SHAREHOLDER ACTIVISM

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BACKGROUND TO SHAREHOLDER ACTIVISM

Shareholder activism represents a range of activities by shareholders of a publicly traded corporation that are intended to result in some change in the corporation.

More generally, the activities of shareholder activism fall along a spectrum based on the significance of the desired change and the assertiveness of the investors' activities. On the more aggressive end of the spectrum is hedge fund activism that seeks a significant change to the company's strategy, financial structure, management, or board.

Hedge fund activism has been around since the 1980s, although they were known as "corporate raiders" since they sought the breakup of companies. Their general strategy included using their own money to obtain a chunk of the company's shares and engage in a proxy contest for control of the board.

Even today, the goals of activist hedge funds include this, as well as changes in the "capital allocation strategy" (e.g., return of large amounts of reserved cash to investors through stock buybacks or dividends, revisions to the company's acquisition strategy). During the past decade, the number of activist hedge funds across the globe has dramatically increased, with total assets under management now exceeding $100 billion.

Moving down the activism spectrum are "vote no" campaigns where investor(s) urges shareholders to withhold their votes from one or more of the board-nominated director candidates. These campaigns are usually sponsored by public or labor pension funds, but rarely succeed. In ousting a director at most companies, a "vote no" campaign would require the support from a majority of outstanding shares—not just a majority of the votes cast at the meeting, which is a much lower threshold. However, a "vote no" campaign has the ability to force the candidate to voluntarily withdraw from the election.

Further down the spectrum is sponsorship of a shareholder proposal (or, more often, the threat of a shareholder proposal). There are many different types of investors that have different goals, which can include changing 1) the board's governance policies or practices, 2) the board composition, 3) the company's executive compensation plans, 4) the company's oversight of certain functions like audit or risk management, or 5) the company's behavior as a corporate citizen.

On the other, more passive end of the spectrum are one-on-one engagements between shareholders and companies triggered by Dodd-Frank's "say on pay" advisory vote. These activities are usually limited to letters or meetings/phone calls with the company. The goal of these conversations is to achieve a substantive change to the compensation plan or alter how it is described in shareholder communications.

A less-known method for shareholder activism is the breaking up of stocks into dual classes. An increasing number of newly listed companies have introduced classes of stock with superior voting rights, which typically allow company founders and top executives to maintain company control even as their economic stake in the business may diminish. Dual-class companies include corporate giants such as Facebook Inc., Alphabet Inc., and Berkshire Hathaway Inc. In 2019, some of the largest U.S. IPOs involved classes of stock with superior voting rights, including Lyft Inc., Pinterest Inc., and Levi Strauss & Co.

However, the growing prevalence of dual-class share structures has raised an alarm because of the potential risks that it poses to common shareholders. They argue that the discrepancy between control and economic ownership reduces accountability to the economic owners of the business, entrenching management and skewing incentives. Meanwhile, proponents of the dual-class share structure contend that control is necessary to protect the company from the short-term pressures of the market and to allow management to focus on growth and long-term strategy[1].

If we were to believe that the period following the financial crisis is a fair comparison to the current period (though it is becoming highly questionable), we would expect to see a substantial uptick in the statistical measurements of shareholder activism in the wake of the COVID-19 pandemic.
The all-time record year for proxy contests was in 2009 at 134 contests that year which was a direct result of the recession. Moreover, 2018 also turned out to be a record year for many shareholders. A record number of shareholder activist campaigns (250) were initiated, and the average market capitalization of the companies targeted has continued to increase as well. First time activists roughly doubled from 2017; however, first time targets represented less than 50% of U.S. targets of financial activists. There was also a 30% increase in the amount of capital deployed, for a total of $65 billion in new activist campaigns. Although a record number of board seats were won in 2018, in most cases, it merely achieves a "voice at the table" rather than an entire change in corporate strategy. Of course, some activist nominees prove to be highly effective and wield outsized influence in the boardroom, but it is important to not overstate the significance of board seats[2].

As with many industries, COVID-19 has brought about an unprecedented period of uncertainty around how the future of shareholder activism will look[3].
Some uncertainties include:

- Whether there is irreparable damage/change in certain industries, business models, and consumer behavior
- the extent of the government's involvement and the regulatory landscape that will be shaped
- the upcoming US presidential election
- The challenges in identifying those companies likely to persevere and prosper post-COVID-19 and uncertainty in how long it will take for the stock market to reward those companies.

Additionally:

- Activists have not been shielded from the current market volatility and may be focused on dealing with their current positions
- Activists may be limited in accessing capital for additional investments. It appears that market volatility will be with us for an extended period, so activists will likely need to be able to access capital with lengthier investor lockups to protect against redemption requests.
- There is the possibility that activists will not be able to count on institutional investors to be as supportive as they have been in the past. Institutional investors may be more focused on seeing companies focus on the health of their business, their liquidity needs, their ability to stay afloat, and their ability to rebound from the crisis, rather than taking steps to enhance shareholder value
- Activists may have a limited ability to credibly criticize company performance and management's strategy, in fear of appearing "tone-deaf"
- Activist-driven board refreshment may not look very attractive, when they need institutional memory and experienced leadership is needed to navigate such times

[1] https://corpgov.law.harvard.edu/2019/02/13/the-road-ahead-for-shareholder-activism/
[2] https://corpgov.law.harvard.edu/2015/04/07/shareholder-activism-who-what-when-and-how/
[3] https://corpgov.law.harvard.edu/2020/04/12/the-impact-of-covid19-on-shareholder-activism/

- Activists may face challenges in coordinating their engagement with the company’s board and management team as well as organizing campaigns when much of the world is working from home and focusing on simply being able to stay afloat.

Provided that COVID-19 has led to dramatic changes in stock prices and market valuations of companies, an important question we will be addressing throughout the course of this presentation is:
Will 2020 be a new record year of the number of activist campaigns initiated?

RETURNS

According to the U.S. Securities and Exchange Committee (SEC), an activist investor or group of investors must have ownership of at least 5% of the voting class of a company’s shares. Additionally, activists are required to disclose their stake by filing a Schedule 13D within 10 days of acquiring 5% or more of the company. A Schedule 13D is crucial to an activist investor because it provides them with useful information about having a majority stake in the company. Activists will also have to file a 13G if they acquire between 5%-20% of a company without intentions for a takeover or anything which will materially impact the company’s shares. An example of such a scenario is if a mutual fund has over 5% ownership merely due to the size of the fund. The announcement of investors’ activism often results in stock price jumps due to a market view change of the company’s future.

In September of 2019, Elliott Management announced it had a $3.2B stake in AT&T, followed by the fund sending a letter to the company’s board detailing how AT&T could “improve its business and realize a historic increase in value.” The announcement and the letter quickly resulted in a 9% increase in the stock price and a tweet from President Trump discussing how the activists may help bring about change to the “very low ratings @CNN”[4].

Another instance in which the share price of a stock was affected after the announcement of an investor’s activism was when Bill Ackman announced Pershing Square Capital Management’s $900 million stake in Starbucks during early October of 2018[5]. The stock saw an increase of as much as 5.6% by the end of the day. Outside of these two recent examples, a notable activist investor is Carl Icahn, whose activist announcements have affected Apple’s stock price and caused large companies such as Google to take preemptive measures and split its stock 2-for-1 by creating a new C-class of its shares[6]. The new class of shares did not have any voting rights, thus activist investors could buy as many of the shares as they would like without having a voice in the company. The examples illustrate that announcing activism can have a significant immediate impact on a company’s stocks and also can push companies to take measures to consolidate their power.

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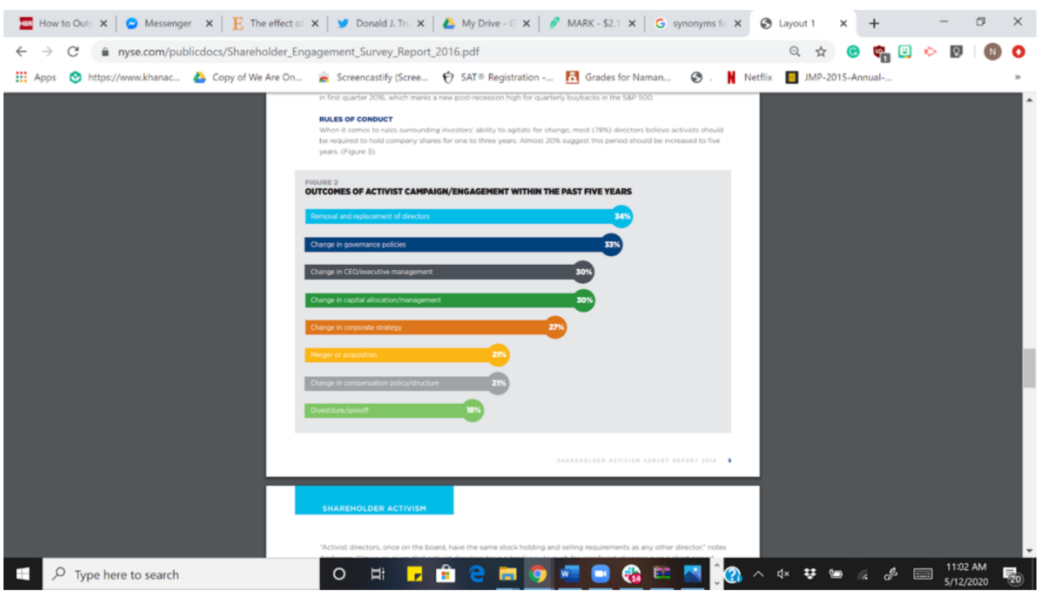
4 https://www.cnbc.com/2019/09/09/att-shares-jump-after-activist-elliot-management-takes-stake-sees-shares-nearly-doubling.html
5 https://www.seattletimes.com/business/activist-investor-bill-ackman-buys-900-million-stake-in-starbucks/
6 https://www.dividend.com/how-to-invest/the-icahn-effect-a-primer-on-activist-investors/

Activist investors have aggressive and more passive approaches to bringing about change to a public company. A large majority lobby privately by stating their intentions and visions for the company through meetings and letters which often can lead to settlements. The more aggressive investors work on bringing about change through private and public platforms. The most common form of lobbying aggressively for change is through media campaigns against the management. 2015 and 2016 were big years for activists where they attacked hundreds of public companies including General Motors, Dow Chemical, Nestlé, Xerox and Mondelez. Activist pressure caused Apple to undergo multiple changes as well such as returning capital to shareholders from their cash reserves. Unless activists want to stay in the company for the long-term, they tend to get out and sell most of their shares after making a sizable profit for themselves and other like-minded investors. According to *Harvard Business Review*, the average holding period of an activist investor is around 7 months, however this is not indicative of the majority as the review also states that the median holding period for an activist investor was well over a year. However, many still retain a portion of the shares in order to maintain power within the company. For example, in late October of 2019 Paul Hilal's Mantle Ridge LP sold off 4.7 million (worth approximately $1 billion) shares of the railroad company CSX after making a 100% return[7]. Hilal still retained less than half of his ownership so that he would still be able to serve as the director and vice chairman of the company's board.

Another important area that should be mentioned is the ethical dilemma that arises from the actions that a company's management takes as a result of being pressured from activists. The agency conflicts frequently cause tensions between activists, management, bondholders, and shareholders[8]. Such actions include but are not limited to:

1. Acquiring other companies which increase the share price but also can increase the overall liabilities the company has.
2. Increase dividend payouts for stockholders
3. Change in governance policies
4. Change in capital allocation and management[9]

Furthermore, Evercore and SpencerStuart collected data on activist impact from years 2011 to 2016 and here were their findings[10]:



The aforementioned actions often come at a cost to bondholders and long-term shareholders because:

1. Activists' demands cause a significant decline in bond returns and affect long-term bonds the most.

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7 https://www.marketwatch.com/story/activist-investor-that-shook-up-csx-sells-most-of-its-stake-2019-10-21
8 https://www.imd.org/research-knowledge/articles/beware-of-activist-investors/
9 https://www.sciencedirect.com/science/article/abs/pii/S1062976917301175
10 https://www.nyse.com/publicdocs/Shareholder_Engagement_Survey_Report_2016.pdf

2. Dividends increase following the activists' demands among firms with negative bond returns because a greater portion of the cash is given out to shareholders rather than bondholders
3. The wealth transfer effects lo ng-term and lower rated bonds more significantly.
4. The strategies are for short-term gain and are not in the companies' best interest for long-term gain[11]

Due to the following consequences, about 84% of directors disagree that shareholders represent the interests of all the company's shareholders and 84% of directors also believe shareholder activism often creates negative distractions for a company's management and the board. For these reasons, there is a lot of pushback from company management and bondholders to shareholder activists.

SUSTAINABILITY

Beginning in the 1980's, shareholder activism sought to transform company governance. Earlier this year, activist investor Carl Icahn prompted Occidental Petroleum Corporation to add three new directors to the company's board of directors. The addition of those three directors—chosen by the Icahn Group—was a result of Icahn's nearly year-long battle with the company in stocks, media, and the court of law. Icahn's battle with Occidental began last May when Occidental bought out Anadarko Petroleum Corporation for $37 billion in cash and Oxy stock[12]. Carl Icahn believed that deal to be one of the worst in financial history, repeatedly calling for the resignation of Occidental's CEO, Vicki Hollub, after she made the deal without putting it to a shareholder vote [13]. Icahn started building a stake in the company and became the second largest shareholder—holding 9.9% of the company—after buying more stocks following the drop-in oil prices during the coronavirus pandemic[14]. Icahn's deal with Occidental includes the retirement of four directors, replaced by two Icahn allies and a board member from a nutrition company.

In recent decades, shareholder activism has followed the sustainability trend. In 2003, 25% of activist investing proposals were related to environmental, social, and governance (ESG) issues; however, 40% of shareholder proposals were related to ESG issues in 2013[15]. Faculty at Harvard's Business School found 2,665 proposals that address ESG issues. The CEO of Blue Harbour Group, Cliff Robbins, even holds ESG issues to the same standard as financial issues, asserting that focusing on ESG issues will reduce risk and improve returns[16]. The performance of Robbins' Blue Harbour Group alone is enough to endorse Robbins' strategy; Blue Harbour Group ended the year 2019 up 33 percent. During that same year, Blue Harbour Group had launched a hedge fund specific to ESG campaigns, with $250 million invested from the California State Teacher Retirement System[17]. While the owner of Blue Harbour Group, Cliff Robbins, is closing the hedge fund for personal reasons, the fund will close with a 14.4% annualized gain since the fund opened in 2004[18]. Blue Harbour's portfolio of 55 companies includes WebMD, a company picked by Blue Harbour to advance the presence of women in the company[19].

Other companies are using active investing to promote ESG issues. The manager of TCI Fund Management, Sir Christopher Hohn, is urging companies in his portfolio to both disclose and reduce their carbon footprint. The British investment banker is using his $30 billion in capital to leverage these demands, even threatening to "dump their shares" if companies fail to meet sustainability guidelines[20]. Sir Hohn is calling on investors to take notice of

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11 https://ideas.repec.org/a/eee/quaeco/v66y2017icp328-344.html
12 https://www.worldoil.com/news/2020/3/26/oxy-calls-truce-with-carl-icahn-makes-changes-to-its-board
13 https://www.forbes.com/sites/christopherhelman/2019/07/23/carl-icahn-blasts-occidental-ceo-as-arrogant-preps-proxy-fight-after-53-billion-anadarko-takeover/#3cb925507efa
14 https://www.marketwatch.com/story/occidental-petroleum-reaches-agreement-with-carl-icahn-to-add-3-directors-designated-by-activist-investor-2020-03-25
15 https://www.hbs.edu/faculty/pages/item.aspx?num=51379
16 https://www.wsj.com/articles/activist-investor-takes-a-page-from-greenpeace-pushing-companies-for-change-1489928400
17 https://www.institutionalinvestor.com/article/b1k0ztq7n2wc6d/Hedge-Fund-Activists-Pivot-to-ESG
18 https://www.institutionalinvestor.com/article/b1k0ztq7n2wc6d/Hedge-Fund-Activists-Pivot-to-ESG
19 https://www.bhgrp.com/app/asset/uploads/2018/01/Financial-Times-Why-Activists-are-Cheerleaders.pdf
20 https://thehill.com/changing-america/sustainability/climate-change/480124-the-most-profitable-hedge-fund-in-the-world-is

the risk presented by climate change, asking them to fire managers who fail to lower their carbon footprints[21]. Some investors are taking the other route. The CEO of BlackRock, Larry Fink, is pulling back entirely from companies who present a climate risk to the economy, such as fossil fuels[22]. In January of 2020, Fink sent a letter to BlackRock's clients as a notice that BlackRock would be offering new portfolios without fossil fuels investments[23].

Some question whether individuals and entities should invest to become activist shareholders or mobilize current shareholders to be active in their company governance rights. Trian Fund Management issued a policy statement in 2017 that promoted the application of ESG issues in financial decision-making[24]. That same year, Trian partners drove the CEO of General Electric off the company board after acquiring 1.5% of the company's shares[25]. However, with 8.66 billion shares outstanding in 2017, that large of a move required hundreds of millions of dollars[26]. While Trian Fund tackled the governance at GE to promote their interests, other firms are looking to invest in companies with current sustainability practices. ValueAct Capital recently acquired 5% of Unifi, a company that produces textiles from recycled bottles[27].

THE CORONAVIRUS AND SHAREHOLDER ACTIVISM

When COVID-19 hit, it forced markets into an unprecedented decline. The S&P 500 dipped almost 35% provoked by state shutdowns and encouraged isolation for non-essential workers. Few industries have witnessed growth as businesses both large and small have traded "more than 50% off their 52-week highs"[28]. Even now, the virus continues to spread suspending business operations and reducing consumer spending leaving companies vulnerable and exposed to rising market fluctuation. As a result, investors remain patient as COVID-19 takes its detrimental toll on our economic landscape.

Unfortunately, the virus came at a time when corporations were gearing to take on annual shareholder meetings, a pivotal time frame for activist investors especially those that hold large equity stakes in target companies. It provides them the opportunity to contest board seats through proxy contests while also ousting ill-performing management teams. Not only that, they have the ability to voice opinions about company operations and policy and push shareholder proposals to amend them. However, despite the historical uptick in activism during this time, what has been witnessed instead is a continued slowdown with Lazard reporting a 38% decline in shareholder activism since the beginning of February 2020[29]. Nonetheless, this remains purposeful as activist investors avoid public scrutiny by not pushing for companies to alter policies or make drastic changes when many are working to stay afloat.

Oftentimes, even to enact these changes (through activist campaigns) or contest board seats, investors must retain a higher stake in a business buying up shares and holding a position long-term. Fortunately, COVID-19 has presented a unique opportunity for that, and while many report a recent slowdown in shareholder activism, it plays right into investor hands. Activists realize that if they bought now, they would witness a potential loss in their shares' value in the near term as the market reacts to the coronavirus. Something that remains apparent with the Dow and NASDAQ down 34% and 29%, respectively[30]. However, these depressed stock prices although volatile for the moment provide future opportunities for activist investors, future entry points for when the economy starts

21 https://www.bloomberg.com/news/articles/2020-01-22/the-world-s-most-profitable-hedge-fund-is-now-a-climate-radical?utm_campaign=news&utm_medium=bd&utm_source=applenews
22 https://thehill.com/policy/energy-environment/478218-investment-firm-blackrock-announces-shift-away-from-fossil-fuels
23 https://thehill.com/policy/energy-environment/478218-investment-firm-blackrock-announces-shift-away-from-fossil-fuels
24 https://trianpartners.com/content/uploads/2017/06/Trian_ESG_Policy_Statement_-_June_2017.pdf
25 https://luchoffmanninstitute.org/shareholder-activism-standing-up-for-sustainability/
26 https://www.macrotrends.net/stocks/charts/GE/general-electric/shares-outstanding
27 https://www.bloomberg.com/news/articles/2019-05-22/hedge-funds-start-to-figure-out-socially-responsible-investing
28 https://corpgov.law.harvard.edu/2020/04/12/the-impact-of-covid19-on-shareholder-activism/
29 https://www.lazard.com/perspective/lazards-quarterly-review-of-shareholder-activism-q1-2020/
30 https://www.jdsupra.com/legalnews/the-potential-impact-of-the-coronavirus-36176/

to bounce back and share prices begin to stabilize[31]. The idea is that, as the market picks up, many of these companies will be trading at "bargain prices" (lower premiums) exposing them to activist involvement who will take advantage of the low-cost shares and buy up large amounts[32]. This can then prove useful in the later term for proxy contests, shareholder proposals, and engagement as they'll exercise a larger say in the company.

Not only that, COVID-19 provides these activist investors the opportunity to analyze company management and board response to the virus throughout this time. Structurally inefficient businesses that have remained masked by the success of the previous bull-market will find their inability to survive the virus outbreak exposed and exploited by activist investors. This is shown as many contain riskier capital structures with higher debt to equity ratios and minimal cash on hand. According to Goldman Sachs, even before the virus "one quarter of the country's largest companies had more cash going out than coming in"[33]. On top of that, "corporate debt had surged past 10 trillion" [34]. Their inefficiency through the virus will provide activist investors the firepower they need to contest board seats, oust management teams, and dispute new operational goals and policies once we've reached economic stability after the virus.

In the end, one should take the recent dip in activism with a grain of salt as it masks the agenda many of these investors are forming for the coming year when markets begin to bounce back. Coronavirus, despite all its unfortunate ramifications, will catalyze future growth in shareholder activism as investors realize the unique opportunity within the space. Companies will remain vulnerable to activist advances as economic decline has brought share prices to an all-time low. This will pave the way for activist investors to buy up a substantial portion of shares in which to incite prospective proxy contests and push shareholder proposals. That, corroborated by evidence of management and board failure throughout the pandemic, will create enough of a platform for shareholder activism to grow.

31 https://www.cravath.com/files/uploads/Documents/5333184_1.pdf
32 https://corpgov.law.harvard.edu/2020/04/12/the-impact-of-covid19-on-shareholder-activism/
33 https://www.washingtonpost.com/business/2020/03/28/recession-economy-coronavirus/
34 https://www.washingtonpost.com/business/2020/03/28/recession-economy-coronavirus/