

Be your own activist

Developing an activist mindset

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Analysis is based on data from Activist Insight which tracks investments, performance and news on over 2,300 activists globally. Activist Insight data continues to be regularly quoted in the leading financial press, including the Financial Times, New York Times and Bloomberg.

Remaining masters of the company's fate

Activist investors have been operating in the marketplace for some time, but today, the combination of a favourable regulatory environment and abundance of funds to invest, means activists have become a force to reckon with and are here to stay. Activists are better prepared than ever, they have more funds to deploy, spend considerable time undertaking sophisticated analysis to finesse their demands, adopt complex hedging strategies that exploits any weakness in the corporate structure, and have stepped up their strategy by courting passive shareholders well in advance in order to influence crucial votes in their favour.

The success they have achieved in the United States (US), has encouraged activists to go global. In recent months, we have seen activism grow from a principally US trend to an increasingly global one, with activist-driven activity on the rise across Europe, Australia and Japan. Activists are clearly here to stay.

The motivation of most activists is their own position and realising the greatest returns for them will sometimes be aligned to a company's objectives and sometimes won't. The success of a company's Board/ Management team will be to act in the interest of the company's long term growth (and interests of all stakeholders, not just a single shareholder) whilst also seeking to incorporate the 'goal congruent' parts of the activist's strategy.

A key consequence of the rise of activism is that it firmly puts a spotlight on the workings of the Board. This means every major business decision, ranging from business strategy and operational performance to capital investment and M&A, is subject to public scrutiny and can often involve public showdowns in the media.

Such tactics can immediately put the Board in a position where they have to respond. Often the ensuing fallout results in other passive institutional shareholders potentially supporting the activist which can compound the pressure on management teams.

CEOs and Boards may wish to 'think and act' like activists to pre-empt and avoid public and costly showdowns: they might want to understand the motivations of activists, ask themselves some hard questions about the company's performance and future direction and then take concrete steps to improve shareholder returns. They may choose to embrace active management of passive shareholders long before activists strike. Executives and Boards who understand and apply activist techniques might be better placed to meet the demands of activists and simultaneously drive shareholder value. Ultimately, the goals of both the Activist shareholders and the Board has to align since they both want to ensure shareholder value creation.

This thought piece is not about the merits or otherwise of activism. Instead, in Part One, we examine key trends in activism, assess the dynamics in the current market, and explore what companies might expect from activists in the near term.

In Part Two we set out the key points from discussions with former activists to provide insight into the 'activist mindset'.

In Part Three we set out how a business might go about rigorously applying an 'activist lens' to its own organisation to independently identify issues that could be the subject of an activist campaign, thereby driving shareholder value on its own terms.

We hope you find this paper insightful.

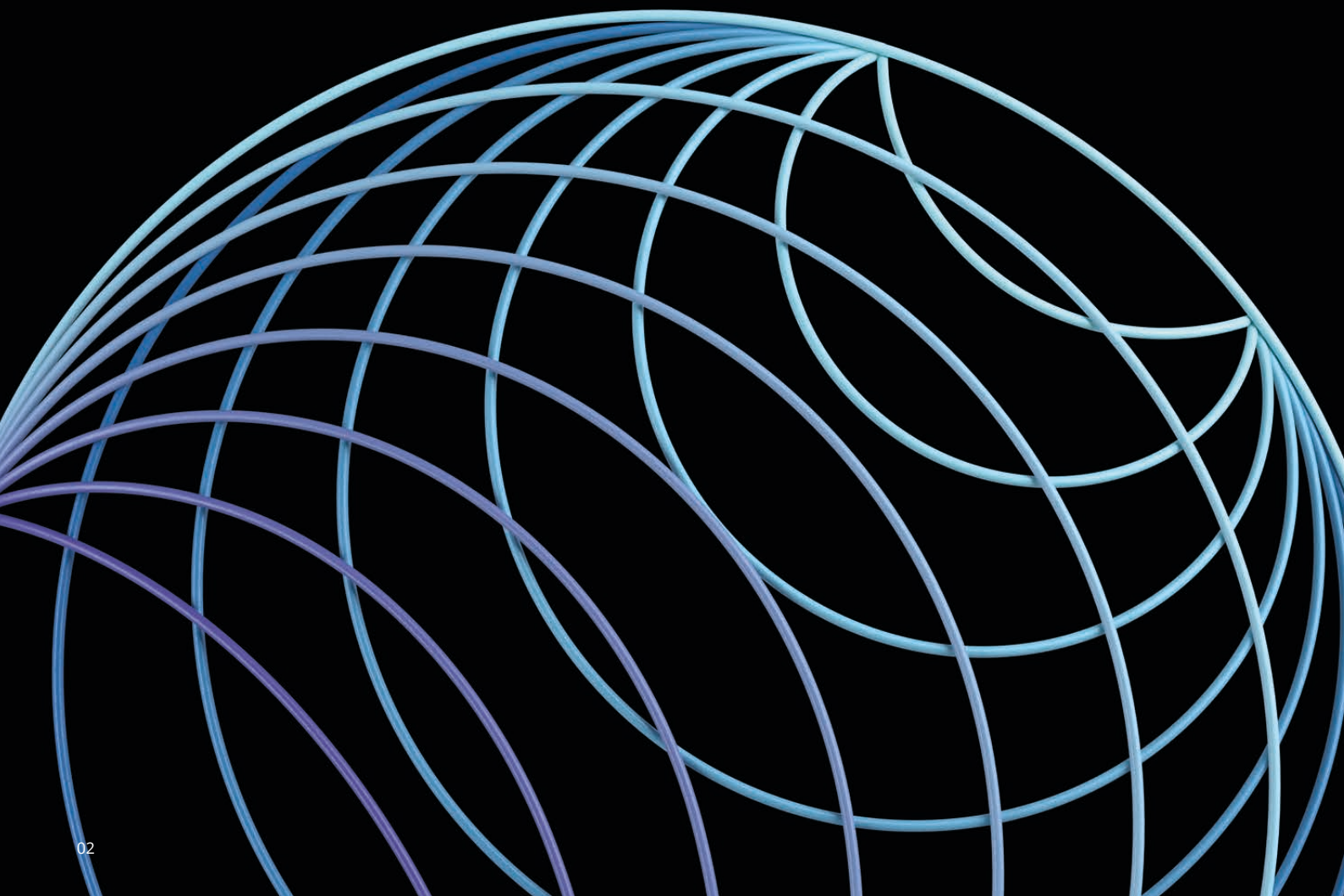


Dr. Jason Caulfield

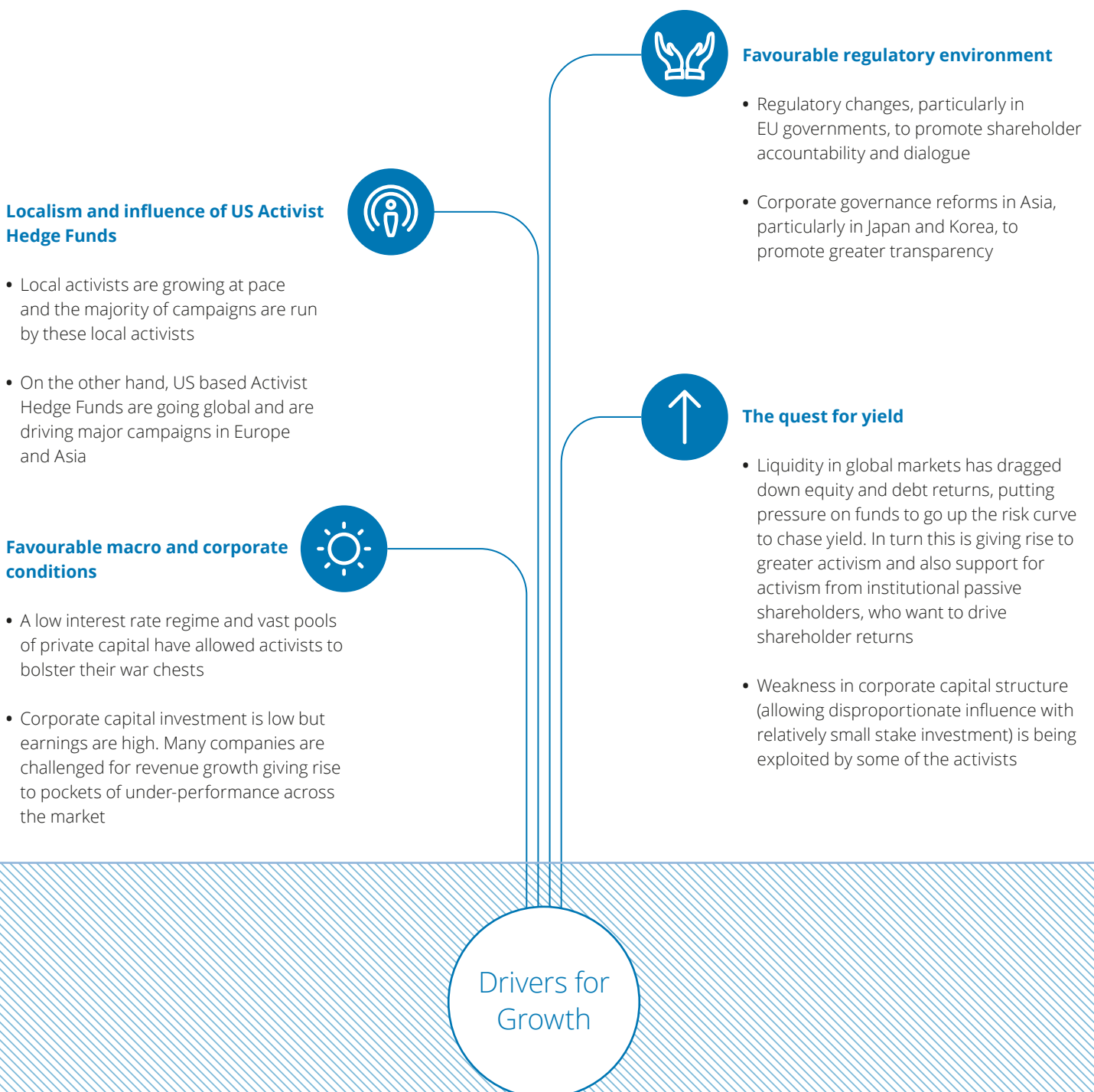
Global Lead, Value Creation Services
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Part One

Activism:
What you can expect



Shareholder Activism is here to stay



Activism: What you can expect

A rising tide...

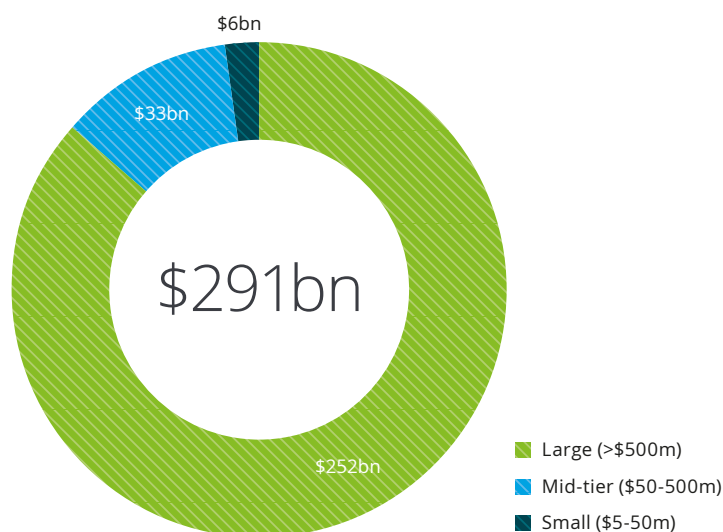
Activism and its impact is growing across the globe.

The wave of activism in recent decades springs from the United States, but some activists now see bigger opportunities outside of the US. Investors, meanwhile, are committing more money to activism, in search of good returns and greater accountability from companies. Governments in Europe and Asia are sometimes inadvertently ready to open the way to activism as they seek to make companies more responsive to shareholders and to environmental, social and governance concerns.

According to Deloitte research based on Activist Insight data, activist investors currently have almost \$300bn invested alongside their public demands for change. In the last 12 months to the end of Q3 2018, the number of campaigns have also surged to over 850.

Between 80% and 90% of the value of the investments has been by large activists (those with >\$500m currently invested), representing around 15% of the campaigns. In this report, we have primarily focused on this sub-set, as they hold the most sway in the market.

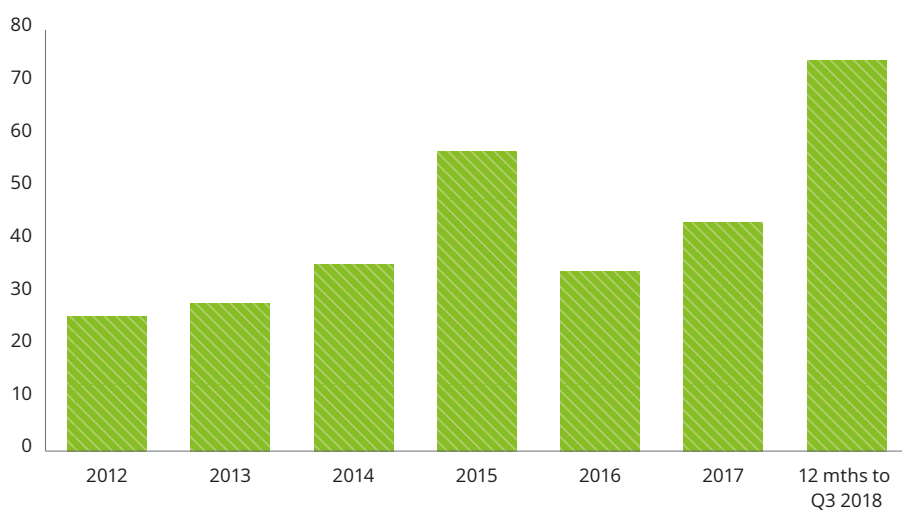
Figure 1. Activist investor funds deployed as at October 2018 alongside demands since 2014, by total funds deployed, \$bn



Source: Activist Insight, Deloitte analysis

Figure 2. Value of activists funds deployed, \$bn

Activist investor funds deployed, \$bn

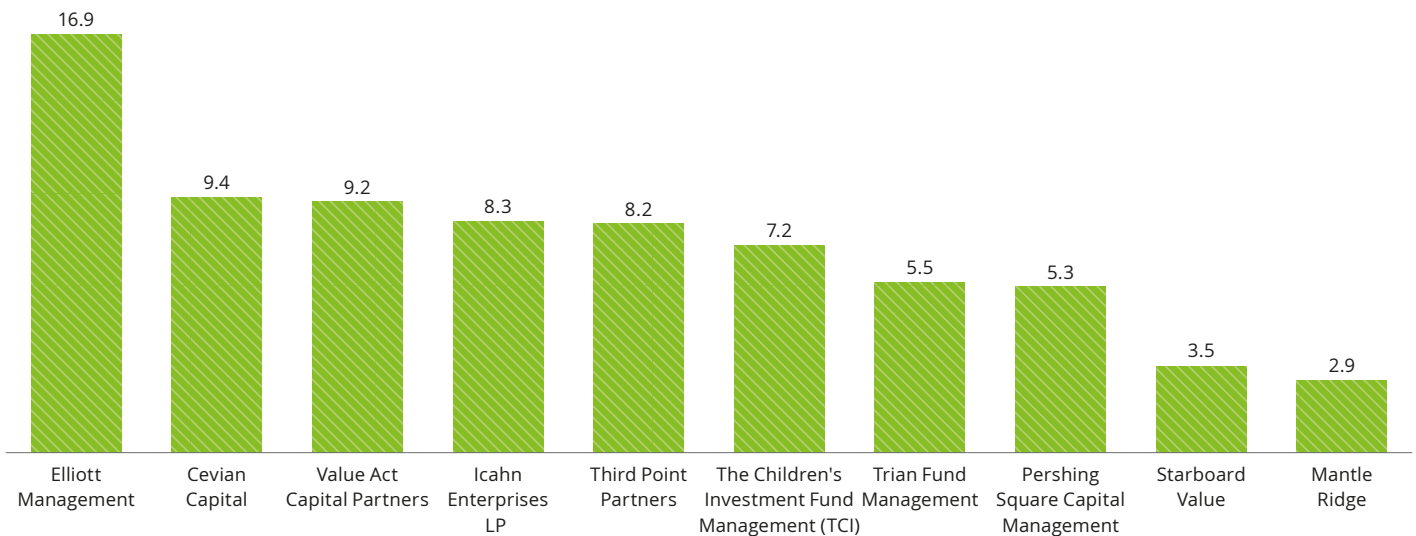


Includes assets under management of primary and partial activists funds which have made public demands, based on data from Activist Insight.

Source: Activist Insight, Deloitte analysis

Figure 3. Top 10 activist hedge funds, by estimated value of deployed funds as at October 2018

Value of current funds deployed, \$bn



Source: Activist Insight, Deloitte analysis

...with bigger targets...

Activists are looking for bigger opportunities – the bigger the target, often the bigger the potential and the greater the opportunity to get a return on their ever increasing funds. The prize needs to be large because activist campaigns are as costly to wage as they are for companies to fight. Large-cap companies, defined as companies with a market capitalisation of more than \$10 billion, are increasingly at risk.

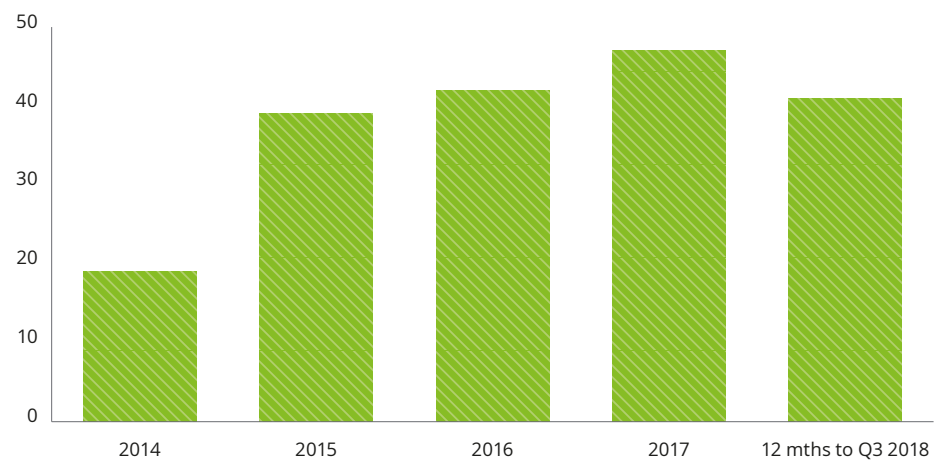
...assisted by the power of passive funds

The disruptive force of the activists is being enhanced, ironically, by the rise of what might seem the precise opposite: passive investors.

According to the Bank for International Settlements' March 2018 Quarterly Review, passively managed funds amounted to \$8 trillion or 20% of aggregate global investment fund assets as of June 2017, up from just 8% a decade earlier (measured by assets under management).

Figure 4. Large-cap companies targeted by top 100 activists with >\$500m currently deployed

Number of campaigns with large-cap companies (>\$10bn)



Note: Large cap companies defined as companies with market capitalisation greater than \$10bn

Source: Activist Insight, Deloitte analysis

The rise of the big passive funds gives activists a crucial advantage. A single fund's huge share ownership means that an activist needs the support of just a few key voters to win a proxy contest. The combination of aggressive activists and heavyweight funds means that even very large corporations are vulnerable to a knock out in a proxy contest.

Look out world

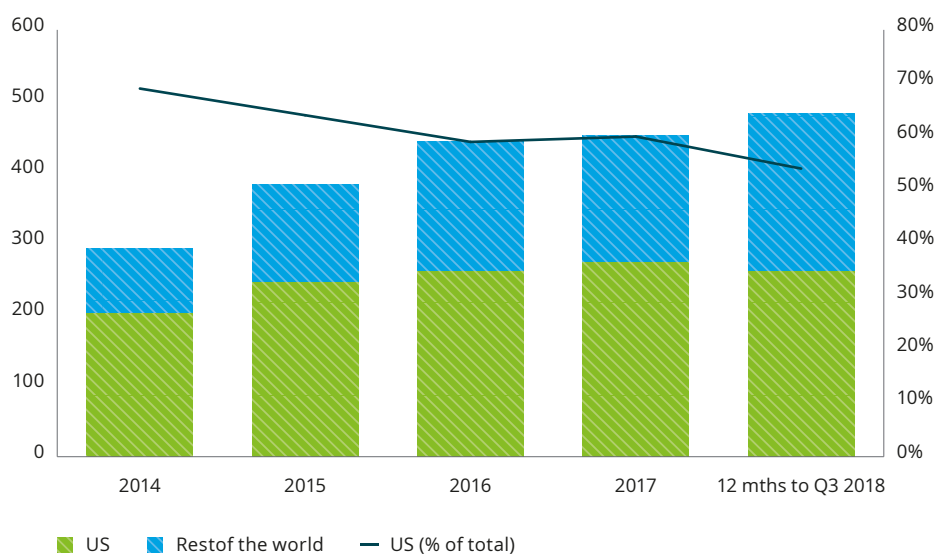
Activism, at present, shares something with global warming: its tide is rising, not just in one place but across the globe. Whilst the US remains the principal market for activist investors – six times that of the second market, Canada, the number of companies targeted around the world has been increasing faster. Our analysis shows that the US share of the largest activists' interest has fallen from almost 70% in 2014 to just over 50% in the last 12 months. In many other countries, including Canada, UK, Australia, Japan and China, the market is already seeing more companies targeted in first nine months of 2018 than the whole of 2017.

US activity levels which fluctuate year-to-year, have broadly plateaued as the activist investor environment matures. The factors behind this are many. While investors are committing more money to activism, in search of good returns and greater accountability from companies, the activists are finding it more difficult in the US to identify large-cap targets. Another deterrent until recently was that US stock markets experienced their longest bull runs in history.

Figure 5. Companies attracting >\$500m of activist investment

Number of activist campaigns

US, % of total



Source: Activist Insight, Deloitte analysis

Activism, at present, shares something with global warming: Its tide is rising, not just in one place but across the globe. Whilst the US remains the principal market for activist investors – six times that of the second market, Canada, the number of companies targeted around the world has been increasing faster.

This means that valuations are stretched, casting a positive shine on companies, pleasing shareholders and making any long position taken by an activist vulnerable should a correction in the market take place. But with some commentators seeing challenges ahead and recent stock markets turbulence, activists may well resurface rapidly in North America.

Recent government reforms in Europe and Asia have opened a path for increasing Activist presence. For instance, in Japan, one of the “five arrows” of Prime Minister Shinzo Abe’s policies to reform the economy is related to corporate governance. In 2015 a new corporate governance code was introduced which sought to make companies more transparent and more responsive to their shareholders.

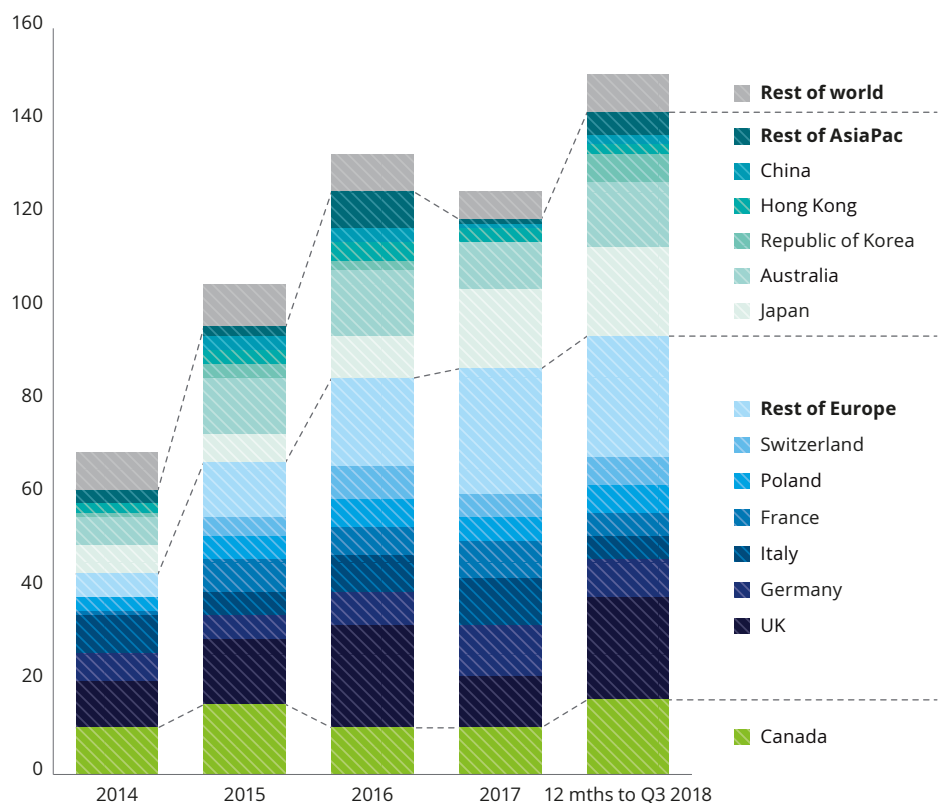
Companies in most emerging markets, however, seem less likely to be challenged by the major activists. They may be fearless but they are also a species that require protection in the form of a stable regulatory and legal environment and a supportive political climate.

It’s becoming more localised, too

Also notable is the rise of what might be called home-grown activism. Our analysis demonstrates that this home advantage is also apparent in US and Asian markets.

That said, our analysis has shown that in the first nine months of 2018, US activists continued to look for opportunities overseas. For example, US activists had made public demands on 20% of the total number of European companies which received public demands, and 10% of Asian companies receiving public demands.

Figure 6. Companies targeted by activists deploying >\$500m, excluding US
Number of activist campaigns



Source: Activist Insight, Deloitte analysis

Figure 7. Activist investor location drives investment location

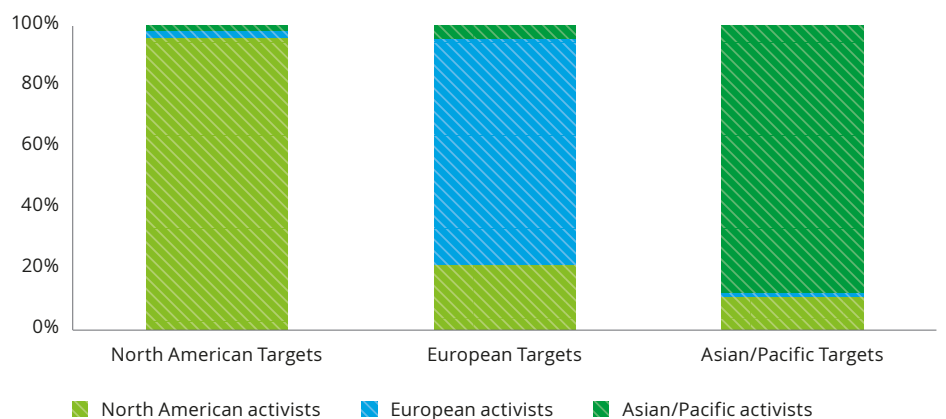


Chart shows campaigns from Q1 2014 – Q3 2018

Source: Activist Insight, Deloitte analysis

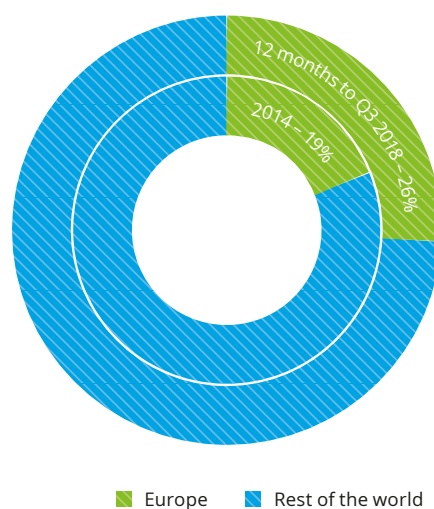
Europe: Unintended consequences

In Europe regulatory change in the legal environment is going the activists' way. As the law firm Schulte, Roth and Zabel's 2018 annual review points out, the European Union has adopted shareholder rights directives that encourage long term shareholder participation. But this could result in activists engaging more aggressively with shareholders, particularly passive investors, to elicit their support in bringing about some of the changes they are advocating. Other factors also favour a move into Europe. European stock markets and company valuations are seen as being less stretched than in the US. In our view the activist presence in Europe is likely to grow significantly.

Economic uncertainties

The trade conflict into which US President Donald Trump has entered into China is also rocking the global economic boat. For corporations planning to invest or expand their activities, these uncertainties might well prove a deterrent. Activist investors are more likely to be spurred. Also, favouring activist activity in the UK are a weak pound and the fact that a large number of passive UK shareholders may be willing to side with activists who are agitating for companies to make changes with Brexit in mind. However, Brexit is just one among many uncertainties for global markets. Companies unbalanced by political and economic instability are likely to find activists attracted by their vulnerability.

Figure 8. Europe: Share of campaigns by activist investors with funds deployed >\$500m



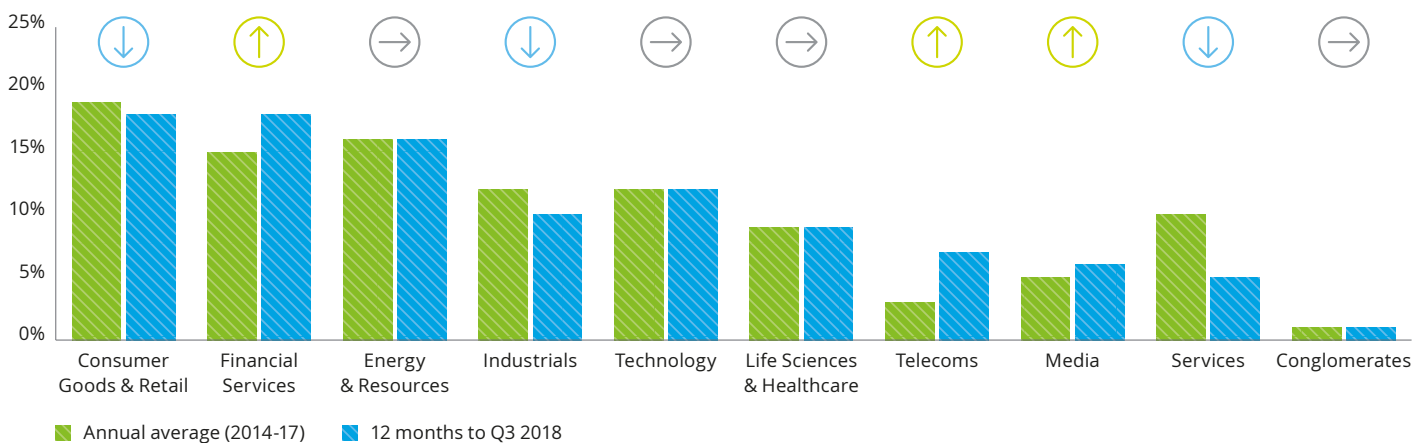
Source: Activist Insight, Deloitte analysis

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Financial, Consumer and Energy & Resources sectors in activists' sights

According to our analysis, the Consumer, Financial Services and Energy & Resources sectors represent over half of the campaigns run by large activist investors.

Figure 9. Sector focus, activists with >\$500m currently deployed



Source: Activist Insight, Deloitte analysis

Figure 10. Notable investments by top 10 activists

By sector, since Q4 2017 up to Q3 2018

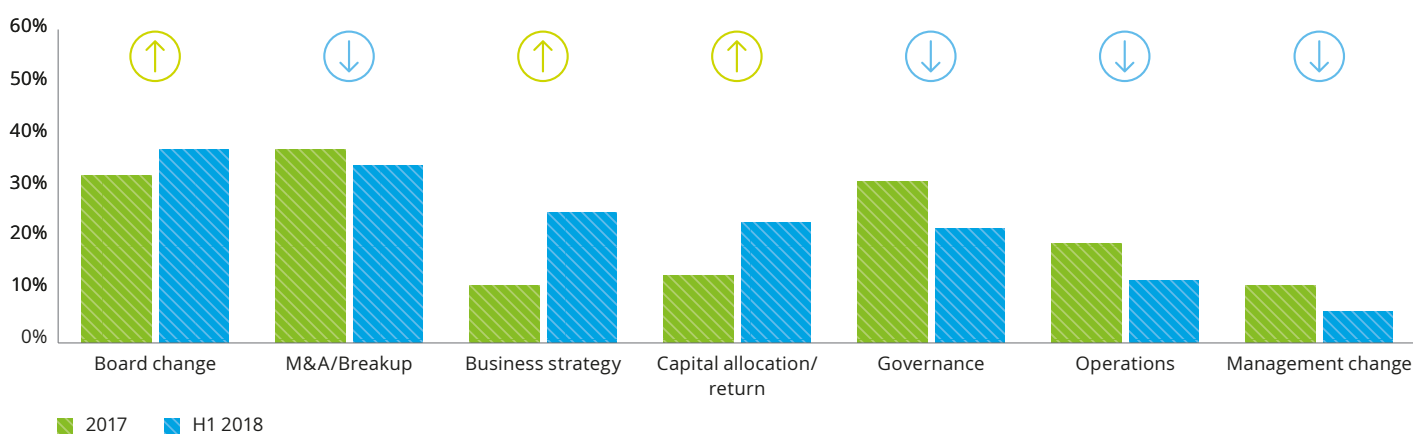
Sector	Company	Activist investor
Consumer Goods & Retail	Nestlé SA	Third Point Partners
	Campbell Soup Company	Third Point Partners
	Whitbread PLC	Elliott Management
Industrials	American Railcar Industries, Inc.	Icahn Enterprises LP
	General Electric	Triun Fund Management
	Trinity Industries Inc	ValueAct Capital Partners
	United Technologies Corporation	Pershing Square Capital Management
Telecoms	Telefonaktiebolaget L.M. Ericsson	Cevian Capital
	Telecom Italia	Elliott Management
Media	Nielsen Holdings plc	Elliott Management
	Lagardere	Amber Capital
Financial Services	Altaba Inc. (formerly Yahoo!)	The Children's Investment Fund Management (TCI)
	PayPal Holdings Inc	Third Point Partners
	London Stock Exchange Group	The Children's Investment Fund Management (TCI)
Energy & Resources	BHP Billiton PLC (BHP Billiton Limited)	Elliott Management
	Hess	Elliott Management
	Edison SpA	Amber Capital
Life Sciences & Healthcare	Smith & Nephew plc	Elliott Management
	Automatic Data Processing Inc (ADP)	Pershing Square Capital Management
	Xpo Logistics Europe S.A. (formerly Norbert Dentressangle S.A.)	Elliott Management
Technology	Seagate Technology PLC	ValueAct Capital Partners
	Symantec Corporation	Starboard Value
	Xerox Corporation	Icahn Enterprises LP

Source: Activist Insight, Deloitte analysis

Demands for Board seats dominate – and succeed more than half the time

What activists are looking for depends on their plan for the company. According to Lazard, changes to the board, followed by demands for M&A and changes to business strategy and capital allocation were the top objectives.

Figure 11. Demand type, activists with >\$500m currently deployed



Source: Lazard's Review of Shareholder Activism - Q2 2018

Winning – without a proxy fight

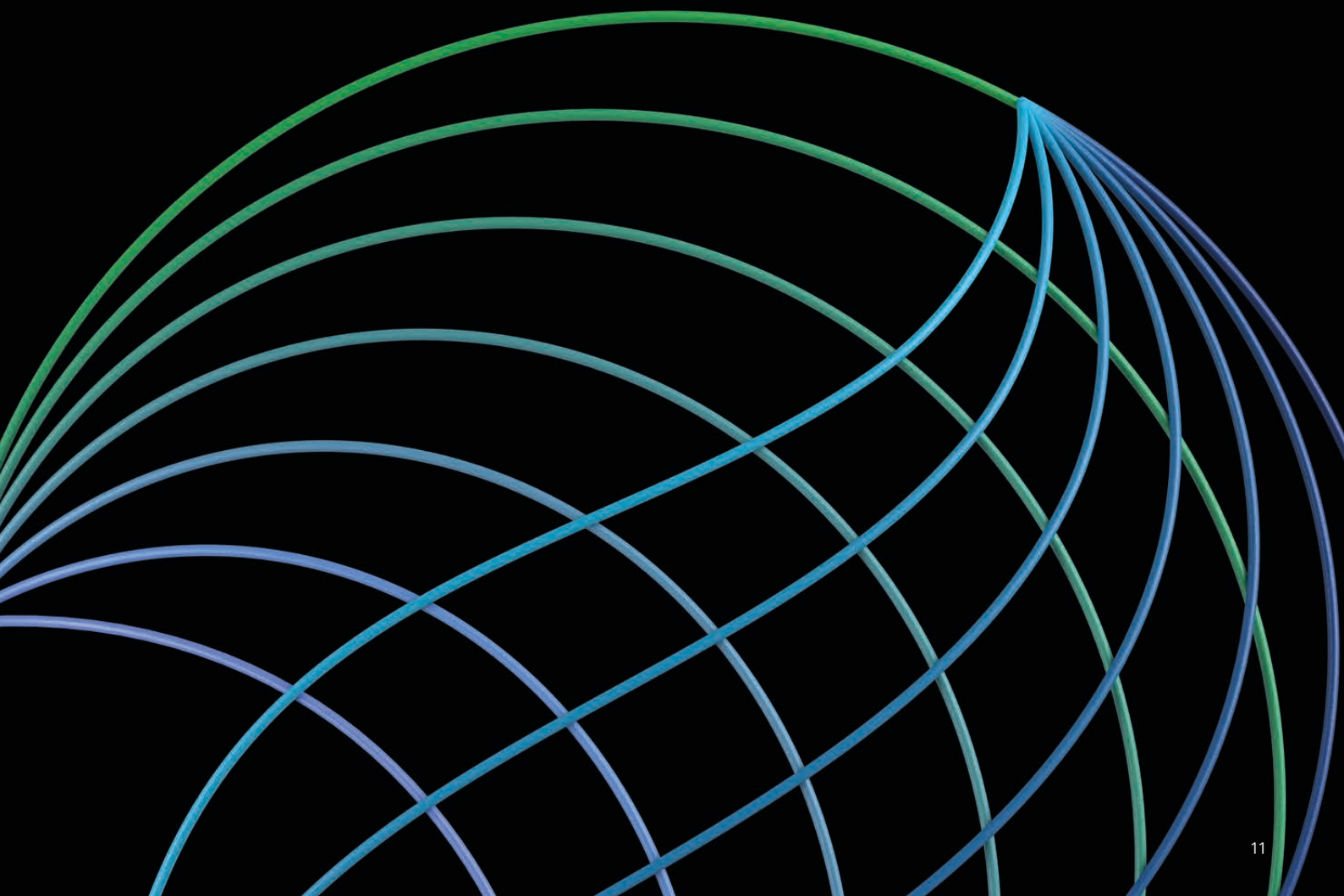
Activists aren't usually looking for a proxy fight in which shareholders decide. They prefer to negotiate to get what they want.

Activist Monitor and Mergermarket's Predictions for 2018 report found that 76% of activists expect companies to make settlements rather than allow a potential conflict with activists to go to an embarrassing and costly proxy fight. However, companies are generally right to fear proxy contests. The concentration of shareholdings and activists' ability to mobilise support means they can be dangerous processes to get into.

Activists aren't usually looking for a proxy fight in which shareholders decide. They prefer to negotiate to get what they want.

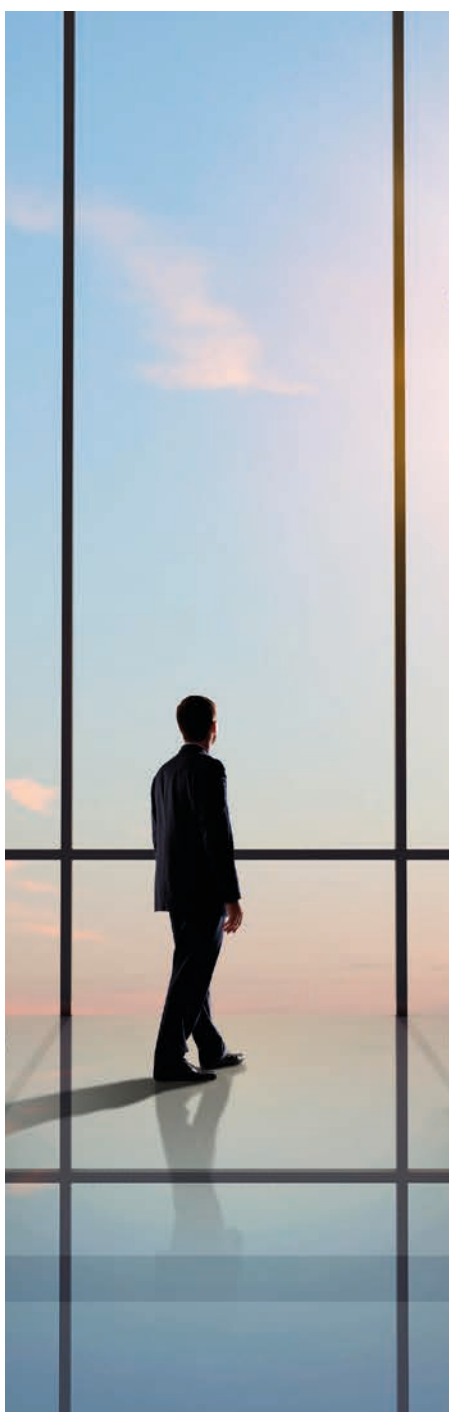
Part Two

Practical insights into the activist
approach and mindset



Practical insights into the activist approach and mindset

To illustrate current activist investor approaches and the mindset that sits behind them, we spoke with several prominent former activists and here we condense their views.



Approach: Identification

Big cap? Small cap? Large cap companies are targeted as they represent the best chance for the requisite absolute returns given the costs of participation, but with finite options and high stock market. The net is being spread outside the US.

Protective environments: Activists need the protection of established governance structures, similar to the US, and hence are attracted to European and mature Asian markets, e.g. Japan, rather than emerging markets.

Target diligence: Targets need to be thoroughly vetted often over many months or even years, with different activists employing different approaches. Some have portfolio managers focused on specific sectors tracking particular companies over extended periods, whilst others look to trends in sectors or industries and find opportunities. Typically, these teams will have industry expertise and a strong background of operations.

“Activists use a bottom up approach where they first think about what they want to change.”

US Activist Investor

Target performance: Activists analyse a multitude of metrics and performance measures including a larger benchmark group of companies, valuations, margins, shareholder return (over 1, 3, 5, and 10 years), shareholder sentiment, etc.

Finding solutions and value: Share price stagnation is only one symptom of the problem, and the activist investor's objective is to identify the problem. The idea is to eventually come up with value, increase profit or harvest value that is hidden in the business. By delving into public data, using ex-employee interviews, and real-world observation of targets, the activist investor may identify pricing differences, assess the productivity of a target's sales force, analyse the product and services portfolio, and identify reasons for the underperformance against peers.

“For activist investors, businesses as which are managed inappropriately tend to be better targets.”

US Activist Investor

They also check for businesses with high multiples that are bundled with low multiple businesses. Activists might target a business that pursued M&A in the past and was unable to achieve synergies.

Route to success: Activists are prepared for an unwelcoming management team. Activists pick and identify companies where change will benefit shareholders – which may not be possible with a top-down approach – with a clear strategy for getting the boards to accede to their demands.

“We ask ourselves, ‘What if the board does not change? How do I pressure the board? How do I influence the board?’”

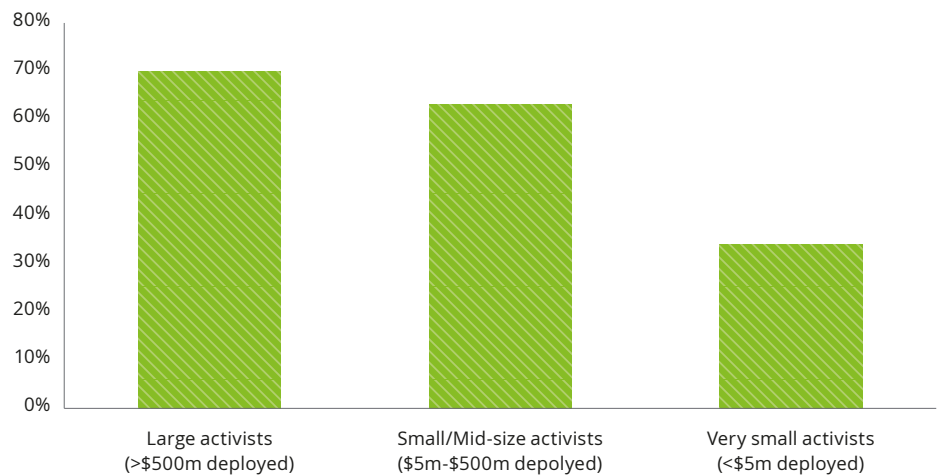
US Activist investor

Our analysis in Figure 13 shows that typically demands for Board seats are far more likely to be successful than other types of demand. M&A demands are some of the least likely to lead to any success or compromise.

Costs: By not taking overall control, activists avoid paying an ownership premium in their stakes; however, in the case of a large company with a high quantity of retail investors, activist campaigns can become expensive. The cost may run into tens of millions of dollars. If the activist’s position is in billions, and the company has a strong outlook, the cost involved in a campaign may be justified.

Figure 12. Proportion of activist demands that have led to at least partial success or compromise since 2014

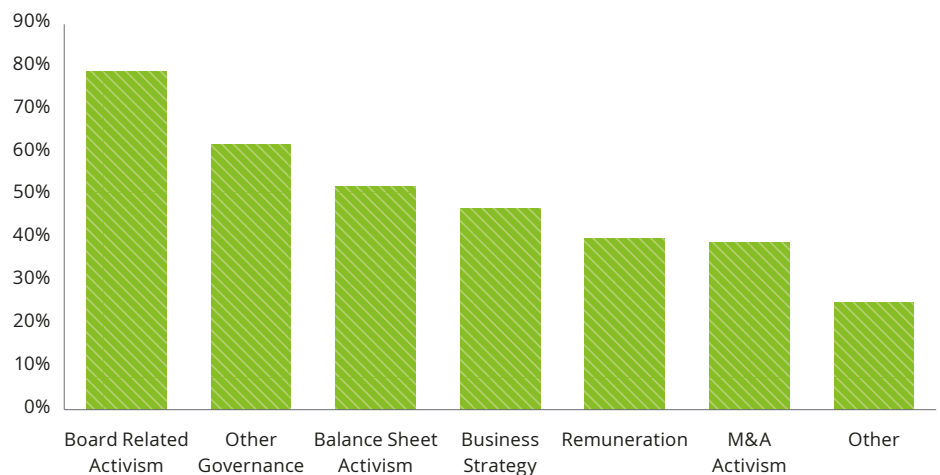
2014 to October 2018



Source: Activist Insight, Deloitte analysis

Figure 13. Type of demand, at least partial success or compromise with demands since 2014 for large activists (>\$500m deployed)

2014 to October 2018



Source: Activist Insight, Deloitte analysis

Approach: Engagement

Activist's investors: Generally, the clients of activist investors are informed about the plan. In several cases, large clients of activist investors provide funds to acquire a stake in the target and provide support. This mechanism is called a side car investment vehicle and is becoming increasingly popular. However, involving more investors in the group raises the risk of information getting leaked.

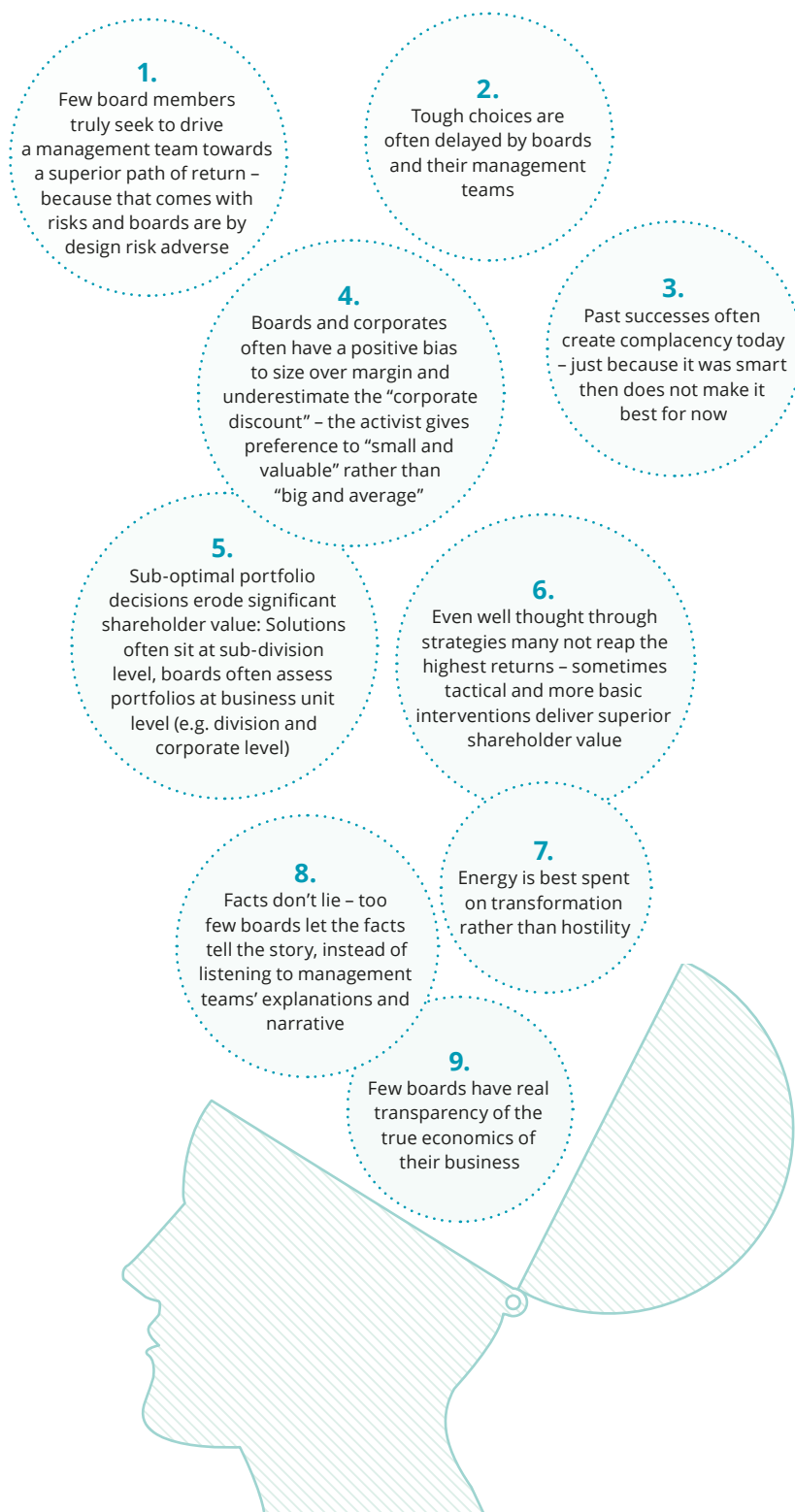
Activist's targets: Once the position is disclosed by the activist investor or the target becomes aware of the activist's position (ideally 5% or more), a meeting is set up with the management team. In this meeting the activist first introduces their firm and tries to establish a relationship with the management team. Thereafter, the activist investor shares their thoughts or expectations about possible improvements.

What's next: This depends on the receptiveness of the target's management team to implementing changes and agreeing to demands for board representation (as well as whether the particular activist investor thrives in a more hostile environment). Sometimes, activists may have to settle for a watered-down set of demands such as a lower number of board seats. However, a target's management can sometimes be less than receptive to activist investor's demands and frequently campaigns can become contested. Depending on market reaction to any plan announced publicly, there may be an opportunity to sell early as the benefits might be priced into the stock quickly.

Fellow shareholders: If additional pressure is required to be applied to a target's management team that is unwilling to co-operate with activist investors, other shareholders can be approached.

Common aspects of the activist's mindset

There are a number of beliefs, inherent scepticisms and features of the activist's mindset that drive their approach:



So, how to avoid activist interest:

Whilst outperformance is naturally the best form of defence, what can board and management teams do aside from delivering strong shareholder returns over long durations, and ensuring shareholders are happy? In short – put themselves in an activist's role to identify areas of improvements.

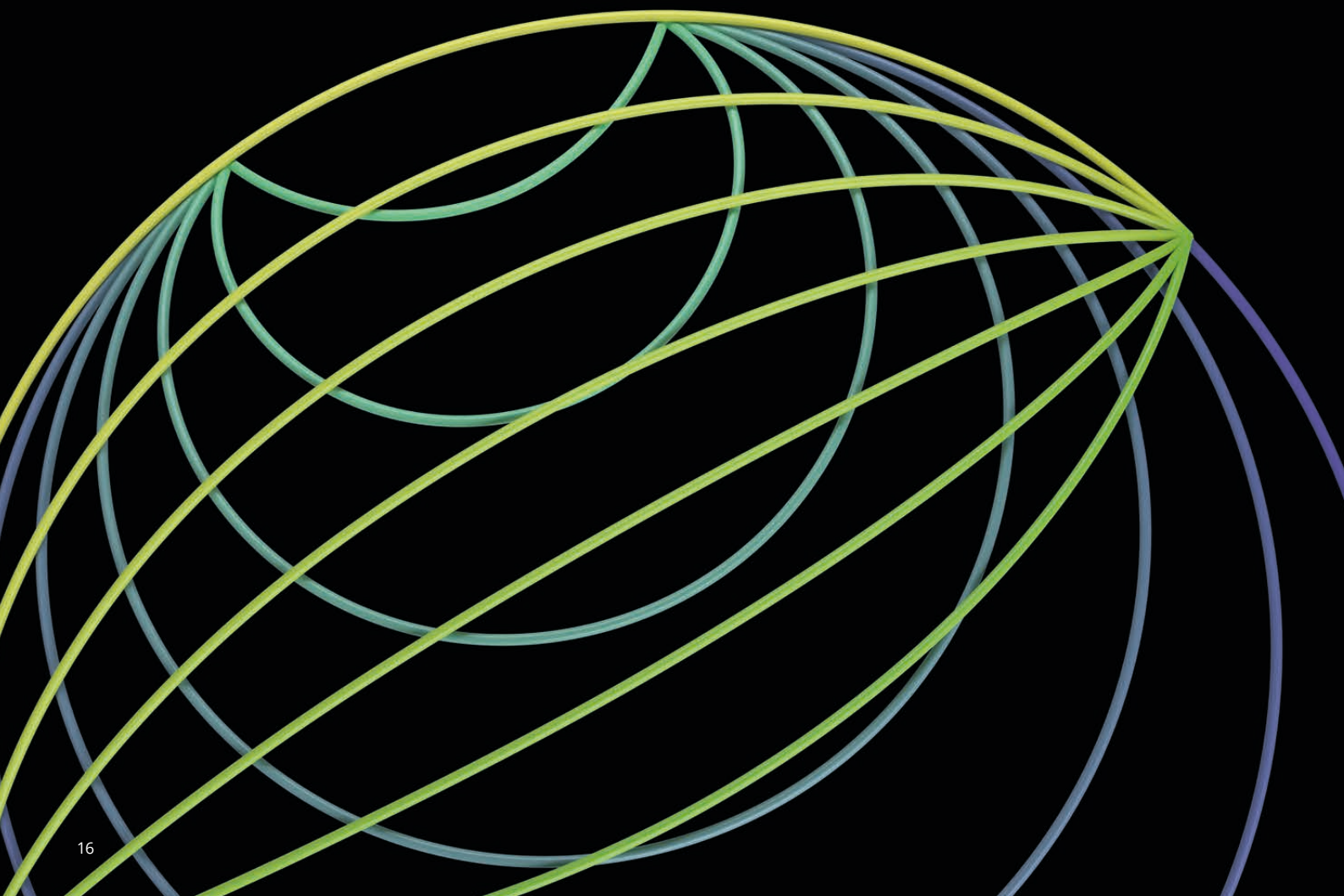
“There is always some truth in the activist's plan, there is something the management is doing that is not in the interest of shareholders or not resulting in the best shareholder return. Ideally, the management of the target company should implement changes proactively to avoid any contest or loss of control.”

US Activist Investor



Part Three

How to be your own activist:
A rigorous self-assessment



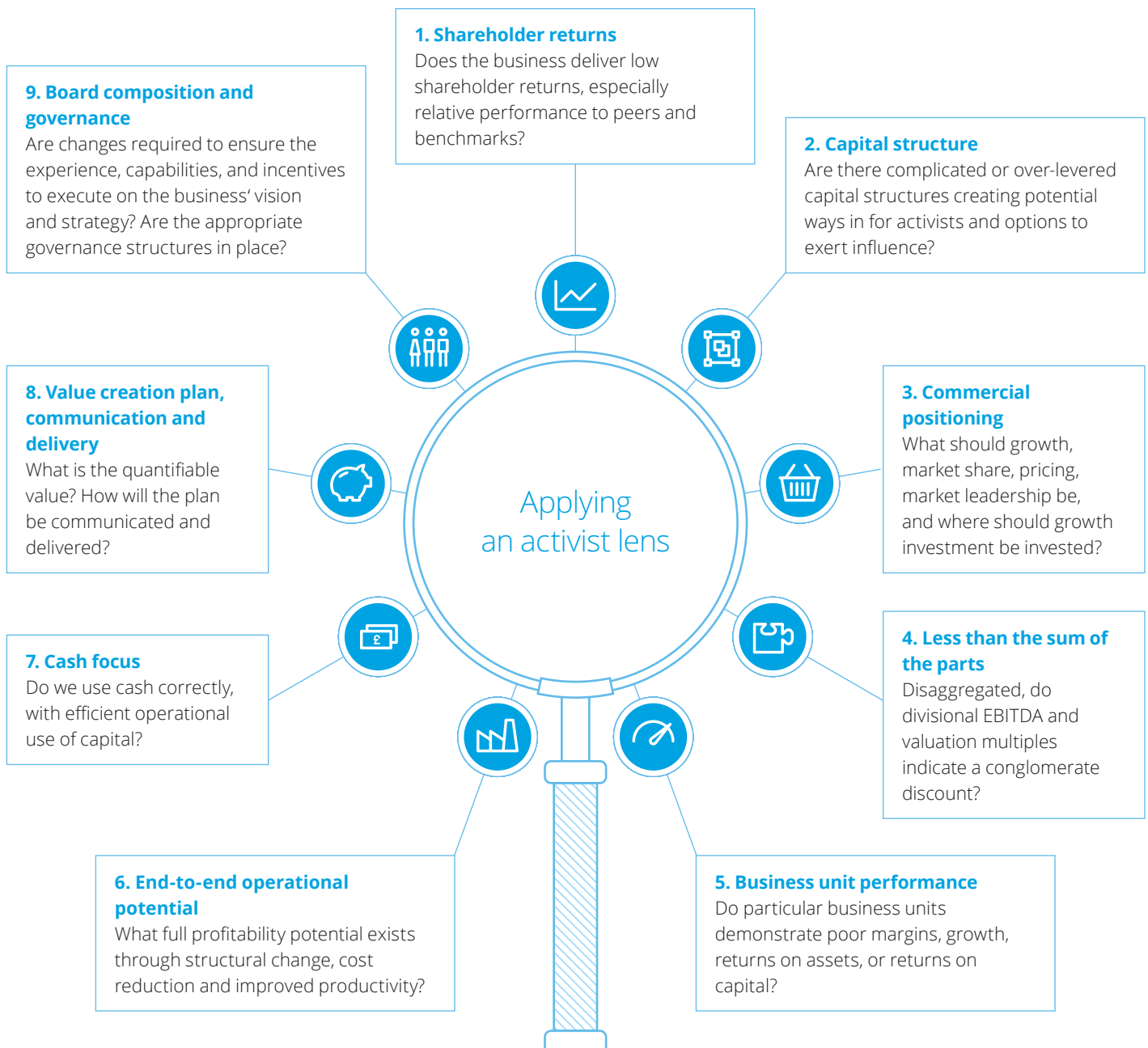
How to be your own activist:

A rigorous self-assessment

A key activist strength is that, coming from outside a company, they are unencumbered by inertia, vested interests and emotional attachments. Their gaze is dispassionate, analytical and calculating.

Companies need to look at themselves in a similarly detached way, spotting weaknesses or unexploited opportunities and rooting out inefficiencies that detract from shareholder value.

We set out below the way in which we would recommend undertaking a systematic and comprehensive self-assessment.



“If you were to assess the business from the outside looking in, what should “good” look like? Leadership should use this unconstrained approach to challenge their thinking.”

Michael van der Boom, Value Creation Services, Deloitte Zurich

Companies need to look at themselves in a similarly detached way, spotting the weaknesses or unexploited opportunities and rooting out inefficiencies that detract from shareholder value.

Our response has been to work alongside companies to assess themselves in this way, supporting their value creation opportunities, divestments, and “disruptive” M&A – targeting smaller but fast-growing businesses – across nine pillars.



1. Shareholder returns

Relative weakness compared to peers and benchmarks for the sector could render a company susceptible and provoke an activist intervention.

If a company is under-performing, it is essential for its management team to analyse and understand what is driving the underperformance. Activists will drill down until they believe they have understood the cause or causes of the drag on the company's shares, and will publicise a plan to address the weaknesses.



2. Capital structure

Excessive complexity in the capital structure of a company or too much or too little leverage can often provide the means by which they do this – and offer a back door to activists.

Management needs to ensure that capital structures, in particular the quantum and nature of debt, do not provide an opening for an activist to gain influence – easily, and with low levels of investment.



3. Commercial positioning

One of the most common reasons for activist involvement in plans growth plans and strategy is because they are unconvinced by the commercial direction and performance of the company. They may ask if the world is moving on and leaving the company behind?

The pace of technological advancement in recent years has been unprecedented. The disruptive potential of such technologies is further amplified by widespread adoption of digital and emerging social and crowd-based business models. Market share is not just being eroded by digitally native disruptive start-ups, but also from non-traditional competitors from across sectors, who are using technology-enabled business models to lower barriers to entry to capture market share. This is allowing new companies to innovate and create new market offerings in emerging areas such as Fin-tech, Health-tech, Mobility-tech and others.

Validation of the underlying assumptions of a strategy is critical – and this is an area in which better sensing tools are now available to monitor trends constantly, test the validity of a company's assumptions and mitigate its risks.

Activists may also challenge a company to invest in order to grow. It may be that the company's performance can be enhanced not by divesting units but also through acquisitions – products, brands, customers – that create corporate synergies, open new markets, strengthen existing market positions or create efficiencies of scale.



4. Less than the sum of its parts?

If EBITDA and valuation multiples for different divisions of a company are disaggregated does the company exhibit a so-called conglomerate discount? If that is the case, activists may be likely to press for business units to be spun off.

Attractive units within the business, with high growth, high returns on capital or high margins may have improved valuations when operating alone.

An activist may also challenge the value-add of expensive central corporate management structures and functions when the synergies between business units and the divisions themselves are not apparent.



5. Business unit performance

Under-performing business units within a company may be seen as signs that senior management is weak or insufficiently active or that board oversight is lacking. Strategic or private equity buyers may see opportunities to deliver greater value by improving underlying performance in a smaller business unit and may not want to dilute their efforts in the acquisition of the entire business.

Management should therefore consider examining under-performing business units and look either to improve their performance, through investment, refocusing, acquisition of complementary businesses or by whatever means suitable – or alternatively seek to divest itself of those business units.



6. End-to-end operational potential

More and more, a few big transformational projects within an organisation – such as digital/IT transformation projects, commercial or operational excellence transformations – are key to its strategic success. It is often the case that a company's profitability could be enhanced through structural changes, cost reductions, improved utilisation of assets or improved productivity, through investment in new technologies or rationalisation of procedures.

If unnecessary complexity in the organisation limits accountability then change will be tortuous. If a company's assets or people are ineffectually utilised, shareholders will naturally look for other perspectives on how to make the most of their invested capital.



7. Cash focus

A big challenge for many companies is how to deal with the ever-growing cash piles many are sitting on. Surplus cash on the balance sheet is highly attractive to activists and signals to shareholders that supporting the activist campaign could prove rewarding.

How management makes its choice may also provide an opening for an activist challenge. The activist may highlight that company management approaches its own hurdle rates for investment in a distorted manner problem solving to meet the hurdle when the return from potential uses falls short, and failing to track and report on the returns from investments when the answer is expected to be negative.



8. Value creation plan, communication and delivery

The management team needs to draw on all the above elements to produce a coherent, cohesive value creation plan, focused on a finite list of implementable changes. A value creation plan provides a logical, fact-based perspective on where to look and what to do, the expected financial benefits and the practical steps required. It then follows this up by challenging management to deliver.

“One of the big areas of strategic risks companies now have is their inability to deliver the change that was part of their strategy.”

Sandra Heuts, Deloitte Netherlands



9. Board composition and governance

A common objective for an activist is a seat on the board. A regular integrated board assessment is a helpful way to identify challenges in oversights, capabilities and structure related to the governance regime in which the company operates.

More broadly, activists consider management's track record in executing historical value creation programmes (e.g. mergers, transformations) and whether the board and senior management team have the required competencies to execute the proposed value creation plan.

Conclusion

Activist investors have changed the corporate landscape, particularly for large corporations, in the United States and now, as the US market becomes more highly valued owing to the long bull market, and more crowded with activist rivals, they are turning more to other developed markets such as those of Europe, Canada, Australia and Japan.

Within Europe, the UK, whose corporate rules, governance and political environment are closest to that of the US, has accounted for around half of activist activity, but activism is also rising in France, Germany and Switzerland. The European Union, keen that corporations should be accountable to shareholders, is opening the way to increased activism even if, at times, national governments show protectionist tendencies. Home-grown activism outside the US, by domestic, not US activists, is another important development. With regards to Mainland China, the A-share market is rather protected from Shareholder Activism, but there are increasing powerful shareholders that are actively involved in the strategy development of their respective portfolio companies.

Companies may wish to consider looking at themselves in the same way activists do; not dismissing disappointing profits, underperforming divisions or weak stock performance as a temporary phenomena, or muting discontent from shareholders, but analysing themselves seriously and as objectively as possible.

A company's rigorous self-examination may lead it to a different view of its current positioning and of what it needs to do in order to improve its focus, performance and returns to shareholders. It is likely to lead to a mid-term and long-term strategy that helps the company form a more convincing vision of itself.

Ultimately it is by showing that it is capable of acting on behalf of shareholders and other stakeholders to achieve superior performance that corporate management may be able to succeed in pre-empting activists.

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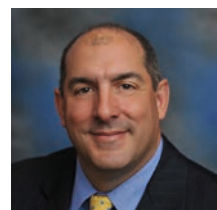
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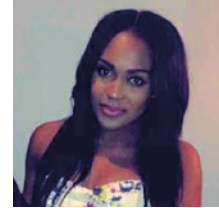
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Endnotes

Notes



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