a Kodak-like approach may be punished for that kind of action by the court of public opinion.

All of this sounds incredibly short-term focused, and that's because it is. As we mentioned, activists aren't in it for the long run. But as long-term global equity investors, we are. So perhaps what we should be taking out of this is:

- **Big Tech is cheaper than it was -** This point is so crucially important to the activist investment case. If it isn't cheap, it's far more difficult to make money. But it isn't only cheap for the activists, it's cheap for everyone. In fact, for the first time in a while, many of the global value managers we follow have also recognized that and started to buy companies like Amazon and Alphabet. Quality-oriented funds like to hunt in this sector as well.
- **It's easy to fix and it's worth fixing -** A lot of the problems that big tech is facing require changes to management or a change in corporate direction. That is a lot easier to fix than a company like Kodak, where your primary business line is facing extinction. In fact, companies like Alphabet, Amazon and even Salesforce are still, through innovation, changing the world we live in in a very meaningful way and there is still great demand for the products they sell.

Ultimately, activist investors may not be the greatest long-term running mates for global equity investors. However, that doesn't mean they aren't useful. From operational underperformance to corporate governance concerns, something seems to have gone amiss with a number of the big tech names. And, by pointing out their flaws publicly, a little bit of tough love from the activists may go a long way towards cleaning up Hotel California.

InvestSense

February 2023

data provided by Refinitiv

MARKET REPORT

28/02/2023

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	4.1%	6.5%	6.2%	19.5%	9.8%	10.5%	17.1%	14.3%
FTSE/JSE SA Listed Property	ZAR	-0.6%	-1.7%	5.1%	2.7%	-3.6%	2.0%	27.0%	21.7%
SA All Bond Index (ALBI)	ZAR	2.7%	2.1%	4.9%	7.4%	7.1%	7.2%	8.0%	8.0%
SA Cash Index (SteFI)	ZAR	1.7%	1.1%	5.7%	4.8%	5.8%	6.2%	0.4%	0.4%
Balanced Benchmark	ZAR	4.3%	5.9%	6.4%	14.2%	9.6%	10.2%	11.8%	9.6%
SA Inflation (1 month lag)	ZAR	0.6%	0.3%	6.9%	5.3%	4.8%	5.2%	1.4%	1.4%
GLOBAL MARKET INDICES BASED TO USD									
Global Equity (Datastream World)	USD	0.2%	4.6%	-6.9%	10.4%	7.4%	9.4%	18.1%	14.6%
Emerging Markets Equity (Datastream EM)	USD	-0.4%	0.9%	-14.9%	1.3%	-1.5%	1.9%	18.9%	17.0%
Global Property	USD	-0.1%	3.1%	-13.2%	1.0%	3.7%	4.6%	18.4%	15.6%
Global Bonds (Barclays Global Bond Index)	USD	0.4%	-0.2%	-13.6%	-5.1%	-1.7%	-0.3%	8.4%	7.3%
Global Cash	USD	1.2%	0.8%	3.1%	1.2%	1.7%	1.1%	0.4%	0.3%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	4.1%	6.5%	6.2%	19.5%	9.8%	10.5%	17.1%	14.3%
Global Equity (Datastream World)	ZAR	8.2%	12.8%	10.6%	16.3%	17.4%	17.5%	17.0%	15.4%
Emerging Markets Equity (Datastream EM)	ZAR	7.5%	8.9%	1.1%	6.7%	7.6%	9.4%	14.2%	13.6%
Global Property	ZAR	7.8%	11.2%	3.1%	6.3%	13.3%	12.4%	18.0%	15.8%
SA All Bond Index (ALBI)	ZAR	2.7%	2.1%	4.9%	7.4%	7.1%	7.2%	8.0%	8.0%
Global Bonds (Barclays Global Bond Index)	ZAR	8.4%	7.7%	2.6%	-0.1%	7.3%	7.1%	15.2%	13.6%
COMMODITIES									
Gold (US Dollars)	USD	4.2%	0.6%	-4.1%	4.8%	6.7%	1.4%	13.6%	14.7%
Gold (Rands)	ZAR	12.6%	8.5%	13.9%	10.3%	16.6%	9.0%		
CURRENCIES									
Rand / Dollar	ZAR	-8.0%	-7.9%	-18.8%	-5.3%	-9.2%	-7.4%	15.8%	15.0%
Rand / GBP Pound	ZAR	-9.8%	-8.6%	-7.2%	-3.4%	-6.4%	-5.0%	13.9%	14.6%
Rand / Euro	ZAR	-11.2%	-7.2%	-12.2%	-4.1%	-6.2%	-5.2%	13.9%	13.3%

Spot Rates		28-Feb-23	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	18.4	17.0	15.5	11.8	9.0	8.1
Rand/GBP	Rand	22.2	20.4	20.7	16.3	13.6	12.7
Rand/EUR	Rand	19.5	18.2	17.4	14.4	11.7	8.7
RATES							
Libor 6m $	US$	5.3	5.1	0.8	2.2	0.5	1.3
Repo Rate	Rand	7.25	7.00	4.00	6.75	5.00	13.50
Prime	Rand	10.75	10.50	7.50	10.25	8.50	17.00
All Bond Index Yield	Rand	10.9	11.0	11.6	8.8	7.2	9.7
COMMODITIES							
Gold ($/oz)	US$	1 826.0	1 815.6	1 903.8	1 319.3	1 582.9	349.8
Platinum	US$	951.0	1 031.0	1 063.0	979.0	1 598.0	681.0
Oil (Brent Crude) $	US$	84.0	84.9	101.2	65.7	112.8	33.8
INFLATION							
SA Inflation	%	6.9	6.9	5.7	4.0	5.8	9.4

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