CEO PERSPECTIVES®

CEO Perspectives
Leadership Discussion Series
April 21, 2015

Changing the Landscape of Corporate Governance

About the Event

On April 21, 2015, *CEO Perspectives* held its second Leadership Discussion Series event to provide the community of Fellows continued access to business and leadership insights, as well as ongoing networking opportunities. The event focused on how corporate boards and executive leaders can work together to understand, anticipate, and manage activist investors.

The program was introduced by Cheryl Francis (Co-Chair, Corporate Leadership Center) and moderated by Sheila Penrose (Co-Chair, Corporate Leadership Center). Speakers included Paul Choi (Sidley Austin LLP), Tom Cole (Partner & Former Chairman, Sidley Austin LLP), and Kristen Rossi (Co-Head Midwest Investment Banking, Managing Director Consumer Retail, Morgan Stanley). Each shared insights related to the shifting activist investor landscape, and how to best address it.

We are grateful to all presenters and participants for their insights.

Key Insights Summary

No One is Safe. With activist investors growing in number, level of sophistication, and success—and with companies keeping more cash on their balance sheets—the risk of being targeted has increased. Even strong performers are susceptible in this environment. Everyone needs to be prepared.

Vulnerability Expands. Activists orient around governance, corporate social responsibility, or value. Vulnerability in one domain can lead to susceptibility in another. Value-focused activists often recruit long-only funds to their cause through connections with buy-side analysts.

Key Insights Summary (Cont.)

Sophisticated Tactics. Tactics have become more aggressive and sophisticated. Activists develop comprehensive whitepapers to express a point-of-view about the target, retain expert financial advisors, and nominate high-quality directors as part of a strategy that plays out through well-established escalation paths.

Plan Ahead. Savvy companies and their boards plan ahead by assembling outside advisors, anticipating activist actions, and even using simulations of worst-case scenarios. They write bylaws to help sidestep activist nominees, and understand the pros and cons of poison pills.

Engagement over Entrenchment. Given activism's ubiquity and success, strategic engagement beats entrenchment. Work hard for behind-the-scenes resolutions to uphold shareholders' best interests. Engage carefully with activist directors, regardless of their agenda.

No One is Safe

Activist investors have more capital ($120B in 2014), enjoy more acceptance from the investor community, and have mounted more annual campaigns (212 campaigns against $500M+ companies in 2014) than ever before. Several factors drive these trends:

- Compelling results. As activists succeed in generating financial returns and replacing directors (73% success rate in 2014), more activist funds (25 fund launches per year since 2004) and campaigns are expected; even small post-activism rises in stock price are seen as victories.
- Performance no bar. While underperforming firms have traditionally been targeted by activists depending on their balance sheets, even strong companies are vulnerable.
- More target areas. Beyond traditional strategy and financial issues, activists are increasingly targeting governance, social, and environmental issues.
- Cash hoards. Large amounts of cash on corporate balance sheets are attractive targets for activists.
- Alluring settlements. A rise in settlements with activists means more campaigns. "If you settle, they will come."

Three Types of Activists

Dealing successfully with activist investors requires understanding their three basic orientations and how vulnerability in one sphere can lead to susceptibility in another.

- *Governance.* These activists focus on issues including executive compensation, staggered boards, and majority voting, with recent success in matters related to proxy access (see recent GE example). Activists seek increasing "engagement" around governance issues. In this area, corporate leaders need to keep in mind disclosure requirements including Regulation FD.
- *Corporate Social Responsibility.* These activists mount campaigns related to CSR areas including employee welfare, climate change, biodiversity, and others.
- *Value.* Top activist funds in this class include Corvex Management, JANA Partners, and Trian Partners. Their focus encompasses M&A (sale or spin-off), balance sheet (such as share dividends), and income statement or operations (including management change). Led by "celebrity" activists, these funds are growing in number and size and have developed varying levels of operational expertise. This can help them persuade even long-only funds to back their causes, especially when they have connections with buy-side analysts at those funds.

Multiple Campaign Types

Activists can launch one or more of these campaign types:

- *Return the cash.* Activist investors target excess balance-sheet cash (as Icahn did with Apple and Transocean). To defend, think carefully and proactively about optimal capital structure and deploy capital strategically.
- *Split the company.* Non-synergistic portfolios are particularly vulnerable to this strategy. (Fortune Brands is a recent example.)
- *Sell the company.* This has become a popular activist strategy in the current low-interest-rate environment. (PetSmart acquisition in late 2014.)
- *Operate better.* A push for more effective operations is often about changing the management team to inject "new blood." (Recent P&G example.)

Well-Established Escalation Paths, Sophisticated Tactics

Activists typically pursue a well-established pattern of escalation that proceeds through several stages:

- *Accumulation of an initial stake* (to establish a toehold).
- *Private engagement* (meetings requested with management).
- *Public announcement of stake* (through filing, public statement, or leak).
- *Public agitation* (to stir up third-party interest).
- *Proxy fight* (submission of director nominees and/or "non-binding" proposals).

There is a growing set of tactics related to this pattern:

- *Whitepapers/Town halls.* Detailed, often public presentations of their case for change, sometimes based on the "simple math" of value creation (Trian with Pepsico).
- *Retention of financial advisor.* This credentials activist positions and theses (Corvex with Williams).
- *High-quality director nominees.* As director nominee quality has increased, this tactic has become more successful (Pershing Square with Canadian Pacific).
- *Partnership with long-only investors.* This can be a formal (filing of joint 13D) or informal partnership with an institutional investor (JANA/Ontario Teachers with McGraw-Hill).

The Best Defense

The best defense against activist investor campaigns involves understanding types and tactics to better wield effective, reinforcing strategies.

Monitor the legal part. Some shareholder proposals have made proxy access easier. At the same time, the Delaware courts have become more sympathetic to activist targets, including the Blasius case ruling, which frowned upon board action that interferes with stockholder votes. Current rules, however, do not prevent formation of "wolf packs" based on activist signals, resulting in toehold investment levels. Pay attention to filed investment schedules (such as 13D/G) and be careful with shareholder derivative positions. You can't detect every toehold, but you can plan ahead.

Plan ahead. Advance planning includes assembling a team of outside advisors (financial, counsel, PR, and others), anticipation of activist arguments and actions (including worst-case scenarios), and development of strategic responses (including full-blown simulations). For example, a 13F filing will result in an onslaught of calls. Be prepared to call a board meeting and never send hazardous emails (see Sotheby's case). Consider bylaws disqualifying director candidates who receive outside-of-company compensation. Understand the limits of poison pills. This tactic won't stop an activist content to stay below a 10% shareholding level, for example.

Don't count on regulation. Regulators tend to advocate a "self-help" approach to activism, with generally vague provisions regarding wolf packs and other activities. Similarly, the ISS supports the idea of adding "new faces" to boards. These stances leave the door open for activist campaigns.

Work backstage where possible. Behind-the-scenes resolutions that yield sensible compromise can be ideal. Strategic private engagement with the activist may even lead to hoped-for desisting (CF Industries achieved this with Third Point). Or preemptive settlement for a board seat may resolve the issue prior to a proxy fight (Hertz did this with Icahn). Don't be reflexively anti-activist: they may spend years developing recommendations for your company, and they may be right. Engagement is almost always a better strategy than entrenchment.

Fight the fight: Public, painful proxy fights can result in everything from settlement for board seats (eBay) to the rejection of activist director nominees at the annual meeting (Agrium). The guiding principle for handling such fights: the best interests of shareholders. This includes counteracting activist misinformation, assessing board and activist director candidates carefully (some candidates may be constructive) and considering adopting a pill.

Engage with activist directors. If you end up with an activist on your board, strive to understand their personality and the value they may bring. Activist directors are often the best-prepared based on their team's research, so it's not wise to treat them as second-class citizens or withhold information (but do have them sign a confidentiality agreement). Remember, they have only one vote. Focus on what's best for shareholders.

Value of Activism

Do value-oriented activists drive short-termism that destroys long-term value? The debate rages on. A recent Economist cover story calls activists, "Capitalism's unlikely heroes." Moreover, some academic studies (including one by Harvard researcher Lucian Bebchuk) find no support for insulating boards from activists. Asset-managers like BlackRock have urged CEOs to resist the pressure of short-term shareholders when this may compromise long-term value. At the same time, the threat of activism may well improve executive-level decision-making.

The only certainty is that activist investors are growing in number, sophistication, and influence, and executives and boards must prepare for activist campaigns.

Additional Reading

"CEOs' Test: Dealing with Activist Investors,"
The Wall Street Journal, November 25, 2014
(https://www.wsj.com/articles/ceos-test-contend-ing-with-activist-investors-1416957944)

"How to Outsmart Activist Investors,"
Harvard Business Review, May 2014
(https://hbr.org/2014/05/how-to-outsmart-activist-inves-tors)

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