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EY Center for Board Matters

What boards need to know about shareholder activism

Shareholder activism has proved to be a permanent part of the global capital markets. In 2009, activist hedge funds had approximately $39b in assets under management. Today, that number is closer to $130b.

Considering assets under management for all hedge funds that pursue activism in at least one of their strategies, the total amount of capital available for deployment globally by activists is many multiples of that number.

The narrative around shareholder activism has also evolved from its early days as an offshoot of so-called corporate raiders, whose post-acquisition cost-cutting strategies were widely panned as lining their own pockets at the expense of the average worker. Shareholder activists now promote themselves as defenders of shareholder value, holding management teams and boards accountable for the destruction of (or alleged failure to maximize) shareholder value. With this carefully crafted shareholder-focused narrative, activism has steadily gained momentum with institutional investors. High-profile campaigns in recent years make clear that large institutional holders are willing to be vocal in both their criticism of targeted companies and their support for an activist's agenda.

While some companies are less likely to be targets, no company is completely immune from an activist campaign. In recent years, activists have even targeted companies delivering impressive shareholder returns or companies that have only recently become public. If value may be viewed as potentially untapped, there is potential for an activist campaign. The stakes can also be high for individual directors. An activist's ultimate weapon is a proxy contest where they nominate one or more handpicked candidates to replace at least some incumbent directors. In the process, not only are the company and its management team targeted, but individual directors as well.

Boards and individual directors should be aware of the current shareholder activism environment, how activists evaluate potential targets and how activist campaigns typically evolve. They should confirm that their companies have fully evaluated the risk of activism and taken appropriate steps to ensure that if an activist does emerge, the company is in the best possible position to defend itself and maintain shareholder support. To help boards in this oversight role, we examine what attracts an activist investor, common activist objectives and the board's responsibilities and opportunities related to preparing for and responding to an activist.

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What attracts an activist?

No one single factor drives an activist's potential interest in a company. While some characteristics will push an issuer toward the top of the list of potential candidates, an activist's decision to target a company is ultimately determined by the activist's confidence in a strong narrative of substantial shareholder value creation. Convincing shareholders that the upside potential is both real and significant enough to upset the status quo is critical to an activist's ultimate success.

A common misconception among both management teams and boards is that an activist must prove to shareholders that their critique or value creation ideas are correct in order to succeed, or that the company can simply highlight the flaws in the activist's thinking to secure shareholder support. Shareholders do not hold activists to the same standard to which management teams and boards are held. They are not expected to have the same depth of understanding of the company and its business. Activists must only demonstrate that they have ideas that seem sensible and should at least be considered by the company. Shareholder support for an activist should not be viewed as agreement with every element of an activist campaign, but as a general call for change. The idea that new blood in the boardroom will bring new ideas and increased dialogue is ultimately what shareholders are supporting when they support an activist.

Key factors that might attract an activist include:

- **Total shareholder return.** TSR, or total shareholder return, is one of the most important quantitative factors to consider when evaluating the potential risk of attracting activist attention. Activists can use absolute TSR as a general barometer of shareholder satisfaction or discontent, and even positive TSR can attract activist attention when compared with a peer set or the market, revealing underperformance on a relative basis.
- **Organizational complexity.** While conglomerate structures in the US are less common than they once were, companies with multiple disparate businesses frequently find themselves in the cross hairs of activists for two reasons. First, businesses with dedicated management teams and balance sheets may perform better when they are no longer a small piece of a larger organization. Second, investors may value the sum of the parts far greater than the value of the combined company if the high-performing businesses were separated.

- **Inefficient balance sheets.** In today's environment, institutional investors support ideas that increase value, not financial engineering that simply moves value from one place on the balance sheet to another. Still, some capital structure-oriented activism persists under the reasoning that excess cash should be given to shareholders to reinvest when the company has no near-term opportunities to deploy that capital, particularly when there are overall underperformance themes raised by the activist.
- **Problematic corporate governance.** Corporate governance problems provide two key advantages to an activist. First, they add to the narrative around the causes for sustained underperformance. Second, index investors and other large institutional investors have developed committed positions on certain corporate governance practices and will readily withhold votes from incumbent directors or vote to elect dissident nominees if they feel their corporate governance concerns are not being heard.
- **Environmental and social issues.** The newest and potentially highest-profile issues being incorporated into activist campaigns are related to companies' environmental and social impacts. Investors increasingly see the effective management of environmental and social risks and opportunities as fundamental to long-term-value creation and are integrating related considerations into investment decisions and stewardship. Like corporate governance failings, a poor track record on sustainability issues can galvanize shareholders against an incumbent board.

Activist objectives

An activist's investment time horizon is typically shorter than most other institutional investors'. While index investors have an indefinite holding period and active managers may target a five- to seven-year holding period, activists typically hold for much shorter periods. In practice, that means that companies must be prepared for an activist campaign designed to drive up the share price quickly, based on quick-hit actions that can create value in the short term, but that may ultimately decrease the company's long-term-value creation potential. This is not a disparagement of activism or shareholder activists, but a reflection of the fact that investor actions are driven by their own objectives, not necessarily what is in the best long-term interest of the company or all shareholders. Activists may counter that it is better to realize actual value for shareholders in the near term rather than take a risk on management's ability to deliver in the future. Management teams and boards must anticipate and prepare for those arguments.

In addition, activists generally want some sort of implicit or explicit recognition of their involvement in driving increased share price. This recognition is critical to increase new funds' profiles and make future fundraising easier. A positive return on investment is a powerful marketing tool for an activist. But also important is an activist's ability to demonstrate that they can be influential when they engage with a company. This ability to effect change is what differentiates an activist hedge fund from any other long-short hedge fund that does not engage with their portfolio companies.

Finally, while board seats, in and of themselves, are not the primary objective of shareholder activists, they are an important means to an end. Gaining seats on the board, either through a shareholder vote or settlement, provides the activist an ability to continue applying pressure to the company from within the boardroom to either take the actions that the activist had been demanding at the beginning of the campaign or to follow through on actions the company has initiated in response to the activist's intervention. The primary objective of the activist remains, however, to make money for the activist's investors and the fund itself.

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The role of the board

In most instances, the primary responsibility for preparing for and responding to shareholder activism will lie with management. Significant coordination is required between the company and its external advisors, and the activities involved in the preparation process are iterative in nature, making it difficult for the board to play a day-to-day role.

In a live defense situation (where an activist has privately or publicly approached the company), management typically takes the lead in engaging with and responding to the activist, both privately and publicly. In this situation, the speed at which activities occur is more conducive to a management-led process, and sidelining management could potentially undermine management's credibility with the activist and other shareholders. Finally, coordination through management, and specifically the CEO, allows the company to ensure that the messaging is consistent and unified.

While management should lead shareholder activism preparation and response activities, the board has a critical role to play in both. Boards, and individual directors, should view their responsibilities with respect to shareholder activism the same way they view their role in overseeing management's development and execution of the company's strategy. Boards should consider the following steps:

- **Understand shareholder activism developments.** Leading boards are incorporating a discussion on shareholder activism into at least one of the board's quarterly meetings. Inviting an outside advisor to speak about recent developments in shareholder activism, activist activity in the company's sector, and the changing attitudes of institutional shareholders can also provide significant value.

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- **Oversee the identification of activism risks.** The board should confirm that the management team is working to identify potential vectors of attack from an activist's perspective. These vectors can be related to strategy, operational performance, valuation, capital structure and allocation, shareholder engagement, corporate governance or ESG. Engaging advisors experienced in defending clients against shareholder activists for this process is important as management may unintentionally fail to identify or take seriously potential vectors of attack that seem implausible to them based on what they know about the business. These arguments, however, can be some of the most powerful from an activist's perspective.
- **Address the risks.** Once the factors that drive potential risk for shareholder activism are identified, the management team and the board should decide what actions, if any, should be taken to mitigate those risks. The board should make sure that management takes timely, appropriate action, particularly relating to changes that are easy to implement, are already being contemplated or present the highest risk of drawing activist attention. The board should separately discuss with the company's outside advisors evolving investor expectations and potential proactive steps that can be taken with respect to environmental, social and governance matters to bring the company in line with leading practice and demonstrate responsiveness to shareholder perspectives. Many corporate governance provisions that were once commonplace, such as combined chair/CEO roles or classified boards, have become hot-button issues for institutional shareholders and may provide a lever for an activist's campaign.
- **Consider direct engagement with key shareholders.** Some shareholders seek a direct dialogue with board members to communicate their views and to better understand the board's perspective and how it is executing oversight. Offering to make a director available to key shareholders can demonstrate the board's commitment to direct engagement and build trust, even if only a handful of shareholders may actually accept that offer. In the event of an actual activist campaign, board engagement with shareholders becomes more critical and has become a standard component of an activist campaign defense. In a live defense it is most powerful if shareholders have been offered a meeting with a director in the past.

- **Oversee a response plan.** When an activist first emerges, it is critical that the company has a well-developed response plan and strategy to quickly engage and evaluate the activist's claims. A response plan is not intended to guide the entirety of an activist campaign defense, but it can provide structure in the rapidly evolving environment that follows the first outreach by an activist. This tactical plan should include details about the defense team, management and external advisors. It should outline the process for activating the defense team as well as escalation guidelines depending on the details of the situation. The plan should also reiterate roles and responsibilities of each advisor group, key members of management and the board. It should have rules of engagement establishing who will be the primary point of contact with the activist and the process for redirecting any outreach to any other member of management or the board back to that primary point of contact. Drafting potential public responses that can be quickly adapted based on the specific details of the situation can be invaluable when managing inbound inquiries from the media or shareholders. These efforts strengthen the company's ability to control its own narrative and not cede the trajectory of future shareholder engagement entirely to the activist.
- **Conduct a simulation.** As part of developing an activist response plan, the board should also consider, together with management, stress testing the response plan using a simulation. These exercises have become increasingly common for companies at the forefront of activism preparedness. In a simulation, the company's key outside defense advisors will lead senior management and select members of the board through multiple escalating scenarios that are typical of an actual activist campaign, asking the management team and board to outline how they would respond to each scenario and then discussing the proposed response strategy with the broader advisor team leading the simulation. The scenarios typically escalate from initial unsubstantiated rumors all the way through the nomination of a dissident slate of directors and the initiation of a proxy fight. The company's advisors can provide valuable insights into how a seemingly sensible response to an early scenario can become a problem as an activist campaign escalates, and the structure of the exercise can highlight areas where alignment between management and the board needs to be strengthened.

Planning for a better outcome

Shareholder activism is a challenge for which every publicly listed company must prepare. For boards, shareholder activism can also have direct implications for individual directors. The ultimate weapon in an activist's arsenal is a proxy contest to replace directors, which can be damaging for individual directors with respect to the target company as well as from a wider reputational perspective. Boards must be proactive in helping their companies prepare for potential activist activity. Vulnerabilities are not always obvious and should be examined through the lens of an activist and the company's shareholders. Focusing too narrowly on what seems most plausible or likely may lead the company to miss potential angles of attack that resonate with shareholders. Boards must be prepared to take a more active role in engaging with shareholders on a regular basis, not only when the company is under attack. Focused attention on shareholder activism preparedness cannot fully inoculate a company from the risk of an activist approach, but it can position the company and its board for a better outcome.

Questions for the board to consider

- How is the company performing relative to its peers and the broader market?
- What has the shareholder experience (TSR) been over the last one, three and five years?
- Is the board getting an unfiltered view of shareholder feedback on the company's strategy and performance?
- How is the board thinking like an activist in considering and proactively addressing the company's vulnerabilities?
- Does the company know who its key outside advisors are with respect to activism?
- Have advisors performed an outside-in vulnerability analysis? Has the board seen and discussed that analysis?
- Does the company have a plan in place in the event an activist takes an interest in the company? Are the rules of the road clear?
- Does the board understand its role in responding to an activist campaign and has it participated in simulation exercises?
- Has the board evaluated actions aimed at decreasing the company's vulnerability to activism? Did that include potential strategic, operational, capital structure and corporate governance/ESG considerations?
- Does the board (select individual directors) have direct dialogue with shareholders? Do shareholders feel they are able to express their views directly to the board?

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