REPRINT

GLOBALISATION OF SHAREHOLDER ACTIVISM

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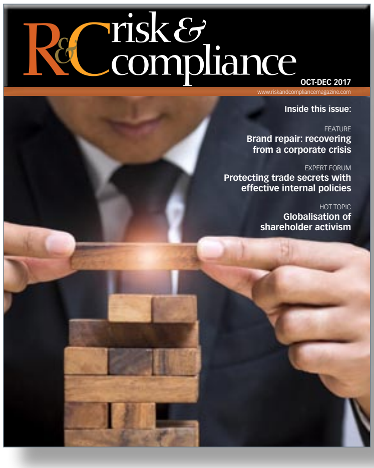

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HOT TOPIC

GLOBALISATION OF SHAREHOLDER ACTIVISM

PANEL EXPERTS

Demi Derem
General Manager, Investor Communications Solutions International
Broadridge Financial Solutions Ltd
T: +44 (0)20 7551 3204
E: demi.derem@broadridge.com

Demi Derem is the general manager of Investor Communication Solutions International at Broadridge, responsible for its global proxy management and corporate governance intelligence businesses. He started his professional career at Barclays as a business analyst and went on to hold leadership roles at Lloyds, Gartmore, KPMG, Cofunds, and BNY Mellon. His 25-year experience covers investment management, investment services and custodian industry segments.

Jason S. Frankl
Senior Managing Director
FTI Consulting
T: +1 (202) 312 9216
E: jason.frankl@fticonsulting.com

Jason Frankl is a senior managing director at FTI Consulting based in Washington, DC. He leads FTI's Activism and M&A Solutions practice where he works with companies that are the subject of shareholder activism or M&A activity in the development and implementation of strategies designed to maximise shareholder value.

Arthur B. Crozier
Chairman
Innisfree M&A Incorporated
T: +1 (212) 750 5833
E: acrozier@innisfreema.com

Arthur B. Crozier is chairman of Innisfree M&A Incorporated of New York and of Lake Isle M&A Incorporated, Innisfree's wholly-owned UK subsidiary. Mr Crozier's practice includes the representation of US and international clients in a wide variety of transactions and proxy contests, as well as annual and special meetings. In addition, he counsels an international roster of clients on corporate governance, shareholder engagement and executive compensation issues.

David A. Katz
Partner
Wachtell, Lipton, Rosen & Katz
T: +1 (212) 403 1309
E: dakatz@wlrk.com

David A. Katz is a partner at Wachtell, Lipton, Rosen & Katz in New York City, an adjunct professor at New York University School of Law and co-chair of the board of advisors of the NYU Law Institute for Corporate Governance and Finance. Previously, he was an adjunct professor at Vanderbilt University Law School and at the Owen Graduate School of Management.

R&C: After years of being primarily a US phenomenon, how would you characterise the extent to which shareholder activism has gone global? Why are shareholders in wider jurisdictions now rejecting their traditionally passive roles to become more vocal as to their rights and expectations?

Derem: Shareholder activism is a broad term with many different interpretations. Whereas typically activists are thought of as large hedge funds that wage public proxy battles, other institutional investors, from US public pension funds to traditional asset managers, have become more 'activist-like' in that they are publicly vocalising their demands of boards of directors and company management. This is a result of a number of factors, including the global financial crisis, and in the US, the significant rise in the assets invested in passive investments – where asset managers have no choice but to own an index of stocks. Passive managers' primary way to influence the strategies impacting the long-term return of their investment is via shareholder engagement and 'activist-like' stances. Passive investments, like index-based ETFs, are not nearly as prominent outside of the US, so the need for this type of activism in Europe and other countries is not as likely to take hold. However, whereas historically European investors primarily carried a lax attitude toward companies' risk taking and corporate governance, the financial crisis spurred a call to action within the EU.

Frankl: Shareholder activism has entered all of the active trading markets in the world. In the US, it has become the 'new norm' as activists target companies large and small. As valuations have run up in the US and other jurisdictions, activists and investors have gravitated toward jurisdictions with lower valuations seeking greater alpha. Although cultural and governance limitations historically restricted the extent to which shareholder activists would invest in foreign jurisdictions, this is currently changing. Countries with dynamic capital markets and leadership, in favour of foreign investment, have seen the most growth in shareholder activism. In these jurisdictions, the strongest indicators that shareholder activism will grow are institutional support, political acceptance of shareholder-friendly corporate governance rules and laws and market opportunity.

Crozier: Activism has certainly gone global. According to a recent study, only slightly more than a majority of public activism campaigns during the 2017 proxy season were directed at US companies, a significant reduction from prior years. While European companies represented 20 percent of campaigns and Asia 14 percent, Australia alone represented 12 percent of campaigns. Institutions around the globe are facing increasing demands for superior returns, driven by competition, particularly from low-fee US passive mangers. Activism can deliver outsized returns at poorly performing companies. Many institutions have seen activism and even just enhanced shareholder scrutiny deliver those superior returns by catalysing significant additional value creation at lagging portfolio companies.

Katz: Although there have been examples in prior years of shareholder activism in Europe and Asia, 2017 marked a sea change in global shareholder activism. In prior years, many European and Asian activist situations involved merger and acquisition (M&A) transactions where an activist could take advantage of high shareholder approval requirements to extract extra value from potential acquirers. This year has been very different; we have seen a number of activist situations around the world pushing for companies to sell themselves, split up or divest themselves of substantial assets. Many of these situations are being pushed by US activist investors who see greater opportunities for value creation outside the US.

R&C: What issues are driving this change in shareholder outlook across the globe? In which countries are you seeing shareholder activism particularly taking root, and with what level of success?

Crozier: A compelling factor is the need to explore various alternatives to produce enhanced returns.

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> *Broadridge Financial Solutions Ltd*

US activists have shown a way to produce such returns and are increasingly undertaking activism campaigns and introducing activist tactics in new markets. The increasing rate of US activists pursuing non-US campaigns is driven by the relative paucity of suitable US targets after the sustained assault on lagging US performers over the last several years and the relative undervaluation of global markets compared to the US, thereby providing a more attractive range of targets. Perhaps as a reflection of their Anglo-Saxon legal structure and market approach, the UK, Canada and Australia have seen the most activism campaigns recently.

Katz: The first issue is that much of the 'low-hanging fruit' in the US has been 'picked', meaning that poor capital allocation decisions or relatively easy restricting scenarios have already been targeted. Thus, US activists with sufficient capital see better investment opportunities outside the country. In addition, institutional shareholders are frustrated from years of low or slow-growth, and are willing to back an activist who is seeking to shake up a company and create significant value in the short term. In the past, largely for cultural reasons, institutional investors automatically tended to support management teams who were targeted by activists. That is no longer case as institutional investors are requiring management teams to show that they can create greater value than the activist, and management teams are no longer getting the benefit of the doubt.

Frankl: Beyond the US, shareholder activism has taken hold in the UK, Canada and Australia. Although home grown or local activists launch most of the activism campaigns in each of those jurisdictions, they are also fertile grounds for the established and well-known American funds. These jurisdictions provide expanded target opportunities from what some view as a saturated US market, however, are similar enough to the US and therefore require fewer resources to perform the significant level of due diligence required to launch a campaign compared to other foreign jurisdictions. In addition, each of these markets is open to foreign investment and has relatively shareholder-friendly corporate governance rules. This combination of factors makes for a seamless expansion for US activists and for domestic activists to copy the strategies seen by their American counterparts.

Derem: Although activism has historically not been as successful outside the US, more recently the tides seem to be changing as both US and non-US funds seek out new opportunities. One of the more successful activists outside the US has been Cevian Capital, Europe's largest hedge fund, which has had success with both Ericsson and ABB Ltd. Note that activists do not always get the support of other shareholders, thus sometimes leading to the loss of proxy fights. For example in the AkzoNobel contest, Elliott supported the board on its plan to spin-off its specialty division after it could not get other shareholders to support the sale to PPG. On a positive note, these campaigns have resulted in changes to governance and strategy at targeted companies.

R&C: Have there been any particular campaigns launched recently which, in your opinion, showcase the evolving nature of shareholder activism? What issues do such campaigns typically address and how are activists strategising their concerns?

Katz: Elliott Management has launched campaigns against BHP Billiton in Australia, Samsung Electronics in South Korea and AkzoNobel in the Netherlands. Each of these battles has a different focus. In the BHP battle, Elliott pushed for board changes and the sale of US shale assets; in the Samsung situation, Elliott, which lost a 2016 battle, pushed for a break-up of its flagship electronics company and a $27bn payout to shareholders; and AkzoNobel resisted a takeover by US rival PPG Industries that Elliott supported and Elliott then pursued litigation seeking to oust the AkzoNobel chairman. Activists are talking to shareholders before they target companies so that the activist tends to have significant backing when it makes its initial approach to the targeted company's management and board.

Crozier: In the US, the success of activist campaigns, particularly by 'brand name', well-capitalised funds, has led to numerous campaigns being resolved behind closed doors with a single shareholder, not unlike the historical prevailing practice in many other markets. Of the more than 300 public activism campaigns launched at US companies during the 2017 proxy season, only approximately 20 have, so far, gone all the way to a contested shareholder vote. 'Peaceful' resolutions reached behind closed doors have become so common that several large, long-term investors have requested to be at least informed of settlement discussions to ensure their interests are not being compromised. Outside the US, however, tactics are becoming more aggressive and directed at senior management and board members, such as TCI Fund's campaign against Safran's acquisition of Zodiac Aerospace.

Derem: Activism can take on many different definitions, from economic activism, where a hedge fund seeks to break up a company or sell off an underperforming asset, to activism in the form of demanding replacement of specific directors. However, in recent years, a notable evolution has been the increase in traditional asset managers voicing their demands for corporate governance changes or disclosure, and then taking broad action when companies were generally not responsive. For example, State Street Global Advisors voted against the election of directors at 400 companies without a single female board member because they did not feel the companies were making significant progress diversifying their boards.

Frankl: Each shareholder activism campaign is going to be unique given the management team, current board, region, industry and other company specifics. However, much can be learned from Elliott Management's campaigns. Elliott's campaigns demonstrate the lengths to which an activist is willing to go to achieve its goals. A great example is Elliott's ongoing campaign against AkzoNobel NV. Elliott initiated the campaign by pressuring the combination of Pittsburgh, PA based PPG Industries, Inc. with the Amsterdam based paint and coatings company. As the Elliott campaign continued, PPG lost interest after many failed bids, yet Elliott held out, seeing the ouster of the company's CEO and chairman, agreed upon the new CEO as well as three new board members and aligned on the strategy to separate the company's specialty chemicals business.

R&C: What, in your opinion, were the most notable features of the 2017 proxy season in the US? What do the assets under management and campaign volume numbers tell us about activism in today's market?

Frankl: There were fewer proxy fights this year, with only 71 announced through July, compared to 99 in the same period last year. This decrease highlights how frequently companies are settling with activist investors. Instead of pushing through a potentially damaging fight, pressure caused some companies to acquiesce to activist demands and accept, in some cases, unfavourable settlement terms. Activists were successful in reaching settlements primarily due to an increase in institutional support. As the strategy evolves, more traditional funds have embraced the tactic and even publicly endorsed activist campaigns or collaborated with an activist to target one of their portfolio companies. A by-product of the muscle that institutional funds have shown is an increased focus on environmental, social and governance (ESG) activism.

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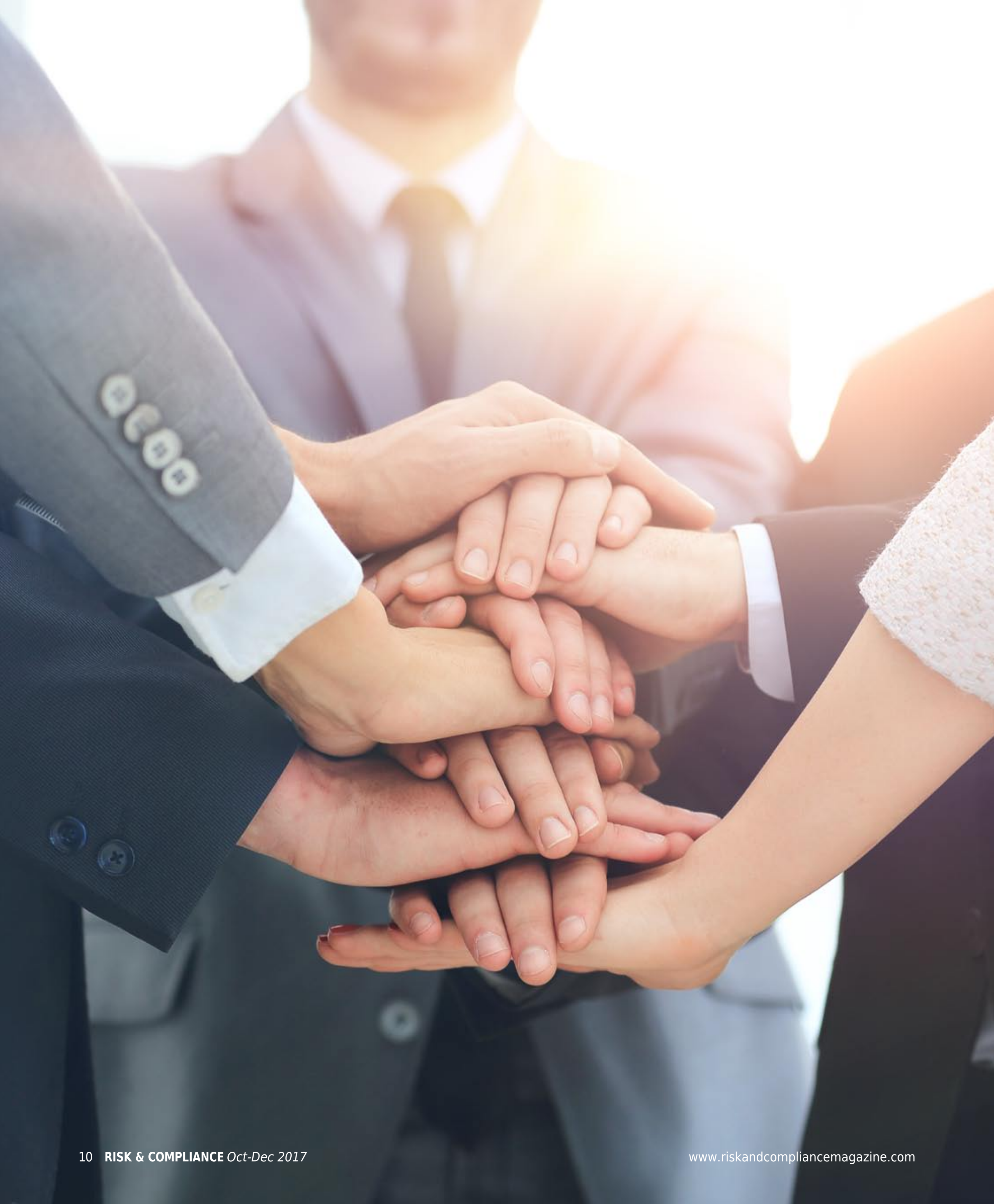
Derem: During the 2017 proxy season, shareholder proposals related to climate change disclosure received significant attention from



investors. Several large institutional investors were more vocal in their support for proposals seeking company reports on the impact of climate change policies, and for the first time, three proposals received majority shareholder support. Additionally, seven more proposals related to climate change issues received at least 40 percent shareholder support. Interestingly, analysis of beneficial shares

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Wachtell, Lipton, Rosen & Katz

show that whereas institutional shareholders voted 66 percent of their shares in favour of climate change-related proposals, only 13 percent of voted retail shares were cast in support. Looking ahead to 2018, companies should expect that these topics will continue to be on the agendas of their investors.

Katz: Activists in the US are targeting more companies pursuing an operational activism agenda. Operational activism is much harder to pursue as it often takes 18 months to three years to see results – requiring a significantly longer investment timeframe for the activist. The current Proctor and Gamble proxy contest by Trian seeks to add a single activist director to the P&G board and Trian has made it clear that it is not seeking either a change in management or sale of the company. We have seen a number of activist situations go to proxy fights in 2017.

Crozier: The most notable features of the 2017 proxy season were: the continuing trend toward more campaigns waged by 'reluctavists', or first-time activists, targeting smaller sized companies; the increase in M&A activism; and a focus on 'alpha by decapitation', essentially the removal of the CEO. Approximately 20 percent of US public campaigns in the past proxy season were waged by first-time activists, while approximately 80 percent of all US campaigns targeted micro cap or small cap issuers. There were approximately 130 M&A focused activism campaigns in the US last year seeking to block a transaction on the buy and sell sides, as well as more traditional efforts to seek a sale or breakup through a review of strategic alternatives.

R&C: To what extent is the disruptive threat of activism forcing corporate boards to improve their understanding of shareholder expectations, in order to address activist concerns should they be targeted?

Derem: All varieties of activism are forcing companies to understand more than just their shareholder's expectations – they also need to garner a more comprehensive view of their shareholder composition. More companies are utilising risk assessment tools to understand who their investors are, how that may be changing on a regular basis and whether such investors have taken an activist position in the past. While this does not prevent an activist situation, it does enable the company to proactively prepare and engage other shareholders in the event that an activist takes a stand.

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>
> *Jason S. Frankl, FTI Consulting*

Frankl: Most boards of directors have taken note that a shareholder activist could knock on their door with a list of criticisms or demands at any point. Neither size, nor performance are deterrents to activists anymore and, as such, boards and management teams are becoming aware of the need to create an activism playbook before an activist arrives. This means that companies are assessing their weaknesses from the perspective of an activist and building out what a strategic communications plan would look like in order to be able to respond quickly, intelligently and to stay on-strategy. Second, it is helpful for a board to hire an independent adviser to review its bylaws in order to create a robust, detailed director nomination and vetting process to show consistency should an activist investor make a nomination.

Crozier: Particularly in the US, few companies feel invulnerable to an activism campaign. Even successful companies, such as ADP, have been the subject of activism. Directors who have been targeted at other boards or have heard gory war stories from targeted colleagues are demanding that management have a strategy in place to address likely shareholder concerns that could give rise to an activism campaign. As a result, companies are actively engaging with their institutional investors to hear their concerns. Directors often participate in these engagements so the board can hear any issues directly. Director participation can also encourage greater candour by the institutions and, most importantly, develop credibility regarding the board's efforts to create shareholder value by responding to shareholder concerns.

Katz: Many public companies are engaging with their shareholders on a more frequent basis to attempt to better understand their concerns. In addition, many companies try to view themselves from the perspective of an activist to see if any of the activist strategies make sense and to develop defences against those strategies that do not make sense.

R&C: What advice would you give to boards in terms of assessing and preparing to respond to a shareholder activist campaign? What options are available to work with activists and find common ground or, conversely, to demonstrate that their own strategy is the best course of action?

Katz: Management teams need to be proactive and make sure that they remain aligned with their board of directors. Boards do not like to be surprised and it is important that the first time a board member hears about an activist it is from the management team, not the activist. Therefore, we urge management teams and, where appropriate, boards, to engage with activist investors early. This often allows there to be private dialogue, as opposed to a public dialogue, which often makes it easier to convince one party or the other that it does not have the right facts. If the activist can be convinced before the situation is public, it is more likely to go away where it does not need to acknowledge a public loss. In addition, companies can often pursue their own strategies that may be supported by the activist so long as the company gives the activist at least some credit for the strategy.

Crozier: The most important thing is to understand the shareholder base, not just who the shareholders are, but why they are invested in the company, in order to identify the critical elements in defending against an activist campaign. Only then can the company realistically assess its options and develop a communications engagement strategy to position itself as effectively as possible under the circumstances. To reach that level of understanding, the evaluation process must be rigorous and sceptical, particularly with respect to the views of large, long-term holders who, while not openly antagonistic, may be frustrated with their investment and attracted to an activist's commitment to catalyse greater value creation. Targeted companies need to engage with the activist since failure to do so will enable the activist to portray the company as unresponsive to shareholder concerns, a potentially fatal characterisation if other shareholders and the proxy advisory firms agree. Such an engagement can lead to a satisfactory resolution under the circumstances if the company has an accurate understanding of its chances in a proxy fight, the ultimate weapon for almost all activists.

Frankl: It is critical for boards to have a defined plan in place prior to an activist campaign. These plans should be developed and tested by a third-party adviser. Part of the preparedness plan should include a perception study of the company's current shareholder base and an assessment of communications to investors to determine whether it is adequately explaining its strategy in a measurable way. Therefore, when an activist does arrive, the board will be in a position to listen and engage in a dialogue with the activist, and then weigh the pros and cons of the activist's proposed strategy against the existing framework. Additionally, if an activist goes public with its demands, the company will be able to convey to shareholders the reasons why the board has approved or refuted the activist's thoughts on strategy and execution, based on the effects it would have on the quantitative and qualitative metrics laid out in its original strategy.

Derem: Technology is changing how communications strategies are being developed and executed, especially with respect to the one-third of shares, on average, that are owned by retail shareholders. The retail segment is particularly critical for micro-cap companies in the US, for which retail investors represent 71 percent of the shares. Big Data enables better analysis of shareholder composition, communication preferences and voting habits so that companies can better tailor communications to this segment, especially when facing an activist situation. In the case of Arconic Inc.'s proxy battle with Elliott Management this spring, Elliott sent an electronic video player to certain retail shareholders explaining why shareholders should support its position.

R&C: How do you expect shareholder activism to evolve across the globe in the years to come? In increasingly sophisticated capital markets, to what extent might shareholder activism become the strategy of choice and the 'new normal' in future?

Crozier: While the total number of campaigns has declined slightly recently, there are no signs that activism is going away – it is now a globally accepted investment class. Activist hedge funds have approximately $120bn in AUM, non-traditional activists, including long-only, actively managed traditional institutional investors, are increasingly adopting the strategy and successful home market activists are present in all sophisticated capital markets, including Japan, long considered the market least likely to respond to public activism. It is likely that shareholder-friendly reforms to corporate governance codes, laws and regulations, such as the ongoing amendments to Germany's corporate governance code, the Deutscher Corporate Governance Kodex, will further accelerate the use of shareholder activism globally.

Katz: Management teams around the world will continue to be vulnerable to activist strategies. In the coming years though, I think that institutional investors will be more willing to push activist strategies rather than depending upon activists shareholders to be the catalyst. We are starting to see this in the US and there is no reason why it will not spread around the world. However, the focus needs to remain on what will create long-term shareholder value as that should drive the strategy of choice.

Derem: Investment dollars tend to follow success, so to the extent that activist hedge funds outperform the rest of the market, we can expect more inflows into these types of strategies. However, activism comes in different forms. Activism in the form of shareholders flexing their rights, demanding disclosure or action, and exercising their right to vote, even against management, is unlikely to dissipate anytime soon. Therefore, companies should take proactive steps to understand their shareholder base, understand their engagement preferences, and utilise technology to alter how communications strategies are developed and executed.

Frankl: The global expansion of shareholder activism has gained so much momentum over the past few years that it would be hard to imagine countries closing themselves off to the strategy. Even in the Netherlands where lawmakers proposed legislation that would provide an avenue to avoid foreign takeovers, shareholder backlash caused the government to reconsider the long-term effects on investment opportunities in the country. R&C