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Shareholder Activism and the 2010 Proxy Season

How Companies Can Prepare for a Rising Tide of Activism

The economic climate since early 2008 exposed flawed business models, poor decision-making and faulty risk management practices on the part of many public companies and their management teams. The resulting economic dislocation has prompted public anger over government bailouts and executive compensation. Investors, still smarting from the destruction in equity values, are demanding a greater say over the governance of the companies in which they invest as a means of avoiding the whipsaw volatility that rendered the first decade of this century the worst 10-year period in the stock market's history. There is now a broad consensus that these events have fostered a sharp rise in investor disenchantment, and will lead to a highly contentious proxy season in 2010.

To identify key issues and likely investor actions over the coming months, FD, the strategic communications segment of FTI Consulting, conducted a proprietary survey in November 2009 that polled responses from 60 institutional investors. In December 2009, FD also hosted a panel of experts who discussed how companies should prepare for the 2010 proxy season. The panel, moderated by Roben Farzad of *BusinessWeek*, included:

- Arnaud Ajdler, Senior Managing Director, Crescendo Partners
- Joseph Frumkin, Managing Partner, Mergers & Acquisitions Group, Sullivan & Cromwell LLP
- Kal Goldberg, Managing Director, Special Situations Practice Leader, FD
- Mark Harnett, President, MacKenzie Partners

Examined together, FD's proprietary research and the panel discussion revealed the primary governance issues facing companies, and also identified ways that management teams can prevent these issues from derailing their strategic plans or creating vulnerabilities that activist investors can exploit.

In the coming proxy season, perennial hot topics like executive compensation, director votes and greater rights for shareholders to nominate board directors are once again flashpoints for most companies. Executive compensation continues to stoke investors' ire, with 37% of respondents in our survey saying that it is the biggest issue that companies will face this year. A substantial majority (60%) would like to see "say on pay" regulation enacted. Specific aspects of compensation on which investors would like to have a say include severance packages (73%), guaranteed bonuses (68%), and option/equity grants (65%). Overall, investors are highly confident that "say on pay" will happen, with 72% expecting most companies will enact it by 2011.

The rising tide of investor frustration coincides with regulatory and legislative changes that will give them a louder voice for expressing their views to management and agitating for change. For one, managers now need to contend with the Securities and Exchange Commission's (SEC) newly enacted NYSE Rule 452. Previously, brokers were allowed to vote the shares they hold in custody for clients, and historically voted in favor of management's proposals and board nominees. This reliable base of support diluted the votes of activists. However, the new regulations preclude broker voting, managements and directors will face greater challenges to their proposals and more support for shareholder proposals. According to FD's research, three-quarters of respondents (75%) said, "it will be easier for activists to garner shareholder support" due to Rule 452, and a comparable amount (73%) say they will support more aggressive shareholder rights plans under Rule 452.

In addition, the SEC is still seriously considering implementing proxy access rules that have gained traction with the current administration. Though not an immediate issue, proxy access remains in the front of investors' minds. Three-quarters of survey respondents say they want the right to appoint their board nominees in proxy materials.

While these regulatory changes are in motion, the climate for activist investors has become more favorable. In fact, the mere presence of an activist leads approximately one-half (48%) of investors to feel that a company is badly managed. Nearly three-quarters of investors surveyed by FD (73%) believe that "activist investors add value to the company." A similar amount (72%) said that "over a one-year holding period, activist investors enhance the stock price of a target company." Perhaps paradoxically, the resurgent equity market may have fostered a greater acceptance of activism as shareholders look for catalysts that can boost stock prices relative to a company's peer group. But, a more likely factor is the lack of confidence that investors have in management following what many are calling the Great Recession.

As it happens, recent academic research supports the investors' views of activism. A study by Alon Brav, Wei Jiang, Frank Partnoy, and Randall S. Thomas (Financial Analyst Journal, November/December 2008) found that activist hedge funds outperform both equity-oriented hedge funds and market indices, leading to a self-fulfilling proposition whereby stocks of targeted companies generate abnormally positive returns. Another study by Christopher Clifford (Arizona State University, June 2007) finds that stocks targeted by hedge funds for activist purposes generate better performance than those targeted by hedge funds for passive purposes, and that there are meaningful improvements in operational efficiency, as measured by return on assets, in the year following the investment.

What makes a company vulnerable to activists?

While there are myriad factors that could spur activism, three-quarters of investors in FD's survey cited a lack of confidence in management. Beyond that, more than half cited weak corporate governance (57%) and a poorly-articulated business strategy (52%) as factors that contribute to burgeoning investor agitation in the public company landscape. The common attributes of all three of these issues is a lack of trust and visibility, which cause investors to look for institutional remedies to ensure that management is serving as good stewards of their investments.

Not surprisingly, the financial services industry is most likely to experience the highest level of investor activism. Banks, investment firms, and insurance companies that have received taxpayer dollars are targets for criticism for the decisions that resulted in their dependence on government largesse for survival. An overwhelming number of respondents (87%) from the survey expect financial services to be the sector that activists target most aggressively.

Countering the Activist Threat

Shareholder communications plays a decisive role in determining how corporations deal with increasingly fraught investor relations. According to FD's panel, steady engagement with investors is one of the best ways to shore up support for management's current strategy and quell percolating concerns that activists can exploit. Few companies that have a regular dialogue with investors will ever need to fight off proxy threats. As noted above, FD's investor survey reinforces this view. A majority of survey respondents (78%) indicate that the factor most likely to make a company a target for activists is a "lack of confidence in management." Over half of the respondents indicated that a poorly articulated business strategy makes a company a greater target for activist investors.

Sustained shareholder engagement with investors can help management spot investors' hot button issues and changing sentiment, and make appropriate changes before activists have a chance to gain traction. Also, steady communications with shareholders will offer more opportunities to garner support for the company's strategic plans and demonstrate management's competence and fiscal responsibility.

Below are additional observations from FD's survey and the December panel:

- The best defense against a hostile threat is to be preemptive and take the high road and steal the activist's agenda – know what the hot button issues will be and make changes accordingly to get ahead of the actions of regulators and activists. Roughly three out of five respondents (57%) indicated that they are influenced to invest in a company that proactively self-regulates, rather than in responding to regulatory statutes. In lieu of co-opting the activist's agenda, management needs to make it clear that their strategy is aligned with investors'. Management does not need to follow the investor's agenda blindly, just make sure the rationale is well communicated.
- Few companies that have a regular dialogue with investors will ever need to fight off proxy threats. As our research and experience demonstrates, poorly articulated management strategies open the door to shareholder agitation. Empowering the Investor Relations Office and ensuring that the CEO and CFO both meet regularly with key investors will go a long way to warding off activists. In many cases, engaging in a dialogue with an activist and treating them the same way a company would treat any shareholder can help ward off public battles while allowing firms to benefit from the more productive ideas from an activist without engaging in a prolonged fight.
- Any company whose operations and stock are underperforming its peers is a potential target. However, at the end of the day, it comes down to relative performance.
- Investors want alignment between their interests and those of management and the board. For example, executive compensation alone will not make an investor's blood boil. Investors want to see a Board and management hold stock – not just options and grants – where their invested capital is at risk.
- Boards should view sound governance practices as a preventative measure rather than a full defense in and of itself. Activists will use the traditional governance issues as a hook to fight a broader battle over performance issues, dividend policy, etc.
- Boards will be increasingly asked for greater transparency and to improve the communication around the rationale for any material decision.
- Bottom line, show investors that you listen and take their concerns to heart.

Management and boards have other effective routes in addition to direct shareholder contact. The large majority (63%) of the respondents in FD's survey indicated that buy-side analysts and other holders were the most influential in affecting their proxy voting. Approximately half of the investors indicated that financial and business media as well as company investor days are effective tactics that management can use to influence proxy voting.

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Conclusion

According to our panel and our research, a list of investor relations best practices would include the following:

- Understand the interconnectedness of SEC rules/regulations and investors' fervor for change
- Promote and facilitate a thorough understanding of a company's strategy for institutions and individuals that own a significant number of shares
- Help to articulate a company's messages and gather and analyze real-time feedback from current, former and prospective owners to determine if management's message is resonating
- Develop a marketing calendar tailored to shareholders that complements existing investor relations efforts
- Maintain proactive communications with all stakeholder groups, in addition to shareholders

In conclusion, if the communications and corporate governance functions within an organization are executing sound programs that target the investment community in the right ways, management and directors can take active steps to quell investors' frustration over compensation, proxy access and other sticky governance issues, and reduce the threat of investor activism during the coming proxy season.

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For more information, please contact:

Kal Goldberg
Managing Director, Practice Leader
Special Situations
kal.goldberg@fd.com
+1 212 850 5731

Elizabeth Saunders
Managing Director, Practice Leader
Capital Markets Communications
elizabeth.saunders@fd.com
+1 312 553 6737

www.fd.com