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Rising Tide of Global Shareholder Activism

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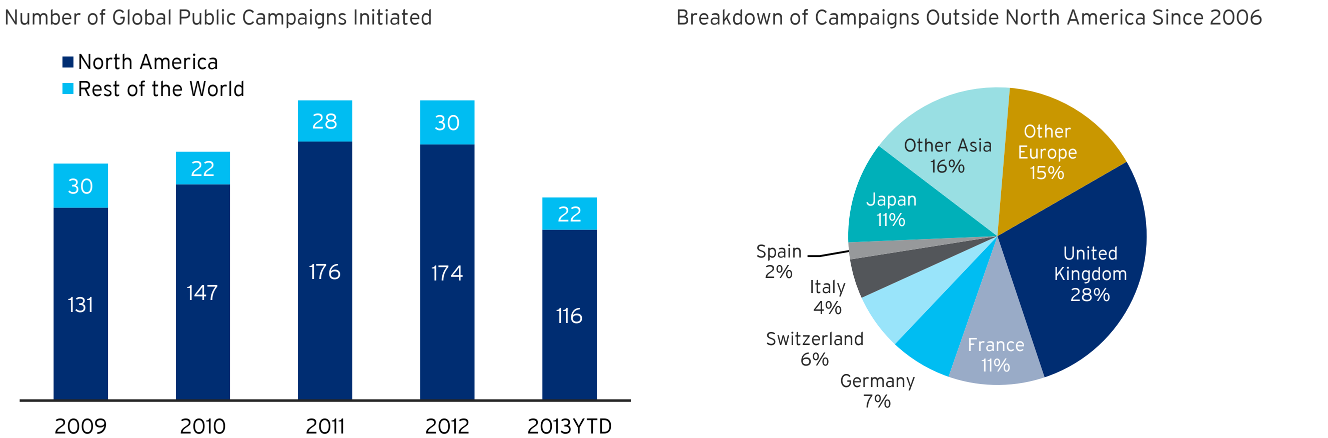
The Global Shareholder Activism Environment

In recent years, shareholder activism has morphed from an occasional threat facing corporate management and boards to a sweeping trend that has spread to companies in all sectors and of all sizes, and increasingly, across all geographic regions. Globally, the pace of public activist campaigns in 2013 is on track to exceed that of prior years. In the US, almost one-sixth of companies in the S&P 1500 since 2006 have faced a public shareholder activism campaign, with some of these experiencing multiple campaigns. Outside the US, shareholder activism has a foothold in the UK and is also gaining some traction in other regions. Moreover, there is a significant number of activist investors in every market who primarily engage with target companies behind closed doors. This is particularly the case in Europe, where research on activism suggests that nearly 45% of all campaign activity is private.[1] Even the threat of activism may affect corporate decision-making; as a result, the frequency of public campaigns underestimates the true extent of activist investors' impact on companies globally.

Figure 1. Global Shareholder Activism Continues to Rise



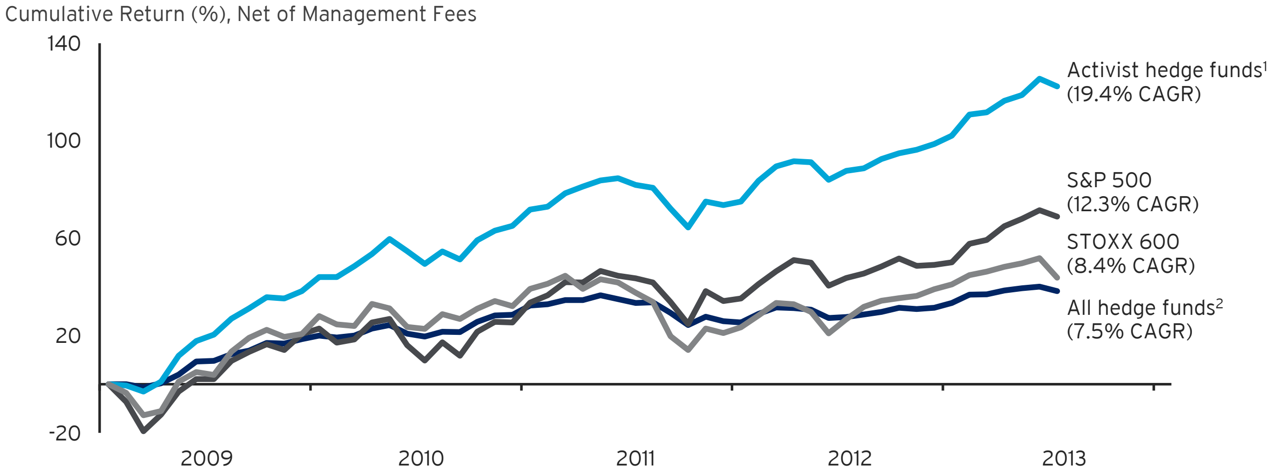
Source: SharkRepellent, ISS, Citi. Data as of August 31, 2013. Sample includes campaigns that sought to maximize shareholder value or gain board representation, excluding purely governance-related campaigns.

A driving force behind the rise in shareholder activism has been the striking outperformance of activist hedge fund strategies. Activist hedge funds have, as an asset class, sharply outperformed their non-activist peers and market indices, generating a nearly 20% annual return since 2009, relative to 7.5% for hedge funds as a whole. This outperformance has spurred large capital flows into new and existing activist funds, and assets under management in such funds have grown by over 50% in the past twelve months alone, further fueling the pace of shareholder activism. The outperformance of "pure-play" activist funds has also led many traditional investment

[1] Marco Becht, Julian Franks, and Jeremy Grant (2010), "Hedge Fund Activism in Europe," European Corporate Governance Institute.

managers to adopt a more active stance with respect to their investments. As a result, the number of "occasional activists" has risen sharply and the activist shareholder playbook is gradually becoming a standard part of the asset manager's tool kit.

Figure 2. Activist Hedge Funds Have Outperformed



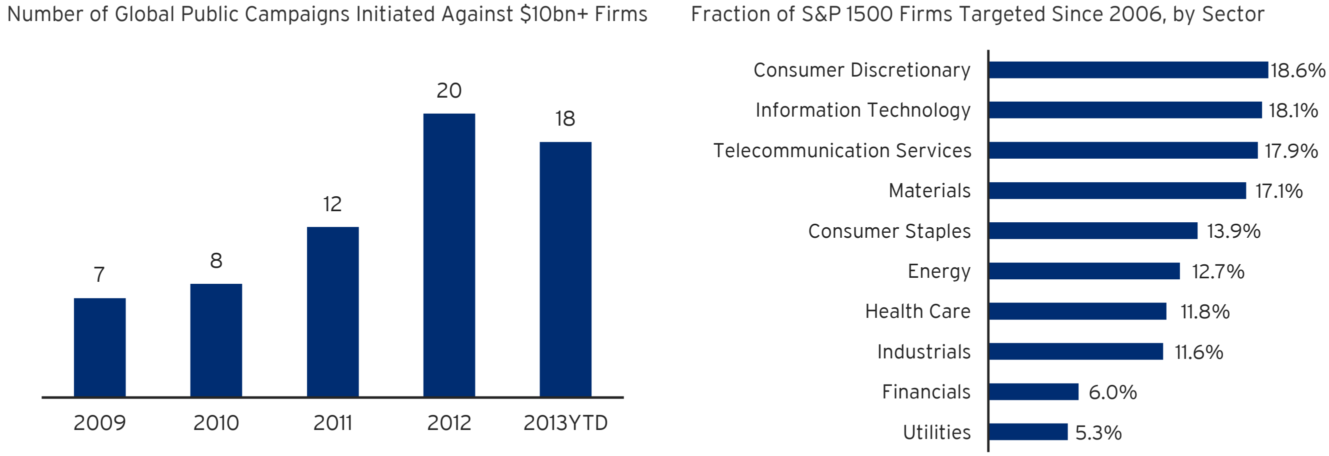
Source: Hedge Fund Research, Hedge Fund Intelligence, eVestment, and fund websites. Data as of June 30, 2013. 1. Activist fund managers included in return series are Barington, Crescendo, Elliott, Greenlight, Highland, JANA, Loeb, Marcato, Millennium, Pershing Square, Raging, Red Mountain, Sandell, Southeastern, TCI, Third Point, and Trian. 2. HFRI Fund Weighted Composite Index.

This transformation of the activist investor landscape has overturned a key belief about shareholder activism — that only smaller firms are vulnerable to activist campaigns. Since 2009, the number of campaigns targeting firms $10 billion and larger has more than tripled, and 2013 has on average seen more than two such large-cap firms targeted every month.

Several factors have increased the exposure of large-cap firms to activism. Many smaller and underperforming firms have already been targeted, particularly in the US. Expanded funding has given activist investors the financial capacity to take meaningful equity stakes in larger firms. Activist investors also exploit with increasing sophistication the intense media scrutiny that large-cap companies are subject to, writing open letters to boards and management, releasing detailed presentations in support of their agenda, and even using social media to publicly pressure their target companies.

Most importantly, however, traditional institutional investors are increasingly receptive to activists' agendas and will engage with and occasionally publicly support them in pushing for change at their portfolio companies. With the advent of annual "say-on-pay" votes in the US and UK, these investors have also begun to vote more frequently against management. This has allowed activist investors to pursue firms where it would otherwise be difficult for a single activist investor to gain influence without the leverage provided by institutional investors who are sympathetic to the activist's agenda.

Figure 3. Activism Wave is Increasingly Affecting Large Firms and All Sectors



Source: SharkRepellent, FactSet, ISS, Citi. Data as of August 31, 2013. Sample includes campaigns that sought to maximize shareholder value or gain board representation, excluding purely governance-related campaigns.

In light of these trends, it is imperative for companies of all sizes and in all geographies to consider whether they are vulnerable to approaches by activist investors, to evaluate the potential sources of such vulnerability, and to formulate proactively strategic plans that optimize financial and operational performance and, ultimately, to create shareholder value. To shed light on some of the factors that may contribute to activism vulnerability, we conducted an extensive analysis of over 1600 shareholder activism campaigns across the globe since 2006 and evaluated the company attributes driving activism trends and how these trends are evolving across time and geographies.

Figure 4. Largest Activist Campaigns Since 2012

US

Company	Date	Activist
DuPont	Aug 2013	Trian
Apple	Aug 2013	Greenlight/Icahn
Air Products	Jul 2013	Pershing Square
Microsoft	Jul 2013	ValueAct
Mondelez	Jul 2013	Trian
Spectra Energy	Jun 2013	Sandell
Dell	May 2013	Icahn/Southeastern
Pepsi	Apr 2013	Relational/Trian
Procter & Gamble	Sep 2012	Pershing Square
Illinois Tool Works	Jan 2012	Relational

Rest of the World

Company	Date	Activist
EADS	Aug 2013	TCI
Sony	May 2013	Third Point
UBS	May 2013	Knight Vinke
Transocean	Jan 2013	Icahn
Danone	Nov 2012	Trian
BAE Systems	Oct 2012	Invesco
Safran	Oct 2012	TCI
InterContinental Hotels	Aug 2012	Trian
Ingersoll-Rand	May 2012	Trian
Xstrata	Mar 2012	Knight Vinke

Source: SharkRepellent, ISS, Citi.

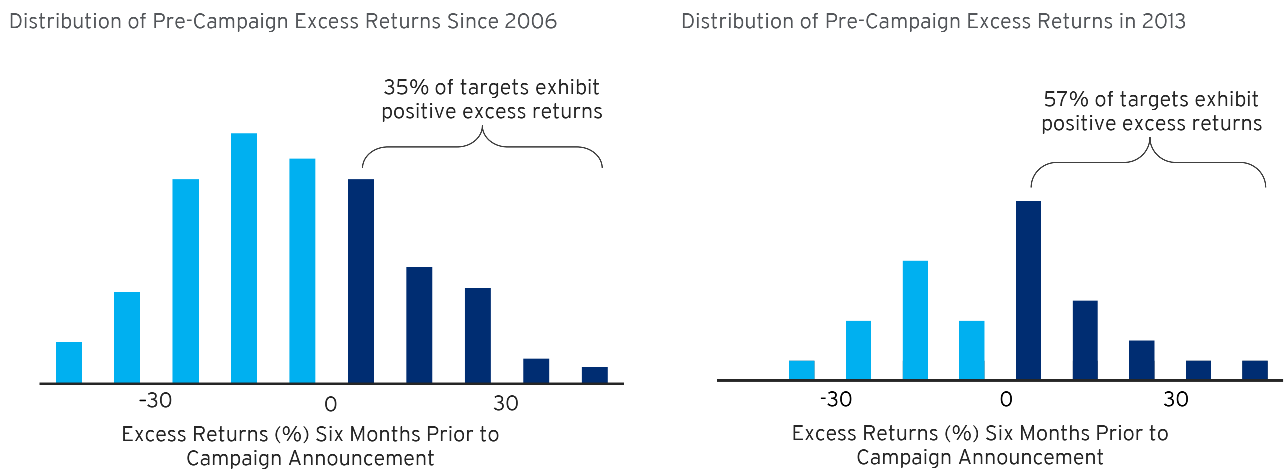
What Makes a Firm Vulnerable to Activism?

Changing Influence of Share Price Performance

It is commonly thought that firms subject to shareholder activism tend to have stock returns and valuation multiples that lag those of their peers – since 2006, targeted firms displayed stock price underperformance of 8.0% in the six months prior to being targeted and had firm value-to-EBITDA multiples that were 2.0x below their industry peers.

However, there is wide dispersion in performance – over a third of the targeted firms actually experienced stock price outperformance prior to being targeted. Therefore, share price outperformance does not automatically insulate a company from activism threats. More importantly, the trend of activists targeting well-performing companies is intensifying, particularly in the US, where 56.7% of activist campaigns against S&P 1500 companies in 2013 involved companies that had outperforming share prices.

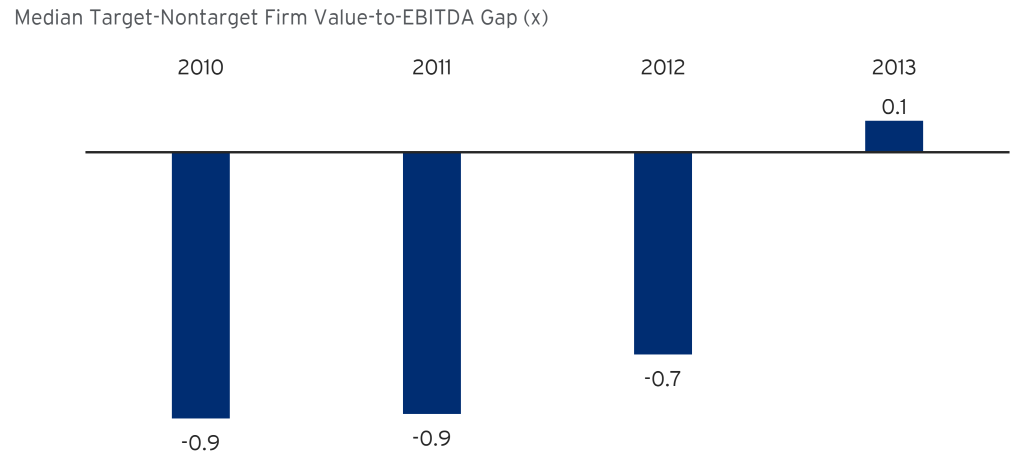
Figure 5. Outperforming Firms are Becoming More Likely to be Targets of Shareholder Activists



Source: SharkRepellent, FactSet. Data as of August 31, 2013. Includes campaigns targeting S&P 1500 firms that sought to maximize shareholder value or gain board representation. Excess return computed relative to GICS industry group peers during 6 months ending 30 days prior to campaign.

This pattern is also evident in valuation multiples. US activist campaigns in 2010 and 2011 involved companies which traded at median firm value-to-EBITDA multiples that were 0.9x lower than their industry peers. By 2012, this gap had narrowed to 0.7x and has disappeared entirely in 2013. It appears that the low-hanging fruit of underperforming firms was largely picked in the first wave of shareholder activism, and we are now seeing a second wave of activism unfold where activist investors are setting their sights on well-performing firms.

Figure 6. Narrowing Valuation Gap Between Targets and Industry Peers in US



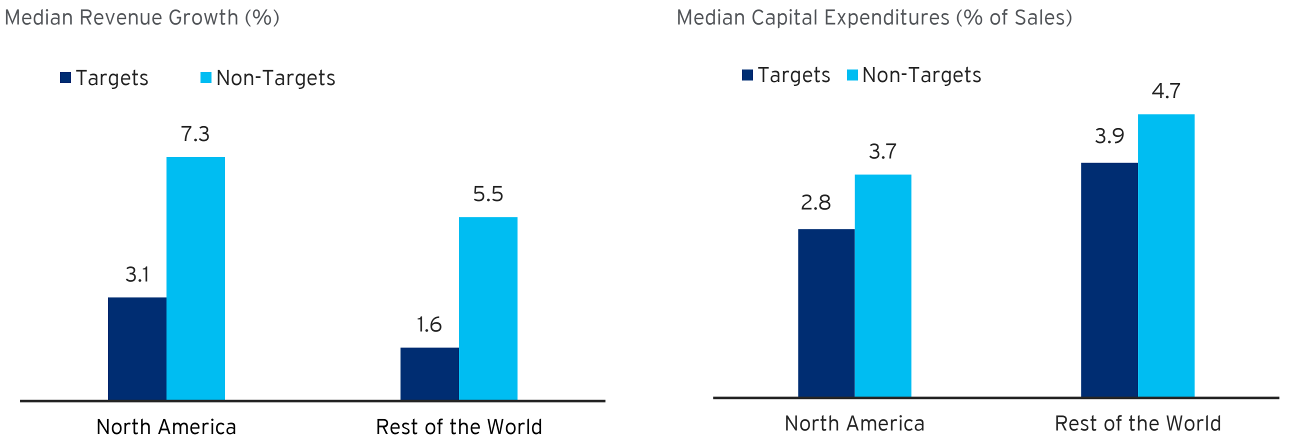
Source: SharkRepellent, FactSet. Data as of August 31, 2013. Includes campaigns targeting S&P 1500 firms that sought to maximize shareholder value or gain board representation. Firm value-to-EBITDA gap computed relative to GICS industry group peers at year-end prior to campaign.

Not all industries or geographies are at the same point in these activism waves. The second wave of activism, where well-performing firms are being targeted, is occurring largely in industries that have already seen substantial campaign activity. For example, in Consumer and Information Technology, the two sectors most frequently targeted since 2006, targets are now more likely to be well-performing firms than in other sectors, where campaign activity has been relatively muted to date. In other words, the sectors that experienced the most campaign activity are entering a new phase in which activist shareholders' agenda has transitioned from turning around underperforming companies to driving change at well-performing companies. This shift partially reflects a departure from concerns over valuation, performance, and simpler balance sheet issues to more complex issues of corporate strategy such as whether to spin off entire operating segments.

Lack of Top-Line Growth

Weak top-line growth is a significant driver of shareholder activism in both the US and globally. US firms that were targets of activist campaigns had grown revenues by about 3% prior to the activist efforts — a sharply lower rate than their industry peers, who averaged revenue growth of over 7%. The difference in growth is even sharper for non-US targets, who grew at 1.6% annually while their peers grew at 5.5% — a more than three-fold difference in revenue growth. A similar picture emerges based on activist targets' investment in growth, as measured by capital expenditures. While their industry peers invested an average of 3.7% of sales in their business, firms who were targeted only invested 2.8%. This suggests that firms are more susceptible to activist overtures when they are investing little in future growth prospects and highlights the need for companies wishing to avoid activist pressure to develop credible growth plans when organic opportunities for growth may be lacking.

Figure 7. Muted Revenue Growth and Low Investment are Significant Drivers of Activism Risk

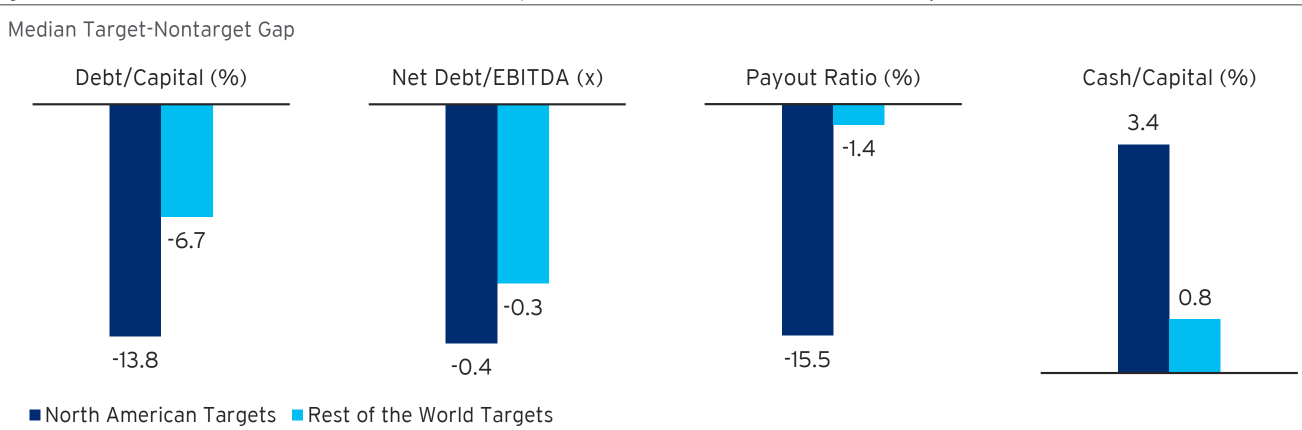


Source: SharkRepellent, ISS, Citi, FactSet. Non-targets are GICS industry group peers for North American companies and FactSet-defined sector peers for the rest of the world. Values for revenue growth are LTM and values for capital expenditures are last full year.

Conservative Financial Strategy

While conservative financial strategies provide management the flexibility to pursue future expansion plans and a buffer for unexpected events, they substantially increase the risk of shareholder activism. Within the US, firms targeted by shareholder activists had lower leverage ratios, lower payout ratios, and higher cash balances than their industry peers. Companies that have had low top-line growth and possess substantial but undeployed financial capacity are particularly prone to activist intervention.

Figure 8. Financial Conservatism Has Been an Important Driver of Activism, Particularly for North American Firms



Each target's value is calculated using most recent financials available at the date of targeting. For each North American company, industry peer benchmark is the respective S&P 1500 GICS industry group; otherwise, it is the regional market aggregate.

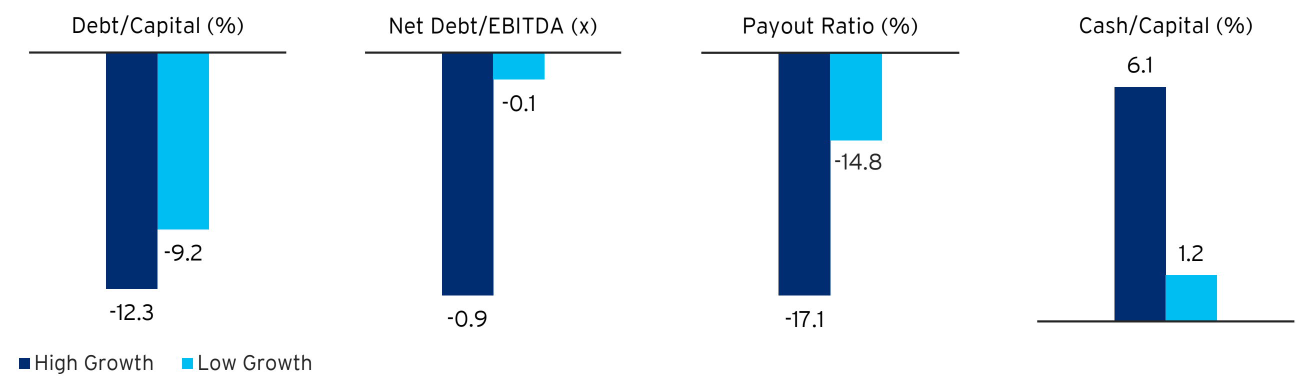
Capital structure considerations tend to be less strongly associated with activism outside North America, with non-US targets holding only slightly more cash than peers and with payout ratios that are only modestly lower than their peers. Part of this difference is attributable to the fact that, in the US market, activists proactively target companies rather than seize upon corporate events. Shareholder activism outside

North America is more often "event-driven" in the sense of being precipitated by an upcoming shareholder vote. In fact, nearly a third of shareholder campaigns outside North America were preceded by triggering events such as mergers, equity issuances, asset sales, management shuffles, or other operational or strategic decisions. By contrast, though US firms also face event-driven activism risk, the incidence of activism in North America tends to be driven more by activists' perception of firm performance and financial policy.

Financial conservatism has been a more important driver of activism for fast-growing firms — the gap between their leverage, payout ratios, and cash holdings vis-à-vis their peers is wider than at firms that were targeted at a time when their growth prospects were limited. Therefore, robust growth does not insulate a company from activism if its financial policies may be viewed by shareholder activists as being overly conservative. The same is true of stock returns — a conservative financial strategy may precipitate an activist campaign even if the target's stock has outperformed peers, especially in the favorable debt environment of recent years, which has encouraged activists to seek large shareholder distributions from mature companies that follow a conservative financial strategy.

Figure 9. North American Activist Targets with High Expected Sales Growth Display More Conservative Financial Policies

Median Target-Nontarget Gap, by Next Twelve Months' Estimated Revenue Growth



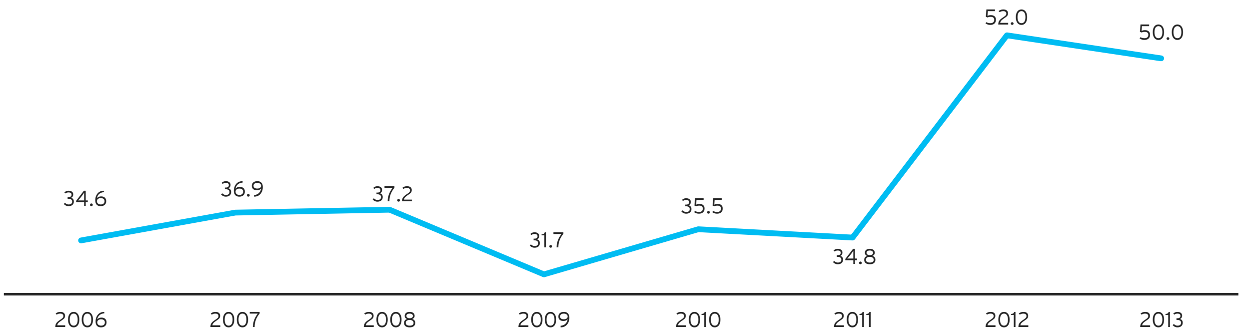
High growth denotes NTM consensus estimate above S&P 1500 GICS industry group median; low growth denotes estimate below median. Industry peer benchmark is the respective S&P 1500 GICS industry group.

Conglomerate Business Model

Firms with diversified business models and multiple operating segments are increasingly exposed to shareholder activists, particularly if they trade at a conglomerate discount and if certain segments may be viewed as being non-core. Since 2006, firms with conglomerate business models have become more frequent targets of activism than those with pure-play business models. In fact, a majority of activist targets in 2012 and 2013 were multi-segment firms. Furthermore, our analysis suggests that the global conglomerate discount has widened recently, from 5.5% in 2010 to 7.4% currently, suggesting that the impetus to target diversified firms is likely to increase going forward. The conglomerate discount is the largest among US and European companies at 8.0% and 9.3%, respectively, indicating that diversified firms in these regions may be more vulnerable than their peers in other parts of the world.

Figure 10. Activists Are Increasingly Targeting Multi-Segment Firms

Fraction (%) of Global Campaigns Where Target Has Multiple Business Segments



Source: SharkRepellent, ISS, Citi, FactSet. Multi-segment firms are those with more than one reporting segment according to financial statements.

Activists' focus on diversified firms reflects in part a general reluctance of some management teams to divest businesses even though there may be recognition that these do not represent core businesses. Companies that have voluntarily pursued asset repackaging and divestiture strategies have historically been rewarded by the markets with excess stock returns averaging around 4% around the announcement of such transactions.[2] In light of these trends, management teams of multi-segment firms should be particularly proactive in assessing the value creation potential from corporate restructuring actions and developing strategies to minimize the extent to which their valuations suffer from a conglomerate discount.

Governance and Ownership Structure

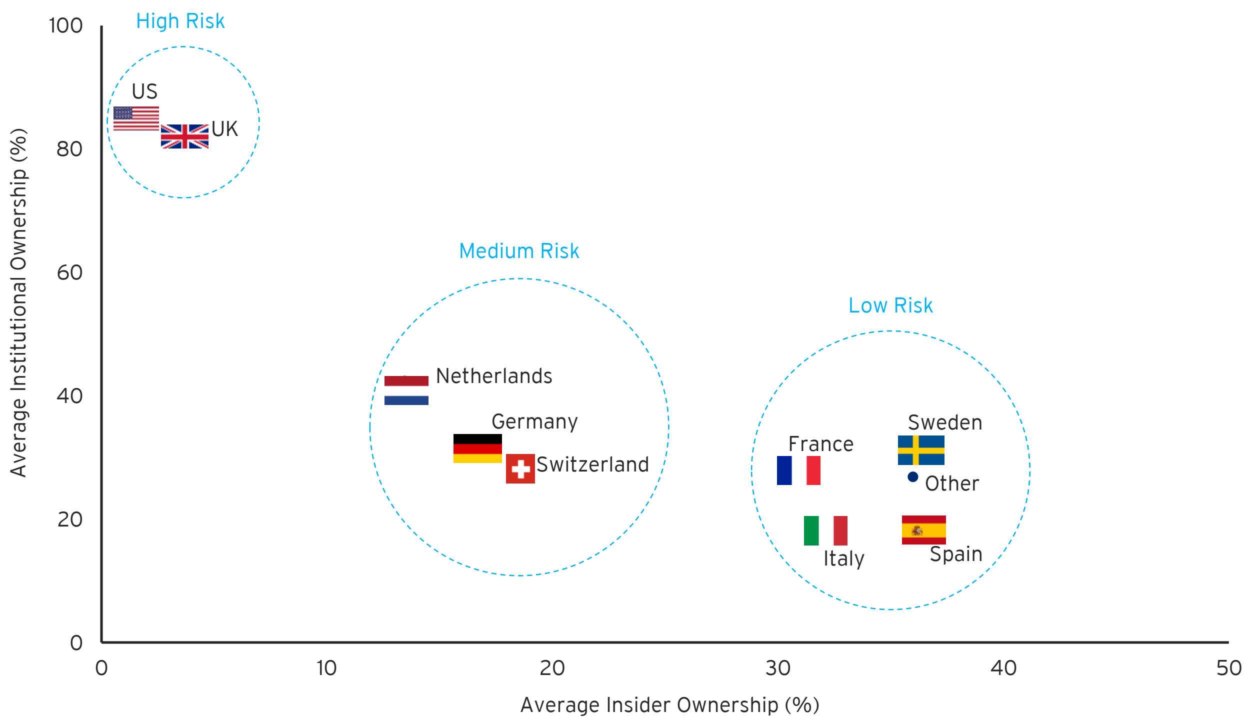
Recent years have seen investors becoming more vocal on corporate governance issues. Some institutional investors such as pension funds have, for example, urged companies to separate the CEO and chairman roles. While there is mixed evidence on whether or not separating the two roles increases value, and the optimal structure is likely company-specific,[3] our research indicates that separate roles increase the likelihood of an activist investor approaching the firm. Since governance is rarely at the top of an activist investor's agenda, however, this should not be interpreted as

[2] See "Spin-offs: Tackling the Conglomerate Discount," Citi Financial Strategy Group, 2011 and "Restructuring and Repackaging Corporate Assets," Citi Financial Strategy Group, 2008.

[3] See, for example, James A. Brickley, Jeffrey L. Coles, and Gregg Jarrell (1997), "Leadership structure: Separating the CEO and Chairman of the Board," Journal of Corporate Finance.

evidence in favor of combined roles. Rather, combined roles likely act as a governance hurdle that may potentially deter certain activists.

Figure 11. Insider and Institutional Ownership of S&P 500 and STOXX Europe 600 Firms, By Country



Source: FactSet. All data as of September 15, 2013 and includes all share classes. "Other" includes Austria, Belgium, Denmark, Finland, Greece, Ireland, Luxembourg, Norway, and Portugal.

Outside the US and UK, corporate governance practices vary greatly, but the ownership structure has a meaningful impact on a company's exposure to shareholder activism. Relative to other regions of the world, companies in the US and UK typically have higher institutional shareholdings and lower insider holdings, making these firms more prone to activism risk. As a result, shareholder activism has been most prevalent among US and UK firms. In other regions, concentrated ownership among insiders, family-owned firms, and relatively smaller holdings by institutional investors make activism campaigns more challenging. For example, countries such as France, Italy, and Spain have average insider holdings above 30% and average institutional holdings below 40%, making activism less prevalent in these regions.[4] In addition, the presence of dual-class shares and cross-shareholding structures, which also varies by region, can have a material impact on activism risk.

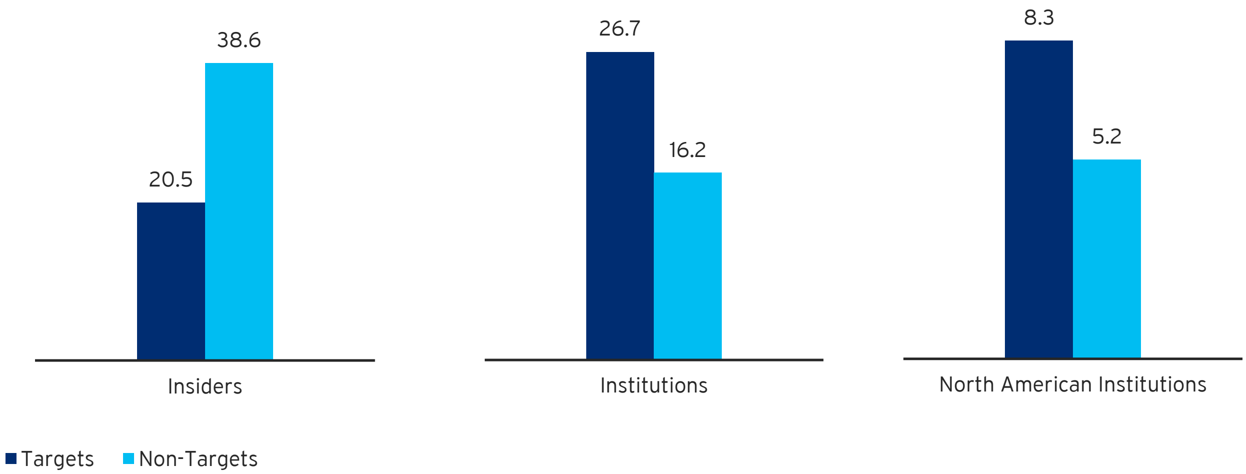
However, many companies outside the US and UK are nonetheless exposed to shareholder activism risk because their shareholding structure may make them relatively vulnerable. Outside the US and UK, the firms that have been targets of

[4] Figures based on medians for companies in S&P 500 and STOXX Europe 600.

activist campaigns tend to have lower inside ownership and higher institutional ownership than their peers — over three quarters of these firms had below-median insider ownership and nearly 60% had above-median institutional ownership. Substantial US public float also has a particularly meaningful effect on activism risk — nearly two thirds of targets outside the US and UK had above-median levels of ownership by North American institutional investors.

Figure 12. Targets Outside North America and UK Have Ownership Structures Closer to North American and UK Peers

Median Ownership (%) Outside North America and UK



Source: FactSet. All data as of September 15, 2013 and includes all share classes.

Stock Price Effects of Shareholder Activism

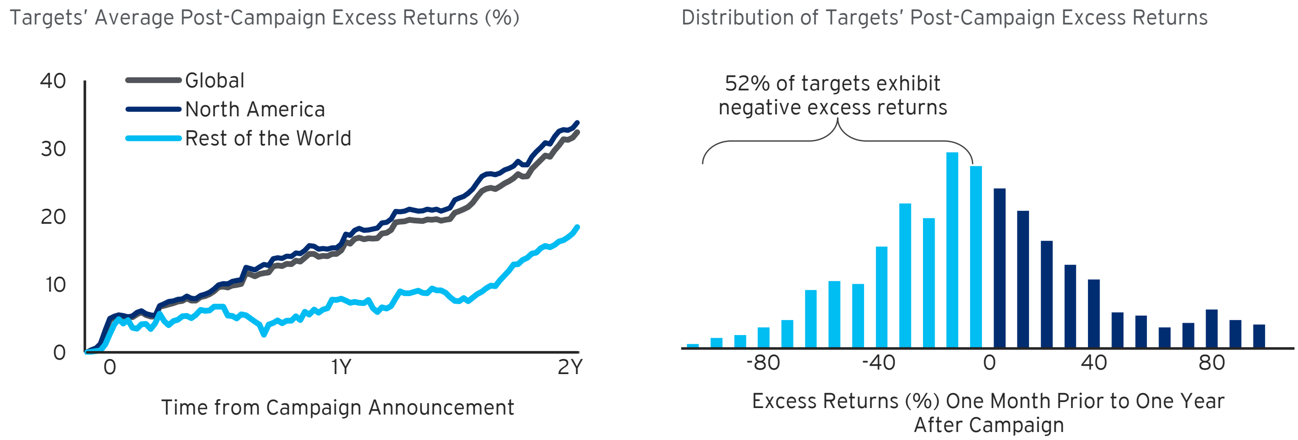
Recently, the long-term consequences of shareholder activism have attracted considerable public debate. Much of this debate has focused on whether being targeted by activists results in sustainable long-term improvements in company performance and shareholder value, or whether activist agendas are driven by short-term improvements in stock price that may not necessarily be in the long-term interest of the company and its long-term shareholders.

Consistent with results of recent research,[5] our analysis shows that stock returns following the initiation of an activist campaign are, on average, positive. For all activism campaigns globally that we studied, target stocks outperform market benchmarks by an average of 15.1% in the year following the campaign and 33.8% over the two years following the campaign. Therefore, on average, activism efforts have been followed by improvements in shareholder value in the one- to-two year period following the campaign.

[5] Lucian A. Bebchuk, Alon Brav, and Wei Jiang (2013), "The Long-Term Effects of Hedge Fund Activism," Columbia Business School Research Paper.

There are, however, two important caveats. Though the average excess returns are positive, the majority of targeted firms do not enjoy these gains in stock price. In fact, 52% of targeted firms actually underperform market benchmarks over both a one- and two-year horizon. Therefore, the large average improvements are driven by a relative minority of activist efforts that result in outsized stock price gains as opposed to share price improvements at a majority of companies. This points to an important dichotomy between the goals of activists and companies. Since activists tend to invest in several firms at a time, they can achieve superior portfolio performance even if only a few of their targets outperform substantially. From a company's perspective, however, the activist agenda may not necessarily always be in the company's long-term interests.

Figure 13. Targeted Firms Outperform on Average, but a Majority Exhibits Negative Returns



Source: SharkRepellent, FactSet, ISS, Citi. Excess returns are computed relative to local MSCI indices. Histogram shows distribution of excess returns from one month prior to campaign to one year after.

Therefore, in many cases, management teams may be better able to deliver superior long-term share price performance by their own well-designed and well-articulated strategies than pursuing agendas advanced by activists. To the extent that activist efforts may be disruptive from a long-term perspective, management teams should be proactive in developing and implementing optimal firm strategies to improve performance, pursue growth, and enhance shareholder value, irrespective of whether their share prices are leading or lagging their peers.

A second noteworthy fact is that, among the firms that outperform following an activist campaign, some do so due to an eventual acquisition of the firm that involves a takeover premium to the shareholders. For example, more than 7% of the targets that outperformed in the six months following the initiation of a campaign were acquired or sold in the subsequent six months — an acquisition frequency that is three times higher than for targets that underperformed following an activism campaign. Moreover, virtually all of the company sale transactions can be attributed specifically to the efforts of shareholder activists. Thus, a common channel through which long-term value is delivered to shareholders is by putting the target firm "in play" for an eventual acquisition. While a company sale may be the most attractive option among the suite of strategic options for a company, it is possible that pursuing a sale without the pressure from an activist investor may result in a larger pool of potential buyers, and ultimately better consideration terms.

Conclusion

Shareholder activism has spread to firms of all sizes in all regions and is here to stay. In this environment, we believe it is of utmost importance for boards and executives to stay abreast of the demands of their increasingly assertive shareholder base. Continuously engaging with investors, carefully considering their outsider's perspective, and clearly articulating the firm's strategy are all key steps to being "white paper-ready" and to being prepared to pre-empt any activist agenda that is not consistent with the firm's strategy. Most importantly, developing and executing on a credible strategy to optimize a company's growth trajectory and its operating and financial performance are of paramount importance to avoid being second-guessed by an activist investor.