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EFFECTIVE ENGAGEMENT, COLLABORATION AND RESPONSE TO ACTIVIST STRATEGIES

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EXPERT FORUM

EFFECTIVE ENGAGEMENT, COLLABORATION AND RESPONSE TO ACTIVIST STRATEGIES

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R&C: In your opinion, what have been the most significant developments within the activist arena over the past 12 months or so?

Suvanto: First, passive funds are flexing their muscles like never before. In Vanguard's '2017 Investment Stewardship Report', the firm highlighted several instances of working alongside activists to unseat board members at portfolio companies. With trillions of dollars under management, passive funds' increased interest and willingness to agitate for change, either in partnership with traditional activists, or directly, is a monumental evolution of the activism landscape. Second, a renewed interest in large caps has reinforced that size is no deterrent. We have seen activists take on behemoths like P&G and ADP with mixed success. At the same time, we have seen a new fervour among companies to fight back, and in some instances, make the first public strike, which marks a new stage in defence communications strategy. Third, activism focused on European and Asian companies is on the rise, driven by both local, home-grown activists as well as US activists looking for new opportunities.

Katz: Over the last year, there have been a number of important developments as activist investors have continued to target public companies. First, it is very clear that neither the size of the firm nor a past record of performance will insulate any company from a determined activist. Second, the most successful activist firms have continued to grow while a number of the smaller firms are falling by the wayside. Third, activism is clearly being exported from the United States, with many of the more successful firms launching activist campaigns in Asia and Europe and even Israel. Fourth, as shown in the ADP situation, companies can still prevail over activist firms if they engage with their shareholders and can support a better business case. And last, but probably not least, JANA Partners and ValueAct are targeting the environmental, social and governance

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>
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(ESG) space and it remains to be seen whether other firms will follow.

Salzberger: The most significant development, in our view, was the surge in large and mega-cap proxy contests. Procter & Gamble, General Motors and ADP were all subject to proxy contests that went to a vote. In 2017, activists were willing to make concentrated bets that they could execute contests at the target company despite their relatively low ownership percentage. On the issuer side, targets were willing to fight, not only because of the size of the activists' positions, but because of conviction that the incumbents had the right long-term strategy. This brings us to a second significant development – a material decline in the number of settlements in 2017. Large cap issuers have the resources and access to high-level counsel to fight proxy contests. And across the spectrum, issuers are now taking the time to evaluate the activists' demands to determine whether to accept them and to analyse the shareholder base with the help of advisers. Such analysis is necessary to understand whether they can win. In General Motors' case, for instance, the board quickly countered Greenlight's dual stock proposal and determined that the shareholder base would be supportive, leading to an overwhelming victory at the annual meeting.

R&C: How is today's geopolitical and economic landscape shaping the tactics employed by activists? In what ways are they managing to extend their influence and challenge assumptions around the sanctity of corporate boards?

Katz: Activists tend to take advantage of opportunities that today's geopolitical and economic environment create, especially when public companies are slow to respond to or recognise these changes. For example, the opportunity created by interest rates at historic lows provided ammunition to activists for companies that failed to appreciate the impact that this could have on capital allocation and shareholder returns. Moreover, the public perception that many companies – including their management teams and boards of directors – are out of touch with societal demands, can give an activist a broad base of public support when it makes its initial approach. In addition, activists that tend to hold their investment for longer periods of time will be better able to pursue operational activism and claim to be focused on achieving greater value over the longer term. To the extent activists can shed the label of being short-term investors 'out to make a quick buck', the more likely they will be able to garner support from passive and index investors who have little choice about the equities they must invest in. Some activist investors have been able to shed the 'hedge fund' label as they act more like investors and less like speculators.

Salzberger: What we are increasingly seeing is a convergence of several trends that are shifting corporate governance and activism. Index funds have experienced significant inflows at the expense of active managers. These long-term indexed investors have more clout than ever and they expect issuers and hedge fund activists to drive sustainable shareholder value, and sometimes more. Thus, BlackRock has issued letters telling issuers that society expects them to serve a 'social purpose', and to gun manufacturers specifically asking them about their response to recent school shootings. The major index funds have also pressed issuers about a lack of diversity on their boards. Activists have taken their cue. JANA recently launched an 'impact capital fund' to drive social responsibility and returns, while Nelson Peltz spoke to the importance of diversity and environmental sustainability in his fight with P&G. Activism is largely a fight over credibility: primarily who should shareholders trust to generate value, but also who can more effectively address issues that shareholders, not necessarily boards, care about. Some have called these trends a shift to 'shareholder-centric' governance and it is gaining primacy over corporate law's prior deference to the board.

Suvanto: ESG concerns are increasingly emphasised by activists as well as the broader investment community. The most striking example of this is JANA and CalSTRS' recent letter to Apple stating that there was a clear need for Apple to offer parents more choices and tools to help them ensure that young consumers are using Apple products in an optimal manner. Illustrating a remarkable and surprisingly long-term view, CalSTRS and JANA said they believed addressing this issue now would enhance long-term value for all shareholders, by creating more choices and options for customers today and helping to protect the next generation of leaders, innovators and customers tomorrow. In a similar example, Blue Harbour chief executive Cliff Robbins told investors his firm will urge companies to focus more attention on environmental and social issues such as climate change, diversity and employee wellbeing as a way of reducing risk.

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R&C: How do activist strategies seen in the US compare with those in Europe and elsewhere? What factors are likely to drive any differences in approach?

Suvanto: Activism strategies in the US are without question more aggressive and more public. While many activists take a 'constructivist' approach – seeking to work collaboratively with management and boards to effectuate change – many activists are quick to go on the attack and air their demands and criticisms through public channels. This approach is immediately frowned upon by both investors and companies in Europe and Asia. Nasty 'fight letters' that heap criticism on the board and management are generally seen as overly brash. Europe and Asia demonstrate a strong aversion to 'American Cowboy' hedge fund behaviour that serves only the interests of the financial community rather than the full spectrum of corporate stakeholders. In addition, certain aspects of corporate governance inherent to European and Asian countries can present an added layer of difficulty for activists, giving companies more negotiating leverage out of the gate.

Salzberger: While home-grown European activists are still quite active, US hedge funds have increasingly looked to Europe to find better values, where the field is not as concentrated and the euro crisis decreased prices that are now reverting to normal. Thus, Elliott targeted Akzo Nobel and Third Point targeted Nestle with large stakes. As the M&A environment improves, we have also seen US activists target deals like Corvex's scuttling of Clariant's Huntsman acquisition. Yet, the tactics need to be modified – the 'consensual stakeholder' models in Europe do not lend themselves to speedy campaigns and the activists' approach is likely to be gradual and initially out of public view. Unions often have significant sway, unlike in the US, and firms may have significant insider positions making any victory far from certain.

Katz: Increasingly, US-based activists are turning to Europe for new targets, the most notable of which was Third Point's more than $3bn investment in Nestle last summer. While US-based activists may have legacy advantages, European shareholder activists have regional advantages, particularly regarding cultural issues driven by the complexity and multijurisdictional regime Europe offers. Since European jurisdictions tend to be more 'shareholder-friendly' than the US, activists may have more tools at their disposal than they would have in the US. For example, in some European jurisdictions, CEOs are more subordinated to the board than is typical in the US, and it can be easier to put pressure on a European board. In Europe, minority shareholders have greater protections than may exist in the US, including the ability to nominate directors, call extraordinary general meetings and add proposals to

the agenda for annual general meetings. Activists can use these tools to their advantage.

R&C: What general advice would you give to companies and their boards in terms of managing an effective response to activists? Is simply ignoring their suggestions or demands rarely an advisable option?

Salzberger: Unless the issuer has a substantial position held by insiders, the days of ignoring an activist's suggestions are long gone. All shareholders, particularly index funds, are looking for the best path to long-term value creation. The incumbent board and management team may already be on that path, but shareholders want issuers to explore all credible options and frown upon boards that disregard strategies presented to them. Seasoned activists will not give up if they believe they have a better alternative and will market directly to their fellow shareholders. If a situation escalates into a proxy contest and it becomes clear that the board simply ignored the activist's suggestions and did not engage, they will lose significant ground in winning over the largest institutions and their proxy advisers.

Katz: In today's world where institutional investors are significant holders on the company's share register, failing to engage with an activist is one of the surest ways to lose the support of your institutional

investors. Failing to engage is often interpreted as wilful indifference by a management team and board. If the activist is a significant shareowner, then the company should treat the activist as it does its other significant shareowners, at least as far as engagement is concerned. In addition, companies that engage with their shareowners regularly, will have greater credibility with their larger holders versus a company that chooses to engage with its shareowners only after the company is under attack from an activist. This pre-activist shareowner outreach should involve directors to the extent appropriate, especially if such engagement is affirmatively requested by proxy voting arms of significant institutional investors.

Suvanto: Ignoring activists is simply no longer an option. An important starting principle is to treat activists as you would any other shareholder. As an example, if an activist shareholder calls a company and requests to speak to the CFO to ask questions about the company's financial statements, this is indeed a reasonable request that any company would generally grant. If the activist shareholder owns more than 1 percent of a company and requests a meeting with the CEO, again, this is a reasonable request that would generally be granted. That said, a meeting with an activist would require a more intensified level of preparation. A second important principle is to engage with the activist so that you can both demonstrate a willingness to obtain input from shareholders and more importantly to learn their views and intentions to the greatest extent possible. Constructive dialogue can be a win for everyone. The activist investor may have legitimately constructive ideas that can increase shareholder value. However, if a company fundamentally disagrees with the activist, that company will be far better equipped to respond to the activist's attacks the more well informed it is.

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R&C: How important is it for companies to be proactive when addressing activist demands? Do you believe an engaging, collaborative relationship often yields a better outcome than a combative defence?

Katz: When an activist shows up, the company's response must be tailored to the specific situation that the company finds itself in. To the extent that the company is positioned to respond quickly to the activist's demands and to be able to do so from a position of strength, the more likely that such response will be successful and will resonate with the company's shareowners. It is essential that the board and management team are fully aligned, as any split between the two will provide the opportunity for an activist to drive a wedge between them, and ultimately succeed in having their demands met. Directors do not like to be surprised, so to the extent that the board has been fully briefed on strategies and various alternatives before the activist arrives, the more likely that management can maintain its credibility with its board of directors and avoid a split.

Suvanto: To be clear, no shareholder likes an expensive, combative defence. Shareholders know these fights consume significant management time and financial resources, and can also lead to sub-optimal decisions that are driven by the interests of a single agitating shareholder. It is also critical to understand that a majority of shareholders, a majority of the time, agree with activists. A recent survey of investors with assets under management of over $1 trillion found that seven in eight investors will support an activist if they believe change is necessary. In addition, 80 percent of investors say that companies are ill equipped to handle an activist campaign. It is incumbent on boards and management teams to thoroughly consider activist ideas and proposals. It is well known that activists conduct significant due diligence and analysis before engaging. If, after engaging with an activist, a company decides to reject their ideas, the company will need to carefully explain why their decision is a better course for maximising shareholder value, or they may have trouble winning support from other shareholders.

Salzberger: A potential target is typically well-advised to engage with the activist, understand its positions, ask questions and determine whether any of the activist's ideas should be accepted for the benefit of all shareholders. And if none of the ideas should be executed upon, why not? How is the board on the right track to create long-term value? It is then a battle for the hearts and minds of the institutions, their proxy advisers and retail shareholders. It is sometimes surprising, however, how close the activist's positions are to the board's. In some cases, activists propose high-calibre nominees who may have the exact skills the board is looking for. While boards must act as fiduciaries for all shareholders and not just for the active minority, and this can often lead to a combative relationship depending on the activist's goals, a collaborative engagement that avoids a costly proxy contest can be a win-win.

R&C: What advice would you offer to boards on implementing strategies and planning processes that allow them to pre-empt activist campaigns, and respond as rapidly and efficiently as possible if such action materialises?

Salzberger: Boards need to be aware of their operational, financial and corporate governance weaknesses on a clear day. With the help of investment banks, legal counsel, investor relations firms and proxy solicitors, these weaknesses can be evaluated and perhaps remedied long before an activist arrives. Setting up this response team is crucial, especially if there is a hint of shareholder discontent. Again, proxy contests are about credibility. Many institutions and proxy advisers use a framework that asks whether change is warranted on the board. If it can be shown that the board acted proactively as its own 'change-agent', the activist will lose the advantage and the board will be given runway to continue with its own strategy. Further, the more rapidly a target can counter an activist by having already anticipated and evaluated its plan, the better.

Suvanto: It is now best practice for a board to 'be their own activist'. This involves a continuous process of evaluating all paths to maximise shareholder value as well as a continuous examination of governance and board composition to ensure the company is best equipped to succeed. With well over $150bn in assets under management (AUM) residing in US pure-play activist shops, as well as an increasing activist orientation within index funds and other large institutional investors, any company that fails to pursue value-maximising strategies will do so at its peril. Best practice boards now regularly engage financial advisers to conduct a thorough review of the company's asset portfolio and financial strategies to confirm their current strategy is optimised. Best practice companies also engage communications advisers along with legal and financial advisers to develop activism scenario plans, which may reveal vulnerabilities that should be proactively addressed. It is also advisable for boards to periodically run through an activism simulation to test their assumptions and preparedness for a potential activist attack.

Katz: To counter potential activist threats, boards of directors need to be proactive. The best way to do this is to take a step back and look at your company the way an activist would. This does not necessarily mean that you should follow the strategies that an activist might pursue, but that you examine the various strategies available to the company and pursue the one that is most beneficial to the company over the long term. This also allows the company to be prepared to counter the strategies that it views as suboptimal should an activist

– who, by definition, will be relying on incomplete information as an outsider – decide to pursue the company and attack the company's existing strategic approach. If companies fail to be proactive, they will be placed on the defensive when an activist attacks and a board is likely to question management as to why the activist's strategies would not be beneficial to the company. In addition to looking at your company as an activist might, boards should consult and consider retaining a team of outside advisers to assist the board in the event an activist approaches. This team usually consists of an investment bank, legal counsel, public relations or investor relations adviser, and proxy solicitor.

R&C: Going forward, what are your predictions for the future of shareholder activism? Do you expect more boards, by necessity, to work collaboratively with activists to satisfy their goals and expectations?

Suvanto: First, a healthy M&A environment is likely to spur activists to push for potential targets to sell. Activists are also likely to target companies with disparate business units in order to unlock value by breaking up 'conglomerates'. Further, activists are increasingly engaging in 'bumpitrage' by seeking higher offers from previously announced deals. Companies should therefore be prepared for M&A-specific activism if they are a potential candidate for consolidation or breakup, or if they are pursuing a transaction that requires shareholder approval on either side. Second, large US activists will continue to target companies in Europe and Asia as they look beyond borders for new opportunities. Increasing international activism will be driven by a perceived value gap at European and Asian companies as well as local governance structures viewed as outdated or ready for challenge. Third, we will undoubtedly see institutional investors, pension funds and index funds flexing their muscles in the context of activist engagements if not directly agitating for change. This agitation will likely be focused on fundamental governance gaps as well as environmental and social inadequacies.

Katz: Shareholder activism is not going to disappear, no matter how much we might want it to. I do believe though that, at least in the US, there will continue to be a shakeout among primarily the smaller firms engaged in shareholder activism. At the same time, the larger funds will continue to grow and they will look for new opportunities to invest, including taking some of their targets private. I also believe that we will see some institutional investors get more activist in attempts to influence company behaviours, as opposed to subcontracting that approach to a shareholder activist. In addition, as larger companies become more proactive, shareholder activists may be forced to focus on smaller companies, where it may be easier to acquire

a larger stake but harder to make as much money. But, unfortunately, there will always be companies that provide fertile opportunities for activists and I do not see that changing.

Salzberger: As the largest institutions continue to experience inflows and build out their corporate governance teams, their voting decisions will become more nuanced and less predictable. They will also use their weight to push companies and activists to desired outcomes, whether outright settlements or significant governance changes like destaggering boards or undertaking substantial board refreshment. Additionally, some of these funds have been vocal in their disapproval of settlements that amount to no more than short-term thinking and financial engineering. These trends may cause issuers and activists to engage more frequently and targets may conduct a more thorough analysis of their chances in a proxy fight. Ultimately, the pendulum may swing to the middle – a balance between hasty settlements and costly contests. R&C