IR magazine

Special Report

Responding to activism: A blueprint for IR

A guide for investor relations teams that want to understand how activists think and prepare their company for engagement

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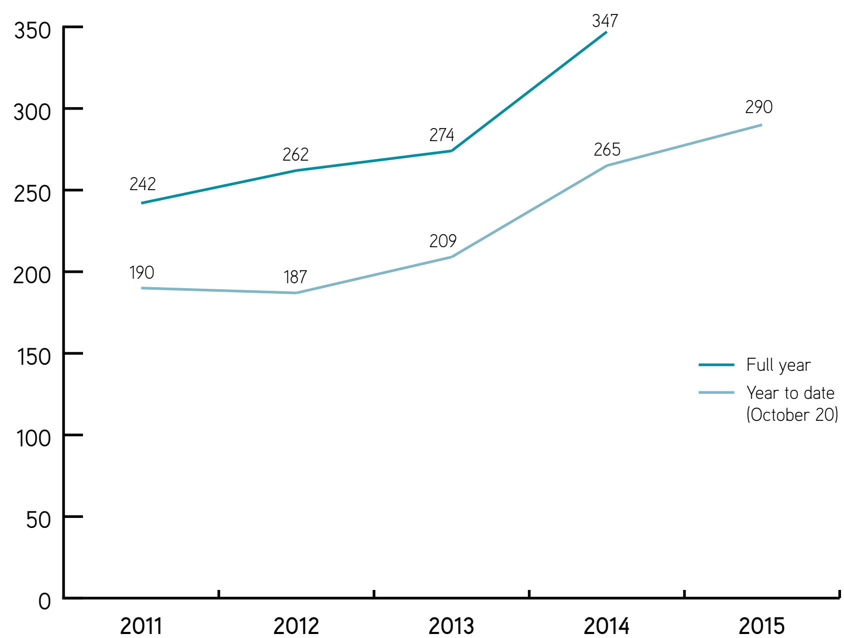
US activist campaigns announced



Source: FactSet

By almost any measure, investor activism is on the rise. Tyson McCabe, senior director at NASDAQ Corporate Solutions, Advisory Services, points out that the number of activist interventions nine months into 2015 had far exceeded the activist events for all 12 months of the prior year. Wes Hall, CEO and founder of Kingsdale Shareholder Services, explains that not only has activism become its own asset class, but this asset class is also a raging success as dollars continue to flow into activist funds. 'Activism is the only asset class making money at the moment,' he says.

Everyone loves a winner, and activists have been steadily logging more victories with each passing year. Hall estimates that more than 50 percent of the time activists now score a win. 'Activists may not get a seat on the board but, in the majority of the cases we've tracked, they get a subset of what they're asking for,' he says. He also points out that after an activist campaign has concluded, companies often implement the very suggestions the activists made.

Meanwhile, Eric Brielmann, partner at Joele Frank, believes the growth of activism should not be wholly unwelcome news for IR professionals: 'Given the rise of activism, the role of the investor relations officer has become much more important. IROs are the canaries in the coalmine. They're usually the first point of contact with a company when an activist comes knocking at the door, and they have a seat at the table when discussing engagement strategy with the board and management team.'

ACTIVISTS TARGET A BROADER RANGE OF COMPANIES

One sign of the growing ambitions of activists is the size and reputation of the companies they're targeting. With Apple, DuPont, American Express and General Motors all having been approached by activists, it's clear no company is too large or too highly regarded to be immune. 'The targets have become much bigger over the past few years,' observes Hall. And the trend shows signs of continuing given that the more capital that flows into the activist asset class, the bigger the quarry activists can pursue.

It's not only the targets that have changed, but also the activists. Josh Black, editor of *Activism Monthly* in London, says 'activists have gained a much more attractive image, certainly since the financial crisis.' He notes that today's most prominent activists are less interested in takeovers, and rather more attuned to the corporate governance agendas favored by large institutions.

Rob Berick, senior vice president and managing director at Falls Communications, a Midwestern communications and IR firm, says the 'scarlet letter' that activists have figuratively worn has disappeared – and activists are sometimes even being portrayed as heroes. 'Activism doesn't have the same stigma it used to have,' he says. 'They've gone from being corporate raiders to being shareholder guardians.'

McCabe points out that portfolio managers and analysts who have gained experience at successful activist funds are starting up their own ventures, while the children of known activists are getting into the game as well. For instance, Matthew Peltz, son of founder Nelson Peltz, is now working at Trian Partners, and Carl Icahn has funded his son, Brett, and placed him in charge of the Sargon portfolio.

In an April 2014 interview with CNBC, Carl Icahn suggested he could spend as much as $1 bn seeding new activist funds in the future: 'Activists are so important, and there are bright young guys who need funding for that.'

WILL ACTIVISTS GO GLOBAL?

'Activists are continentally agnostic in the sense that an opportunity is an opportunity,' says Dan Romito, senior analyst in global targeting and special projects at NASDAQ Corporate Solutions, Advisory Services.

Hall believes overseas markets are ripe for activism. 'The UK and European markets are looking on in amazement at what's going on in North America, but there are a lot of opportunities for activism there, too,' he says.

Patrick Hughes, senior director at NASDAQ Corporate Solutions, Advisory Services, cites a June 2014 statistic from Preqin's Hedge Fund Analyst: it notes that roughly 40 percent of activist funds have a global or European remit. 'Activists are bumping into each other in the US,' says the London-based Hughes, so it's only logical that more of them are starting to look outside the US. 'European companies know this is not just a US phenomenon anymore.'

Although Hughes is convinced activism will catch on in Europe, it arguably has a slightly different flavor there. He explains that some European activist funds behave differently from their North American counterparts and have far lengthier investing horizons. He also notes that 'high-profile media activist campaigns' are not common in Europe, where activists tend to practice a 'more discreet' brand of change management, sometimes sending to management or the board letters that are never made public.

CASE STUDY
Index funds hop on the bandwagon

Institutional investors have become more willing partners of activists. In a September 25, 2015 Reuters article, Rakhi Kumar, head of corporate governance at State Street Global Advisors (SSGA), an index fund company with $2.4 tn in assets, says US pension funds are asking the firm to take a more active stance toward underperforming companies.

As a case in point, SSGA supported the high-profile campaign in which Starboard Value forced Darden Restaurants to replace the company's entire board. Although Kumar emphasizes that the company is not eager to assume the role of an activist, she does acknowledge: 'We engage with activists.'

CASE STUDY
Elliott takes activism to Asia

Earlier this year, US-based Elliott Associates launched a highly publicized campaign to block an $8 bn merger of two Samsung affiliates, proving that Asian companies are not immune to American-style activism.

Although the merger passed with 69.5 percent of shareholder votes cast, the contest was considered a rallying cry for those more generally critical of South Korean companies' corporate governance policies. In this sense, wrote reporters for the *Wall Street Journal* on July 17, 2015, 'opponents of Samsung's controversial merger have lost the battle, but may be winning the war.'

II. Thinking like an activist

'To know your enemy, you must become your enemy' is a saying Berick employs to illustrate the imperative for IROs to understand the activist mind-set. Even with so much media attention spotlighting the rise of investor activism, however, many IROs and senior management teams are still startled when an activist surfaces close to home.

'Too often, we're finding companies are behind the eight-ball when it comes to being prepared for recent activist campaigns,' says Jonathan Eyl, director at NASDAQ Corporate Solutions, Advisory Services.

Hall agrees, noting that forward-looking companies that cultivate an activist perspective are better positioned to communicate about problems and articulate a plan for righting situations before an activist arrives and seizes control. 'If you're not looking at your weak spots – and you're not telling shareholders what you're doing to fix the weaknesses – somebody will show up and do it for you,' he says. 'Every single executive should be looking at his or her company like an activist would.'

When vulnerabilities are spotted, Hall advises immediately approaching senior management and the board and explaining the situation as fully and candidly as possible.

CONDUCTING A VULNERABILITY ASSESSMENT

Of the many red flags for identifying which companies may become activist targets, the largest and most glaring is arguably a company's performance relative to peers, says Bruce Goldfarb, president and CEO of Okapi Partners in New York.

Another red flag is excess cash, says McCabe, who points out that investors are increasingly pushing for a break-up of businesses that don't necessarily belong together. 'When the growth profile of one line of business is substantially different from the others, we find those companies to be potentially susceptible,' he says.

Governance is also increasingly coming under the microscope, adds Black. A company may be vulnerable to activism when there is 'a high level of shareholder discontent, whether that's reflected in say-on-pay votes or annual meeting votes against directors,' he points out. Even issues of succession can come into play. Companies with a very new CEO or those whose chief executive has grown stale may find activists are pushing for changes at the helm, Black says.

Romito points out that activism might potentially come into play 'whenever you're not optimizing the dollars investors have given you.' NASDAQ, for instance, has created an activist diagnostic based on 250 US activist events that occurred over a 30-month period. Given that activists are concerned with a company's performance relative to the broad market, NASDAQ's activist diagnostic takes into account several metrics, including relative value, total yield, dividend payouts, forward-looking consensus growth, capital structure and capital efficiency. 'Activists are methodical creatures of habit,' says Romito – so predicting where they might strike is challenging but do-able.

Although the conventional wisdom is that any company might find itself an activist target, Romito observes that only 40-45 S&P 500 companies rank high on NASDAQ's vulnerability meter. 'But if you are vulnerable, you had better bank on the fact that you're going to be drilled,' he warns.

CASE STUDY
CalSTRS and Legion push Perry changes

Legion Partners Asset Management may not have the activist credentials of a Carl Icahn, a Relational Investors or a Pershing Square, but when Legion teamed up with CalSTRS to push governance changes at Perry Ellis International, the duo saw results.

Perry Ellis appointed two new independent directors and the stock price rose from $17.50 a share in July 2014 to just over $25 in June 2015, when Legion canceled its short-slate proxy contest. With pension funds and traditional long-only funds demonstrating an increased appetite for activism, many believe the success of these efforts will grow.

IMPROVED SURVEILLANCE

Equity surveillance was born in the 1980s, when corporate raiders first showed up on the scene, says McCabe. For decades now, IROs have relied upon surveillance and market-watch services as early-warning systems that detect when an activist might be amassing a position. While surveillance has become more sophisticated over the years, so has the activists' ability to operate beneath the radar. Savvy activists now approach companies in a variety of different ways to increase their odds of remaining undetected – and these tactics are continually evolving.

One tactic is to buy investment vehicles other than equities. 'For example, it can be a lot cheaper and a lot more covert to amass a stake in a company via some sort of derivative swap agreement,' says Eyl.

Hall says that in the depressed energy space in Canada, activists have started buying bonds rather than equity. 'There are a lot of great companies out there, but as a result of where [the price of] WTI [crude oil] is, you can pick up debt at a steep discount,' he explains. 'It's a low-risk strategy because the debt is generally secured against the assets of the business.'

For IROs, the takeaway is to look beyond equity rosters to other types of corporate investors. 'In this climate, I'd be looking at the bondholders,' Hall says. 'They can force you to do things you don't want to do.'

Steve Wolosky, head of the activist practice at Olshan Frome Wolosky in New York, confirms that as companies make greater use of market-watch services, firms like his help 'clients take on a position to reduce the possibility they'll be identified prematurely.' To illustrate, he notes that companies often detect activists by tracking buying activity at various clearing houses. He therefore advises clients to clear through half a dozen brokerage houses to reduce the likelihood of being identified.

MORE NEW ACTIVIST TACTICS

With the myriad changes in the activist landscape, some activist tactics have changed, too. While historically it was necessary to have a 5 percent or greater stake before making demands, activists with smaller stakes are now also voicing concerns. 'Because activists have strong reputations, they don't have to commit to a 5 percent stake before sending letters to the board,' says Eyl. 'Their presence alone can make management start thinking about making changes.'

At the same time, many activists are increasing their clout by joining forces with mainstream institutional investors. 'Activists are gaining momentum by having more conversations with traditionally long-only, plain-vanilla institutional investors that have historically been on management's side regardless of what's going on in the company,' Eyl continues. 'When activists take their case to the board, not only do they have their own stake, but on occasion they now also have the support of passive assets under management showing increasing scrutiny over governance matters.'

Sometimes traditional, value-oriented or growth investors are even approaching activists on their own initiative, observes Romito. 'Portfolio managers are saying, *Hey, we have this dog in our portfolio. Would you mind taking a look?*' he says. 'And that's a huge transition from three years ago, when activists operated on their own little islands.'

Matthew Sherman, president of Joele Frank, has observed a similar phenomenon. 'Long-only funds are now putting out RFAs if they can't get through to management teams,' he says. An RFA, he explains, is the colloquial term for a 'request for activists' or a plea for activists to get involved in situations where management teams have proven intractable. 'Activism is not just for the activists anymore,' Sherman says. 'Traditional institutions are really taking this seriously.'

CASE STUDY
Activists team up against VAALCO

Activists are finding allies in unlikely places – sometimes even among their competition. 'More and more, we see groups of two or more activists working together on the same targeted company,' says Steve Wolosky, head of the activist practice at Olshan Frome Wolosky.

In October, activists Bradley Radoff and Group 42 co-signed a letter to VAALCO Energy's board of directors, charging the company with 'abysmal' governance practices. In the first line of the letter, Radoff and Group 42 point out that collectively they own 11.1 percent of outstanding stock – a number that's distinctly more impressive because of the activists' joint efforts.

III. Preparing your company for engagement

CASE STUDY
Confronted by activists? Some settle fast

In August, less than a week after emerging as a large investor in Sysco, Trian Partners gained two board seats, averting a fight over boardroom control. In July, Citrix Systems entered into a co-operation agreement with Elliott Management, once again with stunning speed.

'In the last couple of months, I see a trend of things settling very, very early,' says Steve Wolosky, head of the activist practice at Olshan Frome Wolosky. On the other hand, he says those companies that don't immediately bow to activist pressure will often see a fight to the bitter end. As examples, he cites the pending votes at Anchor BanCorp and Casella Waste.

The best way to ward off activists is to communicate candidly, making your strategy and story known, as Berick puts it: 'I believe the companies that define themselves make it harder for [activists] to define them in their own terms.'

'Listen to your long-term investors and be sensitive to signs of concern from them,' advises Hughes. He praises governance roadshows as an excellent way of communicating with shareholders proactively, hearing concerns and explaining a company's strategy before a problem arises.

While a savvy IR communications plan can help ward off activists, it still pays to be prepared. 'We're seeing companies putting together an activist playbook to make sure they have clear expectations internally: if X happens, what's the output? Who owns it? Who's my team? Who am I using as a proxy solicitor?' says McCabe.

Beyond assembling an internal team, IROs need to consider how they will communicate more broadly within their own organizations, McCabe suggests. 'A key question to ask is: what am I doing as an IR professional to make sure management is knowledgeable about the landscape?' he says.

WHEN AN ACTIVIST CALLS…

Almost everyone agrees IROs need to be responsive to activist overtures. 'An IR professional who stymies an investor can turn up the heat faster than someone who's willing to be communicative,' says Goldfarb. And Romito agrees: 'With activists, you're guilty until proven innocent.' He therefore encourages IROs to reply fully and to consider how best to communicate their stories.

Brielmann raises similar points, but advises IROs to proceed cautiously. 'We advocate a thoughtful engagement strategy, but when meeting with an activist, it's wise to have someone else in the room,' he recommends. 'You want a third party to take good notes so you'll know exactly what was asked and what was said.'

IROs often find themselves performing a delicate balancing act in these situations because they need to dissuade senior management from becoming overly defensive. Some activists, like Dan Loeb, are notorious for writing scathing letters that make personal attacks on management, but it's never wise for senior management to take the bait.

'CEOs and CFOs, when they get such a letter or demand, can take it personally because they may have an alternate view as to why the company might be vulnerable,' says Romito. 'In their eyes, it's their company and they think they're doing a great job. Activists want to ruffle the feathers of senior management and the board. It's a trap.'

How the company responds during a delicate activist confrontation can make a huge difference. 'Five years ago, if an activist approached, a company might have circled the wagons, but the playbook on the company side right now is engagement,' notes Wolosky. That said, he draws a distinction between meaningful engagement and posturing. 'Sometimes, it readily becomes apparent that a company is just talking because the playbook is to talk,' he adds. 'But if you're not dealing with the substantive issues, that can have a detrimental effect.'

TIPS FOR MEDIA RELATIONS

Carl Icahn has famously made Twitter an important tool in his activist arsenal. But IROs are often reluctant to use traditional and social media to get their corporate stories across to investors and the general public. Black points out that cultivating journalists on the activism beat is usually a wise strategy, given that public opinion can play a role in the outcome of a shareholder vote.

Whether it makes sense to launch a response on social media may depend on your social media stance to date. 'It's very hard to make a start on social media in a time of duress if you haven't cultivated that particular channel already,' explains Berick. 'Otherwise, you're just talking to yourself.'

Regardless of whether companies use Facebook, LinkedIn or Twitter to proactively tell their stories, they should at least be aware of what's being said on the social media channels. Berick suggests using 'social media so you're not caught off guard. You need to know what's being said and what kind of influence it's having on the larger discussion.' For those companies that *do* use social media when faced with an activist threat, 'you want to be nimble in responding, but you don't want to be emotional,' he explains. 'Where there's an approval chain, there might need to be a change so companies are more nimble and able to respond more quickly.'

WHEN AN ACTIVIST JOINS THE BOARD

How difficult life will be once directors handpicked by an activist join the board depends on how acrimonious the fight was – and who is ultimately selected to enter the boardroom. McCabe believes once board composition has shifted in favor of activist input, it's time to mend fences. 'Once an activist joins the board, that suspends a lot of the hostility,' he says. 'At that point, you're all in it together, particularly if it's a non-independent director and an appointee from the fund itself.'

Sometimes even companies that fought hardest to exclude activist intervention come to find that an activist's ideas have merit. 'We're seeing an awareness that the provenance of good ideas does not rest solely with management,' says Goldfarb. 'As an IRO, you have to remember that activists are deep-value research analysts at their core.'

Although activists are often accused of being preoccupied with short-term gains, there is some evidence activism may help a company grow stronger. In *The long-term effects of hedge fund activism*, Harvard Law School professor Lucian Bebchuk and others argue that of the roughly 2,000 interventions at companies by activist funds between 1994 and 2007, share price and operating performance improved, on average, during the five-year period after the activist event occurred.

And beyond the possibility for positive change, IROs may want to make peace with investor activism out of sheer pragmatism. 'In terms of activism as an approach to creating value, we will always see underperformers in the corporate world, and in some of those cases, there will be an opportunity for an activist to unlock value at that underperforming company,' concludes Goldfarb. 'I don't think activism is going away any time soon. The process of being more vocal about how you can create value is part of the landscape now.'

CASE STUDY
Dueling hashtags distinguish eBay fight

Last year, when Carl Icahn made a play for board representation at eBay to force the company to sell PayPal, he publicized his arguments on Twitter. But two can play the social media game, and eBay responded with tweets like this: '@PayPal and @eBay are #bettertogether.' It also bought ads on various search engines, including Google, to bring its ultimately unsuccessful case against Icahn to a wider audience.

IV. Q&A with an activist

Corporate governance guru Greg Taxin, co-founder and former CEO of Glass Lewis, famously became an activist three years ago when he joined the Clinton Group as president. He recently launched his own small and mid-cap activist fund, Luma Asset Management.

ARE ACTIVISTS TODAY DIFFERENT FROM ACTIVISTS IN THE PAST?

I think so. They've got a lot more capital and are able to take larger positions and positions in larger companies. They have also become much more professional in their approach to companies and in their analyses. There was a day when a couple of whippersnappers with a few bucks could publish a letter that might have been half-baked. Today's activists have more resources, analysts and advisers to help them, so the work they do is better quality.

ARE THERE THINGS IROS DO WHEN IT COMES TO DIALOGUE WITH ACTIVISTS THAT THEY REALLY SHOULDN'T?

Failing to identify people in the stock who are unhappy is the first failure; the second is not quickly running it up to senior leadership and boards when they are contacted by such people. Nothing gets activists more exercised than the failure to be able to communicate and reach people they want to have a dialogue with.

There are also things companies have done poorly in responding to activists that aren't solely on the shoulders of the IR department. One is giving short shrift to an activist's suggestions or using tired canards like: 'Our long-term shareholders understand our strategy' or 'We've considered all of these ideas and suggestions before and rejected them and see no reason to revisit them.'

WHAT ARE THE RED FLAGS THAT MAKE A FIRM SUSCEPTIBLE TO ACTIVISTS?

I would caution against simple mathematical screenings or taking solace that the firm's stock is up in a given year or even has performed better than peers. What I think activists are increasingly looking for is gaps between potential and reality, rather than the historical mathematical lines on the chart.

WHAT GOVERNANCE PROBLEMS MAKE A COMPANY A LIKELY TARGET?

A governance structure can make a company vulnerable to a persuasive activist having success with fellow investors. Having these hyper-defensive corporate governance provisions actually makes you more vulnerable, not less. They give the activist more fodder for claiming the management team isn't being held accountable, can't be held accountable and doesn't want to be held accountable.