THE CENTER FOR GLOBAL ENTERPRISE

Managing in the Era of Engaged Investors

Among the many challenges facing publicly-traded companies – in the United States and throughout the world – is a seeming willingness by some parties ("engaged investors") to pressure companies to make changes that will, say these investors, increase shareholder value.

What's changed is that engaged investors have become more common, more coordinated, and more aggressive, which has sparked a fierce debate about the consequences of their activism – for companies, investors, and the nation's economy. While these more engaged investors see themselves helping companies achieve greater discipline and long-term profitability, a variety of other market participants, Delaware justices, and policymakers have stated that the engaged investors promote "short termism" (or "quarterly capitalism") that substantially impairs companies' ability to invest and innovate for the long term.

Amid this debate, companies face an array of questions spanning four phases of engagement: pre-engagement, contact and assessment, management decision, resolution. But many key questions from CEOs, board members and senior management are going largely unanswered. They include:

- How do I "proactively" avoid a campaign by an engaged investor?
- What do I need to focus on 18 months before an engagement?
- How do I avoid common management mistakes/misjudgments?
- What skills are required during different phases of engagement?
- During a "contested" engagement, what is the optimal course of action?
- What data is needed to help make sound decisions?

To help answer these and other questions, while also bringing greater analytical rigor and objectivity to this debate, The Center for Global Enterprise (CGE) has created the Applied Corporate Governance Institute (ACGI). CGE launched in 2013 in order to take applied approaches to advancing management learning. ACGI is intended to further this mission on a topic of foundational importance for public enterprises. It is distinct from other similarly-focused initiatives by virtue of being an independent, neutral voice, operating at the intersection of engaged investors and company management. With stakeholders engaged in a spirited debate about an array of issues, ACGI will help remedy the far-reaching, and sometimes harmful, misperceptions on both sides and develop management practices that will help companies achieve long-term growth and profitability.

As a starting point to advance management learning on the topic, ACGI created a unique database of more than 50,000 shareholder engagements in the United States over the past 25 years. Based on the ACGI's proprietary algorithms and predictive analytics, we developed our own **Engaged Investor Vulnerability Index™** to help management teams predict vulnerability 12-18 months in advance of a campaign. We believe ACGI's database, and predictive analytical models, are more comprehensive and robust than any other on the market. ACGI will also feature a Board of Stewards made up of former CEOs and directors who have first-hand experience with investor engagements.

The Institute is launching an initiative that will draw on its database and predictive models, as well as its Board of Stewards, to help CEOs and senior executives at publicly-traded companies to:

- Understand the current investment climate
- Recognize their vulnerability to activist campaigns
- Utilize management best practices during these campaigns
- Measure and assess their fitness for operating in an era of heightened investor engagement

This document provides an overview of the institute's work as well as an introduction to its roadmap, which shows how companies can gauge their vulnerability to a possible investor engagement and respond with measures that strive to advance the interests of companies and investors alike.

The Environment We're In

Today, institutional investors own over 70 percent of the shares that have been issued by U.S. public companies. In the early 1950s, this figure was less than 10 percent. Engaged investors, who include managers of all asset classes (i.e., mutual and pension funds, passive index managers, and hedge funds), are an increasing source of influence among U.S. publicly-traded companies, using their ownership to reshape the competitive landscape across industries. They take on minority equity stakes and then try to increase shareholder value through a variety of reforms, which are often focused on governance changes, capital structure, and strategy.[1] Engaged hedge fund investors were involved in the 2017 sale of Whole Foods to Amazon, the 2016 split of Xerox into two companies and the merger of Dow Chemical and DuPont in 2015.[2]

There has been robust growth in the asset class of hedge fund engagement (often referred to as "activism"). Between 2003 and 2014, 275 new hedge funds focused on activism were launched.[3] By the end of 2015, $173 billion in hedge funds' assets under management were dedicated to shareholder engagement, representing about 1 percent of hedge funds and 4 percent of total hedge fund assets under management.[4] In the years 2010-2015, around half of S&P 500 companies had a large activist fund in its shareholder base, and one in seven were the object of investor-led shareholder engagements.[5]

A number of macro factors have contributed to the increased demand for activist strategies. One factor has been the historically low interest-rate environment, which has sent money managers seeking alternative sources of yield.[6] But perhaps most important has been the rising popularity of passive investing in the United States. From 2013 to 2016, $2 trillion flowed into index-tracking funds. And as of 2016, nearly 40 percent of U.S. equities were held by passive vehicles, more than double the level in 2006.[7]

The growth of passive funds, as a share of all funds under management, has affected markets and the corporate landscape in a variety of ways. One noteworthy development has been for management at many companies to become more entrenched, given that investments decisions are increasingly driven by automated index strategies and not human-driven performance metrics. This makes way for activists to create value by coming into boardrooms and pressing for changes designed to unlock value in the target companies.[8]
With index investing likely to continue growing in popularity – just 8 percent of U.S. equity funds outperformed the S&P 500 from 2001-16[9] – and companies facing less pressure from traditional money managers, there will be more opportunities for engaged investors to wage activist campaigns.

Key Facts

Campaigns waged by engaged investors often generate significant media attention, with the tone resembling that found in coverage of sporting events or military battles. But this can at times present a distorted picture of the engaged investor campaigns. A number of important facts rarely get mentioned:

- When engaged investors wage campaigns, they typically hold a very small percentage of public company stock – just 7 percent overall and less than 3 percent at companies with a market cap exceeding $20 billion.

- The median market cap for activist target companies in 2016 was actually about $270 million, or less than one per cent of the size of the household names mentioned above. More than 80 percent of activist targets have a market cap below $1 billion.

- Fewer than one-third of the campaigns waged by engaged investors are hostile in nature.

- Today, the majority of engaged investor campaigns are resolved through negotiation.[10]

- Hostile engagements result in slightly greater improvements in firm performance than passive engagements, based on the severity of the campaign.[11] ACGI developed an **Engaged Severity Index™** to measure the impact by the type of campaign launched by an engaged investor.

- Hedge fund activists seeking board representation generate positive "alpha" when board appointments are announced and the positive abnormal returns do not revert up to five years after the board seat grant date. Additionally, they improve certain operational metrics up to five years after joining the board.[12]

- Shareholders give a warmer welcome to announcements of openly hostile engagements than to passive engagements.[13]

- In about two-thirds of cases, the activist hedge fund achieves at least some of their main stated goals by way of a major concession from the targets.

- The goal of removing the CEO is attained nearly 40 percent of the time.[14]

- Cases where the activist is more aggressive in stated goals have a higher probability of success, despite facing greater resistance from the target firm.[15]

Perceptions and Performance of Engaged Investors

There are many competing narratives about the effects of engaged investors, with opinions from market participants, academics, and Delaware Supreme Court justices.

Among the critics, one noted lawyer, Martin Lipton, has said that long-term shareholders in public companies are being undermined "by a gaggle of activist hedge funds who troll through S.E.C. filings looking for opportunities to demand a change in a company's strategy or portfolio that will create a short-term profit without regard to the impact on the company's long-term prospects." Similarly, the chief justice of Delaware's Supreme Court, Leo Strine, has written that, "further empowering hedge funds with short-term holding periods subjects Americans to lower long-term growth and job creation…due to excessive risk taking…when corporations maximize short-term profits."[16] One of the frequent charges leveled against engaged investors is that they seek to optimize their own short-term profits at the expense of long-run value. Laurence Fink, the chief executive of BlackRock, the world's largest asset management firm, has bemoaned the prevalence of purely short-term minded activists, recently calling for tax incentives to be awarded to investors with longer holding periods.[17]

But engaged investors also have supporters. *The Economist* has hailed them as a "force for good," and "the public company's unlikely saviors,"[18] pointing to their work to improve corporate boards and to partner with large money managers. A number of CEOs who have been the target of activist campaigns have also lauded engaged investors. The praise reflects the way in which engaged investors are often an accountability mechanism for the complacent management of publicly-traded companies.

While every activist campaign undertaken by engaged investors involves a unique set of issues, it is possible to draw some conclusions about the effect of these campaigns.

In 2016, for example, activist funds beat out event-driven and long-short funds in returns to be the highest performing class of hedge fund, exhibiting over 10 percent gains compared to the overall hedge fund average return of 5.3 percent.[19]

A *Wall Street Journal* review of 71 activist campaigns, launched between 2009 and the second quarter of 2015, revealed a number of illuminating facts.[20]

> [S]hares of large companies confronted by activists are more likely to outperform stocks among their industry peers than they are to underperform. But the differential isn't great. Slightly more than half, or 38, of the situations in the Journal study led to better shareholder returns than industry peers for the

> period studied after the activist went public. In the end, the median campaign beat peers by just under 5 percentage points.
>
> At the same time, companies in the study slightly underperformed industry peers in terms of growth in earnings and slightly beat them on profit margins. As for capital spending as a percent of operating cash flow—seen as a measure of reinvestment—of the 48 companies in the study with good data for that measure, 25 raised spending or left it at the same level, while 23 lowered it.

Many other studies have reached similar conclusions. Goodwin (2016) found that engagement leads to significant medium-and long-term improvements in corporate performance. The evidence clearly refutes the market over-reaction hypothesis and supports the proposition that hedge fund activists create long-term value for target firms and its long-term shareholders when they function as a disciplinary mechanism to provide oversight of management via board representation.[21] Indeed, even after the initial stock price jump, institutional investors with long time horizons continue to buy the target firm's equity during the two years after the intervention, signifying their votes of confidence that the activist will improve fundamentals more than the market expectation.[22]

Operating performance has been shown to improve following a campaign. In the year following the end of an intervention, targets on average exhibit positive performance as measured by return on assets and cash flow as a percentage of assets.[23] Even in the five years following the end of a campaign, Bebchuk et al. find evidence that a target's performance continues to improve.[24] Combined with the observation that activist hedge funds tend to target companies that have been underperforming in the years prior to engagement, the evidence suggests that the engaged investor is able to reverse the negative trend in operational performance through its interaction with the company.[25]

Overall, the literature suggests that there is an event-window jump in share price for target firms, and that even in the years following the engagement, the positive abnormal returns do not revert. Contrary to the popular opinion of hedge funds extracting short-term value for a quick buck, the evidence supports engaged investors as protectors and promoters of long-term shareholder value.[26]

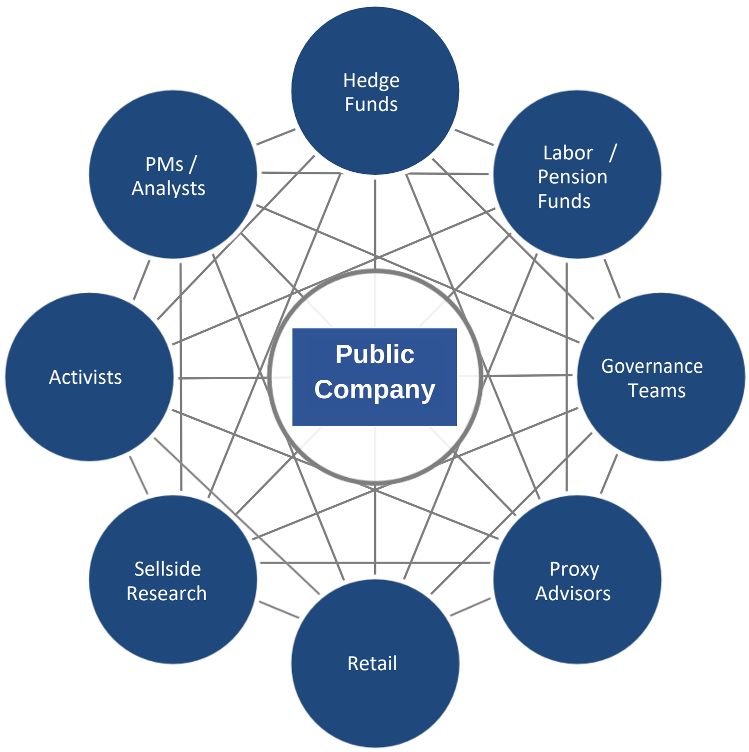
The Issues Impacting Companies' Vulnerability to Activist Campaigns

The companies targeted by engaged investors represent a cross-section of industries, sizes, and performance history. But targets are not chosen randomly. ACGI data reveal what kinds of companies are inherently more likely to be targeted by engaged investors, and what management teams can do to prevent (or welcome) the pressures of shareholder engagement.
In 2015, 343 public U.S. companies managed engaged shareholders, 38 of which were in the Fortune 500.[27] ACGI's analysis indicates that engaged investors target smaller firms, performing and valued below their peers, which may have multiple/disparate business units, more liquid stock and higher institutional ownership. Target

firms also exhibit weak governance and entrenched management, allowing engaged investors to add more value by strengthening governance. Targeted firms tend to have peers that are vulnerable – there is a broader industry vulnerability. These targeted firms also tend to have businesses that are well-understood, so that improvements can be better absorbed into market valuations.[28] The performance characteristics leave room for the hedge fund to create value by helping the firm reach its potential and to better inform the market of their true value.

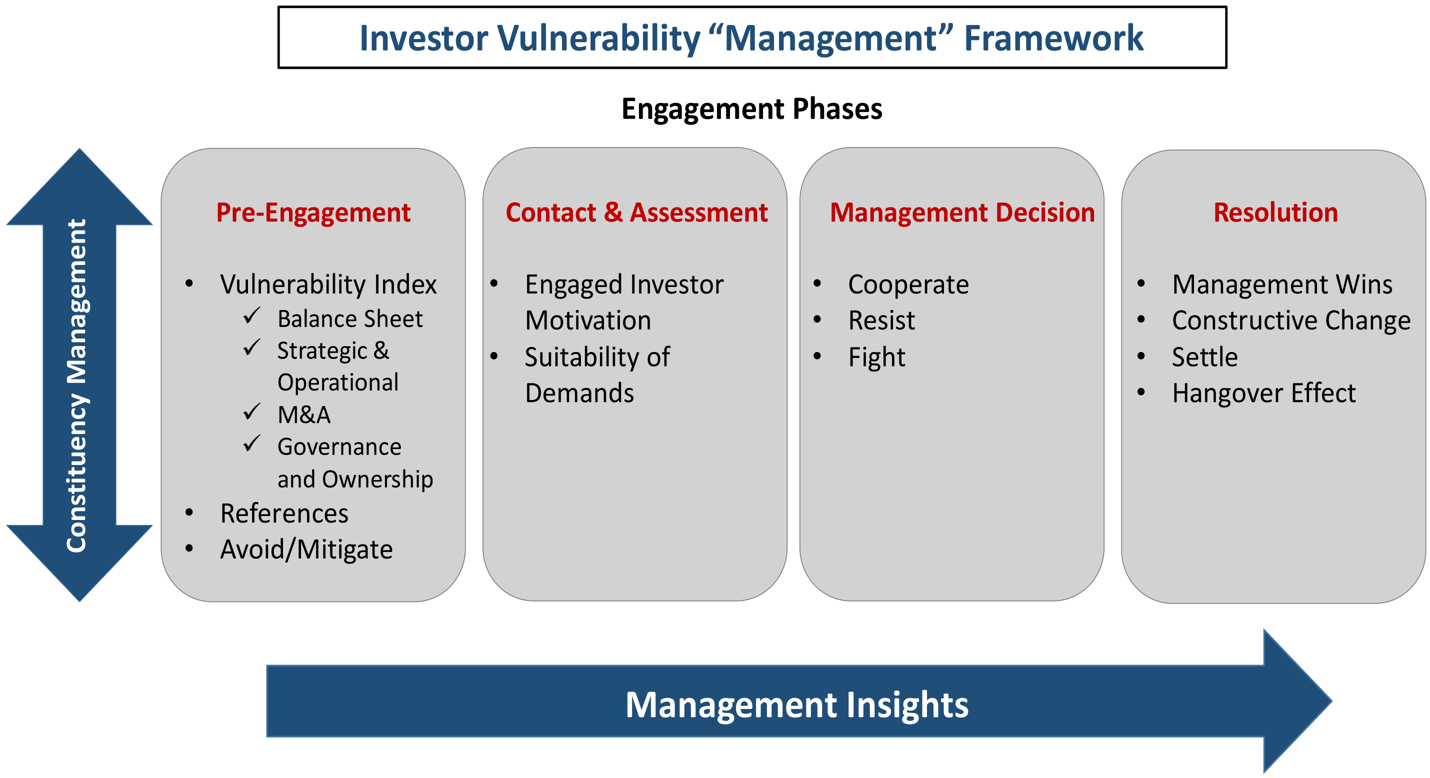
Active Engagement by All Stakeholders

Stakeholders in today's shareholder engagement environment are pushing for more engagement while expanding their own spheres of influence by interacting and collaborating with each other.[29]



Understanding Vulnerability

Two fundamental issues facing management and boards of publicly-traded companies are how to assess and examine their corporate vulnerabilities and how to respond to investor demands. The Institute has developed a framework to help address these issues. The chart below illustrates the first element of this framework and highlights the four phases of engagement by activist investors:

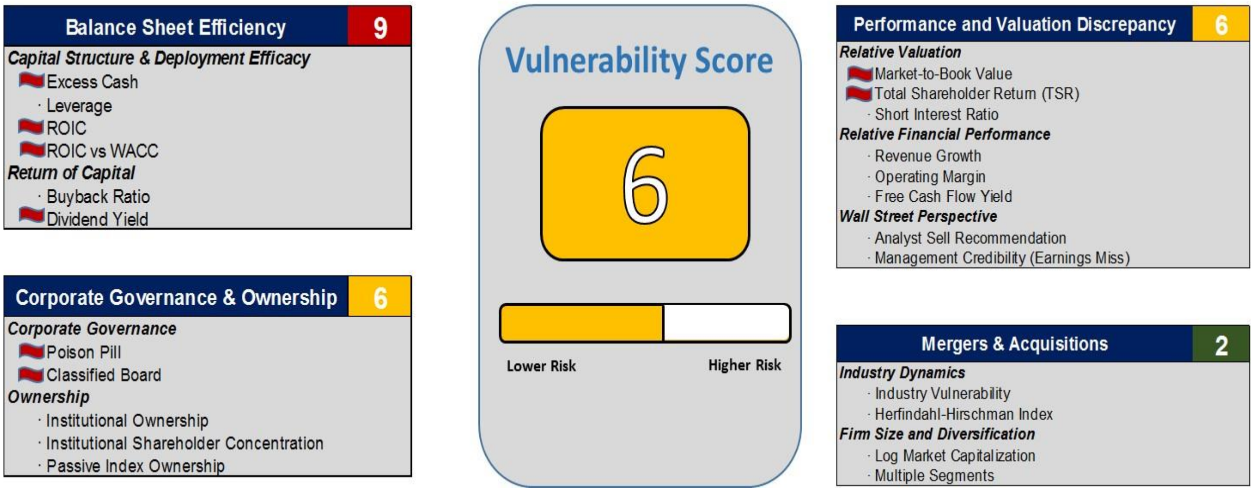


ENGAGED INVESTOR VULNERABILITY SCORE™

A key component of the framework is our proprietary ***Vulnerability Score.™*** It is a data-driven scoring algorithm and predictive screening model designed to help management review quality factors and assess risk and vulnerability in four categories with 23 statistically significant predictor variables (see the chart below).

Balance Sheet Efficiency	
Capital Structure & Deployment Efficacy	***Return of Capital***
· Excess Cash	· Buyback Ratio
· Leverage	· Dividend Yield
· ROIC	
· ROIC vs WACC	
Operational Performance and Valuation Discrepancy	
Relative Valuation	***Relative Financial Performance***
· Market-to-Book Value	· Revenue Growth
· Total Shareholder Return (TSR)	· Operating Margin
· Short Interest Ratio	· Free Cash Flow Yield
Wall Street Perspective	
· Analyst Sell Recommendation	
· Management Credibility (Earnings Miss)	
Mergers & Acquisitions	
Industry Dynamics	***Firm Size and Diversification***
· Industry Vulnerability	· Log Market Capitalization
· Herfindahl-Hirschman Index	· Multiple Segments
Corporate Governance & Ownership	
Corporate Governance	***Ownership***
· Poison Pill	· Institutional Ownership
· Classified Board	· Institutional Shareholder Concentration
	· Passive Index Ownership

The ***Vulnerability Score™*** provides an indication of relative risk with respect to critical areas of potential engagement by investors. It uses a numeric, decile-based score that indicates a company's vulnerability risk relative to its peers. A score in the 1st decile (VS 1) indicates relatively lower vulnerability risk with respect to investor engagement, whereas a score in the 10th decile (VS 10) indicates relatively higher vulnerability risk.



ENGAGED INVESTOR VULNERABILTY INDICES

As noted at the start of this document, one of the key questions facing companies is what they should focus on in the 18 months before an engagement. To understand how a company should prepare and respond to investor demands, it's important to recognize and assess the characteristics of companies that activist investors typically target. To that end, the institute has developed a model to predict future engaged investor campaigns. As noted above, the companies most likely to be targeted typically exhibit a collection of characteristics, including relatively low profitability, relative underperformance and balance sheet inefficiencies. However, these factors alone may be insufficient to draw the full attention of an activist. Accordingly, we developed a proprietary ***Engaged Investor Vulnerability Index,™*** which includes additional factors to more accurately predict an engagement.

Advancing Management Learning and Best Practices

Companies need to have comprehensive strategies in place related to all four phases of engagement by investors: pre-engagement, contact and assessment, management decision, resolution. And while every strategy will be different for every company, there are a number of baseline elements:

Pre-engagement

Focus on "best practices" corporate governance

Corporate governance is fundamental to the ability of companies to survive and thrive over the long term. Key elements include robust board oversight; board membership that's driven by diversity of thought, background, skills, experiences and tenures; compensation that's aligned with the long-term strategy of the company and incentivizes the generation of long-term value; and a focus on good corporate citizenship.

Promote effective shareholder relations
The significant rise of shareholder activism over the last decade has sharpened the focus on investor engagement in boardrooms and by executives. Companies need to recognize that every investor meeting is an opportunity for a company to better refine or explain its corporate growth story. Management should be purposeful with respect to its objectives and goals with every investor engagement. Additionally, companies should solicit feedback and encourage investors to articulate their own agenda as well.

Be prepared and consult with the board
Management should keep the board fully informed of their ongoing analysis of likely activist approach tactics. As discussed earlier, there are often early warning signs to indicate that an activist approach may be in the offing. Management, with the assistance of outside experts, should conduct a mock activist attack – "become the activist within" – and discuss the results with its board of directors.

Maintain transparent disclosure practices
Throughout a business cycle, it's not uncommon for companies to have write-downs, impairments, restatements, restructurings or challenges that affect operating performance. While any one of these events may invite attention from engaged investors, once a contest for control begins, an activist will find and use every mistake the company ever made and highlight the material ones to the marketplace. Therefore, it's critical to disclose the good and the bad news before the contest begins rather than during a campaign. Companies with a history of transparency may be given deference by institutional investors vis-à-vis an activist promoting a short-term agenda.

Contact and Assessment
Assemble the team
Assemble the small group of key officers, legal counsel, investment banker, proxy soliciting firm, and public relations firm that were identified in the "clear day" planning process to determine initial strategy and response. There is no duty to discuss or negotiate, but it's usually advisable to meet with the engaged investors and discuss their point of view and proposals.

Conduct Deep Dive Review of Investor(s)
Management should conduct a thorough review of the investor(s) to determine the typical style of campaign and level of aggressiveness they are willing to escalate. What level of success has the activist had in the past? Have they targeted similar companies? What strategies have they used? How do they negotiate? How have other companies reacted and what successes or failures have they experienced?

Management Decisions
Inform and Consult with Board
Maintaining a unified board on key strategic issues is essential to success in the face of an activist attack. In recent interviews ACGI conducted with a number of senior executives at publicly-traded companies, there was

unanimity about the need for management to convey the importance of "real-time" communication with the board. They stressed the need to not only seek counsel and advice but to ensure the board was informed. During a campaign, management should keep the board informed of options and alternatives analyzed by management, schedule periodic presentations by the legal counsel and the investment banker to familiarize directors with the current activist environment and the company's preparation, and encourage rigorous (internal) debates over business strategy.

Communicate with the Engaged Investor
Management should engage with the investor to determine the objectives and proposal(s). Open communication can lead to productive discussions, which in turn can lead to negotiations, which may result in a compromise/settlement.

Resolution
Understand All Potential Contingencies
Before reaching any settlement, a company must be sure to have completed a comprehensive and robust review of its strategic alternatives.

Consider Ongoing Board Impact
It is a common insight of CEOs and Board members that post-engagement the company's board will not be the same. The working rapport, chemistry, and engagement levels among members are referenced as being impacted, and in some cases irrevocably so. Management must think about this prior to any resolution and have an expectation and plan for dealing with this.

ACGI'S Commitment and Mission

The corporate landscape is undergoing dramatic change, as companies face both greater competition and expanded opportunities – at home and abroad. The renewed pressure from engaged investors underscores the way in which companies are in a new era and need to pay heightened attention to the issues being raised by these investors. Such vigilance can help to reduce costly, prolonged battles and bring about changes that benefit investors and companies alike.

The Applied Corporate Governance Institute, armed with comprehensive data, experience-based insights, and unbiased opinions, will play a critical role in this process. We will convene diverse stakeholders who are interested in this issue and inform them of our research. We will also directly assist organizations from both sides to understand the applied value of our work, with a special focus on advancing management best practices for current and future corporate leaders. With this work, the Institute is laying the foundation for companies and investors to better understand each other and ultimately achieve greater long-term growth and profitability.

Applied Corporate Governance Institute Services

- Meet with a company's management team to conduct a "vulnerability assessment and fitness checkup" providing a sense for the firm's positioning relative to an engagement;
- Meet with and present to the Board chairman, lead director, and other members at an annual strategy review to highlight the investor environment and the potential vulnerabilities of the firm;
- Assess key company risks relating to strategic and governance matters;
- Develop engagement strategies to proactively address potential investor challenges;
- Facilitate client efforts to build strong relationships with the institutional investor governance community;
- Provide insights into shifts within the corporate governance and investor landscape; and
- Ensure that clients are deploying shareholder engagement best practices.

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