Risks And Opportunities Of Hedge Fund Activism

by Ethan Klingsberg

Activist funds have been on a roll lately, with big victories such as stock buybacks at General Motors, and proxy access changes at General Electric. The traditional management and boardroom response is to "circle the wagons" and fight back when a fund investor launches a campaign for change at your company. In some cases caution is indeed warranted. However, sometimes activists may be sending a message your board should hear.

A well-prepared and well-advised board should be able to navigate the risks and opportunities presented by hedge fund activism. Here is an overview of why boards need to pay attention, what they are up against, and how to prepare and respond.

The amount of money committed to activist hedge funds continues to rise, growing over 20 percent per year over each of the last four years to exceed $110 billion. Meanwhile, the number of funds focused on activism has expanded, while the range of market caps and sectors to which they direct their efforts is now without limit.

Activists now enjoy broad shareholder support. Big institutions may never run a proxy contest, but are now not shy about supporting activists if they believe change is needed.

The sheer number of activist campaigns over any rolling twelve-month period during the last year has risen to the range of 140 to 160 campaigns per trailing 12 months, up from approximately 120 campaigns four years ago. Returns generally have been sufficient to justify expectations that these trends will continue.

In addition, activists now enjoy broad shareholder support. A board cannot rest easy simply because its shareholder profile does not show any aggressive activists. Traditional institutional shareholders, such as T. Rowe Price and Fidelity, may never run a proxy contest, but may not be shy about communicating with and supporting activist hedge funds if there are corporations in their portfolio they believe need shaking up.

There is no reason to believe non-activist hedge funds, pension funds and sovereign wealth funds are not willing to similarly support activist funds going forward. Further, companies with steady cash flow and a healthy balance sheet are not immune from an activist campaign. Indeed, studies have indicated that these characteristics may well make the company more vulnerable.

There are three principal areas of focus of the activists. A long-time favorite target of activists is the return of excess cash to stockholders through special dividends and share buybacks. This is often coupled with increased leverage—often referred to as "financial engineering." As long as cash balances at corporations remain high and interest rates remain low, directors should expect these campaigns for "financial engineering" to continue.

A second area of focus is pushing for split-offs, spin-offs, and divestitures of units currently embedded within larger, listed companies. There are teams of analysts at activist hedge funds scouring public companies for divisions that may be valued at a higher multiple than the consolidated parent if these divisions were separate companies.

You may argue that these "de-conglomeratization" efforts are misguided because they will result in a loss of synergies. This often fails to win over the market in the face of claims by the activists that many of these synergies may be preserved through alliance agreements put in place before the spin-off.

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The third area of activist targeting is improvement of operations. This often evolves away from debates about how to run the business and morphs into campaigns to change management, or explore a sale of the company. So-called "operational activists" target companies that are underperforming peers, and propose new approaches to achieve profitability.

The entire concept of "operational hedge fund activist" may seem an oxymoron when one considers an activist sitting in an office on Park Avenue trying to figure out how to be a better operator than those on the ground. At the end of the day, the "operational activist" may lack managerial expertise, or have ideas on how to run the business that are based only on fluff. Still, their campaigns to replace senior management or to put the company in play, and their citations of underperformance relative to peers, can be very effective.

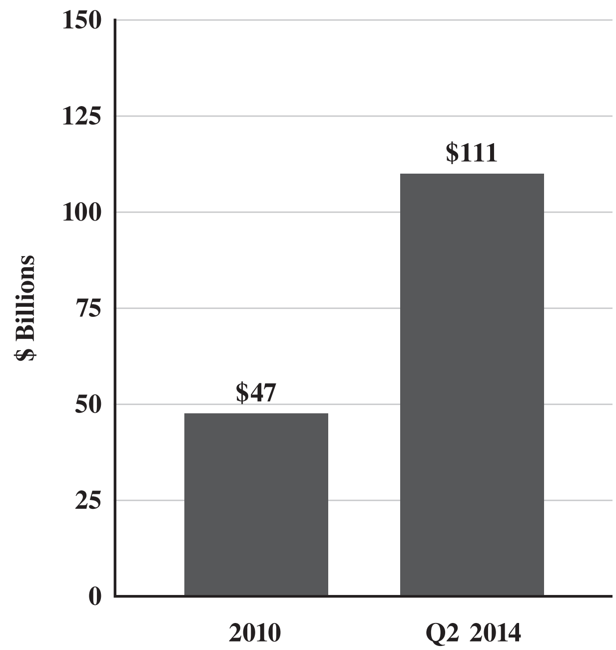
A few years ago, almost all activists sought only minority board representation. Now, they are increasingly emboldened to nominate replacements for every board member.

The playbook for implementing campaigns in these areas has changed over the years, and now sees several steps. First, the activist confidentially accumulates a significant equity position. These "under the radar" accumulations take advantage of HSR exemptions (e.g., using options), and the fact that a public statement of ownership on Schedule 13D need not be filed until 10 days after crossing the five percent beneficial ownership threshold.

The activist then uses social and traditional media, as well as filings on Schedule 13D, to distribute aggressive letters and white papers. In the case of the largest funds, these have become increasingly sophisticated, smoothly composed and well-researched.

The next step is to leverage tacit and overt support from other investors and proxy advisory firms. The relationships between the largest hedge funds and these actors are now well-established. Finally comes the threat of the proxy contest. Activists are no longer necessarily waiting until the annual meeting.

Activist Assets Are Exploding
21 Percent Compound Annual Growth Rate



They are taking steps to call special meetings, and threatening to act by consent in lieu of a meeting where permitted by the charter and bylaws.

Just a few years ago, almost all activists sought to have only minority board representation. Now, they are increasingly emboldened to nominate replacements for every board member. Their nominees range from fund employees to purported industry gurus to academics with "good governance" credentials.

In addition, as the war chests, market power and agility of activist funds increase, we may see more direct roles for activists in M&A activities. They could make more takeover proposals on their own or in tandem with partners as diverse as sovereign wealth funds and strategic operating companies. Activists may also make tender offers (subject to the limits of poison pill rights plans) to increase dramatically their control at mid and small cap companies, and put companies into play.

How should boards of directors prepare and respond? First, boards should engage in more intensive and focused strategic planning. Directors must participate, at least annually, in comprehensive strategic planning to ensure there is consensus and confidence in the corporation's direction. For this effort to be effective, several matters ought to be covered.

At the top of the agenda should be operational direction and reform, including a thorough understanding of performance relative to peers and performance goals and targets. Major questions for directors to explore with management and advisors are:

- ☐ Which companies are our peers?
- ☐ Why are we underperforming or outperforming?
- ☐ What are our long-term targets for key operating metrics and how will we get there?
- ☐ What has worked historically?
- ☐ What changes are merited?
- ☐ What is the feedback from shareholders and analysts about operations and performance?

Next on the agenda should be the topic of balance sheet management, including plans for dividends, share buybacks and leverage. Directors should focus on these questions:

- ☐ Should we be incurring more debt?
- ☐ Should we be dedicating more excess cash to capital expenditures or M&A?
- ☐ Should we be returning more value to shareholders directly?

Any board of a corporation with multiple divisions, units or segments should conduct annual "sum of the parts" analyses and explore the costs and benefits of spin-offs and sales of business units. Similarly, strategic alternatives analyses of why the stand-alone plan is in the best interests of stockholders should be conducted at least annually. Do not save these for a stressful and rushed meeting that is reactive to an unsolicited approach by a potential acquirer.

A well-run board should always have better insights than the outsider activist, but this advantage will be lost if the corporation fails to effectively communicate these insights.

Just as important as the board's unified and well-founded understanding of the strategic plan is for it to be involved and have confidence in how this strategic plan and its objectives and targets are communicated to investors. Too many corporations put all their IR energy into managing the market's understanding of their quarterly and annual earnings guidance. They fail, however, to engage with stockholders enough to obtain buy-in to the corporation's approach to the bigger picture issues that are most likely to be raised by hedge fund activists.

A well-run board should always have better insights than the outsider activist, but this advantage will be lost if the corporation fails to effectively communicate these insights. Consider annual investor days, direct one-on-one meetings with major shareholders (including the participation of top executives and, at times, the lead director), presentations that explain the strategic plan for achieving long-term objectives and targets, and an overall IR approach that goes beyond the earnings guidance game.

Additionally, boards should take the time to understand their vulnerabilities from a "good governance" perspective. Hot button issues can attract shareholder proposals, withhold vote recommendations (such as failure to implement a precatory shareholder proposal that received majority support at last year's annual meeting) and other forms of negative attention from pension funds and proxy advisory firms. This can create volatility that an activist hedge fund can leverage.

Examples include lengthy tenure of directors, lack of board diversity, lack of industry expertise among the directors, over-boarded directors, members with poor attendance records, unnecessary levels of related party transactions, executive pay plans that result in poor support for the corporation's "say on pay" vote, and staggered board structures. Board should discuss candidly the pros and cons of their approach to these matters, and ensure that the corporation is fully prepared to actively defend these positions against criticism from activists.

There is a growing body of literature and debates about whether hedge fund activists have a good or bad impact on public companies and the economy generally. This data is often fed to directors when trying to help them prepare or respond to hedge fund activism. In most cases, these macro-debates and the underlying academic and policy papers are a distraction. These materials may be useful tools for influencing regulatory reforms, but they are not what a board should focus on when determining what is in the best interests of its shareholders at a specific corporation.

Board focus on these debates risks turning their activism preparedness into a doctrinal exercise. The concerns of activists are then dismissed as inherently short-term, and the activists caricatured as evil doers that must be crushed. Instead, focus on the company itself, and a deeper board understanding of the best direction for the company.

Ensure that your board's bylaws include tools to guarantee that the board is fully informed about the efforts of any activist shareholder.

There are more technical, but worthwhile, exercises for boards to undertake when making sure they are prepared for activists. First, ensure that the bylaws include the tools to guarantee that the board is fully informed about the efforts of any activist shareholder. The most important tools are advance notice bylaws and the related notice provisions. These require the activist, when nominating directors or making a shareholder proposal, to be transparent about the material relationships and interests that the fund and its board nominees have.

It is worthwhile to review these bylaws regularly to assure that they are written in a way that would neither cause a court to be reluctant to enforce them due to overly burdensome disclosure requirements, nor fail to pick up valuable information (about derivative holdings, "golden leashes," and interests in and relationships with competitors).

Another topic that is worth considering, at least, is the adoption of a shareholder rights (i.e., poison pill) plan, either in response to the presence of a hedge fund activist or to preempt the influence of an activist. Boards need to keep in mind that, at best, the rights plans will provide the company with protection on a short-term basis. At worst, it will have no impact on the effectiveness of activists, and only further complicate investor relations.

There is no doubt that a rights plan is justifiable and defensible when an activist with a reputation for seeking negative control of companies files a Schedule 13D, indicating that it may acquire more shares or engage in change in control transactions. Still, the board still needs to consider the costs and limitations of the rights plan. Glass Lewis has recommended withhold votes against governance committee directors even when a board adopts a rights plan with a term of only one year. ISS is committed to recommending "withhold" against the incumbent directors once the plan's term is extended beyond 12 months, absent a prior stockholder approval.

More importantly, the rights plan may be of limited effectiveness against activism. At mega-caps, where not even the most wealthy hedge funds can afford to exceed the three percent ownership threshold, activist campaigns still regularly gain board seats, financial engineering and spin-offs.

For somewhat smaller companies, a rights plan can give the board some space to deliberate and protect against accumulations beyond the 10 percent or 15 percent threshold. The rights plan may discourage additional activists from explicitly collaborating due to fear of exceeding the beneficial ownership threshold. However, it will not stop additional hedge funds from simply jumping on the bandwagon. In the case of defending against activism, the rights plan is typically of limited utility and net benefit.

General counsels attest that some of their best, most informed, active and prepared directors were nominees of activists.

Boards should consider an approach to activists that extends beyond concepts of "defense," and that has space for constructive relationships. The nature of many activist funds has evolved to the point where there are often opportunities for boards to forge positive relationships with these funds and their board designees.

Look for opportunities to leverage these relationships into support for the corporation's strategic plan. General counsels occasionally even attest that their "best" directors (those who come to meetings fully prepared, make extra efforts to build bridges with other directors, and keep meetings focused on what is best for shareholders) were nominees of activists. This is not always the case, but directors should not assume that reaching an amicable settlement with an activist by adding an activist designee to the board automatically leads to disruption.

Indeed, having an activist "under the tent" is often more constructive than reciprocal disparaging public statements, or the necessarily awkward meetings where the activist, less informed than the representatives of the board, explains its perspective on the company.

Representatives of the board, meanwhile, are not in a position to say much in response due to the constraints of Regulation FD and the reluctance of activists to enter into long-term non-disclosure agreements. (In these cases, an activist without board representation at most may sign a non-disclosure agreement that requires the corporation to assure that any material non-public information disclosed to the activist is eventually made public so that the activist may be free of insider trading restrictions).

If a settlement with an activist involves the addition of new directors designated by the activist, the board should consider obtaining some kind of standstill undertaking from the activist, as well as appropriate undertakings relating to use of confidential information by the director and the fund.

In addition, the board should ensure that it has done background checks on the new nominees, and that it is aware of any "golden leash" arrangements that would create an incentive for an activist director to pursue a strategic direction divergent from the interests of the public shareholders. Replacement of "golden leashes" with alternative fee arrangements that do not misalign incentives (such as flat fees from the hedge fund for agreeing to be nominated and commencement of service on the board) are a reasonable part of any settlement with a hedge fund.

In addition, when an activist joins the board, it is important for the board to understand the implications for board processes going forward. If the representative of the fund who serves on the board is trying to work with the board (as opposed to adopting an overtly adversarial posture), the director needs to be treated the same as every other director. The board, management, and advisors to the board make a mistake if they exclude the activist director from meetings, provide the activist director with inadequate notice of meetings, or assume that the activist director does not have rights of access to internal documents and privileged materials.

Furthermore, boards should be conscious of the risks that arise from "withhold" vote recommendations when there is an activist on the board. For example, one board recently extended its rights plan beyond one year, while activist directors on the board were the only ones to vote against the extension. As a result, the proxy advisory firms recommended "withhold" votes on the entire board, other than the directors who voted against the rights plan and one new director, resulting in majority "withhold" votes for all directors other than the activist directors and the new director.

If the company had had a majority vote policy, depending on its mechanics, the entire board (other than the new director and the activist directors) may have had to resign or, just as awkwardly, submit their resignations subject to the decision of the new director and the activist directors as to whether the resignations should be accepted.

Hedge fund activism has increased the pace and intensity of activity in the board room. A well-run board should not have a problem being up to the task of keeping up. ■

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