Schulte Roth & Zabel

Shareholder Activism Insight

A Schulte Roth & Zabel report in association with Activist Insight and FTI Consulting

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Activist Insight

FTI Consulting

Contents

Methodology

In June and July of 2016, Schulte Roth & Zabel commissioned Activist Insight and FTI Consulting to interview 37 respondents from different activist firms. The survey sample consisted of economic activist funds with combined assets under management of $153 billion that have engaged over 420 companies in more than 50 countries in public activist campaigns since 2010, including some of the largest and most high-profile situations. Respondents were asked about their experience with shareholder activism in their respective regions and their expectations for activity in the next 12 months. All respondents are anonymous and results are presented in aggregate.

Schulte Roth & Zabel foreword

Schulte Roth & Zabel is pleased to present the 2016 edition of *Shareholder Activism Insight*, a survey of activists' views published in association with Activist Insight and FTI Consulting.

Corporate advisers had predicted, or at least hoped, that a combination of factors – increased competition in the activist sector, fewer attractive targets, increased engagement by institutional investors and some poor returns in 2015 and early 2016 – would stem the rise of shareholder activism in 2016. While the headwinds led some to believe that activism must have peaked, the activists are having none of it and continue to expect the level of activism to rise. The market has evolved into a complex dance between public companies familiar with the classic activist playbook, newcomers making forays, and seasoned players engaging in unique types of campaigns.

If anyone thought that the vulnerability of multi-billion dollar behemoths such as Apple, Allergan, DuPont and Yahoo in the past two years was an anomaly, activists' large cap campaigns in 2016 were a wake-up call. The number of campaigns at large cap companies for the first three quarters of 2016 has already surpassed the total number of such campaigns in 2015 by 20%. Given the finite number of large cap companies, however, activists in our survey reported that they do not anticipate significant future activism in the largest companies, with over two-thirds of respondents predicting little to no activist opportunities in the mega cap sector.

With companies now well-studied in classic activist campaign tactics, those targeted by activists know better than to pull from the old bag of tricks like poison pills, shareholder-unfriendly bylaw amendments and litigation. Companies have come to understand that to stand a chance, they must engage in early and open dialogue with investors – both active and passive. Where in the past activists often criticized companies for aggressively attacking their shareholders, many companies have pulled from the shareholder playbook and now regularly accuse agitating shareholders of "not playing nice."

Regardless of the public posturing of targeted companies and an increase in the average length of time before companies enter into settlement agreements, a majority of activists reported that they were able to more easily settle disputes with management teams in 2016.

In 2014 and 2015, activists running majority slates became a norm, with nearly one-third of proxy contests seeing a majority slate proposed by activists. A significant percentage of respondents expect even more majority slates to be a cornerstone of activist campaigns through 2017.

Proxy contests, however, only represent one tool in the activist playbook. A majority of activists expect to see an increase in precatory proposals over the next year. After Carl Icahn's successful push at eBay for a PayPal spin-off following his announcement of a precatory proposal, and Relational Investors and CalSTRS' success with a similar proposal at Timken, activist funds have grown to appreciate that success does not always require a full-fledged proxy fight. While such proposals are nonbinding, companies know that the failure to implement a proposal supported by shareholders will lead to increased scrutiny from Institutional Shareholder Services possibly including withhold recommendations, and an increased likelihood of a fight with shareholders next year.

Fading are the days of the "activist season" – the predictable six-month stretch between the time when activists build their stakes and submit notice of their proposals to companies and when annual meetings are held in May and June. A significant number of activists have turned to post-annual meeting tactics, such as the use of special meetings, consent solicitations and simple public campaigns, to exact corporate change. Thus, not only should we expect activism to continue to thrive, we should expect it to become an ever-present activity in the marketplace seeking to unlock value and hold managements accountable.

Marc Weingarten, Partner
Schulte Roth & Zabel

Eleazer Klein, Partner
Schulte Roth & Zabel

Activist Insight foreword

These are hugely interesting times to be covering the world of shareholder activism. After three years of activism going from strength to strength, there are again questions about whether this growth can be sustained. Some have argued that there is a brewing rejection of activist ideas by other investor groups, or that capital will be pulled from activist funds as rapidly as it has been poured into them. Sudden dislocations in the market – last September and in January of this year – have added to the conviction of these voices, especially when prominent activist positions have been among those to suffer.

The evidence of this survey suggests activists are far from pessimistic. While there is plenty of nuance in the pages that follow, activists believe most stakeholder groups have become more accepting of their role in capital markets, that the volume of activism will at least stay the same, and that they will continue to find management teams willing to work with them to create value. Many are even planning to add to their assets under management.

In particular, activists believe companies remain keen to settle campaigns before they get out of hand, even though the time taken to negotiate such agreements has lengthened. This may not be a contradiction – activists are not becoming any more modest in their demands, if their expectations for majority slate contests or special meeting demands are anything to go by. Yet the diversification of activism has made room for many different approaches. Sandell Asset Management may be followed by many other firms, if its use of a precatory proposal at Bob Evans Farms helps prompt a strategic transaction.

Although recovery in the markets has surely helped ensure that activists do not feel under siege, there are signs that their jobs will become slightly harder. Despite slightly more optimistic responses than last year, many still feel that the U.S., historically the source of most activist opportunities, is overcrowded. Favorite sectors to target, such as consumer goods, appear to be more fully valued. Larger targets are less plentiful.
All of the above may push some activists overseas and the evidence is that Europe and the U.K. in particular, will be the focus of attention if this is the case. If anything, “Brexit” may have made these two destinations more attractive to activists. By contrast, fewer activists seem to be intrepid enough to follow the likes of Elliott Management and Third Point into Asia.

The sections of this report dedicated to how activists identify their targets contain insights rarely touched on elsewhere. First, it is performance that matters most, not valuation (surprising, given that many activists see themselves as value investors first and foremost). Second, although activists expect their investments to last three years on average, and spend six months researching before buying stock, M&A opportunities are the most prominent catalysts. The selection process is therefore a mixture of careful review and opportunism, not one or the other.

We at Activist Insight are pleased to be collaborating this year with Schulte Roth & Zabel and FTI Consulting – two firms we already have strong relationships with. This is our third year conducting this survey, and the results have always been interesting and often predictive about the trends we can expect to see in the year ahead. They will help guide our editorial decisions – especially as we add to our team of reporters in our London and New York offices.

We hope you will enjoy the analysis in this report. If you have any questions or observations about its findings or shareholder activism more generally, I would be delighted to hear from you.

Josh Black, Editor-in-Chief
Activist Insight
jblack@activistinsight.com

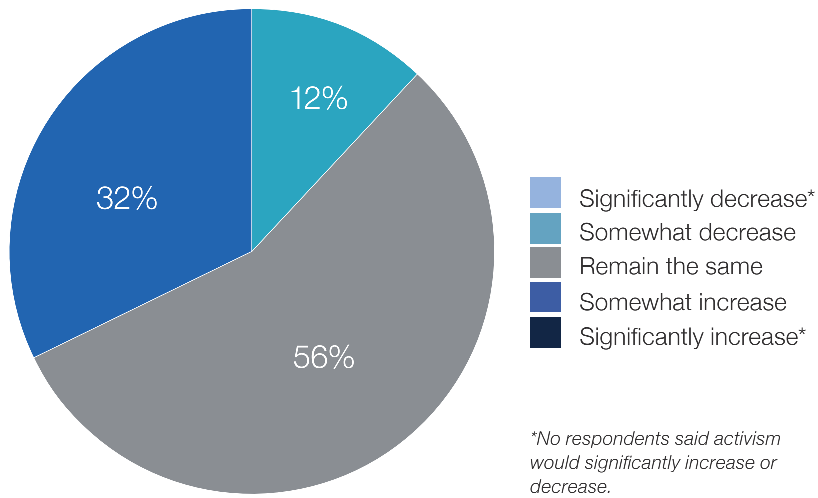
Will activism continue to grow?

What do you expect to happen to the volume of shareholder activism campaigns over the next 12 months?

Many factors have been predicted to precipitate the decline of shareholder activism, from higher interest rates to greater corporate preparedness, a more long-term agenda from passive shareholders, and the topping of the M&A cycle. So far, none have been able to dent activism's rise.

In recent years, shareholder activism has gone from being a niche investing strategy to a thriving industry. Activism has facilitated some of the biggest transformations in capital markets – from sector consolidation to changing capital allocation trends – and accelerated the search for margin growth.

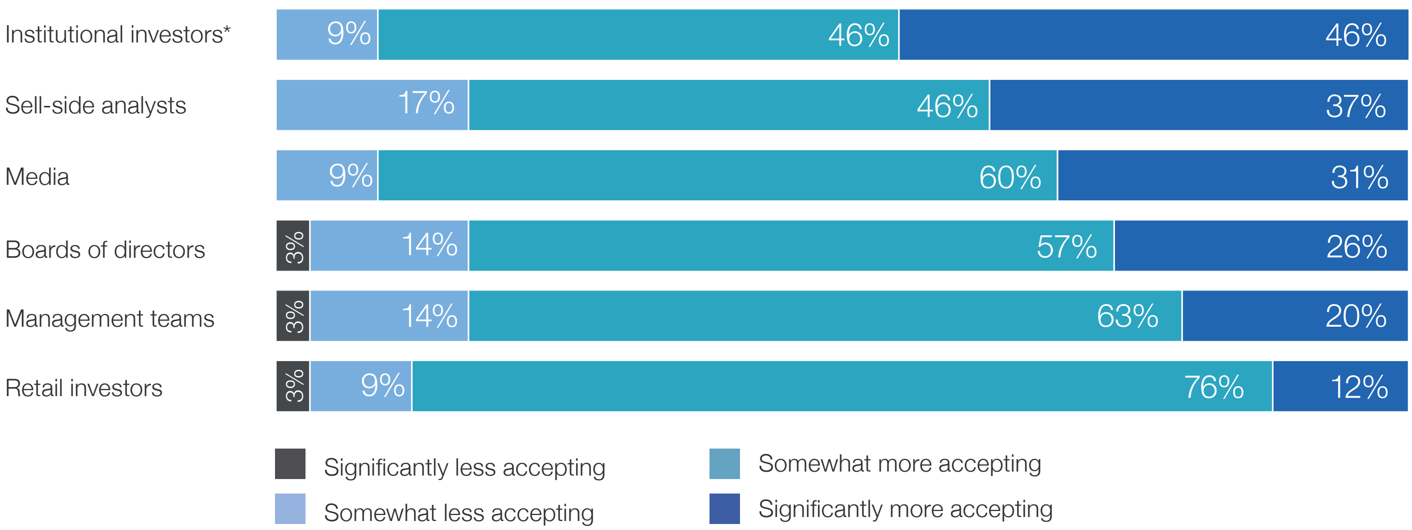
Today, few activists expect any backsliding. Only 12% of those surveyed see the volume of activism decreasing over the next 12 months – and almost three-times as many (32%), expect it will increase. However, the bulk of respondents expect activism to continue at current levels.



**No respondents said activism would significantly increase or decrease.*

> "Activism is an established asset class with constant, continued growth."
>
> *Marc Weingarten, Partner*
> *Schulte Roth & Zabel*

Compared to previous years, how accepting have the following stakeholders become of activist investors?



**All percentages are given to the nearest whole number.*

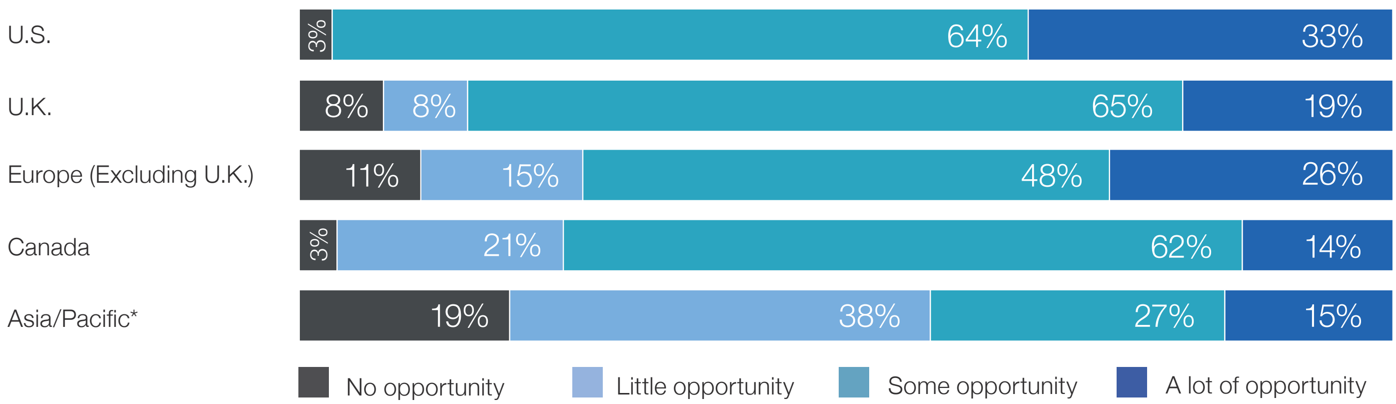
As they did in 2015, activists surveyed for this report believe most stakeholders have become more accepting of their role. Notably, 92% of respondents believe institutional investors are more accepting of activists than in previous years, with activists also experiencing increased receptivity from the media, retail investors, directors and management.

On the other hand, some activists have come to expect a tougher ride from sell-side analysts. While none of the funds surveyed last year believed that analysts were becoming less supportive, 17% of respondents this year perceive a growing chill in attitudes.

> "Acceptance and support for shareholder activism continues to increase across all types of investors."
>
> *Eleazer Klein, Partner*
> *Schulte Roth & Zabel*

Where is activism heading?

For shareholder activism, how much opportunity do you anticipate in the following regions?



**All percentages are given to the nearest whole number.*

Activism continues to be a predominantly U.S. phenomenon. It has, however, spread around the world in recent years. Activists remain confident there is a place for it in Europe and Canada.

Activists believe the U.S. continues to present the largest investment opportunity, with 97% saying there is some or a lot of opportunity there. Activists have become more bearish on Canada, however, with 21% seeing little opportunity – up from 5% last year – perhaps because of continued weakness in commodity prices.

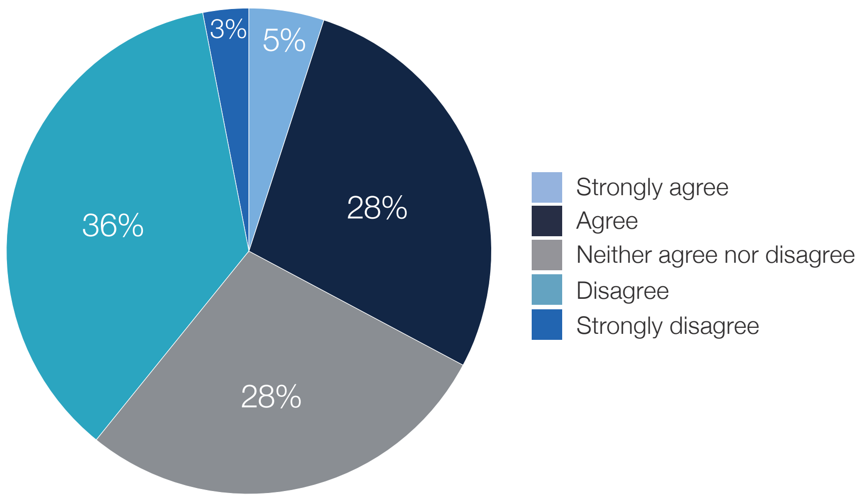
In Europe, respondents foresee a stronger future for activism in the U.K. than on the Continent, with 84% seeing some or a lot of opportunity in London-listed stocks, compared to 74% on the Continent. Surveys were sent out immediately after voters in the U.K. opted to leave the European Union, so this development should be factored in – although the timing and impact of “Brexit” remains unclear and subject to dispute.

A majority of activists surveyed see little opportunity for activism in Asia, despite notable campaigns at Samsung C&T, China Vanke and Seven & i Holdings in recent years. Indeed, almost one-fifth expect no opportunity for activism there – a view that is sure to be tested in years to come as recent corporate governance and shareholder rights reforms in markets such as Japan and Hong Kong are applied.

> “In Continental Europe, which activist tools work and which do not need to be carefully analyzed, while in the U.K., Brexit is casting a long shadow.”
>
> *Jim McNally, Partner*
> *Schulte Roth & Zabel*

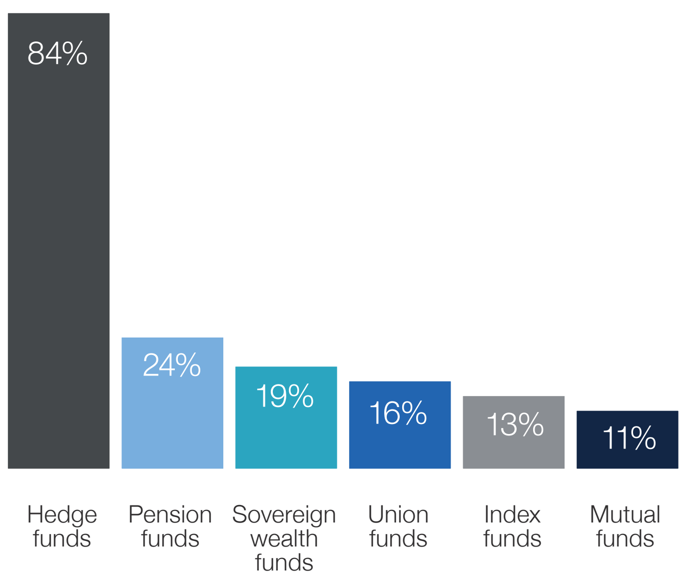
To what extent do you agree with the following statement: “Activism is becoming crowded in the U.S. and targets are becoming increasingly hard to find”?

In 2015, activists were evenly divided over whether U.S. opportunities had become overcrowded. This year, while they still divided sharply, more disagree with the above statement (39%) than agree with it (33%), suggesting that a shakeout in financial markets has bolstered the conviction activists have in their strategy. Indeed, the proportion of activists believing opportunities remain rose seven percentage points.



From which of the following investor groups do you expect to see activism increase over the next 12 months?

As expected, an overwhelming majority (84%) of respondents expect hedge funds to continue to take the fight to management. Activists were entitled to select more than one option, but less than one-quarter see pension funds becoming more involved. And despite much talk of a more muscular approach from index funds to underperforming companies, only 13% of activists surveyed expect them to increase their efforts.



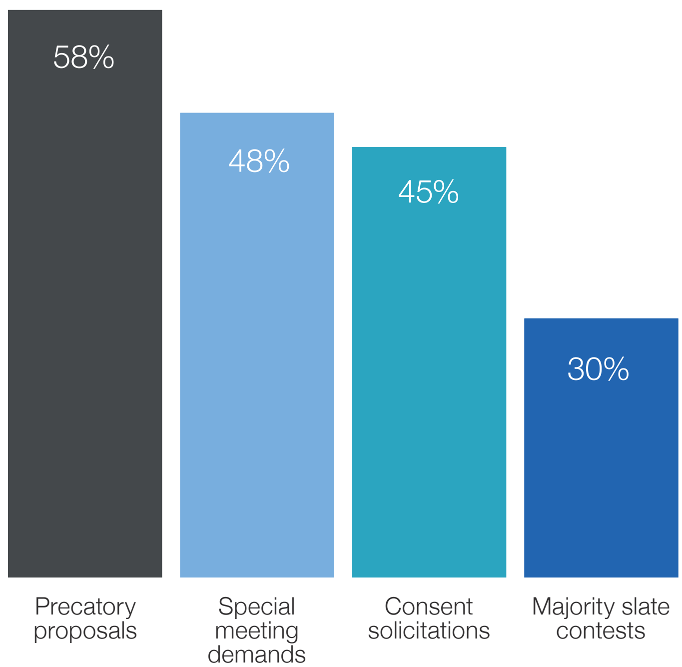
> “Traditional long-only investors are seeing value in activism and are awake to its benefits.”
>
> *Jim McNally, Partner*
> *Schulte Roth & Zabel*

What kind of activism can we expect?

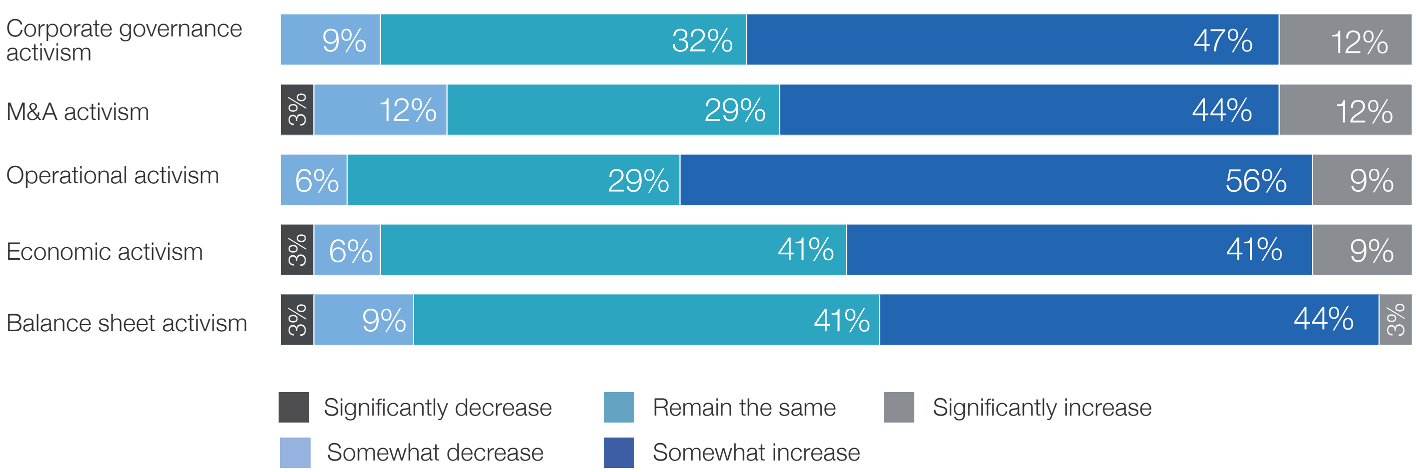
Do you think there will be an increase in the following activities in the next 12 months?

Although activism is dominated by hedge funds, pension and union funds have always had a broad role in shaping the governance of companies in their portfolios. Might the different types of activists learn from each other tactically?

A majority of activists (58%) expect to see an increase in precatory proposals, and several instances of activists using the tactic over the years to push for spinoffs or strategic reviews – even when not taken to a vote, as at eBay – may light a path forward. And while substantial minorities of activists expect to see increases in special meeting demands and consent solicitations – confirming activism as a year-round phenomenon – it is notable that three in 10 expect to see an increase in majority slate proxy contests, showcasing the heightened ambition of some funds.



For the types of shareholder activism below, what are your market expectations for the amount of each type over the next 12 months?



As for the type of activism anticipated, most activists expect the full gamut of demands to continue to be in use. A high point in the M&A cycle appears to signal a reduction in the amount of activism designed to initiate, amend or halt deals.

In 2015, nearly 80% of respondents expected M&A activism to increase – in 2016, that number fell by 24 percentage points. In its place, activists expect to see a small increase in operational campaigns (up 4% year-on-year) and a big return to balance sheet activism (up 41%).

> "Activists continue to focus on excess cash and underwhelming margins but will pursue any strategy that can generate value."
>
> *Steve Balet, Managing Director*
> *FTI Consulting*

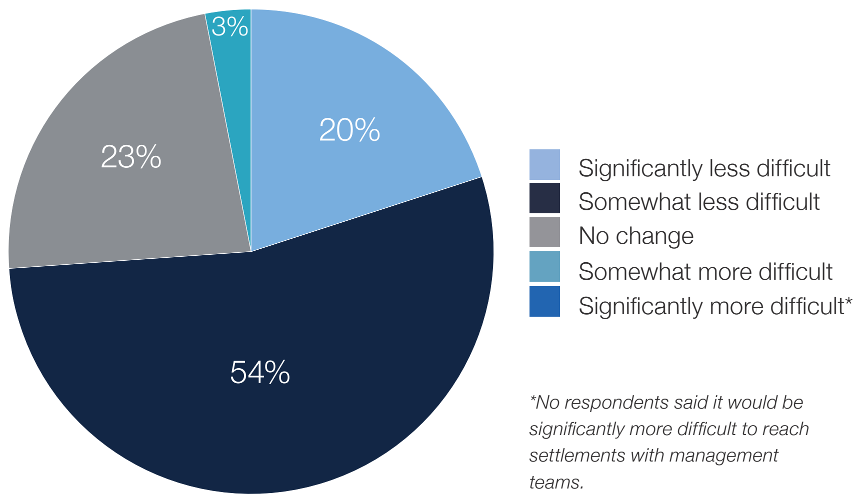
Is the age of the settlement over?

Compared to previous years, how difficult is it for activist investors to reach settlements with management teams?

Proxy fights have increasingly become just one of many tactics used by activist funds. Growing acceptance of the influence and value of activism has seen companies work with activists to the benefit of all shareholders, reflected beyond all else in the rise of settlement agreements.

Activist Insight data suggests that between 2013 and 2015, companies became much more willing to add activist nominees to their boards without a public fight. The time taken to broker such deals fell from 74 days to 56 days over that period. In 2016, that figure rose for the first time on record to 69 days, suggesting a pullback that may have to do with several well-publicized activist situations that have gone wrong, or indications from some institutional investors that they may be less willing to support activists in the future.

Despite this pullback, just shy of three-quarters of 2016 respondents feel that it has become easier to settle disputes with management teams. Only one respondent said it has become somewhat more difficult, and more than one in five feel there has been no change.



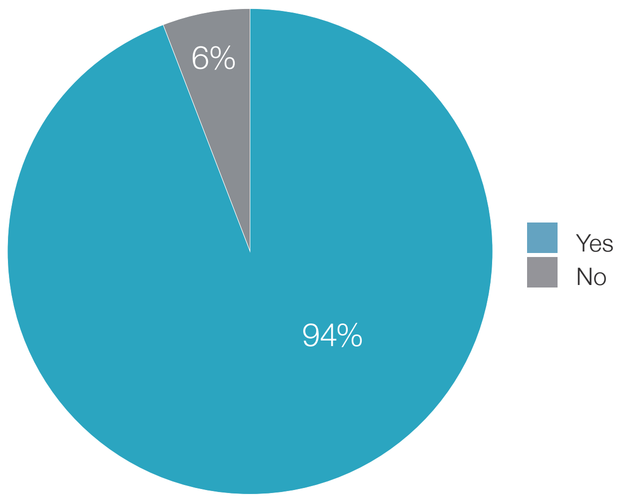
**No respondents said it would be significantly more difficult to reach settlements with management teams.*

> "Settlements continue to be the trend, but the tides may be changing."
>
> *Eleazer Klein, Partner*
> *Schulte Roth & Zabel*

Do you believe it is appropriate for shareholders to have board representation?

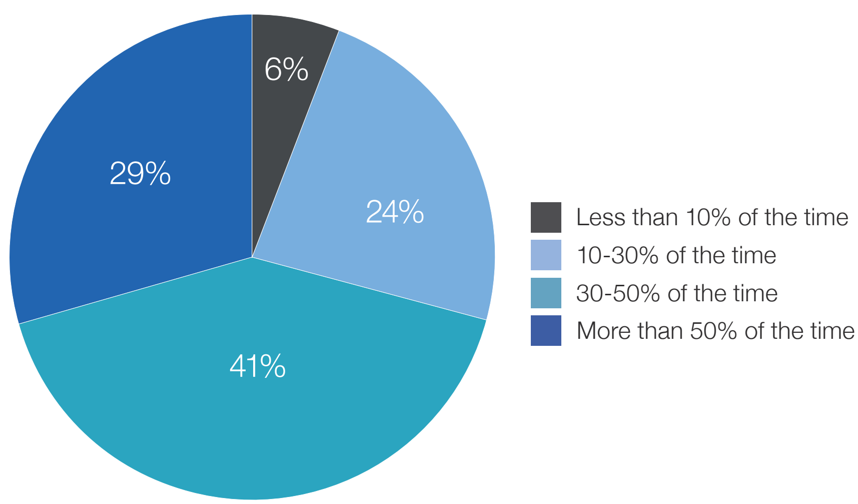
The activist revolution appears set to continue, although it may be slowing. Last year, 91% of respondents felt settlements were becoming easier to negotiate, whereas in 2016, only 74% feel similarly. That matters, because 94% of activists see board representation for shareholders as appropriate, if not necessary in every situation.

> "Shareholders with investing experience are needed in more boardrooms."
>
> *Marc Weingarten, Partner*
> *Schulte Roth & Zabel*



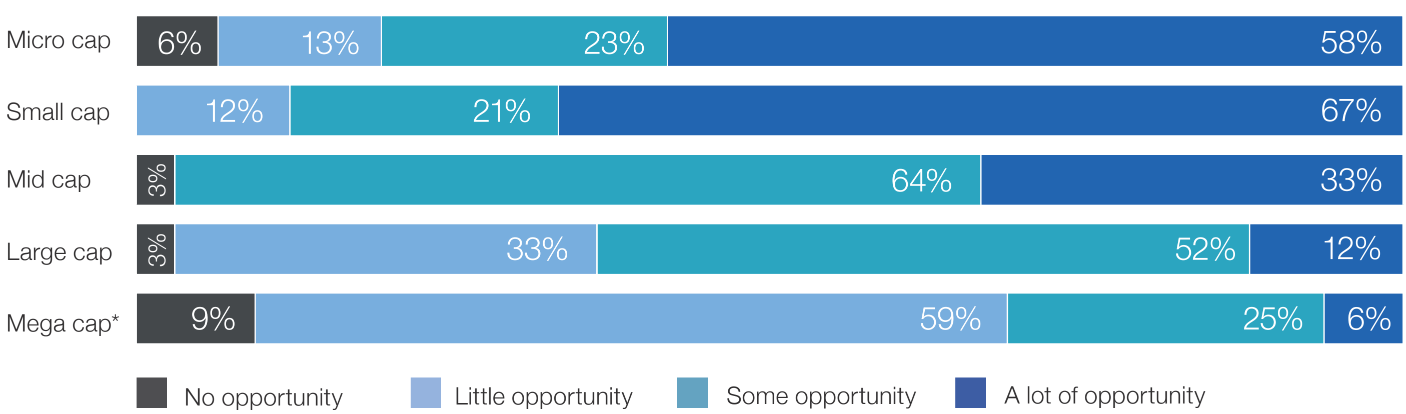
In your experience, how often do activist investors and corporations work together cooperatively without receiving media attention?

Although activists believe the media has become more accepting of their craft, there is little doubt that extensive coverage can sometimes complicate delicate negotiations. Therefore, it must be some relief that activists feel they can work with companies outside of the spotlight at least some of the time. However, only 29% find this to be true more often than not, with the vast majority feeling they could engage with companies out of the public eye between 10% and 50% of the time. Only 6% report that their campaigns were hardly ever conducted in private.



What opportunities are activists pursuing?

For shareholder activism, how much opportunity do you anticipate in the following market cap ranges?



**All percentages are given to the nearest whole number.*

History doesn't repeat, but it does rhyme. Here, we look at the prospects for activists facing a collective change of direction.

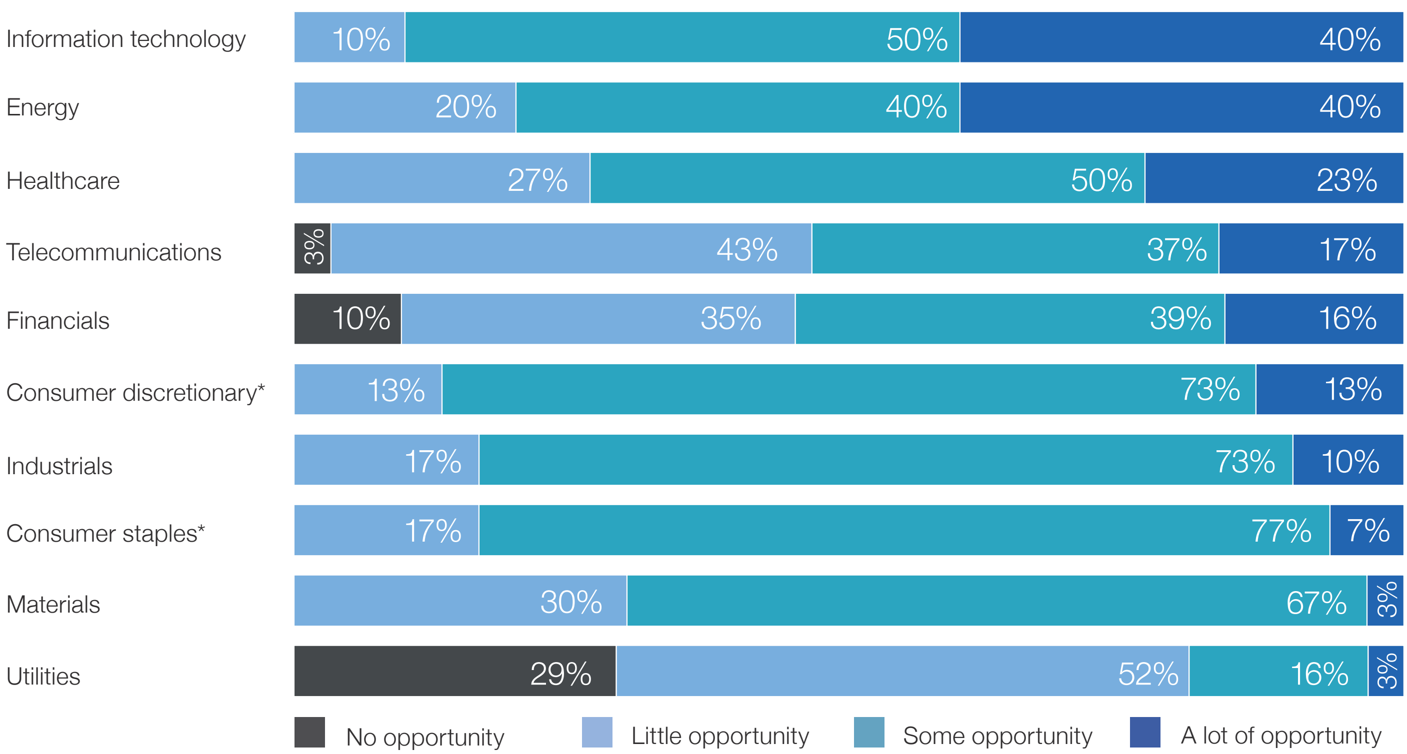
Despite the need for some of the biggest activist funds to find places to build concentrated positions, activists as a whole seem to be waning in their enthusiasm for the largest targets. As with last year, the highest proportion of respondents see limited opportunities in mega cap companies. Significantly, the proportion seeing some or a lot of opportunity fell from 48% in last year's survey to 31% this year.

In contrast, two-thirds of respondents now feel that small cap companies present a lot of opportunity for activism – slightly ahead of even smaller micro caps, perhaps due to difficulties these companies might face in a tightening credit or more volatile investment climate. Fully 97% of respondents feel there is some or a lot of opportunity in mid cap stocks, however, this was the only category to increase this year compared to 2015, when the figure was 91%.

6 months

Median time activists spend observing potential investment opportunities.

For shareholder activism, how much opportunity do you anticipate in the following sectors?



**All percentages are given to the nearest whole number.*

Four in 10 respondents see a lot of opportunity in both IT and energy stocks this year, suggesting there will be plenty of activism in these areas.

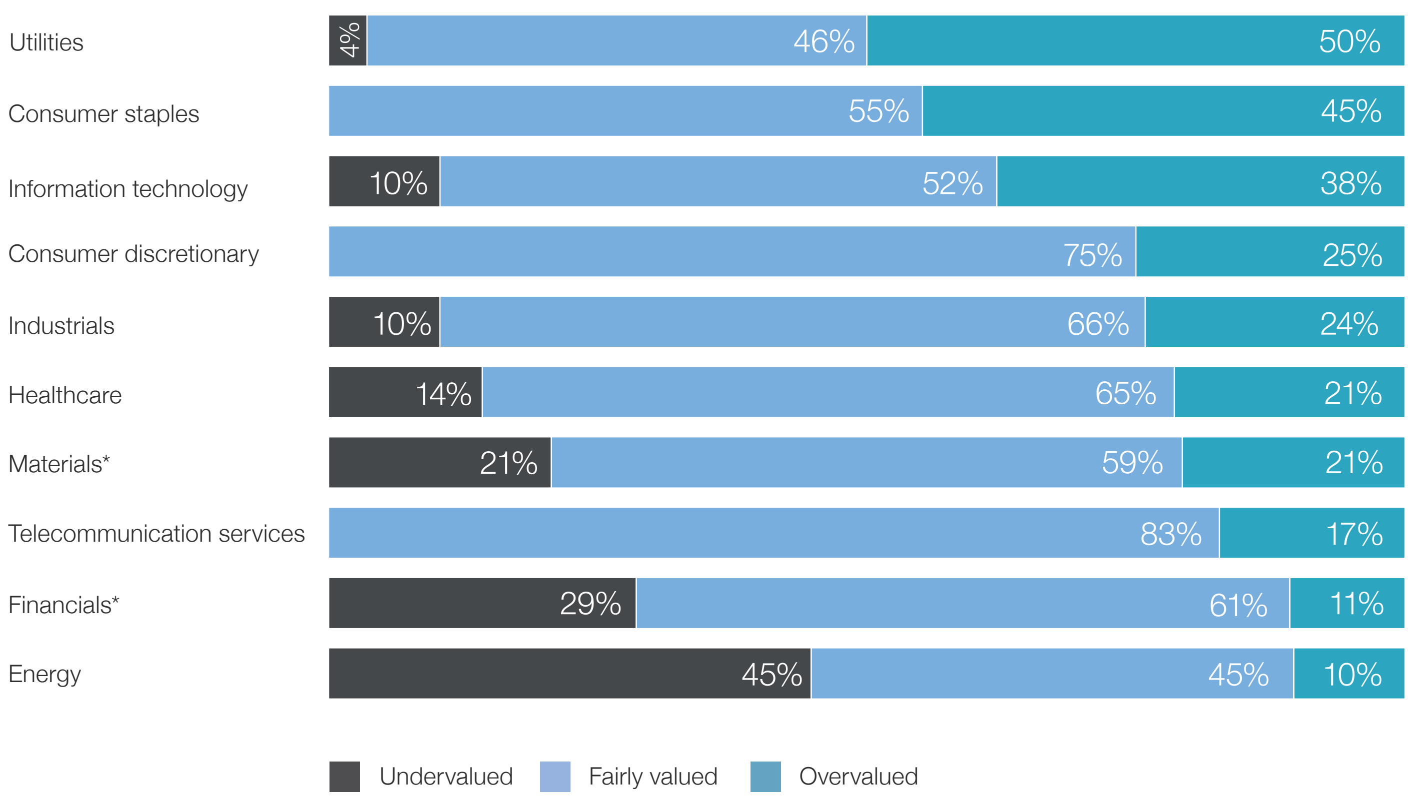
Slightly behind energy are financial stocks, which nearly three in 10 activists see as undervalued. ValueAct Capital's investment in Morgan Stanley, Carl Icahn's in AIG, and a revival of fund arbitrage signal that an uptick of activity in this sector has already begun. However, regulatory issues mean there is also a sizeable group of activists who view financials as not worth the risk – 45% of respondents say there is no or little opportunity there.

Retail and consumer goods have seen plenty of activism in recent years, including Mondelez, Avon Products and Macy's. Activists still seem interested, but overall volumes may decline, as almost all respondents believe valuations in consumer staples and consumer discretionary have become excessive. And utilities bosses can rest easy – over 80% of activists see little or no opportunity in that sector.

> "In today's market, there are sophisticated activists capable of identifying and challenging any size company with deficiencies."
>
> *Eleazer Klein, Partner*
> *Schulte Roth & Zabel*

What does opportunity look like to an activist?

Within each sector, how do you view current market valuations?



**All percentages are given to the nearest whole number.*

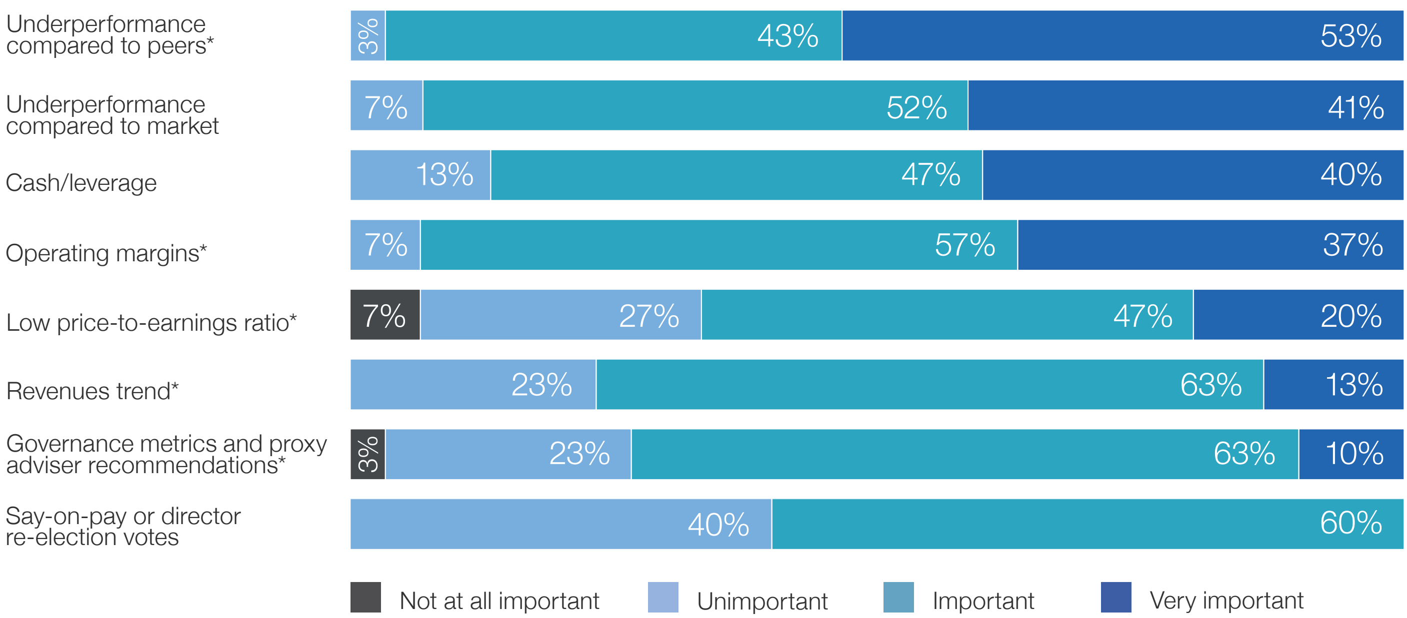
In 2016, 45% of respondents see energy stocks as undervalued. After a year in which activity was seemingly frustrated by the volatility of oil prices, this may be the sector to watch over the next year.

Those surveyed say that, on average, they hold their activist investments for around three years and seek to realize a 20% return on investment. Over a shorter period, that sort of increase would be hard to produce without a major change in ownership or financial structure, but turnarounds and operational campaigns fit the three-year timeline better. Even so, those critics who accuse activists of encouraging short-termism are unlikely to be convinced.

> "For the second year in a row, activists have cited energy as the most undervalued sector. Whether they can act on it is another question."
>
> *Steve Balet, Managing Director*
> *FTI Consulting*

Who's vulnerable?

When generating investment ideas, how important are the following to screen for targets?



**All percentages are given to the nearest whole number.*

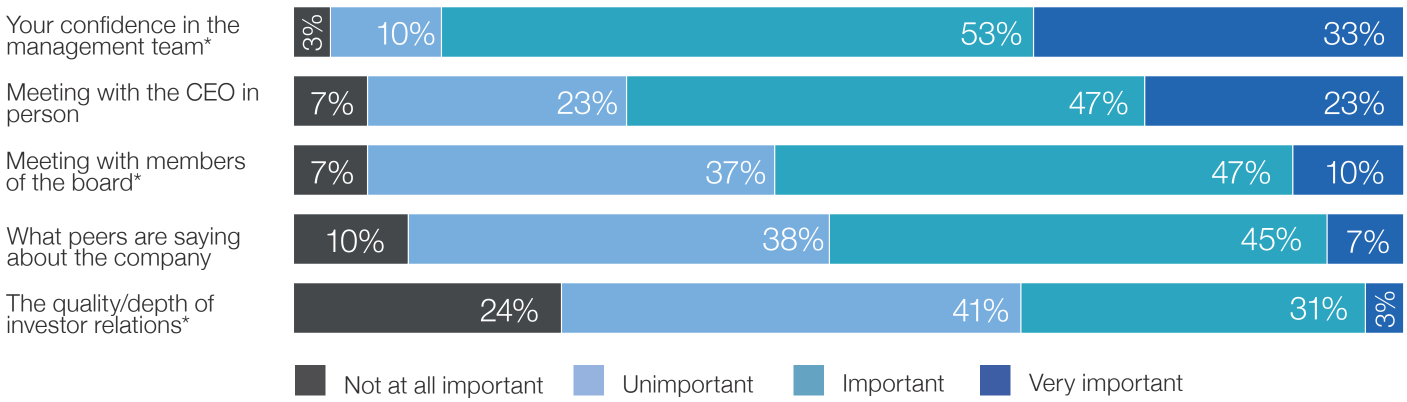
With many activists following a potential investment for six months before building a stake, companies have only a limited amount of time to reverse setbacks before they become a target. Here, activists explain what they look for in a target, and what might catch their eye in the year ahead.

Companies with poor corporate governance as their only issue can perhaps rest easy. Activists attribute some of the lowest weightings to traditional metrics in this area, such as proxy advisory recommendations and shareholder votes on remuneration. Nor, surprisingly, is valuation ranked as highly as might be expected – only 20% of respondents say a price-to-earnings ratio was a very important screen, and only 47% cite it as somewhat important.

Cash on hand and leverage were not universally regarded as important, although a sizeable group (40%) of respondents believe they are very important – second only to relative stock performance. Bad management, on the other hand, features highly. Practically all activists look at the company's performance relative to peers, and 94% consider operating margins important or very important.

> "There's an activist for any kind of opportunity."
>
> *Steve Balet, Managing Director*
> *FTI Consulting*

When conducting due diligence on a potential investment for the first time, how important is the following in forming your opinion about the company?

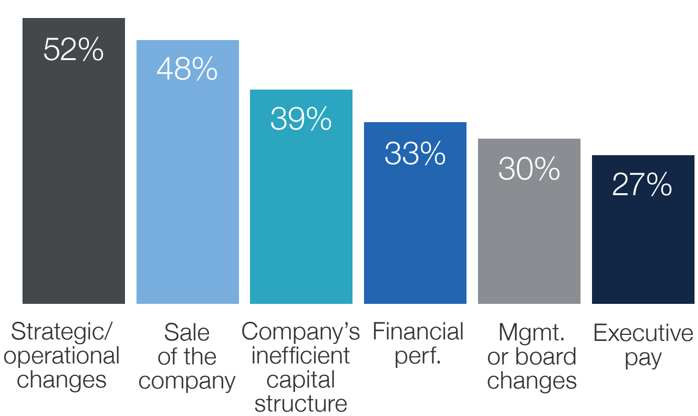


**All percentages are given to the nearest whole number.*

The survey results reveal that 86% of respondents feel confidence in management is an important or very important part of their due diligence. Considerably more feel that meeting with the CEO is an important part of due diligence compared to a meeting with board members.

> "Human capital is still the best indicator of a company's quality."
>
> *Marc Weingarten, Partner*
> *Schulte Roth & Zabel*

What will the most important catalysts of shareholder activism be over the next 12 months?



By far the biggest expected catalysts are strategic or operational changes (52%) and a sale of the company (48%). Industry trends, particularly consolidation and technological change designed to enhance margins, are therefore likely to draw activists in. Consistent with an expected rise in balance sheet activism in the next 12 months, 13% of activists expect inefficient capital structures and 18% cash balances to catalyze activism in the year ahead (not shown in chart).

What defenses work?

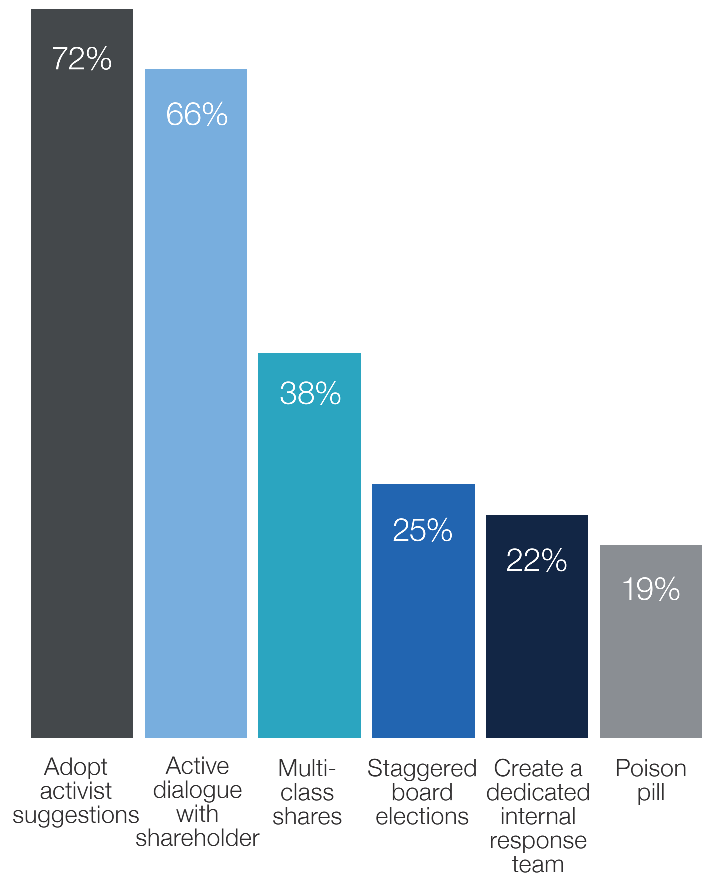
What are the most effective defensive tactics a company can use against activist investors?

Activists take a dim view of "hard" defenses, preferring companies to enter into a dialogue. Poison pills, for example, have played their part in corporate responses to activism, even if they are perceived as being in decline. Activists don't see these as a useful deterrent, perhaps because their use will often incur the wrath of proxy voting advisers.

Instead, two-thirds of activists feel companies should enter into an active dialogue with investors as a defensive tactic. That may be a more palatable response to the uppermost item on activist wish lists – full acceptance of their recommendations.

Notably, 38% of activists feel multi-class share structures are an effective defense. Although agitation at Viacom over the past year shows it is not a universal deterrent, it has so far protected much of Silicon Valley from the attentions of activists.

Not shown in the adjacent chart are advance notice bylaws, cited as effective by 19% of activists, and litigation or outperforming the market, each cited by 6% of respondents. Only 3% feel disqualifying activist nominees would be an effective defense.



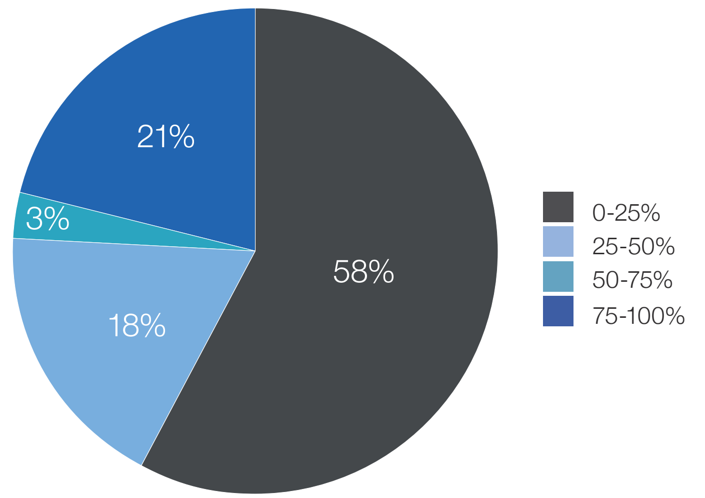
> "Remember, in some markets, such as the U.K., the availability of some traditional defensive tools (staggered boards, poison pills, etc.) is limited."
>
> *Jim McNally, Partner*
> *Schulte Roth & Zabel*

Will fundraising continue?

For the capital you manage, what are your expectations for the amount of new capital to be raised over the next 12 months, expressed as a percentage of your current capital under management?

After several years in which activism was a hot fundraising strategy, expectations have dampened. Some funds are still on the hunt for capital, but they may have to be more inventive to get it.

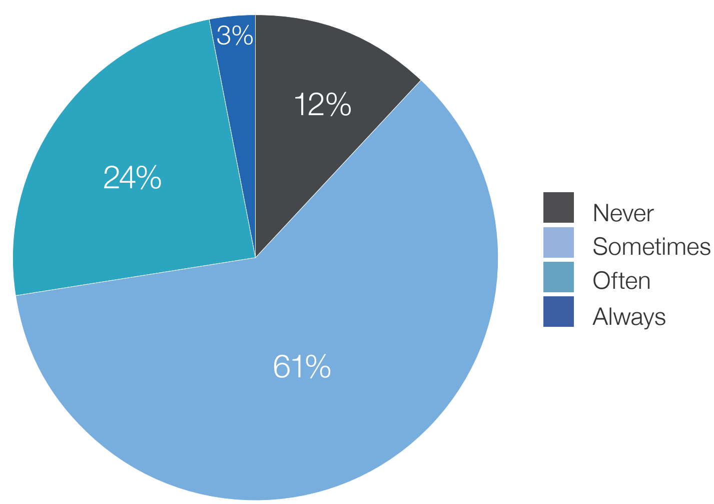
In 2015's survey, more than half of activists said they were raising some capital, and three in 10 said they were raising a lot of capital. This year, only 21% of respondents expect to increase the amount of their assets under management by 75-100%, while only 3% hope to raise the equivalent of 50-75% of their capital. By contrast, 58% expect to add less than a quarter of their current assets to their war chests.



How often do you use co-investment vehicles rather than deploying capital from your main funds?

An interesting development may be a warming to co-investment strategies as a means of gathering capital. Pulling in assets for specific campaigns appears to be a widespread practice in the industry – 61% of respondents say they sometimes use co-investment vehicles. In 2015 only 10% of activists said they often used co-investments, a figure that rose to almost 24% this year.*

**In 2015, activists were given a choice of deciles for what percentage of the time they used co-investments. Only 10% used such vehicles more than 40% of the time. In 2016, the question was asked with the options never, sometimes, often and always as possible responses.*



Schulte Roth & Zabel

About Schulte Roth & Zabel

As counsel on many of the highest-profile activist matters in recent years, Schulte Roth & Zabel is the go-to firm for representing the interests of investors, shareholders and target companies alike. Our dedicated team of lawyers has unparalleled experience in shareholder activism, having advised on hundreds of campaigns, from micro cap to mega cap companies.

The firm's lawyers provide both legal and strategic advice that is critical to conducting today's sophisticated campaigns. We bring to each matter a refined knowledge of market practices, vast experience, and expertise in the applicable corporate laws, securities laws and proxy rules.

Serving activists, "occasional activists," investment advisers and issuers, we provide cutting-edge advice on navigating the maze of applicable laws and regulations in both the United States and the United Kingdom as well as covering markets in Continental Europe and other parts of the world.

When it comes to assessing risk and navigating challenging environments in shareholder activism situations, clients rely on Schulte Roth & Zabel. Our **Shareholder Activism Resource Center** is updated regularly and includes a wide variety of lawyer-authored articles of interest, alerts on cases and emerging rules and regulations, practice highlights, and industry news and publications.

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