The director's guide to shareholder activism

pwc

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Preface

This guide is divided into two principal parts. The introduction analyses the most important current trends we are seeing in shareholder activism. The chapters that follow provide considerations and practical steps companies could consider taking.

For many people, the phrase may conjure images of hedge funds waging proxy battles as they try to win control of their target's board. That is one possible guise of activism, but, for the purposes of this document, the term refers to the efforts of any investor to leverage their rights and privileges as an owner to change a company's practices or strategy.

This could therefore include an institutional investor's engagement with companies around governance and other ESG matters, a retail investor's shareholder proposal or a hedge fund's threat of divestment.

Introduction >

Shareholder activism in 2020-21

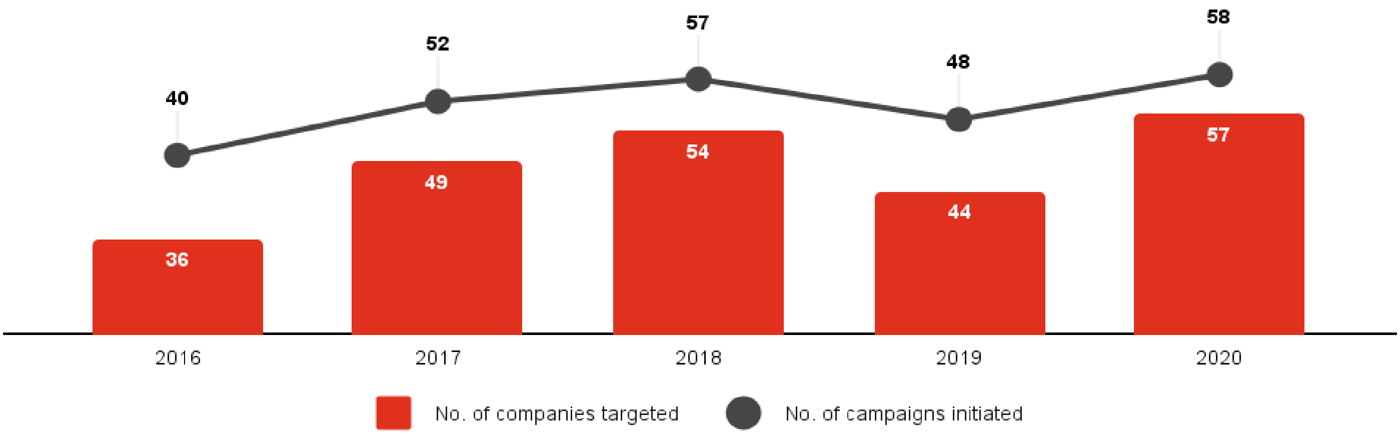
Globally, levels of shareholder activism have risen in recent years. As the pressure builds on asset managers and hedge funds to outperform their peers and deliver greater returns in an increasingly competitive environment, alongside favourable macroeconomic conditions providing pools of capital, the stage has been set for increased activism. With experts predicting that this trend will continue, we look at what boards of directors need to know to navigate this environment.

The pandemic's impact

The COVID-19 crisis has left its mark on all aspects of society and business. Shareholder activism is no exception. In 2020, activists in Europe and the UK started the year by targeting fewer companies as the pandemic rocked financial markets and sparked an economic recession. However, as the year progressed campaigns rebounded strongly. The result was a record year of activism as companies that were underperforming became more obvious - for example, those whose boards were not exploiting the market opportunities. In Europe, including the UK, activists launched 21% more campaigns and targeted 29% more companies in 2020 than they had the previous year, with the fourth quarter seeing a dramatic rebound[1]. Notably, Germany saw the highest ever number of campaigns, while the UK, France and the Netherlands saw numbers equal their historic highs.

During the first half of 2021, hesitancy returned as Europe, including the UK, faced renewed lockdowns, and activist campaigns fell by 29% year-on-year[2]. Some commentators believe that the second half of the year will see an acceleration in campaigns as activists reposition themselves and look to capitalise on the economic recovery as the COVID-19 crisis appears to abate.

European (including the UK) activist activity[1]



Mergers and acquisitions (M&A) have historically been among shareholder activists' top objectives. This could mean pushing a company they invest in to sell all or part of itself, or to seek better terms if it's already in talks to be acquired. These kinds of outcomes remained activists' most common goals in 2020 and into the first half of 2021[2]. With the pandemic causing economic turmoil worldwide, activists pushed more companies to unlock value by implementing strategic and operational turnarounds, breaking themselves up or selling business units, particularly at the smaller company end[1]. Across Europe and the UK in 2020, activists' objectives were primarily focused on M&A, followed by board and management changes, changes to strategy and operations, capital returns and governance.

Having appropriate operational carve out, disposal or closure plans for parts of their business that may suddenly become non-core as a result of shareholder activism should be considered in the strategic planning process, so that boards are ready to implement such actions effectively if needed.

Several activist hedge funds made no secret of the fact that they were taking advantage of the steep decline in equity prices during the early days of the pandemic to build up stakes in potential target companies. Investments like this position activists to continue to increase their activities in 2021/22.

The pandemic has put boards and management teams to the test. It may also open their companies up to additional shareholder scrutiny, as well as make them an activist target, if their performance is underwhelming.

ESG in focus

Environmental, social and governance (ESG) matters remain a priority for institutional investors when engaging with the companies whose shares they hold—and climate change is arguably at the top of their agenda. In addition, widespread protests against racial injustice in 2020 prompted several of the largest asset managers to emphasise inclusion, diversity and equity in their public statements and proxy voting policies to a greater degree than in years past.

ESG is expanding beyond being just a concern of institutional investors. Hedge fund activists are increasingly pushing companies to increase disclosures and adopt more sustainable business practices. They see better ESG metrics as a path to unlock value as well as meeting the demands of their own investors. Some traditional activists have begun to press companies in which they invest on ESG matters[5]. A handful of recently launched hedge fund firms are dedicated specifically to ESG-focused investing and activism and a number of existing hedge funds are launching dedicated funds focused on ESG investing or with ESG 'exemptions'. Some have even undertaken proxy fights in the hope of placing their own directors on company boards.

Other emerging trends

Special purpose acquisition companies (SPACs) have emerged as a popular alternative to an initial public offering (IPO) for some private companies. They aren't new, but the volume of deals involving SPACs is. By March 2021, the volume of SPAC transactions had already surpassed 2020's total[6].

Shareholder activists have tapped into this trend. They're using SPACs as a way to raise capital for M&A. Many of the most active hedge fund activists have launched SPACs recently.

Early 2021 saw the emergence of what could be a new frontier in shareholder activism. Retail investors used social media and stock-trading apps to coordinate the buying of a handful of consumer brands' shares and effectively targeted the hedge funds who were shorting those companies' shares. Within a month, they had pushed prices of the stocks to dizzying heights. And even more quickly, the shares collapsed as the investors moved on. Is this risk here to stay? Or simply an internet-enabled fad? It's too soon to say. But there may be good reason for boards to consider the risks that this kind of investor behaviour poses to their companies. One key difference between the shareholders behind this phenomenon and traditional activists is that these investors didn't seek any changes in strategy, disclosure or capital allocation from the companies they targeted. That may change in the future. It's a risk that may be worth monitoring.

Section 1 >

Activists: Who they are and what they want

A large asset manager pledges to vote against the boards of companies that fall short on ESG matters. A hedge fund a fraction of that size threatens a proxy battle at a company it feels has too much cash on the balance sheet. Both fall under the umbrella of shareholder activism: seeking change because they think management isn’t maximising their targets’ potential. But while they may share an ultimate goal, their tactics can differ greatly.

Institutional investors

Pension funds, insurance companies, and firms that manage funds and exchange traded funds (ETFs) are all examples of institutional investors. Not only do institutional investors own a larger proportion of publicly traded companies’ shares than retail investors do, but they also vote their shares at a much higher rate. This makes them influential stakeholders for many public companies.

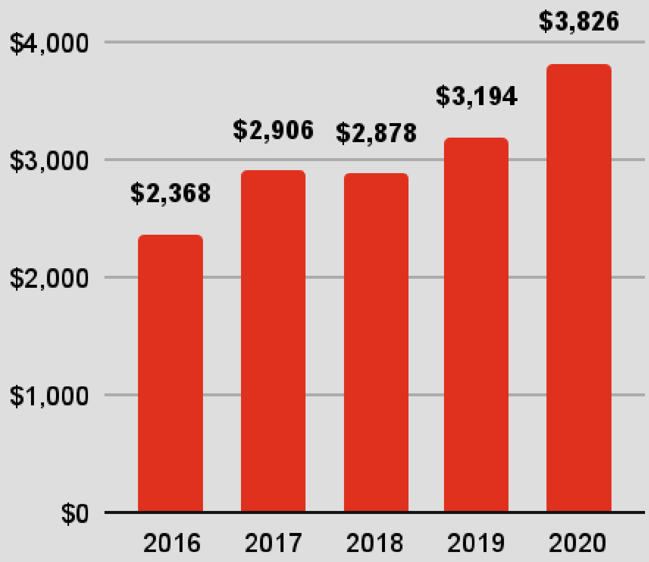
Institutional investors are normally long-term shareholders. Many benchmark their holdings to broad stock market indexes like the FTSE 100. Others offer index funds to retail investors, who are attracted by their low fees. Passive funds can’t just sell a position if they think a stock is underperforming, or if they believe the company’s governance practices hinder its long-term value. Activism is one of the only levers they have to address these concerns. Through activism, they can bring attention to their concerns and drive the change that they believe will create long-term value—including through changes in corporate governance practices. The largest asset managers are vocal about their belief that companies with strong corporate governance practices can deliver better value in the long run.

Hedge funds

Hedge funds attract significant investment from investors seeking above-average returns. So they are always looking for untapped value. Hedge fund activists often see that untapped value in the way a company is run or the strategy it pursues. They see ineffective management, a stale board, or a company missing out on new opportunities. They see the potential for a new capital allocation strategy or changes in operations that will increase share value. And when their efforts to engage with executives or directors about these ideas fail, they often try to get board representation to help achieve their goals.

Hedge fund activists traditionally focused on capital allocation issues, such as dividends and share buybacks. Many then began looking for company combinations and break-ups—mergers, carve outs, and spin-offs. Now there is a greater focus on operational activism, which has more of a long-term focus. Activists join the board (or appoint independent directors), replace members of management and help execute a new strategy. While many hedge funds had been thought of as being too focused on short-term gains, the longer-term operational activism has helped to shift that perception somewhat.

Accelerating growth in global hedge fund AuM[3]



* These amounts are in billions of dollars.

Other investors

Traditional asset managers and hedge funds account for most activist activity. And because they manage the most money—and vote the most shares—they have the greatest ability to make a serious push for change. But they aren't the only shareholder activists.

Religious groups, non-profits, and other advocacy organisations also use the tools of shareholder activism, most notably shareholder proposals, to encourage companies to change.

There are also a small handful of individuals who have made a name for themselves as activist shareholders through retail investing. In fact, these shareholders are responsible for a majority of all shareholder proposals that go to a vote each proxy season. Historically, they have tended to focus on 'good governance' matters. Recently they have broadened their strategy to include ESG and other matters as well.

Section 2 >

Tactics: How activists pursue their goals

Some shareholders turn to activism because they feel it's an effective way to increase the value of the companies whose stock they own. Others do so to address governance practices they believe are hurting long-term value. Or they take issue with the company's products or business practices. Activism can take many forms. But the goal is the same: to motivate management and boards to make changes in the way their companies are run.

The tactics that shareholders use will depend on their objectives. What makes sense for an institutional investor with a long-term horizon may not work for a hedge fund looking for a quicker return. You might even think about activist tactics as a continuum that begins with routine shareholder engagement. Not every request to meet with management from an activist is a prelude to more drastic forms of activism. But many shareholders who seek change will start by attempting to persuade. Others are more likely to start at the more aggressive end of the activist spectrum.

	Less aggressive			More aggressive
Tactic	**Shareholder engagement**	**Shareholder proposals**	**Vote no campaign**	**Proxy contest**
What it is	A request to meet with management (and/or the board) to discuss the shareholder's concerns about the company	A non-binding resolution asking the company to pursue a course of action that appears on the proxy statement for shareholders to vote on	A campaign seeking to persuade shareholders to vote against members of a company's board or to withhold support on say-on-pay or other matters	An attempt to replace some or all of a company's board with directors nominated by the shareholder activist

Shareholder proposals

In some cases, investors view a shareholder proposal as a way to begin the conversation with a company. In other cases, institutional and retail investors submit—or threaten to submit—a shareholder proposal if direct engagement with the company and its directors doesn't produce changes.

In the UK, shareholder resolutions can be made in one of two ways under Section 338 of the Companies Act 2006. Shareholders can require a company to give notice of a resolution to be considered at the next AGM by fulfilling one of the two following requirements:

1. Shareholders representing not less than 5% of the total voting rights of shareholders entitled to vote on a shareholder resolution; or
2. Shareholders number at least 100, holding shares on which there has been paid an average sum per shareholder of not less than £100.

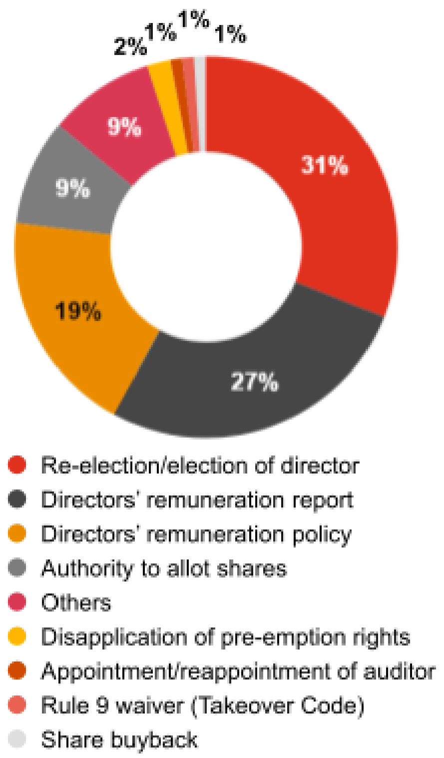
Proposals from activists often focus on governance practices or policies, executive compensation, or the company's behaviour as a corporate citizen. Activists watch how the major institutional investors are voting on issues and have a sense of which shareholders may be likely to support their proposal going in. They also often reach out to other shareholders to encourage support for the measure. By the time the company receives the shareholder proposal, its sponsor may already know whether it will pass. A company may receive the same proposal over multiple years with increasing support until it finally achieves a majority.

Vote no campaigns

'Vote no' campaigns urge shareholders to vote against (or withhold their votes from) director candidates or other matters such as say-on-pay. Vote no campaigns can send a strong signal about shifting shareholder priorities.

The vote doesn't actually have to fail for a vote no campaign to achieve results. Overall shareholder support both for directors and for say on pay is typically above 90%. If support levels fall below 80%, not only does it send a stark message about shareholder dissatisfaction, it triggers the need for action from those companies with a UK premium listing, e.g. those companies who comply with the UK's highest standards of regulation and corporate governance as per the Listing Rules. Under the UK Corporate Governance Code, should 20% or more vote against a resolution, a company needs to consult shareholders to understand the result and publish an update on what they heard and what they plan to do or have already done, within six months of the meeting. A further update should be provided in the annual report on the impact the feedback has had on the decisions and actions the board has taken. It also generates media scrutiny, and can affect a director's reputation. Directors often serve on multiple boards, and low support levels at one company can affect how that director is viewed at his or her other companies as well.

Resolutions that passed with significant no votes[4]



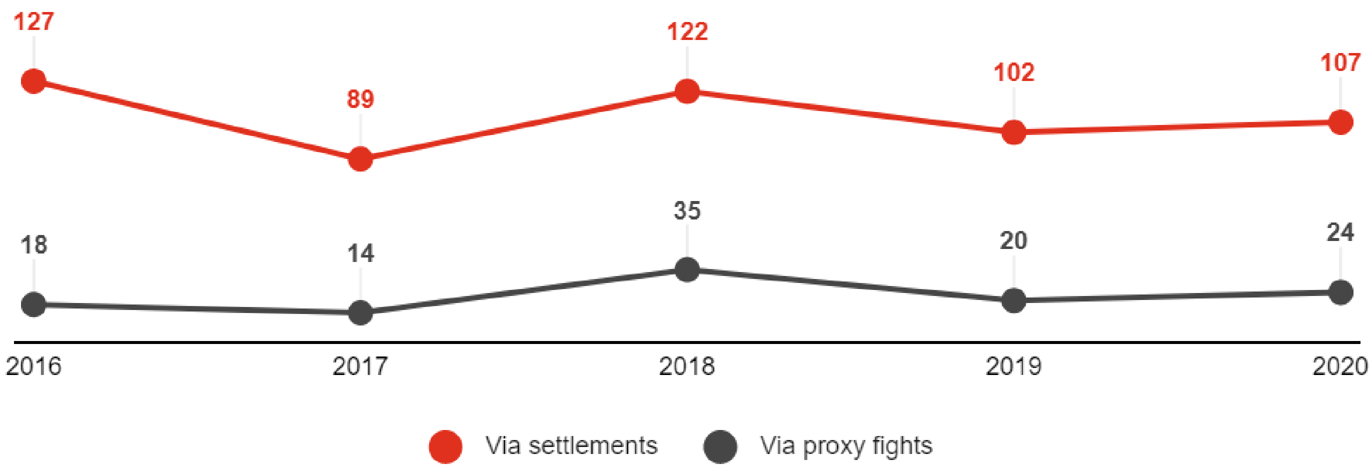
Proxy battles

Shareholder activists may conclude that the best way to achieve their goals is to replace some or all of a company's board. In that case, they advance their own slate of director candidates and try to persuade other shareholders to vote for them. Proxy contests can be expensive and controversial. Historically, they've been most closely associated with activist hedge funds.

The precise activism playbook may vary from investor to investor, but there are several steps hedge funds commonly take to make the threat of a proxy battle more credible. They may try to win the support of a company's other shareholders by circulating a lengthy white paper that lays out the case for the changes they'd like to see. Or they may publish an open letter to the company's management or board listing their concerns. It's a virtual certainty that documents like these will end up in the hands of the media, further ratcheting up the pressure.

Proxy battles are long, expensive and draining for a company. Success isn't assured for the hedge fund, either. That's why activists and the companies they target sometimes reach a settlement that heads off a full-blown proxy contest. As a result, the activist may receive seats on the company's board or assurances from management that some of the changes it seeks will be enacted. From 2016 to 2020, 83% of the global board seats won by activists came via settlements[1].

Global board seats won, 2016-2020[1]



Some institutional investors have grown concerned in recent years that companies are settling too easily. Before rushing to settle, they urge companies to at least reach out to their significant shareholders to solicit their views. In the UK the Investor Forum, a community that helps investors to work collectively with the boards of UK-listed companies to escalate material issues, is one way in which shareholders and companies can have this dialogue. Sometimes investors agree with the activist—and sometimes they want the company to hold their ground against the activist.

Section 3 >

Risk factors: The red flags that can lure activists

Every shareholder activist has a unique agenda. But history shows that companies that attract activist engagement tend to have some issues in common. Poor performance in the stock market, weak earnings compared to peers, governance missteps, and lack of attention to ESG matters can all trigger shareholder activism.

Poor financial, operational or share performance

Shareholders are rarely happy to see a company underperforming its peers, hanging on to non-core divisions that don't fit with the rest of its business, hoarding too much cash on their balance sheet or operating with capital structures that are excessively complex or risky. From an operational perspective activists will be assessing whether the company strategy is the right one, and whether it is being executed in the right way and at the right pace. The chances also tick up if there are other governance concerns.

Hedge fund activists are typically looking to unlock value they believe is going unrealised. Companies with a low ratio of market value to book value, excessive cash on hand or lots of monetisable assets like real estate may fall into their crosshairs.

Activist hedge funds are also becoming more interventionist in distressed and restructuring situations, especially in response to lender demands that may impact longer term equity value or result in equity dilution for existing shareholders. Often there are other hedge funds in the lender group driving the lender agenda. In some cases, this could precipitate a conflict between shareholders and lenders, leaving the board and management 'in the middle' managing competing stakeholder groups when the survival of the business itself may be on the line.

Whether shareholders turn to activism often depends on their investment strategy. Institutional investors are commonly less likely to support activism at a company unless it also suffers from one or more governance weaknesses, as discussed next.

Governance weaknesses

Governance problems can both indicate other weaknesses at a company, and can have a detrimental effect on its value. Issues that may prompt investors to engage with a company, to submit a shareholder proposal or take even more drastic measures may include:

- **Board structure and composition.** Many institutional investors are intensely focused on board composition, tenure, and in particular on board diversity. Companies that make it difficult to vote out underperforming directors can also draw the ire of shareholders.
- **Executive compensation.** Companies with problematic pay practices, pay that is out of alignment with company performance or that don't respond after a low say-on-pay vote can all become targets of shareholder activism.

ESG shortcomings

Activists may see perceived poor practices in the ESG realm as an opportunity to create value.

The focus on ESG has in part been driven by factors such as: substantial inflows into ESG-based funds reflecting the views of increasingly conscious consumers, regulatory environments that promote improving ESG performance, and an increase in shareholder proposals in this area.

Sometimes activist campaigns may relate to the environment. For example, this could include a lack of disclosure around risks related to climate change, or pressure from shareholders to divest parts of the business that don't fit with commitments to move toward a low carbon economy (e.g, coal mines). Or they may relate to social matters such as diversity or inadequate labour, health or safety practices.

Many of the largest asset managers have called for more disclosure in this area. They want companies to discuss how issues such as climate change, energy transition and inclusion, diversity and equity factor into their strategies. And they want to know companies' plans for confronting those challenges.

Ignoring shareholder concerns

Lack of responsiveness to investors can bring companies unwelcome attention. Sometimes an issue that has come up during shareholder engagement may evolve into a shareholder proposal. Other times, if the company hasn't taken action in response to a concern, the consequences can be more severe. For example, if a company's resolution on their remuneration policy garners low support levels, shareholders expect to see changes in the company's incentive plans. If those changes don't come, shareholders may launch a campaign to vote against the directors on the remuneration committee. The bottom line: It rarely hurts to hear a shareholder out, determine whether their arguments have merit and, if so, consider acting in response.

Section 4 >

Heading off an activist

Shareholder activism can come as a surprise. When an activist presses a company to divest an underperforming asset or put itself up for sale, it can leave the management team and board scrambling. They may ask themselves why they didn't see it coming. Even being on the receiving end of a shareholder proposal can feel like an unwelcome intrusion.

Directors have a key role to play in the company being prepared. They can anticipate which activists may engage with the company, the issues they may raise and how other shareholders might respond. They can push management to address issues that may attract activist attention. Not only can these actions help ward off an activist, but they may also help improve the company's performance and its relationship with stakeholders.

Take a candid look at your company

Directors should always make it their business to stay informed about their company's strategy and how effectively it's being executed. This requires looking at the company's performance with an objective and critical eye. However, the data that directors get can sometimes be so granular that it's hard to see the big picture. Or else it might be so high level that important details are easily overlooked.

Focusing on common triggers for activist engagement may help boards cut through the noise. Asking how the company's ESG disclosures compare to best practices, for example, or how the dividend stacks up against peers that have been targeted by activists may help bring clarity. Ask to hear from outside experts, industry analysts, investment bankers or others from outside the company to get a better understanding of how the company is seen by investors and potential activists. Make sure to ask for outsiders' 'unvarnished' views—ones that haven't been toned down (or whitewashed by management).

If there are issues, take proactive steps to address them. This can reduce the chance of becoming an activist target. It can also strengthen your credibility with the company's shareholders. Even if the company chooses not to make any changes, going through the critical process will help company executives and directors reaffirm and articulate why they believe the company is on the right course.

Know your shareholders

Ensure that the board is informed when an activist takes a significant position in the company or in an industry competitor. And make sure the board hears about broader activism trends that could affect the company in the future. Understanding what these shareholders may seek will help the company assess its risk of becoming a target and help it know what tactics to expect.

And of course, directors should keep up to date on the views of the company's largest shareholders. Whether this is through regular engagements or through third party providers that conduct shareholder perception studies, this insight is critical. This includes carefully watching any changes to their public engagement priorities or proxy voting agendas.

Create an engagement plan

Once a company identifies areas that may attract activist attention, engaging with other shareholders around these topics can help prepare for—and in some cases may help to avoid—an activist campaign. Being transparent about the company's vulnerabilities and its strategic choices can help change a shareholder's view of the issue, and demonstrate that the board is fulfilling its oversight responsibilities. Even before the company receives an activist overture, some companies may find it helpful to start getting directors involved in discussions with major investors. If shareholder activists do target the company, directors will already have credibility with other investors. That may make the board of directors more effective spokespeople for the company's position.

Section 5 >

How to respond to an activist

When an activist comes calling, the company's response is critical. An ineffective response may make things worse by giving the impression that the company's management and board are not attuned to shareholder concerns. While the activist's scrutiny may be unwelcome, that doesn't mean their concerns are entirely without merit. An encounter with a shareholder activist may make the company stronger in the long run—if it's handled effectively.

Objectively consider the issues on the table

Activists usually do extensive homework before they approach a company. Based on that research, they develop specific proposals for unlocking value—at least in the short term. And they have often discussed these ideas with other shareholders. Assume the company's institutional investors have already spent time evaluating the activist's suggestions. Investors will expect the company's executives and board to do the same—even when it's uncomfortable. And it often is. They might be looking for changes in the boardroom, which may feel like a personal affront to the directors around the table. Or they may be looking for a change in management, which will almost certainly feel like an attack on the CEO. But none of these ideas should be dismissed out of hand.

It's also important to take a shareholder proposal or vote no campaign seriously. Take a step back. Few companies are perfect when it comes to corporate governance. Perhaps the company's practices are justified. But are there areas that could be improved? Could communications with the market be better? Changes that have been avoided as a result of status quo bias? If that's the case, shareholder pressure could be a valuable wake-up call—as long as it isn't ignored.

Determine how best to respond to the investor

When it comes to activists, the strategy may differ depending on their approach. If the activist approaches with a private request, it may make sense to respond. This gives the company a chance to hear about the criticisms. It may also lay the groundwork for future private conversations—which can be helpful if the company later wants to negotiate a settlement with the activist. When activists take their campaigns public, however, the smartest move may be to say very little. There's very little potential benefit for a company in trading blows with an activist in the media.

For companies that have received a shareholder proposal or that have been targeted for a vote no campaign, their best bet is to reach out to the investor directly to discuss their specific concerns. When dealing with a shareholder proposal, the company and the shareholder may be able to agree on some action at the company in exchange for withdrawing the proposal. Shareholders don't always insist on immediate action. They know change can take time, and often they are satisfied if the company demonstrates that it has a plan in place to address the issue and communicates regularly on its progress. Communication might not put an end to a vote no campaign, but understanding the shareholder's perspective will help the company respond.

Reach out to other shareholders

When activists are contemplating a vote no campaign or proxy battle, they will need support from other shareholders to be effective. It's safe to assume they're already engaging with the company's other investors, so it's important that management and the board make themselves heard as well. An approach from an activist can present an opportunity to discuss the issues they raise with other shareholders. Take the chance to articulate the company's view about why its current course is in the best long-term interests of the company and all of its investors (if it is).

Ideally, the company already has an established relationship with those shareholders to build upon. If the company doesn't believe the activist's proposed changes are in its best long-term interests, investors will want to know why—and just as importantly, how the company reached this conclusion. On the other hand, if the company has decided to make some changes, be open about what those are. And consider disclosing the breadth of the company's shareholder engagement efforts in the proxy statement to give yourself credit for your outreach. Often we hear that the suggestions activists make are ones that the company had already been considering.

Look for ways to build consensus

More companies than ever are finding ways to work with activists. Proxy contests are costly and time consuming. It may make sense to find common ground with shareholder activists to take these risks off the table.

Reaching an agreement with a shareholder activist may require the company to increase disclosure of certain information, change its capital allocation or even add new directors to the board. These moves may not have been in the company's plans before the activist encounter, but they may make sense if the alternatives include even more drastic changes—such as a proxy battle that could give the activist control of the board.

Activists are also motivated to reach agreement. Even though target companies typically spend many times as much on proxy solicitation efforts, the cost to an activist is also significant. If given the option, most activists would prefer to spend less time and money to achieve their goals. Once they agree, the activist and the company enter into a standstill agreement that sets the terms of their relationship going forward.

Even non-binding shareholder proposals can cause embarrassment if they pass—or even just receive unwanted media attention. It may make sense to see if there's middle ground between the company and the proponent that both can live with.

Section 6 >

How PwC can help

Even as activism—by institutional investors, hedge funds and others—continues at a healthy pace, many think the number of campaigns still could be on the upswing. For companies, listening and being prepared are crucial to navigating the changing landscape of shareholder activism.

To have a deeper discussion about how this topic might impact your business and how PwC can help, please contact your engagement partner or a member of PwC's Investor Engagement team or the Business Restructuring Services team.

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