Shareholder activism in Japan

Learn from activist strategies to increase value and mitigate the risk of an activist attack

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Foreword

The sweeping changes to governance and stewardship implemented in recent years have been accompanied by a gradual increase in shareholder activism. Recent high profile successes of activists are likely to encourage a second, potentially much larger wave of activism, both home-grown and foreign. Yet many business leaders, still adapting to ever-increasing focus on returns and value creation in Japan, are feeling unprepared to deal with the challenges from shareholder activists.

Activist funds typically buy a stake in a public company and use their position to advocate significant change to the strategic direction, operations, governance or financial structure of the company. While activists typically have a proprietary method of analyzing a target company, many look for underperforming assets that may be creating a drag on overall stock performance. They often advocate the divestiture or break-up of one or more business lines as a way to unlock shareholder value and generate cash that can be allocated to high-growth areas of the business or returned to shareholders.

With an abundance of listed companies with (i) conglomerate-like structures; (ii) significant cash balances; (iii) large amounts of capital tied up in low-yielding investments and other non-core assets; and/or (iv) inefficient capital structures, circumstances in Japan would appear to be ripe for an increased level of activism.

In this paper, we examine:

- emerging opportunities for activists in Japan
- what strategies activists have employed in recent campaigns in Japan
- how companies can learn from activist strategies and mitigate the risk of an activist attack
- how companies should respond to an activist campaign.

Shareholder activism is on the rise, with expectations that activist targets will increasingly be located outside of the US; Europe and Japan are likely targets for both home-grown and foreign activist funds

In recent years, shareholder activism has increased dramatically with assets under management growing to well over US$ 100 billion.

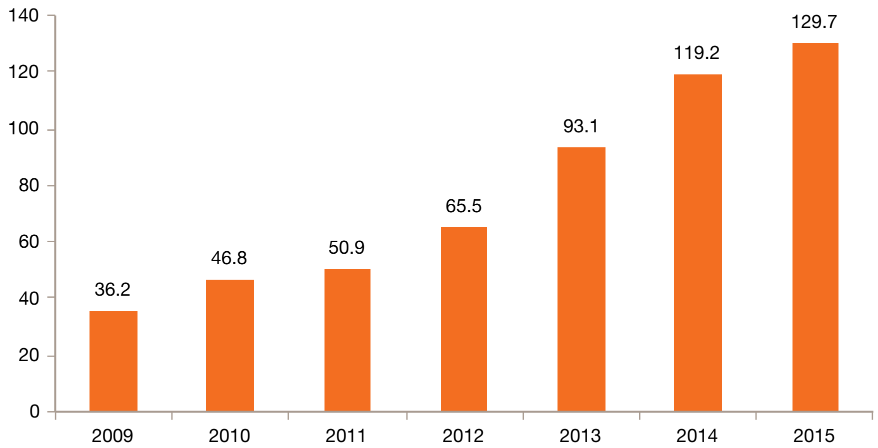
While much of this money has been put to work in the US, there is an increasing focus on other parts of the world, particularly Europe and Japan.

What is motivating the rise in shareholder activism? Probably the most compelling reason for the increase is the significant returns achieved by activists (primarily in the US) in a number of recent years.

As a result, a significant amount of capital is flowing into these funds, and activists are gaining credibility for their ability to bring about positive change for the shareholders of companies they target.

In the US, there has also been a fundamental shift in shareholder sentiment towards activists, who are no longer viewed as villains or corporate raiders. Instead, they are increasingly being viewed as legitimate investors who are seeking broad increases in shareholder value.

Activist Hedge Funds' Assets Under Management (US$'bn)



Note: Assets under management data is for single-strategy US-based activist managers – non-US-based funds as well as multi-strategy funds and investment managers engaging in activism as a sub-strategy are excluded.

Source: JP Morgan, originally from HFR Industry Reports

While activists are still viewed with suspicion by many in Japan, the new breed of less hostile activists are enjoying greater success

It is too early to conclude that sentiment in Japan now favours activists but the less hostile approaches taken by activist investors (many of whom are commonly referred to as "engagement funds") in recent campaigns is finding greater acceptance than the more aggressive approaches of activists in the past.

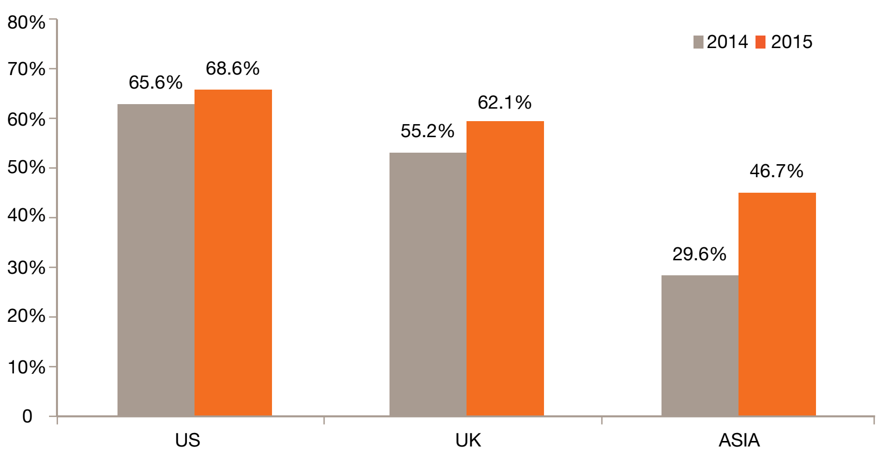
According to ValueWalk, since 2013, public activist demands have been made at 23 companies in Japan. However, this is likely to significantly underestimate the level of recent activist activity as, in line with the less confrontational approaches being adopted by many activists, activist demands are often not being made public, at least in the initial stages of a campaign.

And while Japan-specific data is limited, the success rate of activists in Asia as a whole has increased significantly, according to the Activist Insight 2016 Annual Review. While it remains well below the levels observed in the US and the UK, such data will likely encourage more funds to target Asian companies, with Japan being one of the most popular destinations for activist funds in the region.

It is not just traditional hedge fund activists that are engaging with management of investee companies. As of 24 March 2016, 206 institutional investors had indicated their intention to accept the Stewardship Code, and with it their obligations as shareholders.

While the tactics employed by institutional investors may differ from those of activist funds, their intent to engage with their investee companies will nevertheless place Japanese corporations under ever-increasing scrutiny.

Success Rates of Activist Demands by Region



Note: Percentage of activist demands at least partially satisfied
Source: Activist Insight 2016 Annual Review

"Japanese corporations will be under increased scrutiny by institutional investors to improve corporate governance if an informal agreement made [in early May 2016] by the top investment officials of the $186.8 billion California State Teachers' Retirement System and Japan's $1.3 trillion Government Pension Investment Fund becomes a reality."

Source: The Board Director Institute of Japan (original source: Pensions & Investment)

The sweeping changes to governance and stewardship implemented in Japan in recent years have resulted in the gradual dismantling of the barriers to shareholder activism

Cross-Shareholdings

The cross-shareholding structures prevalent in corporate Japan have made it difficult for activist investors to obtain the necessary support from other shareholders for their proposals. As such structures were created in order to enhance and maintain business relationships, rather than for dividends or capital gains, cross-shareholders have generally supported management and the status quo.

Under the Corporate Governance code, listed companies are required to disclose and justify their policies for investment, which would include their cross-shareholdings. Since the Code came into force, the Japanese mega-banks, for example, have each pledged to reduce their cross-shareholdings.

Stakeholder vs. Shareholder Focus

Traditionally, many companies have been run for the benefit of various different stakeholder groups, with employees, customers and lenders often viewed as more important than shareholders. As such, activists have encountered resistance to proposals focussed on increasing shareholder returns, particularly if they are not viewed as beneficial to other stakeholders (as, for example, a share buyback may be perceived).

Changes to governance and stewardship have increased the focus on the generation of adequate returns on capital and the need to take decisions that increase corporate value. While stakeholder/shareholder trade-offs remain, activists may now receive greater support for their proposals if they are viewed as value-enhancing.

Past Failure of "Aggressive" Activists

In the early public cases of activism in Japan, activists typically took a confrontational approach to their interactions with the management of target companies. While sometimes enjoying a degree of success, during the mid-2000s, in certain high-profile cases, activists were rebuffed by management, with other shareholders siding with management even though it was not necessarily in their own immediate economic interest to do so.

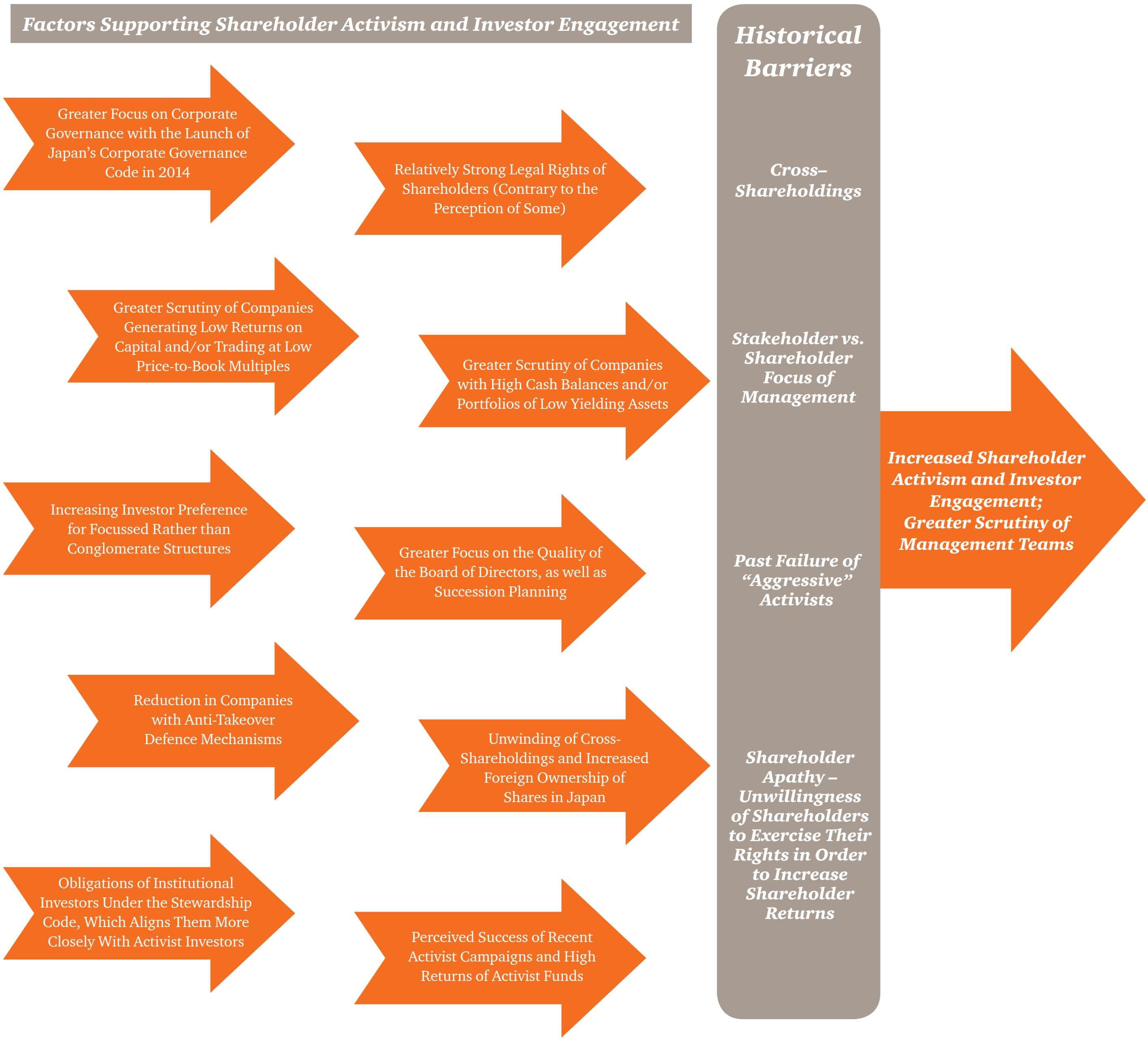
Recent high-profile successes of activists using less confrontational approaches than in the past are likely to encourage a second, potentially much larger wave of activism, both home-grown and foreign.

Shareholder Apathy

Contrary to the perception of some, the rights of shareholders in Japan are actually quite strong. However, shareholders of Japanese corporates have not typically leveraged their rights to force the management of under-performing companies to effect the necessary changes to improve shareholder returns, often staying silent and apparently supporting the status quo.

The launch of the Stewardship Code in 2014, to which over 200 institutional investors have now signed-up, means that doing nothing about under-performing investee companies is no longer an option for such investors. The increased level of foreign ownership in listed company shares may also lead to greater levels of investor engagement, and more support for activist strategies.

The increased focus on operating and value performance, as well as governance and stewardship, is creating opportunities for activists



The attributes of companies most at risk of an activist campaign include poor operating and capital market performance, weak governance and a relatively low level of insider or "controlled" ownership

Before considering potential risk mitigation approaches, it is important to understand what draws activists, including the process they use to identify, target and scrutinize potential opportunities.

It is important to recognize that there is no typical target profile. A target can be small, medium or large, and while many Japanese activists still target relatively small companies, global activism has trended towards much larger targets. Activists are also industry agnostic. They take a very broad approach and many different industries have been the subject of activism in recent years.

What activists are looking for are companies where management is either unwilling or unable to address issues that seem apparent to market participants, including investors and analysts.

Common Attributes of Activist Targets

Operating, Value and Capital Market Performance
Poor capital market performance relative to peers
Return on capital below the cost of capital
Underperforming business segments; lack of a coherent strategy
Low-yielding assets in non-core business areas
High cash balance/sub-optimal capital structure
Lack of new products, poor track record of innovation
Governance Profile
"Stale" board, "Zombie" directors
Lack of transparency and communication
No investor engagement program
Investor Base
High level of institutional ownership, low level of insider/controlled ownership

"California Public Employees' Retirement System (CalPERS), a huge US pension fund, is already planning to make the most of Japan's growing openness to corporate governance campaigners.

In a September 2015 presentation, it said it would engage with a select few companies to try and make inroads into the country's "systemic" governance problems, including board independence, cross-shareholdings and director recruitment.

Some experts refer to the plans as an example of an institution taking activism "in-house"."

Source: Activist Insight 2016 Annual Review

While the processes used by activists to identify targets may differ, most share certain broad similarities and typically focus on characteristics such as the following:

- A company has a low price-to-book multiple and/or is generating a return on capital below its cost of capital.
- One or more of a company's business lines or segments (operational and/or geographic) is significantly underperforming in its market.
- A company lacks a coherent strategy and management is unable to explain how the company is harnessing its capabilities to thrive in its chosen markets.
- A company's cash reserves exceed both its own historic norms and those of its peers, and are high relative to its market capitalization. The market is unclear about the company's rationale for the large reserve.
- A company is generating no or very low organic growth and has a weak pipeline of products and a poor record of innovation.
- A company's board composition does not meet today's "best practice" expectations. For example activists know that other investors may be more likely to support their efforts when the board is perceived to be "stale" – that is, the board has had few new directors over the past three to five years, and most of the existing directors have served for a long period and are ineffective.
- Companies that have been repeatedly targeted by non-hedge fund activists are also attractive to some hedge fund activists who are alert to the cumulative impact of shareholder dissatisfaction.
- Institutional investors own a majority of a company's outstanding voting stock.

On performance metrics alone, a significant proportion of large Japanese corporates would appear to be vulnerable to an activist attack; board and shareholder composition often increase this vulnerability

Proportion of JPX-400 companies generating returns on capital below the cost of capital in FY15

22%

Despite recent improvements in operating performance (driven in part by the weaker yen), and the abundance of cheap capital, 22% of JPX-400 companies failed to achieve a return on capital above the cost of that capital in FY15. For these companies, improving operating margins and capital efficiency should be prioritized over top-line growth in order to create sustainable value.

Proportion of JPX-400 companies trading below book value at the end of FY15

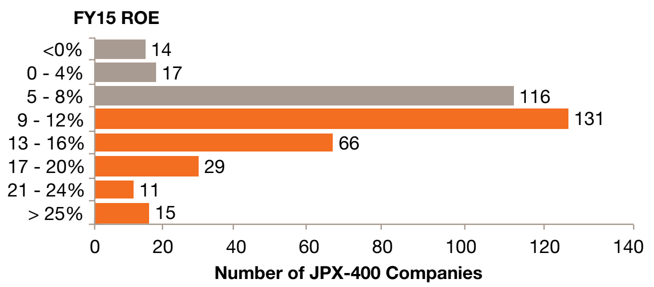
23%

Compared to other developed economies, the market value of Japanese corporates is relatively low – the JPX-400 trades at around 1.3x book value, less than half the level of the S&P 500. Consistent with other observations, this reflects the low returns on capital generated by many corporates, which often do not significantly exceed, and in many cases are lower than, the cost of that capital.

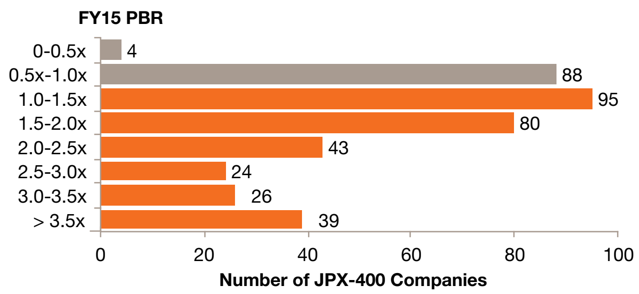
Proportion of JPX-400 companies that generated an ROE below 8% in FY15

37%

The average ROE of JPX-400 companies was 9% in FY15 but 37% of companies generated an ROE below 8%, the minimum level set out in the Ito Review, which stated that "a value-creating company is one that has an ROE above its cost of capital" and that companies should continually seek "to generate an ROE higher than 8%".



Source: S&P Capital IQ



Source: S&P Capital IQ

Activist campaigns take various forms from private communication to law suits; many of the recent activist campaigns in Japan have been limited to public and/or private communication with the Board of the target company

There are various phases to activist investing. Initially, activists look for situations where they believe the value of a company's shares is lower than it should be and where they think they can capture a step change in that value. They will then begin buying shares and will be required to file a report under the Financial Instruments and Exchange Law within 5 business days after their holding exceeds 5%. In practice, many activists have embarked on campaigns with holdings below this level.

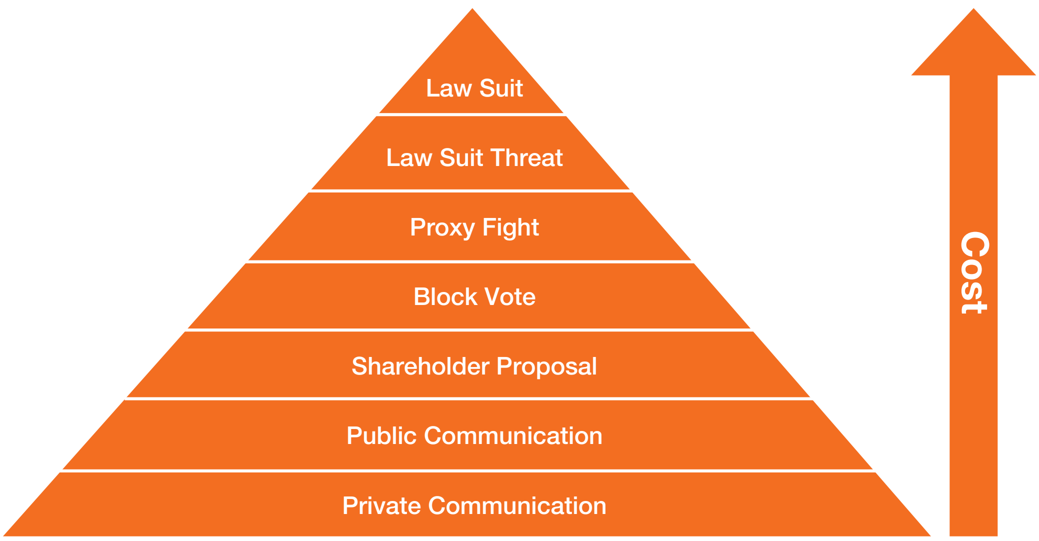
Having built up a stake, there are various ways for an activist to achieve its goal. Each method can vary in terms of the costs involved, as well as the extent of hostile/friendly behaviour towards the management/board of the target company.

A typical first step is to communicate the measures that the activist would like the target company to take. This can be effected through private conversations and/or written communication with management or the board. If this does not work, public communication via media may be used to put pressure on the company.

If communication, whether private or public, does not have the intended effect, the activist can decide to make use of its rights as a shareholder. This might be by way of a shareholder proposal, using blocking votes against management proposals, using proxy votes or even law suits.

Any shareholder with voting rights may submit a proposal at any time, including a proposal to nominate directors. Shareholders owning more than 1% of the shares, or 300 or more voting rights, for at least 6 months are able to require the company to include the proposal in the convocation notice of the general shareholders' meeting. Furthermore, a shareholder owning more than 3% of all voting rights for at least 6 months may call an extraordinary shareholders' meeting.

Recent activism in Japan has largely been non-confrontational in nature and has utilized private and public communication as its primary tool.



Activist strategies to generate a return from their holding in a target company's shares can loosely be classified as value creative or value extractive

A key argument in fights between companies and activists, is the extent to which actions promoted by activists benefit the company in the long run or only provide short-term gains for activists at the expense of other stakeholders.

In this regard, strategies can broadly be split into two categories, being value creation strategies and value extraction strategies.

The former are typically viewed as longer-term strategies that require more fundamental changes to a business, and are in line with the objective of increasing corporate value. As such, they typically, though not always, require the involvement of the activist for a longer period of time in order to realize the full returns of the strategy.

Value extraction strategies involve measures that can be implemented quickly and in relation to which the full impact of value creation is immediate.

Not surprisingly, value extraction strategies are typically considered to be detrimental to other stakeholders in a company as they often trade-off long-term corporate value for short-term shareholder return, while value creation strategies may be beneficial to a broader group of stakeholders in the long run.

Activists' Value Creation strategies include:	• Divest segments or non-core assets • Capital structure/cost of capital optimisation • Enter new markets, develop new products/services • Acquisition strategies • Restructuring measures • Board/management changes
Activists' Value Extraction strategies include:	• Using excess cash or debt to increase dividends or undertake share-buybacks

Activists primarily focus on one or more of four campaign themes: (1) capital structure; (2) acquisitions or divestitures; (3) operations; and (4) governance

Theme	Potential Circumstances	Activist Strategy	Value Creation or Value Extraction?
Capital Structure	The target company has a low market value relative to book value, but is profitable, generally has a well-regarded brand, and has sound operating cash flows and return on assets. Alternatively, the company's cash reserves exceed both its own historic norms and those of its peers. This is a risk particularly when the market is unclear about the company's rationale for the large reserve.	Increase leverage to reduce the cost of capital	Value creation – cost of capital optimization (unless accompanied by a demand for higher dividends or a share buyback, which would extract value)
		Use excess cash to increase dividends and/or undertake share buybacks	Value extraction – increasing shareholder returns
Acquisitions or Divestitures	The target company should put itself, a business segment or non-core assets up for sale, or is the subject of a bid and should seek a higher premium.	Sale of the company or parts thereof to a more "natural owner". Greater focus on "core" businesses. Negotiate a better deal.	Value creation – disposal value to exceed "value-in-use". Higher returns on remaining businesses, if partial sale only
	The target company should abandon a proposed merger or acquisition.	Abandon a deal that the activist considers would destroy value	Value creation (more appropriately termed, value protection) – maintaining value by avoiding a "bad deal"
Operational	The target company has underperformed its peers over various time periods. For multi-business companies, activists are also alert for one or more of the company's business lines or sectors that are significantly underperforming in their respective markets.	Develop a coherent strategy to improve performance – may include entering new markets or developing new products/services	Value creation – improve returns of core business
		Operational or financial restructuring. May involve board/management change	
		Divest underperforming businesses or non-core assets	
Governance	The performance of the board is not perceived to be strong and/or the target company is run by a dominant individual who is due to retire. There may be no coherent strategy as to how the target company will create value in the future and poor disclosure may render it difficult for an outsider to obtain an adequate understanding of how critical business decisions are made.	Change the composition of the board and/or the leadership of the company	Value creation – CEO/board/management change to improve returns of core business
		Improve the investor relations function – enhance disclosure of non-GAAP metrics and communication with investors	Value creation – close the "gap" between company and market valuations

Domestic activists typically target much smaller companies than their foreign counterparts; this may reflect the perceived challenges of succeeding with an activist campaign against a large high profile company…

Sector of Japanese Target/Activist Home Country	Period	Target Size	Campaign Summary* *drawn from publicly available sources
Electronics/US	From Mid-2013 to Late-2014	Large Cap	The Activist wrote a public letter to the President and CEO of the Target, indicating that it had taken a sizeable stake in the Target. The Activist recommended the partial spin-off of the Target's entertainment business and a greater focus on businesses in which the Target is an industry leader. The Target subsequently sent a letter to the Activist, following a unanimous vote of its Board of Directors, rebuffing the Activist's requests. Despite this, when the Activist reported the sale of its stake around 15 months later, it indicated that it had generated a return of almost 20% on its investment. (Source: Target's website, Activist's website)
Entertainment/Hong Kong	From Mid-2013	Large Cap	The Activist wrote three public letters to the President of the Target requesting that the Target utilize its IP more effectively by moving into new business areas, and return capital to shareholders. The Target subsequently announced a partnership in a new business area and its shares increased by approximately 8% on release of the first product of the partnership. In 2016, the Target announced plans to further utilize its IP. (Source: Activist's website, Financial Times)
Network Solutions/Japan	From Mid-2014	Small Cap	The Activist publicly disclosed a 3.4% holding in the Target. In a public letter to the Target, the Activist sought to exercise its right to make a shareholder proposal (seeking higher dividend pay-outs) ahead of the upcoming annual general meeting of shareholders. This was publicly rejected by the board of the Target and the proposal failed to obtain enough votes of the shareholders at the subsequent annual general meeting. (Source: Target's website, Activist's website)
Industrial Machinery/US	From Early-2014 to Late-2015	Mid Cap	The Activist reported to its investors that it had taken a stake in the Target, indicating that it believed the intrinsic value of the Target's stock to be more than 60% above the current price, and suggesting ways to unlock value, such as the spin-off of the Target's real estate assets. The Target did not provide a public response to the Activist, which subsequently sold its shares in late 2015. (Source: Activist's website, Nikkei)
Musical Equipment/US	From Mid-2014	Small Cap	The "friendly activist" first announced that it had accumulated a stake in excess of 5% in the Target in 2008. In 2014, the Target's CEO reached out to the Activist to discuss the idea of an MBO. Despite opposition from the founder, who held a 9.8% stake, the MBO went ahead in October 2014. (Source: Kyodo News, Nikkei)
Interior Design/Japan	From Late-2014	Mid Cap	The CEO of the Target reported a meeting with the Activist to discuss ways to improve the business and return more cash to shareholders. The Activist prepared an analysis of the Target, and the Target subsequently announced a share buyback plan. The stock price rose 19% the day after the plan was announced in November 2014 and by 58% from the date of the Activist's investment in October 2014 to August 2015. (Source: Nikkei, Bloomberg, Wall Street Journal)

…it may also reflect the challenges faced by domestic activists in raising funds from institutional investors who are concerned about damaging relationships with activist targets

Sector of Japanese Target/Activist Home Country	Period	Target Size	Campaign Summary* *drawn from publicly available sources
Robotics/US	From Late-2014	Large Cap	The Activist reported to its investors that it had taken a stake in the Target. The Activist followed this by meeting with management to request the Target to make better use of its JPY 8.5 billion cash pile and improve its investor relations. The Target subsequently announced that it would set up an investor relations function to improve dialogue with investors and double its dividend pay-out ratio from 30% to 60%. (Source: Activist's website, Target's website, Financial Times)
Electronics and Energy/Hong Kong	From Early-2015	Large Cap	The Activist reported a stake of around 1% in the Target, indicating that it saw potential for the Target to restructure its solar business and cut its shareholdings in an airline and a telecommunications company. The Activist suggested that if the Target sold its JPY 1 trillion stake in the telecommunications company it could return approximately half of the proceeds to shareholders. In April 2016, the Target announced a review of its dividend payout ratio, targeting a 40% ratio (up from 30%) from 2017. (Source: Financial Times, Bloomberg)
Electronics/ Japan	From Mid-2015	Small Cap	The Activist and its affiliated funds held a collective 15.8% stake in the Target and submitted a shareholder proposal to appoint four new outsider directors to the board. The proposal was backed by proxy advisers but shareholders holding approximately 60% of the company's stock rejected the proposal. The Target's stock fell 8.3% following the vote. (Source: Activist's website, Financial Times, Bloomberg)
Retail/US	From Mid-2015	Large Cap	The Activist wrote a letter to the Target and publicly requested that the company focus on its core businesses by spinning-off its under performing general merchandise store business, restructuring the remaining business and closing stores. The Activist continued its campaign with public criticism of management and public endorsement of a candidate to succeed the longstanding CEO. The CEO subsequently resigned following his failure to remove the Activist's preferred candidate to succeed him. (Source: Activist's website, Bloomberg)
Publisher/ Japan	From Mid-2016	Small Cap	The Activist disclosed that a fund with which it has a discretionary investment contract owned a 4.46% interest in the Target, and sent a letter, made public on its website, to the Target to exercise its right to make a shareholder proposal ahead of the upcoming annual general meeting of shareholders. The shareholder proposal called for the company to immediately dispose of its cross-shareholdings, which it "holds for reasons other than pure investment purposes". (Source: Activist's website)

Companies have responded to the changing environment by increasing dividends and share buy-backs, and investing heavily in cross-border deals

As return on capital and value creation have come to the forefront, companies have responded by significantly increasing their returns to shareholders, by way of both higher dividends and a sharp increase in share buy-backs (up by 58% and 248%, respectively, over the last 3 years). They have also continued to aggressively target cross-border deals as they seek growth and higher returns in overseas markets.

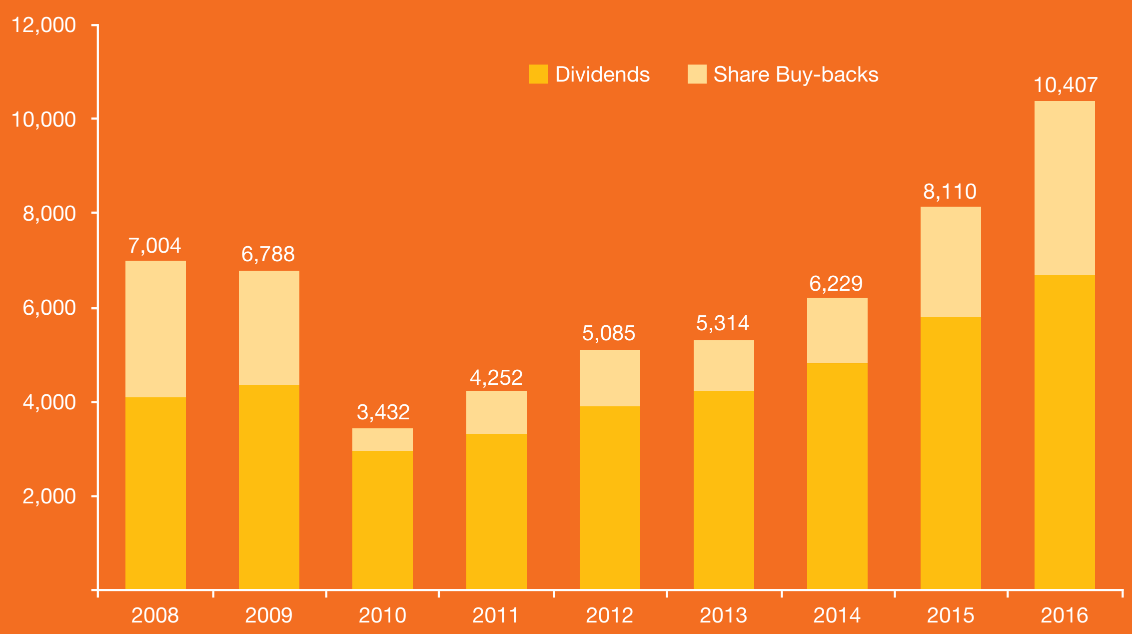
While these trends have been underway since the inception of "Abenomics" in late 2012, they have accelerated over the last 2 years.

But many companies have yet to address more difficult challenges, particularly those associated with:

- Underperforming business segments, specifically how to identify divestment targets from within a portfolio of assets and overcome internal resistance to successfully execute divestments; and
- Non-core assets, specifically how to determine what assets are core (i.e. consistent with a company's purpose and capabilities) and what are non-core, and take action to strengthen the former and divest the latter.

Companies that fail to articulate a clear strategy in relation to underperforming businesses or non-core assets may find themselves being targeted by activists or other shareholders fulfilling their stewardship responsibilities.

Dividends and Share Buy-backs of JPX-400 Companies (ex. Financials) (JPY'bn, Year to 31 March)



Source: S&P Capital IQ

Learn from activists' value creation strategies – review your business through an activist lens… and then do more

We believe that conditions are ripe for an increase in shareholder activism in Japan. However, there are still those who are sceptical that activists can ever achieve large-scale success given the challenges faced by activists (i) in raising funds from domestic institutions; and (ii) in building sufficient support for their proposals, given the relationship and consensus-driven business culture in Japan.

Whether or not you are one of those sceptics, however, we believe that a lot can be learned from the value creation strategies proposed by activists, both in Japan and elsewhere, and that it has to be beneficial to periodically behave like an activist by placing an activist lens on your own business.

But corporate executives can go further than any activist as they have a more powerful tool for creating value: deep knowledge of their business and its customers.

Despite the wealth of disclosures that companies make in regulatory filings, investor presentations and media releases, outside activists get only a snapshot of what is going on inside a company. By contrast, management has access to deep and granular information on the company's operations, customers, markets and competitors.

Understanding where and why value is concentrated enables management to prioritize investment in the highest-potential areas for growth and identify areas where margins need to be improved.

Management should use this information to develop a more effective plan than any plan an outsider could create – and do it in advance of being approached by an activist investor.

Think Like an Activist

The impact of an activist campaign

Once an activist reveals their interest in a company, the impact is sometimes substantial. There are three main ways a target company can be affected.

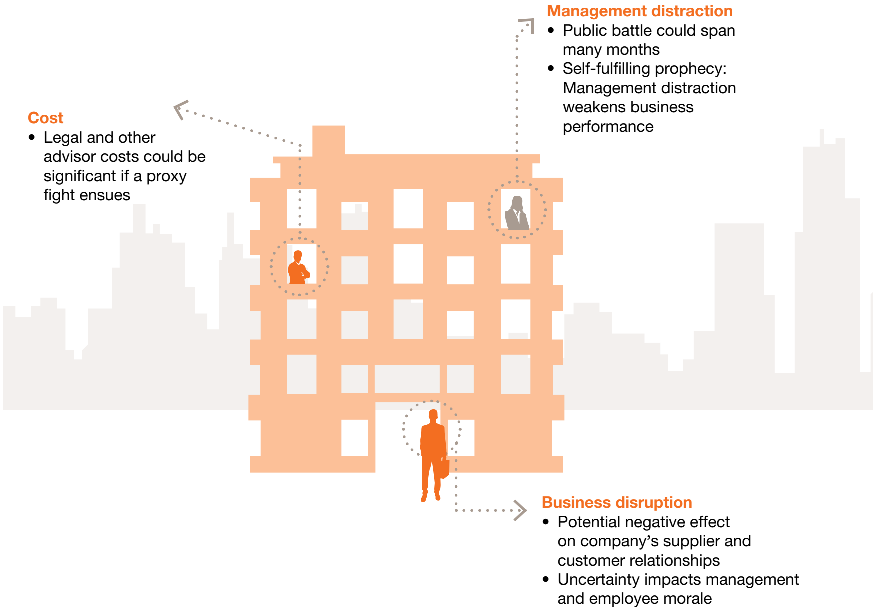
The first is management distraction. These are typically public battles, where even the early stages tend to be played out on the front pages of the business press, and the public relations toll can be devastating. If the activist's position is that the management team is underperforming, this can actually turn into a self-fulfilling prophecy because the process of responding to an activist campaign can distract management from the day-to-day running of the business.

The second impact is financial. The legal and advisory costs of a proxy battle can be substantial, even before considering the internal resources and time spent interacting with advisors, which can potentially double the cost.

Finally, there is the business disruption itself. Relationships with suppliers and customers can be negatively influenced. Employee morale suffers, and top talent may start heading for the exits; it can also be difficult for management to attract top talent during periods of uncertainty.

It can take many months, if not years, for a full activist campaign to run its course. Given the associated costs and potential damage that can occur over such a protracted period, it is critical that management make a concerted effort to mitigate the risk of attracting activist attention and prepare for the possibility by assessing exposures, evaluating strategic alternatives, and formulating a response in advance.

Activist Impact on a Target Company



How can a company effectively prepare for an activist campaign?

We believe that companies that put themselves in the shoes of an activist will be most able to anticipate, prepare for and respond to an activist campaign. In our view, there are four key steps that a company and its board should consider before an activist knocks on the door:

Critically evaluate all business lines and market regions

Some activists have reported that when they succeed in getting on a target's board, one of the first things they notice is that the information the board has been receiving is not sufficient to properly assess the performance of critical business lines, markets, products or customers. Accordingly, it is difficult to assess which parts of the business are creating value and where in the business there are underperforming assets.

Boards may want to reassess what data they review, in particular at what level key operating and value metrics are presented. For example, are the revenues and costs of each component of the business being clearly reported (component being a general term that could represent an operational or geographical segment, or even a product line or customer group), so that the profit & loss of each component of the business can be critically assessed? Is there balance sheet and cash flow information for critical components?

Monitor the company's ownership and understand the activists

Companies routinely monitor their ownership base for significant shifts, but they may also want to ensure that they know whether activists (of any type) are current shareholders.

Understanding what these shareholders may seek (i.e. understanding their "playbook") will help the company assess its risk of becoming a target.

Evaluate the "risk factors"

Knowing in advance how an activist might criticize a company allows a company and its board to consider whether to proactively address one or more of the risk factors, which in turn can strengthen its credibility with the company's overall shareholder base. If multiple risk factors exist, the company can also reduce its risk by addressing just one or two of the higher risk factors.

Even if the company decides not to make any changes based on such an evaluation, going through the deliberative process will enable company executives and directors to articulate why they believe staying the course is in the best long-term interests of the company and its investors.

Develop an engagement plan that is tailored to the company's shareholders and the issues that the company faces

If a company identifies areas that may attract the attention of an activist, developing a plan to engage with its other shareholders around these topics can help prepare for—and in some cases may help to avoid—an activist campaign. This is true even if the company decides not to make any changes.

Activists typically expect to engage with both members of management and the board. Accordingly, the engagement plan should prepare for either circumstance.

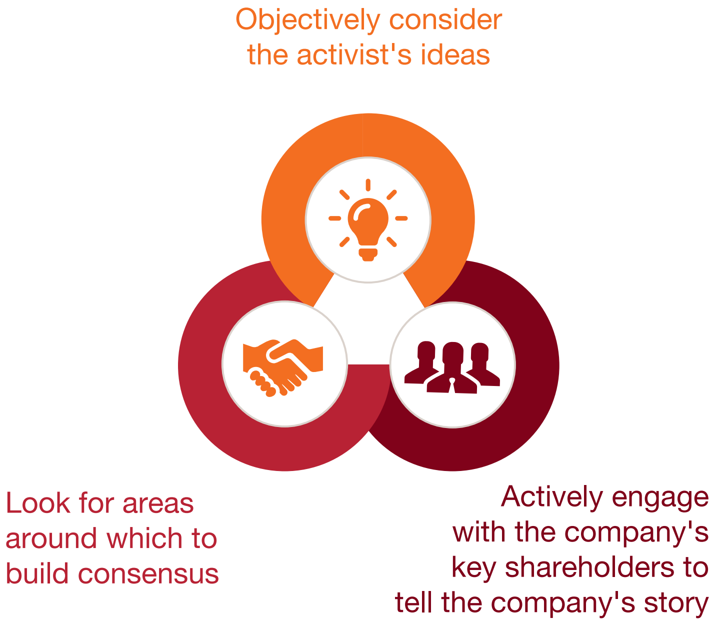
Whether the company decides to make changes or not, explaining to the company's most significant shareholders why decisions have been made will help those shareholders better understand how directors are fulfilling their oversight responsibilities, strengthening their confidence that directors are acting in investors' best long-term interests.

How can a company effectively prepare for an activist campaign?

These communications are often most effective when the company has a history of ongoing engagement with its shareholders. Sometimes, depending on the company's shareholder profile, the company may opt to defer actual execution of this plan until some future event occurs (e.g. an activist in fact approaches the company, or submits a shareholder proposal effectively announcing its intent to seek one or more board seats). Preparing the plan, however, enables the company to act quickly when circumstances warrant.

How to respond to an activist campaign

In responding to an activist's approach, a company should consider the advice that large institutional investors have shared with us, that good ideas can come from anyone. While there may be circumstances that call for more defensive responses to an activist's campaign, in general, we believe the most effective response plans have three components:



Objectively consider the activist's ideas

By the time an activist first approaches a company, the activist has usually already (i) developed specific proposals for unlocking value at the company, at least in the short term, and (ii) discussed (and sometimes consequently revised) these ideas with a select few of the company's shareholders. Even if these conversations have not occurred by the time the activist first approaches the company, they are likely to occur soon thereafter. The company's institutional investors generally spend considerable time objectively evaluating an activist's suggestion – and most investors expect that the company's executive management and board will be similarly open-minded and deliberate.

Look for areas around which to build consensus

In 2013, 72 of the 90 US board seats won by activists were based on voluntary agreements with the company, rather than via a shareholder vote (source: FactSet Insight). This demonstrates that most targeted companies in the US at least are finding ways to work with activists, avoiding the potentially high costs of proxy contests.

Activists are also motivated to reach agreement if possible. If given the option, most activists would prefer to spend as little time as possible to achieve the changes they believe will enhance the value of their investment in a company. While they may continue to own company shares for extensive periods of time, being able to move their attention and energy to their next target helps to boost the returns to their own investors.

Actively engage with the company's key shareholders to tell the company's story

An activist will likely be engaging with fellow investors, so it's important that key shareholders also hear from the company's management and often the board. In the best case, the company already has established a level of credibility with those shareholders upon which new communications can build. If the company does not believe the activist's proposed changes are in the best long-term interests of the company and its owners, investors will want to know why – and just as importantly, the process the company used to reach this conclusion. If the activist and company are able to reach an agreement, investors will want to hear that the executives and directors embrace the changes as good for the company. Company leaders that are able to demonstrate to investors that they were part of positive changes, rather than simply had changes thrust upon them, enhance investor confidence in their stewardship.

Epilogue – life after activism

When the activism has concluded – the annual meeting is over, changes have been implemented, or the hedge fund has moved its attention to another target—the risk of additional activism doesn't go away. Depending on how the company has responded to the activism, the significance of any changes, and the perception of the board's independence and open-mindedness, the company may again be targeted. Reviewing your business through an activist's lens as part of the company's ongoing processes, conducting periodic self-assessments for risk factors, and engaging in a tailored and focused shareholder engagement program can enhance the company's resiliency, strengthening its long-term relationship with investors.

End Notes

Reference has been made to the following PwC publications:

Shareholder activism – Who, what, when, and how? (March 2015)

Shareholder activism – Strategies for mitigating risk and responding effectively

Secrets of the Activist Manager (16 December 2015)

How PwC can help – with our independent, objective viewpoint, we can act as a “friendly” activist, working with you to identify long-term value creating strategies…

Your Friendly Activist

Sometimes, what is obvious to an outsider, such as an activist, may not be so clear to those on the inside. Strategies that would seem to be value accretive in the long-run, and in the interests of a broad group of stakeholders, are avoided because they would be “too hard” to implement given existing corporate structures, decision-making processes and internal politics.

We can provide an independent, objective assessment of a company’s performance, firstly from an “outside-in” or capital market perspective (the way an activist would analyse a company), and then from an “inside-out” or management perspective (using management’s deep knowledge of its business and customers).

A key objective of the value assessment would be to determine the existence and magnitude of the value gap – the gap between the market valuation of a company and the sum-of-the-parts valuation based on management’s inside knowledge and plans – and to identify reasons for that gap. The next stage would (i) consider strategies to close that gap; and (ii) re-assess whether management plans do indeed represent the highest value strategy.

An Approach to Being a Friendly Activist

Value Assessment

Value Assessment

- Assess historical value performance of the business
- Determine investor expectations of future performance
- Quantify the value gap between current performance and future expectations

Company Assessment

- Determine where and why value is concentrated within the business and market through a detailed strategic, financial and organisational assessment
- Define the agenda that will fill the value gap

Value Impact

Agree Strategies

- Identify options, evaluate options and developed detailed execution plans for each value agenda
- Agree highest value strategies and detailed implementation plans

Support Execution

- Help align capabilities, resources and performance management
- Prepare materials to communicate the agenda with stakeholders (shareholders, board, banks)

...and help you respond effectively to an activist campaign

Responding to an Activist Campaign

We can support a company that is the subject of an activist campaign by:

- Working with the company's management to objectively evaluate the activist's proposal, comparing it to management's own plan to assess whether the activist's ideas are in conflict with, or complimentary to, those of management. For example, if the activist is seeking to extract value by way of a share buyback, assessing whether management's plans make better use of excess cash by creating long-term corporate value. Or if the activist is seeking to create value by divesting an underperforming business segment, assessing whether management's plan for that segment (which is, after all, based on information that may not be available to the activist) would create more value if successfully executed.
- Undertaking an investor survey by conducting interviews with a selection of analysts and investors to obtain a capital market view on the performance, strategy and governance of the company, and the information disclosed by the company.
- Assisting the company with the development of (i) a strategy for its communication with all shareholders (and stakeholders); and (ii) its response to the activist.

About PwC

About PwC

PwC helps organisations and individuals create the value they're looking for. We're a network of firms in 157 countries with more than 208,000 people who are committed to delivering quality in assurance, tax and advisory services.

About our Strategic Value Consulting practice

With increasing focus on returns and governance, every management team needs to understand the value performance of individual segments within their business portfolio, be able to explain their value creation strategies and be able to answer questions on how critical business decisions are made. Unfortunately, most leadership teams don't have ready access to the information required to understand which parts of their portfolio are creating value and which are not, let alone to assess which strategic options will create the most value for their organization.

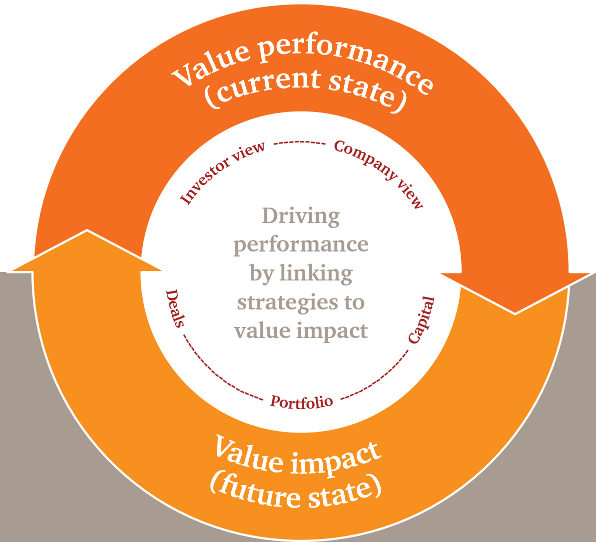
PwC's Strategic Value Consulting team provides leaders with the value insight they need to make the right corporate and capital market choices. Unlike traditional valuation approaches, we combine enhanced modelling techniques with sophisticated data and value analytics to uncover insights that enable senior teams to make strategic decisions that enhance corporate value.

Working closely with the strategy consultants of Strategy&, a member of the PwC network, as well as technical and industry experts from within our Advisory business, we deliver independent value insight to inform leaders on where in their portfolio value is being created or destroyed and on the value impact of critical business decisions.

We can support you by:

1. Modelling your business portfolio to identify where value has been created in the past, and expected value creation in the future
2. Improving your M&A and CAPEX evaluation processes
3. Identifying divestment candidates within your portfolio of businesses; helping you to execute the divestment process
4. Evaluating your portfolio mix, assessing where in your portfolio you have a competitive advantage
5. Determining hurdle rates specific to an investment opportunity (or existing business)
6. Developing systems, tools and processes for board and management reporting of key value metrics
7. Benchmarking your operating, value and capital market performance against domestic and international peers
8. Evaluating your organization's total impact from a social, environmental, fiscal and economic perspective
9. Recommending improvements in what and how you communicate with stakeholders

Contacts



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