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The Rise of the Investor-Centric Activism Defense Strategy

Shareholder activism is often thought of in binary terms: activist v. company, dissident nominees v. company directors. Media coverage dramatically frames the "showdown" of prominent and press-savvy activists taking on companies as both sides seek the upper hand on the way to the ballot box. While an "us vs. them" mentality makes for a compelling narrative, this framework has a major flaw: it doesn't include shareholders, who are the most important constituency in driving the outcome of proxy contests.

Gaining the support of shareholders, in particular large institutional shareholders, through a well-crafted "investor-centric" activism defense strategy is increasingly the key to success in activism situations. Below we outline how activism defense and the investor landscape have evolved and why the "investor-centric" strategy has become the optimal path to victory for most proxy contests, regardless of whether they culminate in the withdrawal of the activist, a shareholder vote or a mutually agreed settlement.

Where it Began – Tactics, Tactics, Tactics

Five years ago, it would not have been uncommon to find a whiteboard on the wall of a company boardroom in a contested situation filled with a list of tactical measures to thwart the activist's campaign: poison pills, changing bylaws, moving meetings to remote locations, lawsuits, and shifting record dates. The primary focus of a tactical strategy was to outmaneuver the hostile acquirer or activist, the latter of which was more often than not pursuing a straightforward "sell the company" or "lever up and distribute" thesis and had limited ability to sustain a multi-year campaign.

Today, investors and proxy advisory firms are more skeptical of actions taken by the Board that appear purely tactical or are otherwise perceived as impinging upon shareholder rights. Often, these actions carry the risk of souring investors who might otherwise be willing to support the company but feel disenfranchised from decisions that materially impact the value of their portfolio company. While such tactics may still be part of the activism defense toolbox, they should be considered with great care and in the context of their impact on maintaining support from companies' increasingly diverse and sophisticated shareholder base.

The Activist-Centric Defense Strategy

As tactical considerations became less effective as an activism defense strategy, boards turned their focus directly to the activists and their agendas. Specifically, some companies took actions with the goal of either preempting the activist or appeasing them, aiming to implement enough of the activist's thesis to make the remainder of their demands not worth fighting for. The resonant concept was that boards should "think like an activist." In some cases, these actions resulted in a settlement with the activist or the activist withdrawing after achieving a partial, but "sufficient," victory.

However, in present times, the major problem with a defense strategy focused primarily on addressing the concerns of an activist is that while the activist may have been satisfied by the outcome, some or many of the activist viewpoints may not have been shared by the broader base of long-term investors. In fact, in recent years, there has been significant pushback from large institutional investors, whose risk profiles and investment time horizons often differ from those of a vocal activist fund, about the practice of companies reaching settlements without receiving input from other shareholders. An unsettled shareholder base can leave companies vulnerable to a follow-on campaign either by the initial activist or another activist with a different agenda.

Evolution of the Investor Landscape

The evolution of defense strategies has occurred against a backdrop of recent tectonic shifts in the investor landscape that have reinforced the centrality of the broader, long-term shareholder base in activism situations. The oversight failures of the early 2000s and 2008 financial crisis spurred many investors to become more active owners and voters. Over time, governance-focused institutional investors have built out their proxy voting teams, which has allowed them to engage with a broader range of companies and other market players. Activism itself has undergone a transformation, with activists seeking to shed their “corporate raider” label while building relationships with investors. Additionally, active managers under pressure to generate alpha are more receptive than ever to activist theses.

Underlying all of this is the increasing concentration and acceleration of fund flows into passively managed index funds and ETFs over the past several years. Today, the top five institutional shareholders hold more than 20%, on average, of S&P 500 companies and one of the three biggest index funds (BlackRock, Vanguard and State Street) is the largest single shareholder in 88% of companies in that same index. These passive investors are increasingly important as they tend to have a longer-term perspective which results in them being more willing to support a company if they believe in its long-term strategy regardless of potential short-term negative impacts to the business or stock price.

The growth of assets held by passive investors has also heightened the focus on corporate governance and board-related matters across the market. These topics are now a critical focal point in activism campaigns. As a result, success in an activist situation increasingly requires companies to persuade and win the support of a range of constituencies much broader than the traditional portfolio manager and buy-side analyst community, including governance teams, proxy advisory firms and key asset owners such as public pension funds.

The Investor-Centric Defense Strategy

The evolution of the investor landscape, in addition to the aforementioned problems that have arisen with prior defense strategies, has elevated the concept of an “investor-centric” defense strategy. Unlike previous strategies, this approach begins well before an activist arrives with their demands and is built on companies understanding their investors’ concerns through years of engagement and relationship building. As the Chairman and CEO of Vanguard recently wrote, quoting a corporate CEO during one of their engagements, “You can’t wait to build a relationship until you need it.”

Rather than “think like an activist,” the right approach for companies is to “think like a shareholder representative”: engage with investors, understand and incorporate their perspectives, and educate them on why the company is pursuing a particular strategy, particularly before an activist appears. Ongoing dialogue enables companies to build credibility with key decision-makers within both the investment and governance teams at institutions, even if there are topics where these disparate teams are not in complete agreement. Even in situations where there is a large and supportive base of retail investors, it is these key decision-makers who will make the ultimate difference between winning and losing.

While companies typically have very active investor relations efforts focused on portfolio managers and research analysts, they must also understand how to engage with all investor constituencies that will drive outcomes in a potential activist situation.

For actively-managed funds, where communication during an activism situation is frequent, feedback will generally be more direct and the decision-making process will be primarily focused on core economic issues. Companies that have built buy-in for their strategy in advance of a fight by being responsive to feedback from these funds will benefit from a higher probability that these investors will vote with management.

On the other hand, governance-focused investors often enter a fight with a limited understanding of the company and are concerned about a range of strategic, financial and governance elements. Building trust with this constituency often means demonstrating that the company has the right board in place to evaluate and oversee long-term strategy, and that the board is operating with a focus on the best interests of shareholders. While this trust can be established in the fast-paced environment of a proxy fight, companies that have proactively built relationships with governance teams and proxy advisors will generally fare better than those that are scrambling to do so under a stormy sky.

With all of this in mind, it is clear that companies in an active defense situation must evaluate every decision through the lens of how investor constituencies will view the action and how it will affect the potential vote. Even if a threatened proxy contest ends in settlement, the leverage that companies have in negotiation derives primarily from the support of these key investors.

Takeaways for Issuers

The delicate balance among boards, management teams, investors and activists is a constantly-changing equation. Over the past several years, a small number of asset managers have amassed trillions of dollars of assets and significant power. These investors represent the ultimate "swing vote" that can effectively determine the outcome of an activist situation and are more willing than ever to exercise their vote. Activists have adapted their approaches to appeal to this increasingly powerful bloc of voters, while public companies have been somewhat slower to proactively build relationships beyond traditional investor relations efforts.

Given these new dynamics, it is critical that companies view their potential actions through an investor lens, whether three weeks before a meeting or during the off-season. A key step is engagement and relationship-building with all key investor constituencies before being confronted by an activist. If an activism situation occurs, company management and the board will be able to draw on the trust generated with key decision-makers, will have had the opportunity to tell their story on critical strategic and governance issues, and will have heard and addressed the feedback and concerns of their investors.

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