Ashton Partners

The New Crisis: Shareholder Activism

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Introduction

The corporate crisis that looms today - shareholder activism - is with different actors but the same stories. In the 90's it was hostile takeovers. Today it is hostile hedge funds frustrated with performance and employing new strategies to improve overall returns. Ironically, shorter-term investors that once "voted with their feet" are now taking the long road of shareholder activism. And if track records are any indication, activists are winning the battle with Corporate America.

According to a recent proxy study for 2005, there were 24 contested proxies, of which 14 (58%) were either settled, reached a split decision or passed dissident shareholder proposals. Institutional Shareholder Services (ISS), the leader in proxy advisory services, claims that the impact of contested proxies goes far beyond the ultimate vote tally. According to one of their studies of proxy contests, approximately 80% of companies researched were either acquired or run by new management within three years after the proxy contest.

This article will discuss this crisis, its evolution, what happens to create the perfect storm and how companies can react and ultimately overcome the threats.

History of Shareholder Activism

Shareholder activism can be traced back 80 years when Henry Ford chose to cancel a special dividend and instead spend the money on advancing social objectives. The court ultimately sided with dissident shareholders, reinstated the dividend, sparking a new paradigm in shareholder activism.

In the late 1980's, shareholder activism took a more aggressive turn with corporate raiders like Paul Getty. Shareholders took on management, engaging in hostile takeovers and leveraged-buyouts to gain control of undervalued and underperforming companies.

In the 1990's shareholder activism found mainstream pension fund managers like CalPERS pushing for the repeal of staggered boards and poison pills. These players used a form of "quiet" activism – favoring abstentions and withholding votes for important proxy issues – as a way to influence management and Board decisions.

Hedge Funds – The New Player in Town

Today, the face of shareholder activism has once again changed and rabble rousing hedge funds are in the spotlight. Martin Lipton, the New York lawyer and renowned corporate advisor who pioneered the poison pill in the early 1980's recently described the number one issue for corporate directors as, "Anticipating attacks by activist hedge funds seeking strategy changes by the company to boost the price of the stock." Lipton believes activism by these hedge funds could have far-reaching impacts on Corporate America with an estimated $1 trillion in assets. Carl Icahn agrees calling hedge funds, "The activist's ally," and exhorting colleagues that, "The environment for shareholder activism continues to improve." Mr. Icahn contends that the "tremendous flows" of hedge fund money have helped him make headway at companies like Kerr McGee and Time Warner.

Why the sudden change in strategy for these investors? First, hedge funds on the whole are underperforming the market today. Legends like Michael Steinhardt have precipitously retired conceding the market is too crowded to achieve above average returns. Too many hedge funds pursuing the same investment ideas have dried up volatility and limited possible returns. Even large firms like Citadel have lost about a third of its assets in the fixed income area, battered by the onslaught of investors in the corporate junk bond market making above average returns unattainable.

And, hedge funds tend to move in packs. With many lead steer hedgies like Carl Icahn and Ed Lampert paving the way, smaller hedge funds have been quick to follow. And the results have been quite astonishing. According to research conducted by Michael Jensen and Rickard Ruback, shareholders in companies that experience a proxy contest earn an eight percent higher return over the long term regardless of the outcome.

Is Your Company a Target?

Every day, more news hits the wires on hedge funds taking on corporate management teams. They do it for a few reasons. Chronic stock underperformance drives activism, but usually there is more to the story. More often than not, spurned investors are energized into action by their perception of missed opportunities. The following are a few of the more commonly cited catalysts:

- Consistently lagging operating performance relative to industry peers (SITEL Corporation).

- Idle cash sitting on the books with no definitive plan to reinvest or distribute to shareholders via share repurchase program or a dividend (Kerr McGee).
- Entrenched management and Boards unwilling to seriously evaluate possible strategic alternatives (Time Warner).
- Possible M&A opportunities spurned by management and the Board (MCI).
- Turnaround situations failing to generate sustainable returns (General Motors).

Modus Operandi

In most cases the activists are willing to begin a dialogue with management aimed at bolstering shareholder value. A peaceful resolution is almost always preferred – but not without the promise of substantive change. Paying lip service to increasing shareholder value but failing to implement the strategies required will only serve to agitate the situation. More often than not, activists tend to focus on overall strategy, 'use of cash' decisions and competitive positioning. But they expect short term action.

Initially, shareholder activist tactics will be relegated to letters sent to the management team and Board (and often times made public via press release) outlining a series of initiatives that the hedge fund expects the company to adopt. In the most extreme cases the matter gets handled in a proxy contest. This could become the mainstream approach, however if recent SEC proposals are passed that allow online distribution of proxy materials – a low-cost alternative for dissident shareholders.

Most dissident shareholder proposals are focused on the following issues:

- Changes in corporate bylaws to allow for increased shareholder control/participation in proxy matters (i.e., change in proxy notification date, ability to call a special meeting of the Board of Directors, ability to remove Directors with or without cause.)
- Initiation or continuation of a share repurchase program or dividend. Cash-hoarding companies have been pressed aggressively to return idle cash to investors. Based on our research, this appears the most popular proposal (likely due to anticipated widespread shareholder support.)
- Nomination of new Director slates. Boards that are perceived to be entrenched, ineffective, unaccountable or unwilling to consider broader proposals brought to them including strategic alternatives are the most likely to see a nomination contest. With new faces on the Board, activists believe they have a better chance of pushing their broader agenda.
- Evaluation of strategic alternatives. Although this can include restructuring plans, cost-cutting initiatives and the like, the majority are focused on transactions.

Lessons Learned

Having worked with a number of companies challenged by shareholder activism, we have unique insights to share from our experience. Following are 10 important guidelines to follow:

Lesson #1: Don't avoid talking to activist hedge funds and hope they go away. Either open discussions privately or be prepared to face a PR battle.

Lesson #2: Don't take it personally and respond publicly with a hostile tone. In many cases these activists are genuinely looking for ways to increase shareholder value. Spend time educating them on your business and strategy and re-focus them on the long-term valuation potential.

Lesson #3: Like all crisis situations, preparation is critical. Be prepared to act and react to various scenarios under a well defined strategy.

Lesson #4: Don't be reactive. Management will earn more credibility and support from investors if they proactively announce a new initiative instead of reacting to the public requests of a dissident shareholder.

Lesson #5: Don't come out with an incomplete strategy just to appease investors in the short term. Thoroughly vet it out and announce it when you have the whole picture including the growth strategy and capital allocation strategy. If contemplating a share repurchase program or a dividend, delineate the 'use of cash' decision making process. Tell them what might sway the company to make different decisions and what processes are in place to evaluate the situation. If the company is in a turnaround situation, tell investors how the problem was assessed or isolated, what steps are being taken to resolve it and give a fair assessment of how long it will take to fix the problem.

Lesson #6: Relationships with top holders are still important. Don't give hedge funds the ability to influence other holders without hearing the company side of the story. Many investors are willing to give management the benefit of the doubt if management is proactive and has a plan in place. Talk about the issues directly and be honest in telling them what isn't finalized yet.

Lesson #7: Don't simply pay lip service to acting in the best interests of shareholders. Understand the true sentiments of your shareholders and have confidence that core investors will support the company's decisions. Conduct follow-up calls and perception study calls on a regular basis to be clear where investor sentiment is at all times.

Lesson #8: Spend time determining what likely support levels will be, and how much support from smaller investors is needed for success. Identify key supporters and determine appropriate outreach strategies to investors that are "on the fence."

Lesson # 9: Build a pipeline of new institutional investors to help dilute the influence of the activist shareholder. By adding bench strength to your shareholder base you can ensure a smooth exit if/when the activist decides to get out of the stock.

Lesson # 10: Work with ISS and other governance firms who can play a significant role in determining the outcome of a proxy contest or shareholder proposal. This holds especially true for small-cap companies with high index or passive ownership that typically vote with ISS on the majority of proxy issues.

Final Thoughts

Shareholder activism often highlights differences in strategy or poor communication. In numerous activist situations we have found companies believing they've told one story, and the investment community hearing another, or nothing at all. Inconsistency in messaging and lack of information breed investor discontent, and ultimately shareholder activism. If ignored long enough, the situation comes to a breaking point where activist investors choose a drastic approach.

Committing to open dialogue with activist hedge funds can help a company understand the activist's key concerns or issues and how they are valuing the investment. Activists tend to be very open about this information. By initiating dialogue, it's easier to assess the factors of a possible contested proxy or public relations battle.

Lastly, the underpinning to nearly all shareholder activism campaigns is to increase shareholder value. Through a collaborative relationship, management can turn an activist hedge fund into an attractive long-term investor. While in the past management has viewed the relationship as adversarial, we instead suggest that the potential exists for a mutually beneficial relationship. Aren't activists and management striving for the same objective – to increase shareholder value?

About Ashton Partners

Ashton Partners is a strategic advisory firm specializing in investor relations (IR) and corporate communications. We work in partnership with top-level corporate executives to manage and position the information that impacts a company's credibility, reputation and ultimately, its valuation. For more information contact us at www.ashtonpartners.com or 312-553-6719.