European Audit Committee Leadership Network

April 2020

EACLN VIEWPOINTS

Shareholder activism

The rise of shareholder activism has caught the attention of boards across Europe. Companies that once viewed themselves as protected from activism based on factors including size, shareholder base, or governance structure are no longer immune. In many cases, activists launch campaigns built on sophisticated financial analysis of a company—and offer critiques about management and governance that ring true with other investors.

On 21 February 2020, members of the European Audit Committee Leadership Network (EACLN) met in Amsterdam to discuss how European companies respond to shareholder activism. They were joined by Richard Thomas, the leader of Lazard's European shareholder advisory practice.[1] *For a complete biography of Mr. Thomas, see Appendix 1, on page 9. For a list of network members and other participants, see Appendix 2, on page 10.*

Executive summary

EACLN members and their guest explored the following three topics:

- **The state of shareholder activism in Europe** *(page 2)*
  Shareholder activism is on the rise in Europe. Activist funds have adopted a more aggressive, demanding, and public style of activism. These investors are intervening at companies with compelling stories about ways to improve their governance and their financial performance. Moreover, these campaigns are more likely than ever to receive support from both active and passive fund managers, each of whom seek to unlock value in their portfolio companies.
- **Preparing for potential activist campaigns** *(page 2)*
  Companies are doing more to assess themselves with a critical eye and to proactively address the vulnerabilities they uncover. One often-overlooked aspect of this assessment is an analysis of the company's governance to identify perceived weaknesses in the board's skills. Engagement with institutional investors—especially before any activist intervention—can help a company establish more meaningful relationships and obtain valuable new perspectives. Companies can also develop a crisis-response plan in which company leaders understand the role they will play from the minute an activist arrives.
- **Responding to an activist intervention** *(page 5)*
  Speed is essential to a successful response to an activist intervention. One way for boards to make faster decisions is to form an ad hoc or special committee to oversee the company's response. The right negotiation posture depends on many factors. Setting the terms of information flow and confidentiality lend predictability to the discussion while protecting the company's interests. Written settlement agreements help companies gain clarity about the role the activist will play going forward.
  For a list of discussion questions for audit committees, see Appendix 3, on page 11.

The state of shareholder activism in Europe

Shareholder activism is evolving rapidly in Europe, with the total number of European companies targeted by shareholder activists increasing steadily over the last five years.[2] *"The driving force has been Elliott Management. They've validated a more aggressive, demanding, and public style of activism that many had said wouldn't work in Europe,"* Mr. Thomas said. According to the *Financial Times*, in 2019 "more shareholders than ever opposed company decisions or policies, including many doing it for the first time."[3]

An analysis by Lazard, noting an increased focus on activism in France, Germany, and Switzerland in 2019, observed, "Activism in Europe has now broadened across the European landscape and activists are targeting all countries in their search to unlock value and to capture alpha—leaving no stone unturned."[4] This trend is visible in France, where at least five companies experienced activist campaigns during 2019,[5] and in Italy, where "North American and British investors, who favor more aggressive investment styles, have been steadily building their presence."[6] The trend is also evident in Germany, where shareholder activism has increased over the last decade: "Since the activists have become familiar with the legal framework and cultural idiosyncrasies … targets are becoming larger and the tactics more aggressive."[7]

Activist hedge funds are launching campaigns with significantly smaller initial stakes in European targets because other investors are willing to support them. Active-fund managers are open to new ideas because they are under pressure to beat the returns of index and exchange-traded funds. Ultimately, Mr. Thomas explained, *"Shareholder activism in Europe isn't about the activist. It's a by-product of what's really happening in the active manager universe."* Institutional investor support for shareholder activism is not limited to active managers: *"We're seeing index funds support activists. Pension funds, sovereign funds, governments—all support activists in their theses,"* Mr. Thomas said.

Firms that historically were not activists are beginning to wage their own campaigns. "Many [activists] are large asset managers who not long ago were loath to speak publicly about a portfolio company, preferring to lobby behind the scenes or stay quiet."[8] But asset managers' activity may be increasingly open. Wellington Management and M&G have each recently taken public activist stances.[9] Mr. Thomas noted the challenge of a campaign led by a long-only asset manager: *"Institutional shareholder activism tends to be less aggressive and less personal, but it can be a more difficult antagonist to oppose and resist. After all, these are the people that have invested in support of your strategy."*

Preparing for potential activist campaigns

In this new era of shareholder activism, boards are looking to anticipate potential campaigns and be well prepared. Mr. Thomas said these *"sunny day"* preparations, which occur before investors take any action, are critical. He advised EACLN members that their boards should approach preparation by thinking about the company like an activist shareholder would. Engaging with a broad swath of investors on these issues helps prepare for and even prevent campaigns.

Identify vulnerabilities

It is imperative that boards understand how a shareholder activist would view the company. For companies that are performing well or take security in the composition of their shareholder base, there is a temptation to feel complacent. However, Mr. Thomas said, *"Every company is vulnerable."* He recommended a different mindset for conducting a vulnerability assessment: *"You need to understand the true vulnerabilities. Assessments with a scorecard, matrix, half-moons, or red and green lights aren't adequate. Activists don't think in terms of overall performance scorecards. Even if the picture is positive on most criteria, if there exist even one or two attractive value-creation levers that remain unpulled, then they have a campaign."*

Mr. Thomas suggested that boards engage an outside adviser to write the white paper that an activist would publish. A member agreed that the critique should be rigorous but said boards should take greater ownership: *"What you're describing should be the normal work of the board, and the board should lead it."*

Common vulnerabilities that invite shareholder activism

EACLN members and Mr. Thomas identified some of the common vulnerabilities that can trigger an activist campaign:

- **Lack of synergies.** Conglomerates or holding companies that do not demonstrate that the whole is greater than the sum of its parts are susceptible to an activist intervention. Carl Icahn recently urged a Xerox merger to realize synergies.[10]
- **Underperforming business.** Activists often focus on businesses or business units with unlocked value. They sometimes see more opportunity than is being realized in units that already perform well. "Activists targeted high performing larger companies to accelerate existing plans, and smaller companies with weaker performance where options to 'fix' or redefine strategy are more effective,"[11] Lazard found.
- **Underperforming share price or valuation.** Low share prices, trading multiple discounts, and weak dividends are easily overlooked invitations to activist shareholders. They also may be symptoms of underlying problems.
- **Poor public image.** Companies whose reputations have suffered invite activist interventions. Bad corporate actors regularly make the news, and assets in exchange-traded funds related to environmental, social, and governance issues have quadrupled since early 2018—underscoring investors' heightened attention to a company's public image.[12]
- **Capital structure deficiencies.** Shareholders target companies that they perceive to have too much cash on hand. Debt fuels opportunities, but it also increases risk. Investors challenge the strategies and practices underlying these conditions.

Review board composition, skills, and experience

Shareholder activists generally have a business thesis for improving performance or share price, but they often identify governance deficiencies as a hook to garner support and drive change. *"The public campaign is less about the financial math and more often driven by governance,"* Mr. Thomas said. *"They ask, Is the right board in place, executing the right policies and structures? If they have faith and trust, then they'll support the company and the board."*

Boards can spot weaknesses before investors do if they critically assess their skills, experience, and competencies. Mr. Thomas said that the usual approach that boards take may no longer be enough: *"The skills matrix was once considered a great tool, but it has been delegitimized,"* he said. An effective governance analysis should answer the question, *"Why is this person relevant and what does this person add to this board, in this industry, today?"* he said.

Boards should not overlook director and executive tenure as part of their assessments. Shareholder activists can point to lengthy tenures as a reason for change. Long-serving CEOs and board members may have overstayed their welcome in the eyes of activist investors, especially if performance factors invite additional scrutiny.[13]

Engage with shareholders

Meeting with investors to help them better understand a company's strategy and governance is a critical aspect of activism preparation. If, as outsiders, investors have unanswered questions or misunderstandings about the company, a meeting can resolve them. Investor engagement also helps to build a relationship so that the company does not have to start from scratch in a time of crisis.

Mr. Thomas suggested taking a fresh approach to investor engagement with an eye toward building lasting support: *"Many management teams I speak to think in the old model: have a shareholder meeting, field questions from investors, and straighten them out."* He suggested companies take a more collaborative approach by listening for investors' ideas and validating those that warrant further consideration. Investor engagement does not require boards to accede to demands or validate every dissident strategy, however: *"If you don't listen to the activists, they'll have the conversation with other shareholders. If I'm the company, I'd rather have the first conversation with shareholders."*

Some members sought advice on securing meetings with some of the more prominent institutional investors. *"It's not easy to get in the door with some institutional investors. I see a lot of outreach, but they won't always talk to us,"* one member reported. One way that companies can get investors' attention is by providing new information. *"It helps to be able to share some material change or new, relevant information to get them interested in engagement,"* Mr. Thomas said. *"You always want to go out with a hook."* Changing who represents the company in such meetings can make a difference as well. Mr. Thomas said, *"It also helps if the chair or another director is going to engage."* He added that funds that do not have portfolio managers expect a governance-specific presentation: *"You need a tailored set of materials, not just the 500-page reference document you use with all investors."*

Develop a holistic response plan

Even if companies feel confident that they have fixed their vulnerabilities and assuaged the concerns of their investors, it is important to prepare an activism-response plan.

Mr. Thomas shared three tips:

- **Assume an attack is inevitable.** An attack may come as an immediate surprise, but it need not catch the company off guard. Mr. Thomas said that companies must be on guard because the activist has complete control over when to begin a campaign: *"Activists get to pick 'day one' every time."* He added that these investors often launch their campaigns at the worst possible times. *"Companies are bound by quiet periods that put a lock on the ability to tactically engage. Activists are not bound by these same rules and seek to take advantage of it."*
- **Prepare external messaging.** A company should be prepared to deliver a public message to investors, the press, and other audiences. Mr. Thomas suggested always having a press release on hand that is continually updated. *"Have a proactive media plan. When the story comes out, we press 'Go,'"* he said.
- **Coordinate who will speak on the company's behalf.** As with any crisis-response plan, engaging all the necessary internal players and dividing the response tasks thoughtfully helps the company stay coordinated. It is also important to remind people—including non-executive directors—not to speak to investors or the press before clearing it through the proper channels. In the case of external outreach, Mr. Thomas suggested, *"Have a calling tree of who calls which of the top shareholders. The answer can't be investor relations. In most cases, it should be the chair or the CEO."* Legal and accounting staff and third parties like public relations firms may also be needed.

Responding to an activist intervention

Once an activist declares an interest in a company and formally launches a campaign, the company must chart its response. In most cases, that begins with a negotiation, followed either by an agreed resolution or a proxy battle. EACLN members and Mr. Thomas discussed the critical steps a board should consider to resolve its dispute with an activist.

Acting fast is critical to a successful response

Mr. Thomas encouraged members to consider forming a subcommittee to handle oversight of the company's response. *"We try to convene three to four board members. It's a lot easier to convene four people than 14—it's nimbler."* He also encouraged careful selection of the subcommittee because *"not all board members are created equal for these purposes."*

Mr. Thomas encouraged board members to speak cautiously with outside parties during an activist situation. He recounted examples of close conversations at public gatherings and private dinners where board members expressed positions about the company, not knowing that they were speaking to investors. *"Board members need to be briefed about rules of the* *road and not make absolute comments either way. They aren't always up to speed on how to respond, and yet they may be confident in their views,"* he said. Members agreed that restraint is a good practice, especially for directors other than the board chair. *"You need a policy that nobody on the board speaks to the press,"* a member said.

Negotiating with shareholder activists

Each activist campaign is unique. In many circumstances, a shareholder activist declares their intentions to management and the board in private, with an explicit or implied threat to eventually go public should the parties fail to reach a resolution. In others, a company's first notification of an activist's intent might come at the time the activist discloses its stake in the company to the public. Even if the company is well prepared for any attack, a formal campaign can be jarring.

A member who had been through an extensive negotiation with a shareholder activist said that, at the outset, *"the challenge is (1) whether or not you're going to engage with them at all, and (2) in what way."* Most members agreed that given the trends it is important for the board to be open to engagement. Another member described a conversation with an activist investor: *"I asked him what he could provide, and he said information. I have a whole team to do this. Even if you do your job as an independent director, you have only so many hours*."

Members also cautioned that as an outsider, an activist is working with incomplete information and is therefore prone to drawing conclusions that a well-informed board may reject out of hand. Mr. Thomas expanded on the challenges of communicating with activists: *"It's an unbalanced playing field. Companies are legally accountable to the word and the number. That's not so for activists. Try to figure out what they're saying; read their feedback. But it is difficult—it's like tracking an animal in the woods; you're relying on footprints and broken twigs."*

Regardless of the difficulty of dealing with an activist, a negotiated resolution brings a welcome conclusion to a difficult experience. Written settlement agreements are common in the United States, Mr. Thomas said, but are less common in Europe. Mr. Thomas encourages boards to obtain a written agreement where possible: *"If you don't have a settlement agreement, you're missing a huge level of protection. Never put an activist-nominated director on the board without one."* Settlements can, for example, set the terms by which a dissident director is renominated and require the activist to refrain from agitating for a defined period.

Working with dissident directors

At the conclusion of a negotiation or proxy fight, a board may find itself with a newly appointed director. These activist nominees frequently are experienced board members and executives like the members who already serve on the board, and incumbent board members often welcome these qualified nominees. Several EACLN members have worked with or been an activist nominee of this type. A second category of activist nominee is the dissident director—a partner, employee, or other affiliate of the activist fund whom the fund sought to place on the board. These dissident directors present a governance challenge for the rest of the board because while all board members serve shareholders and are themselves shareholders, dissident directors bring the bias of the activist firm into the boardroom. Leveraging the research and analytical capability of the firm from which they originate, these *"super directors,"* as Mr. Thomas said activists call them, can complicate governance by seeking more information and taking more aggressive postures on issues than their fellow board members.

Mr. Thomas had two suggestions for boards to consider as they work with a dissident director:

- **Manage information flow.** Mr. Thomas said boards can put protocols in place to determine who permits the release of information and how it is released. If the investors have information they want to discuss with the board, the board can say it will not discuss it with the fund until the board has discussed it on its own first. Mr. Thomas said, *"Find a way to get the information back in the board room."*
- **Codify the board meeting and agenda processes.** Having a set of rules to which the board is bound may discourage investors from thinking they can dictate the course of negotiation. Establishing formal, predictable board procedures *"makes sure all are clear that we've got a set process that's in our rules,"* Mr. Thomas said. For example, rules can prevent surprises by requiring reading materials and input on agenda items to be submitted to the board a certain amount of time before a board meeting.

Lessons learned

Members' discussion with Mr. Thomas revealed a mix of challenges and opportunities arising from shareholder activism. In the past, many board members felt that shareholder activists were ill informed, hostile, and not acting in the interests of long-term shareholders.

Many members now acknowledge that sophisticated activists may at times help the company. Mr. Thomas acknowledged that there can be *"constructive engagement"* with activist shareholders. Members said shareholder activists provide two general kinds of benefits:

- **Offer valid criticism of the board and management.** Shareholders challenge boards just as boards challenge management. *"Activist board nominees can enhance board effectiveness,"* a member said. Another member agreed: *"There is no doubt that they do their homework and often have good ideas."*
- **Catalyze quick improvements.** Shareholder activists operate at their own pace. In doing so, they can stimulate improvements sooner than the board or management would on its own. A member recalled an activist campaign that ended in a negotiated resolution: *"Had it not occurred, we might have done things differently or more slowly. It brought things into sharp relief. It's an experience you don't want to go through. There was a lot of unrest, but everyone walked away in a better place than when they started."*

Conclusion

A new era of shareholder activism in Europe presents challenges and opportunities for Europe's public companies. No public company is exempt from investor scrutiny; even in good times it is critical to prepare thoroughly because an activist could launch a campaign at a moment's notice. One of the most effective ways for a company to repel an intervention is to constructively engage with its institutional investors so that those investors are less prone to support an activist's position—or to engage in activism themselves. Companies can also prepare for activism by choreographing their initial response to an intervention through a set of well-defined rules and responsibilities. Taking an open-minded approach to negotiating with an activist is important to the ultimate success of the engagements. In fact, these engagements can be successful; EACLN members acknowledged that activists sometimes present ideas that could improve the board and the business.

About this document

The European Audit Committee Leadership Network is a group of audit committee chairs drawn from leading European companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

EACLN

Appendix 1: Guest biography

Rich Thomas is a managing director in Lazard's shareholder advisory group, where he leads the European practice for advising clients on preparing for and responding to shareholder activism, unsolicited approaches, and other related matters. He joined Lazard in 2006 as part of the Industrials group, where he provided advice to clients on a broad range of topics including mergers and acquisitions, restructuring, and capital structure-related decisions.

Selected recent European advisory experience includes Pernod Ricard in its negotiations with Elliott; EDP's supervisory board in relation to Elliott's white paper; Hammerson in its settlement with Elliott; and AkzoNobel on its defense from PPG's unsolicited offer and its negotiations with activist shareholder Elliott and Rolls-Royce on its settlement with ValueAct. Selected US advisory experience includes Forest City on the collapse of its dual-class share structure and its negotiations with Land & Buildings and Scopia Capital and Buffalo Wild Wings on proxy contest with Marcato and Xerox on its settlement with Icahn Associates and its separation into two businesses. Rich also has broad experience outside of the shareholder advisory group, primarily in the Industrials sector. Rich advised Dow on its merger with DuPont, RockTenn on its merger with MeadWestvaco, TI Automotive on its sale to Bain Capital, Knauf on its acquisition of Guardian Insulation, ArcelorMittal on its acquisition of ThyssenKrupp's Steel USA business, and Domtar on its acquisition of Indas. Rich also assists a broad range of clients on their corporate preparedness on a confidential basis.

Following his graduation from the US Military Academy (BS in mathematics, BS in mechanical engineering), Rich was an officer in the US Army for six years, after which he attended Harvard Business School prior to joining Lazard.

Appendix 2: Participants

The following EACLN members participated in all or part of the meeting:

- Aldo Cardoso, Bureau Veritas
- Carolyn Dittmeier, Assicurazioni Generali
- Eric Elzvik, Ericsson
- Byron Grote, Tesco, Akzo Nobel, and Anglo American
- Margarete Haase, OSRAM Licht
- Marion Helmes, Heineken
- Liz Hewitt, Novo Nordisk
- René Hooft Graafland, Ahold Delhaize
- Guylaine Saucier, Wendel
- Erhard Schipporeit, RWE
- Carla Smits-Nusteling, Nokia
- Charlotte Strömberg, Skanska
- François Thomazeau, Bolloré

EY was represented in all or part of the meeting by the following:

- Jean-Yves Jégourel, EY EMEIA Assurance Leader
- Julie Teigland, EY EMEIA Area Managing Partner

Appendix 3: Discussion questions for audit committees

- ? Are your board colleagues attuned to the rise in shareholder activism? Are the executives at your company aware of the trends? How are these trends being presented to the board?
- ? How is shareholder activism affecting your company's governance and business strategy priorities?
- ? Are your board and top managers thinking enough about potential activists and the campaigns they might wage? Which potential vulnerabilities concern you the most?
- ? Are there priorities or practices your board is unwilling to change even if it makes you more vulnerable to an activist?
- ? What should a board do to be prepared for activist shareholders? How detailed a response plan do you have in place?
- ? How is your board likely to approach an activist campaign?
- ? In what circumstances, if any, would your board be receptive to an activist intervention?
- ? Would a qualified dissident director be welcome on your board? How would it change the boardroom dynamics?
- ? What are the challenges of serving on a board alongside an activist hedge fund manager?

Endnotes

[1] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby comments are not attributed to individuals or corporations. Quotations in italics are drawn directly from conversations with network members and other participants in connection with the meeting.

[2] Lazard's Shareholder Advisory Group, *2019 Review of Shareholder Activism* (New York: Lazard, 2020), 8. A copy is included with this *PreView* as supplemental reading.

[3] Lindsay Fortado, "Companies Faced More Activist Investors Than Ever in 2019," *Financial Times*, January 15, 2020.

[4] Lazard's Shareholder Advisory Group, *2019 Review of Shareholder Activism*, 10.

[5] David Keohane and Harriet Agnew, "Activist Investors Lay Down Challenge to Corporate France," *Financial Times*, November 29, 2019.

[6] Maria Pia Quaglia, "In Italy, Activist Investors Find a Happy Hunting Ground," *Reuters*, March 29, 2018.

[7] Amadeus Moeser, "Shareholder Activism in Germany," *Harvard Law School Forum on Corporate Governance* (blog), January 29, 2019.

[8] Lindsay Fortado, "Fund Managers Turn Activist in Bid to Prove Their Worth," *Financial Times*, March 26, 2019.

[9] Fortado, "Fund Managers Turn Activist in Bid to Prove Their Worth."

[10] Lazard's Shareholder Advisory Group, *2019 Review of Shareholder Activism*, 3.

[11] Lazard's Shareholder Advisory Group, *2019 Review of Shareholder Activism*, 11.

[12] Lazard's Shareholder Advisory Group, *2019 Review of Shareholder Activism*, 19.

[13] Will Ashworth, "The Activists Should Jump All Over IBM Stock," InvestorPlace, January 27, 2020.