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An Active Challenge

Learn what activists are thinking and how you can prepare for them

THE ACTIVIST PERSPECTIVE

Two fund managers share their thoughts on how they target companies.

By Nicole Noutsios

If you take a quick look through recent business headlines, it becomes strikingly clear that shareholder activism is achieving greater levels of influence across a broader range of companies than ever before. Once considered a tool used almost exclusively by niche funds focusing on smaller companies and event-driven themes, shareholder activism has evolved into a strategy employed by a more diverse group of investment managers who are casting a wider net across the investment universe. Even high-performing, blue-chip mega-caps have come under pressure from activists.

We spoke to two activists to get their perspectives on investor activism as an investment strategy and on recent trends in the industry.

J. Daniel Plants is founder and chief investment officer of Voce Capital Management LLC, an investment adviser based in San Francisco. According to Plants, Voce is a fundamental, research-driven investor that takes a long-term, value-oriented approach to investing. Voce also selectively uses public activism to enhance the firm's returns and mitigate its risks. Plants currently serves as a director of Destination Maternity Corporation and Cutera.

Glenn W. Welling is founder and chief investment officer of Engaged Capital, based in Newport Beach, California. Welling explains that Engaged Capital brings an owner's point of view to the governance and decision-making processes and believes that, by working constructively with company management teams and boards, they can be a catalyst for positive change. Taking a long-term perspective, the firm focuses on strong small- to mid-cap companies with undervalued, premium assets that offer multiple paths to value creation. Welling is a director at Jamba, ROVI Corporation, and Medifast.

Growth in Shareholder Activism

During the past few years, there has been considerable growth in shareholder activism as an asset class. Research by HFR reported that assets managed by activist hedge funds have increased to more than $129 billion, more than double what they managed three years ago, and significantly more than the $29 billion activists managed 10 years ago. As more capital flows into activism as an asset class, many high-profile activists are amassing hefty war chests, allowing them to pursue larger, high profile campaigns. For example, there were multiple cases in 2015 in which an activist made billion-dollar bets with larger well-known companies, including Yum Brands, American Express, and General Electric, to name a few.

Welling explains, "The vast majority of the capital inflows into the space have been concentrated among the largest managers, giving them more power to launch campaigns at larger companies. This has also resulted in crowding in the large-cap space with multiple activists in the same investment. Many of the best activist managers have moved upstream to the large-cap world and left a void in the small- and mid-cap space."

Despite news reports that 2015 and early 2016 have been challenging for hedge fund returns, many experts speculate that activism will remain a viable tactic for many of these funds. The two fund managers we spoke with agree that driving a return through an activist strategy can be successful across market cycles.

Plants observes, "2015 was a challenging year, although by sticking to our knitting our holdings appreciated more than 5 percent and marked our fifth consecutive year of gains. We've heard anecdotally that some funds are pursuing fewer contests this year, or perhaps turning to arbitrage or other strategies. We are not changing our strategy.

"Some people think activism is a 'bull market strategy,' but we don't agree. Perhaps it is for purely 'event-driven' activists, but for long-term investors who are active in every one of our investments, there are strategies to create shareholder value at all points in the cycle. For example, refocusing operations or eliminating unproductive investments can make a lot of sense during uncertain economic times. That may not lead to a quick stock price pop, but that's never been our objective. We focus on creating long-term value for all shareholders."

Activists Working With Mainstream Investors

A number of industry trends have supported the rise of investor activism. Institutional investors -- from actively managed to index funds -- have become more willing to support activist campaigns and, in some cases, have provided suggestions to activists. Some traditional funds are putting out RFAs, or requests for activism, if they believe that their feedback is not well-received by management teams. Activists are also capitalizing on this rising trend to engage and often get support from mainstream institutional investors.

In February 2016, BlackRock's CEO, Larry Fink, sent a letter to 1,300 company CEOs across the globe, saying, "Those activists who focus on long-term value creation sometimes do offer better strategies than management. In those cases, BlackRock's corporate governance team will support activist plans. During the 2015 proxy season, in the 18 largest U.S. proxy contests (as measured by market cap), BlackRock voted with activists 39 percent of the time."

According to Michelle Edkins, managing director at BlackRock and global head of its investment stewardship team, "Our observation is that, on the whole, most activist campaigns have some merit. If the issue comes to a vote, such as for a contested slate of directors, we will vote in the way that reflects what we believe would be the best long-term outcome for our clients."

Other asset managers are also jumping on the bandwagon and taking an active stance toward underperforming companies as compared to their peer group. In a *Reuters* article from September 25, 2015, Rakhi Kumar, head of corporate governance at State Street Global Advisors (SSGA), explained, "We engage with activists. It's part of our policy to talk to both sides. We recognize that activists have been successful for a reason, but it is time for us to say we are here for you provided you take us seriously too." As an example, SSGA supported Starboard Value when the company wanted to replace the entire board of Darden Restaurants, Olive Garden's parent company.

"As activism has become more mainstream, as shareholder bases have become more fragmented, and as the misalignment between shareholders and management continues to grow at many companies, traditional funds have turned to activists to help," Welling notes.

Plants sees a natural fit between large traditional investors and smaller activists, but also a limit to what a traditional firm can do. "There are a growing number of institutional investors that want to take on the mantle of activism these days," he says.

"While we believe that large institutional investors have not only the right, but also the obligation, to be heard on issues of importance at their portfolio companies, we also think that effective public activism is a distinct skill set that requires a tremendous amount of experience and a willingness to go 'all in' if necessary. Very few institutions are able to do that and we think that places a ceiling on their ability to effectuate fundamental change by themselves."

Vulnerability to Activism

A number of factors make companies vulnerable to shareholder activism. These can include a depressed stock price compared to a company's peer group, underperforming business units, a corporate strategy that shareholders disagree with, deficiencies in corporate governance or in board composition and structure, excessive management compensation, an unattractive balance sheet, overall negative shareholder sentiment and frustration with the company, among others.

If companies meet any of these criteria, they should consider conducting a vulnerability assessment and monitoring the ecosystem. Some key areas to focus on include monitoring the landscape for activist activity, identifying changes in the shareholder base or signs of investors buying and selling in tandem, understanding negative investor sentiment and frustration, and addressing possible corporate governance inefficiencies. Companies need to be prepared to clearly articulate a strategic plan to key stakeholders about how they will fix any deficiencies.

While Welling starts with the key metric all investors care about, he also points out other concerns companies should take into account. "Number one is share price underperformance," Welling advises. "If you have a history of lagging returns, you are vulnerable. Material deficiencies in margins and/or asset utilization are red flags and areas for activist involvement, as are business units that are perennial underperformers that take capital away from the good businesses in the portfolio."

Plants continued on this theme by digging a little deeper into how he finds and evaluates companies as potential targets: "We are a value-oriented investor, but we do not invest in distressed or broken companies. We invest in fundamentally good companies with sound business models and balance sheets. Yet all of them have issues of some kind impacting their current valuation because, if they didn't, they would be priced to reflect that perfection and therefore unable to clear our demanding return hurdles. Nonetheless, we invest around 'fixable issues' such as capital structure, capital allocation, business mix and/or corporate governance. We seek asymmetric outcomes where our downside is protected (by the business's fundamental strength and balance sheet), but the upside from remediating the issues can be significant."

Tactics to Produce Shareholder Returns

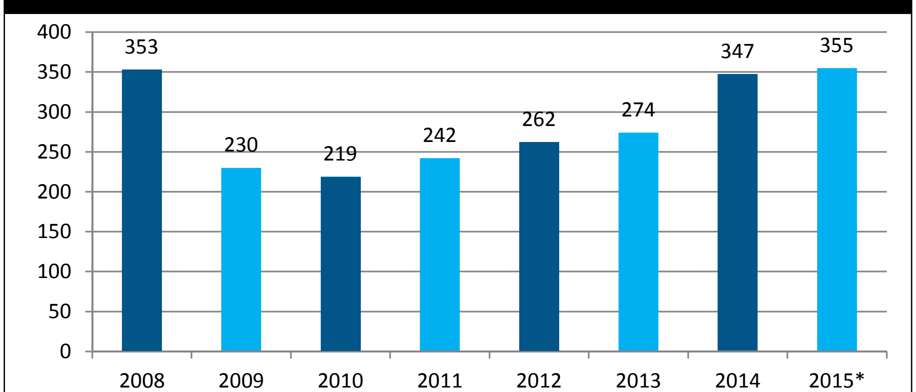
Activists employ a number of strategies to drive a company to greater shareholder returns and operational efficiency. As our interviews showed, an investor can utilize several techniques depending on what is needed at the target company. Options to improve financial performance can include boosting operational efficiencies, such as by selling off underperforming divisions; optimizing capital allocation through dividends and share repurchases; or fixing corporate governance deficiencies, such as board reform. In many sectors that have experienced M&A consolidation, such as technology, pushing to sell the "target" company or orchestrating a merger with another company have also becoming prevailing tactics.

"We focus on all those types of issues and have been successful multiple times with each," Plants notes. "For example, our actions have resulted in substantial returns of capital to shareholders through share repurchases, tender offers, and dividends; the reduction of wasteful spending on frivolous pet projects; and the outright sale of three companies."

One tactic frequently used by activists is winning board seats for themselves or handpicked candidates who are aligned with the activists' visions. Many activists who employ this strategy believe that being involved in the company at this level will enable them to unlock value by being more directly involved with the company's strategy, as well as corporate governance processes.

"Lax governance is typically the culprit that allows issues to arise in the first place,"

U.S. ACTIVISM CAMPAIGN ANNOUNCEMENTS



SOURCE: FactSet. * 2015 as of December 14th, all others full year

Plants explains. “Corporate governance and performance are not separate issues; they are tightly interrelated. Along the way we have fought for and secured many corporate governance reforms, such as adoption of majority voting at two companies, the defeat of a shareholder vote to ratify a poison pill, successful opposition of a shareholder vote to approve a dilutive share issuance, enhanced transparency and disclosures and the termination of related party transactions, and significant board reform, such as the appointment of shareholder representatives and the departure of entrenched leaders, including several long-tenured board members, three chairmen, and three CEOs.”

Change does not happen overnight, and Plants’ comments highlight this point: “We are a long-term investor that uses public activism selectively and usually as a last resort. We focus on strategic and financial issues that we believe will unlock substantial value. We are fine if that takes quarters or even years, as long as the rewards are commensurate with the time and the risks involved in realizing them. For example, we recently resolved a pending proxy contest with Air Methods Corporation. But we have been shareholders there for almost five years, the vast majority of which involved no public activism whatsoever and, with the open issues resolved for now, we remain shareholders going forward.

“I’ll give you another example. Last year we settled a proxy contest with Investment Technology Group and soon thereafter the company disclosed that it was the subject of an SEC investigation (for which it subsequently paid a $20.3 million fine). Not only did we remain invested following the settlement with the board, but we owned more shares than we had prior to the settlement. We then ramped up our involvement and recently entered a second settlement. We remain heavily invested in the company because we believe it has many avenues to create shareholder value going forward. There cannot be any doubt that we are a committed, long-term investor in ITG as proven by our actions.”

Quicker Settlements

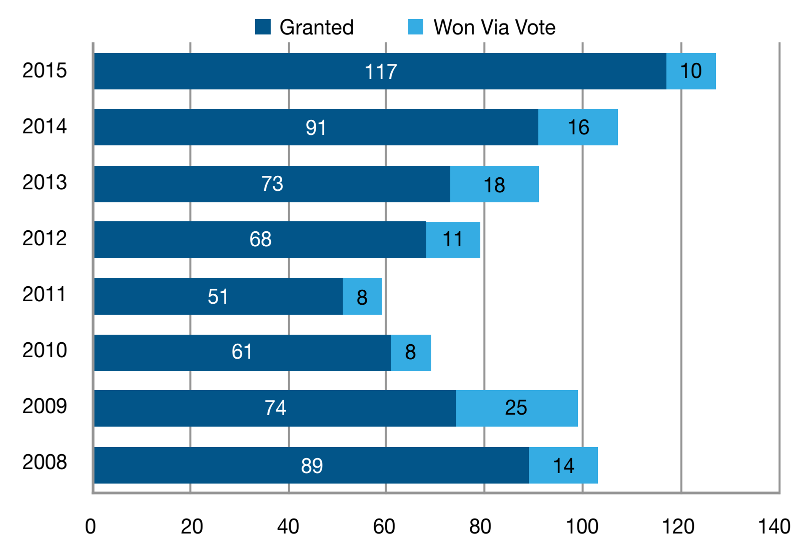
Many companies targeted by activists are deciding to settle quickly in an attempt to lessen the business distraction of a public activist campaign. According to Activist Insight, the average number of days it takes companies to reach a settlement with activists threatening a proxy contest from the time of disclosure is 56, which is down from 83 days in 2010. Some of the common settlements reached between activists and companies include board seats, management changes, corporate governance improvements, and operational changes, such as divestiture of underperforming lines of businesses. According to Shark Repellent, based on 2015 data, activist campaigns that resulted in board seats is at an all-time high.

When Activists Become Engaged

Once an activist is engaged, chances are they are not going away. It is important to keep in mind that the activist has typically completed a lot of research and most likely has spoken with many of your top investors and analysts before reaching out to the company. Further, many activists have become highly sophisticated and often work in tandem with other activists, sometimes called a “wolf pack;” it is not uncommon to see two or more activists working together on an activist campaign to build a position in a stock.

With these considerations in mind, if an activist reaches out to your company, you should be professional and timely in your responses. In addition, investor relations, senior management, and board members need to be open and willing to objectively listen to the activist’s perspective and possible demands. The company will have enhanced credibility

CAMPAIGNS RESULTING IN BOARD SEATS



SOURCE: FactSet. Based on seat won/granted date

“Settlements have definitely been the case the last few years, as activism has become more mainstream,” Welling says. “However, I am seeing more companies start to ‘dig in their heels’ this year. So, not sure what the future holds, but most of the time, we are better off with private negotiations that avoid distracting and costly contests.”

in the market if the activist's requests or proposals are handled in a proactive and professional manner. It will also help minimize the PR chatter that can come with an activist campaign.

"I always suggest that companies listen and approach activists with an open mind. We took the position in the company because we believed the company was undervalued and there were multiple opportunities to fix the undervaluation," Welling explains. "Executives and directors should want to hear those ideas. If the activist that owns the stock is credible and has a good track record, you should hear them out and engage strongly in a dialogue. In our investments, when we begin to transmit our ideas to the management team or board, it is only after we have discussed them with the other large shareholders and know that there is broad support for the changes we are recommending. So, you ignore these ideas at your peril."

Plants voiced a similar view: "I would advise boards and management teams to remember a few things. First, if everything were hunky-dory, an activist would be unlikely to show up in the first place. So the mere arrival of an activist should suggest to you that change is likely in some form, whether you embrace it or have it imposed upon you. Second, a few companies try to hide from investors that they believe don't drink the company Kool-Aid, whether that be short-sellers or investors perceived to be activist. This is badly mistaken in our view, because refusing to engage misses an opportunity to communicate the company's message in its preferred manner. It almost never deters the investor, even if he has a different agenda, and, in fact, evasive behavior often feeds the narrative of entrenchment or, worse, suggests that perhaps the company has something to hide. We think open communication, effective messaging, and transparency are essential elements in building shareholder value."

Once you have begun an open dialogue with an activist investor, it is important to be thoughtful in your course of action. Rushing to make quick changes to try to appease the activist will not necessarily make them go away. It is important that the company carefully evaluate the substantive issues that are at the core of the activist's thesis. Also, actively engaging advisors, from proxy firms to lawyers with strong expertise on how to professionally address an activism campaign, can add tremendous value. However, be wary of making a quick move to try to show engagement without a lot of thoughtful planning and internal discussion.

"We have had several experiences where, in the middle of our discussions with a company about how to increase value, the company makes a tactical decision to rush out an announcement of changes, such as a new hand-picked board member or the institution of a capital return policy," Plants comments. "Often they are attempting to make it appear they acted on their own rather than in response to an investor's suggestion – as if that would be such a bad thing. Unfortunately, in the haste to get ahead of us they usually end up adopting a half-measure or, worse, something unwise that only compounds their predicament and strains the relationship. It rarely deflects us."

How IROs Can Add Value

As activism becomes more prevalent, it is more important than ever for boards to be continually informed of Wall Street's perspective on the company. It does not serve the company well to have a board surprised by negative shareholder sentiment and perception of the company, especially as an activist is mounting a public attack. Many boards are requesting annual independent perception studies to clearly understand the sentiment of Wall Street; third-party and confidential perception studies help companies gain a clear and unbiased understanding of key issues that may impact perception and valuation. Also, conducting corporate governance roadshows with both management and select members of the board, not just during proxy season, is a good way to have board members and key members of management communicate proactively with shareholders before a problem arises.

"The IRO can play a very important role in educating the board and management about the concerns of the shareholder base," Plants explains. "Company leaders will often be in the dark about investor concerns, either because they don't meet regularly with shareholders or, when they do, they hear only what they want to hear. We have had experiences where the IRO was instrumental in convincing management that our concerns were broadly shared within the investment community, which then led to constructive engagement."

Over the past few years, shareholder activism has been one of the fastest growing, and often, best-performing asset classes. Therefore it is unlikely we will see any reduction in activism as a strategy. There is a strong need for companies to be proactive and anticipate the changing environment that may bring an activist to their doorstep. With activism becoming more commonplace, companies will benefit from IROs being more involved with communicating with boards on an ongoing basis. IROs can bring a Wall Street perspective and empathy on important issues that face the company and industry, as well as provide valuable feedback on potential corporate governance vulnerabilities. IRU

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