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CFO Insights
Activist shareholders: How will you respond?

If it seems like activist investors have had a more visible and powerful presence over the last few years, it's because they have.

In fact, according to the results of the Q1 2015 *CFO Signals*™ survey, just under three-quarters of public company CFOs say they have experienced some form of shareholder activism—most often in the form of communication with management or the board, and sometimes in the form of proposals that have gone directly to shareholders. (See Figure 1, page 2.) Moreover, about half say they have made at least one major business change specifically because of shareholder activism (share repurchases, leadership changes, and divestures being the most common).[1] (See Figure 2, page 2.)

The trend also shows no signs of abating. In the wake of the financial crisis, Dodd-Frank, and Say-on-Pay votes, shareholders have become more assertive in expressing what they want from the companies they invest in. And for CFOs, this new dynamic between public companies and shareholders presents an evolution in corporate governance that may need to be addressed.

There are several steps that CFOs can take to prepare their companies to manage increasingly vocal and influential investors. In this issue of *CFO Insights*, we will discuss how finance chiefs can identify and address company financial issues that could attract activist attention; why a more proactive engagement with the investment community is needed long before an activist campaign begins; and what some of the key components of a playbook are for responding to an activist campaign.

Trends in shareholder activism

One of the keys to being prepared for activists is to understand what they're doing and why. To a large extent, activism is a debate about capital deployment, risk tolerance, and performance—topics that are typically part of management's and the board's agenda in the normal course of business. If your company has issues in these areas, however, you probably want to be in control of the situation and prepared to respond to activists.

Being prepared also means understanding some of the trends shaping today's shareholder-activist campaigns. For example:

- Some activists have a longer-term investment horizon than their reputation suggests. A study of 2,000 activist campaigns over the last 10 years by Columbia Business School Professor Wei Jiang found that activists' average holding period is just over two years.[2]

- Activist campaigns are often "friendly." The majority of such campaigns studied by Professor Jiang occurred without getting into the press. Typically, a shareholder approached a company with a point of view on either how capital should be deployed or opportunities to enhance value, and there was a conversation between company management and the investor.[3]
- Activist campaigns vary in objectives and tactics.

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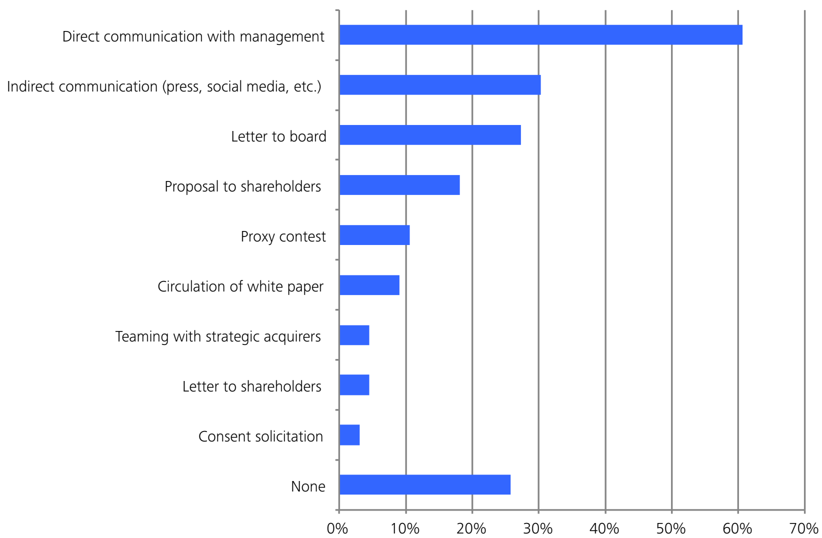
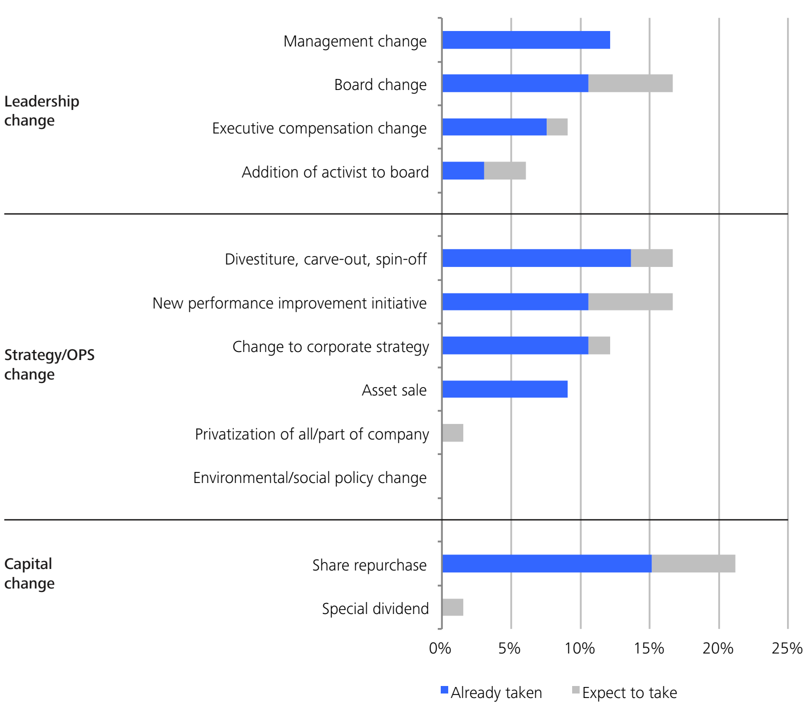
Figure 1. Which forms of shareholder activism has your company experienced?
Percent of public company CFOs who indicated having experienced the following activities (n=66)



Source: *CFO Signals*, Q1 2015, CFO Program, Deloitte LLP

Figure 2. What actions have you taken (or do you expect to take) specifically in response to shareholder activism?
Percent of public company CFOs indicating their company has taken or is likely to take each action (n=66)



Source: *CFO Signals*, Q1 2015, CFO Program, Deloitte LLP

Certain activists discreetly put forth proposals focused on incremental value creation through constructive interaction with company management. Others mount more aggressive, public campaigns aimed at proxy contests or other tactics to force major company transformations or change the composition of the board or management.[4]

- Different industries have attracted varying amounts of attention from activists, although no industry appears immune. Even when national security or regulatory interests come into play, activists have made their mark across a broad range of industries and will likely continue to do so.

- Factors that tend to attract activist attention are strong cash flow, low dividend payout ratios, conservative balance sheets, recent underperformance, capital-intensive businesses with assets ripe for selling or spinning off, and industries facing shifting market forces and business models.

Be proactive and prepared

What do these findings and others from recent activist campaigns suggest in terms of what public companies might consider doing about activism? Lessons learned and emerging leading practices include the following:

Identify issues that might attract activists' attention. A starting point for CFOs is understanding how investors think about your company, and then helping them understand your business model and capital allocation decisions. To identify potential issues that could draw activists' attention, CFOs might ask, "How does our cash-flow performance compare with historical trends and our peers?" "Is strong performance generating a lot of cash that is building up on balance sheets?" "Does our capital structure have a conservative bent that might spur debate on whether additional leverage would be appropriate?" "Is the sum of the parts worth more than the whole?"

- *Articulate the value proposition.* Have a compelling, fact-based investment thesis that includes a clear case for why the company made its strategic choices over alternative strategies and financial decisions.

- *Regularly evaluate strategic and transaction alternatives.* Companies need to regularly and objectively evaluate and prioritize various alternatives for delivering value to shareholders. If various alternatives haven't been evaluated in a few years, or if they are not being reviewed objectively, you may be setting yourself up for trouble.

- *Review governance policies and board composition.* In particular, determine if performance is aligned with compensation. Excessive compensation or a lack of alignment between performance and compensation in and of itself can generate activist interest.

- *Get out in front of significant events.* If management is contemplating a major strategic shift or a transformational M&A transaction, ask, "Are we out in front of that story, communicating what the investment or change in strategy or business model is, why that action makes sense, and how it is going to generate long-term value for shareholders?"

- *Monitor market activity.* Be regularly apprised of what's happening in your stock and with your shareholder base. Have there been recent changes in investor behavior or interactions? What is happening in the industry? Are peers being targeted by activists, and if so, which funds and what proposals are being put forth?

Address shareholder demands for information, transparency, and access. Proactively engaging with investors on a wide variety of topics can be a strong management tool. A high level of engagement and two-way communication help establish credibility with the investment community that management has the shareholders' interests at heart, and provides crucial feedback on issues many investors are concerned about. This may be especially helpful when engaging with major shareholders, who can be cornerstones of an activist defense.

Attract and retain top talent in investor relations. A more dynamic IR strategy may require companies to significantly upgrade the talent and tools of their IR organization. The IR head should be working closely with the CEO and CFO on investor communications and be fluent in company strategy and finance so that he or she can have an interactive dialogue with stakeholders.

Creating your response playbook

Just as many companies have crisis management teams and playbooks, it can be critical to develop a clear plan on how to respond if an activist launches a campaign. Having a protocol and a dedicated team with clearly articulated responsibilities helps companies take control of the situation from Day 1 and avoid missteps in the heat of the moment.

Consider including financial advisors, attorneys, accountants, IR, and public relations in the response team. And one of its first steps is not to ignore the activists. Stonewalling, after all, may only incite activists to become more aggressive.

Moreover, it is critical that senior management keep the team informed and aligned with their response to the activist campaign. You don't want the wrong message being communicated externally, so keep everyone informed of what management is thinking and planning. One question the team should ask almost on a daily basis is, "Should we inform the board?"

Once directors are informed, however, consider engaging them in the dialogue. For example, if the chair of the compensation committee can meet with an investor who questions the alignment between pay and performance and justify it and defend the compensation structure, it is far more effective than having the CEO defend it. And while you probably don't want to make the chairman available on Day 1, you should have an idea of when you might take that step, if required.

In our Q1 2015 *CFO Signals* survey, we asked CFOs how they are changing their IR approaches in response to activism. About half said they have changed very little—mostly citing preexisting programs that are already working well. The half who said they have made substantial changes tended to cite heightened monitoring of activist activity, more proactive planning around activists' concerns, and more (and more preemptive) communication with current and potential investors.[5] Incorporating these steps and others outlined in this article may not lead to a comprehensive defense against shareholder activism, but they are crucial to effective management of an activist campaign. And given that shareholder activism is likely not going away anytime soon, the steps offer a road map to understanding and proactively dealing with this new environment.

Endnotes

1 *CFO Signals*, Q1 2015, CFO Program, Deloitte LLP.

2 Corporate Development 2012: Leveraging Relationships in M&A, Deloitte Development LLC, pages. 38- 39.

3 Ibid.

4 Ibid.

5 *CFO Signals*, Q1 2015, CFO Program, Deloitte LLP.

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