Investors and the Board

POINT *of* VIEW

SpencerStuart

Shareholder activism is gathering pace around the world — and it is here to stay. Behind the scenes, traditional long-term institutions are joining forces with activists in an attempt to drive stronger investment returns. Every board has to understand where its business is vulnerable to attack, whether it has a strong and convincing story to tell, and whether its engagement strategy is robust enough to meet the expectations of today's shareholders.

Since the financial crisis, shareholders of listed companies around the world have become increasingly active, seeking deeper engagement with the companies they invest in, using their influence to drive improvements in governance and holding boards to account on a wide range of issues, from strategy and performance to composition and CEO pay.

Proxy advisory firms have become more powerful, and institutional investors, often with a long-term holding strategy, have strengthened their governance teams to shine a light on perceived weaknesses in investee companies. Many boards are finding themselves at the receiving end of shareholder activism as interest rates remain low and alpha becomes more elusive. Indeed, activism has itself become an asset class, outperforming index funds and attracting capital looking for higher returns. According to a review of U.S. shareholder activism in 2016 by Lazard, 25 percent of the 149 campaigns were launched by first-time activists.

There is growing political pressure from public funds on diversity and societal impact, including carbon emissions and the environment. For example, among the desired director attributes listed by CalPERS, which runs the largest public pension fund in the U.S., are "expertise and experience in climate change risk management strategies."

All these developments are unnerving many boards. They hear conflicting messages from different investors and cannot possibly satisfy them all. They are suspicious of the short-term agenda of opportunistic activist investors when it is their duty as directors to safeguard the long-term interests of the company.

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When faced with myriad pressures, boards may be tempted to retreat from all the noise and adopt a defensive attitude, keeping their contact with shareholders to a minimum. This is a mistake and one that can cost companies dearly. Activists build relationships with other investors in order to enlist them in applying pressure, so boards must ensure that they have ongoing relationships with shareholders of all kinds and listen to what they have to say. As Sacha Sadan, director of corporate governance at LGIM, remarks: "If you've got to the point where you have an activist investor on your heels, you've probably got some unhappy longer-term investors."

Frustrations between shareholders and companies run in both directions, but much can be done by boards to turn them into opportunities. In our experience, the most effective boards are those that have a robust strategy, can communicate the investment case clearly, seek a constructive dialogue with all the relevant parties, and are willing to listen to and understand their concerns. "The board needs to have the right CEO, CFO and investor relations director in place," says Sir John Parker, chairman of Anglo American. "The chairman should be known to shareholders and always available to talk to them about governance, board composition and any issue they prefer not to raise with senior management."

We have identified five steps that boards can take to improve their relationships with shareholders:

1 Understand the triggers that prompt shareholder intervention

There are multiple reasons why shareholders might want to talk to a board. At the top of the list is weak business performance. "When the company is not performing, like it or not management and the board are exposed. It's naïve to think otherwise," says Ray Milchovich, a member of the board of The Dow Chemical Company, former lead director of Nucor and former chairman and CEO of Foster Wheeler. "As a CEO, I always assumed that if we were not performing relative to our peers or creating value for our shareholders, our position was unsustainable in the long term. Why should people want to invest in this company for people to sit here and not perform?"

The quality, composition and tenure of the board are also important factors that shareholders watch closely. According to Sir John Parker, "The best bulwark against destruction of shareholder value is to have broad-based experience in the boardroom as well as domain knowledge." Investors know how important it is that the board has the mix of competencies and knowledge that will

SHAREHOLDER ACTIVISM IN ASIA AND EUROPE

U.S.-style shareholder activism has had to adapt to different cultures and governance regimes. Since many businesses in Asia are majority-controlled, shareholder activism has been less of an issue to date, although there is no room for complacency. Indeed, companies ambitious for global expansion may need secondary financing and will therefore attract the attention of overseas investors. As a result, boards are having to take notice of investors' views on governance issues and are still learning how best to relate to them. Across Europe, there has been a rise in the number of challenges by activists but these have met with varying success. However, boards cannot afford to ignore the fact that activists' campaigns are often based on excellent research and that institutional investors are increasingly willing to collaborate with them to get results.

enable directors to judge whether the strategy is the right one and whether management has an effective execution model to deliver on that strategy. "I also want to know how agile the company is," says Sadan, who insists that boards must keep their fingers on the pulse of a rapidly changing business environment. "Instead of trying to find a director with all the requisite skills, maybe you need to find people who can sit just outside the board, perhaps on an advisory board or external technical committee; they can come and talk to you a few times a year, and you can swap them out for different experts if needed."

Shareholders are also becoming vocal on the subject of diversity, engaging with boards around the world to ensure that they appoint more women directors. Other measures of diversity matter too, including international outlook, ethnicity, age and background.

Investors are scrutinizing governance structures, particularly the separation of roles at the top. In France and the U.S., where it is quite common for the chairman and CEO roles to be combined, boards are under increasing pressure to ensure that independent voices are being properly heard and that board leadership roles are clearly delineated, with the presence of a strong lead or senior independent director with whom shareholders can have a candid conversation if they have concerns about management.

The chairman and/or lead independent director must also be able to demonstrate that the board has a carefully considered process for CEO and board succession. Shareholders continue to express their frustration over the number of boards that talk about succession but then fail to deliver a smooth transition of power.

Shareholders are also concerned about the dynamic among directors and the quality of debate in the boardroom. Milchovich believes that a high-performing board must operate well as a team yet also get involved in what he calls "constructive conflict." "Directors inevitably develop relationships with each other over time and this is an important part of what makes a board work. However, when the social aspect of the board interferes with the responsibility of directors to delve into the issues, ask difficult questions and challenge groupthink, there is almost certainly trouble ahead." One of the ways that shareholders gain reassurance about the quality of boardroom debate is by knowing that a board will be assessed by a respected external adviser whose job it is to explore how well the board deals with difficult issues and to make recommendations for improvement.

> *"Active investors are always trying to find out whether the firm has the right strategy and if they have the right person in place to drive that strategy."*

CEO compensation continues to vex shareholders, especially when there is a clear disconnect between reward and performance. A key consideration in the appointment of any compensation committee chairman should be how effective he or she will be in articulating compensation policy, explaining decisions to shareholders and addressing their concerns.

Among the other issues that trigger investor pressure are a perceived lack of strategic direction, the allocation of capital, voting rights and the return of surplus cash to shareholders. Boards must think carefully about which of these concerns are uppermost in the minds of investors and be able to show that they are taking remedial action where necessary.

2 Decide who will engage, and how often

Boards must agree who will take the lead in shareholder communication, so that everyone understands their role and keeps each other informed. In some jurisdictions, directors' communication with shareholders is strictly regulated. In Germany, for example, the supervisory board chairman is only entitled to speak to shareholders on matters relating to the board, while it is the CEO's responsibility to discuss operational issues. Bruno Lafont, former chairman of Lafarge and lead director of ArcelorMittal, agrees with this principle: "The chairman should be the point of communication for governance issues and shareholder relations; the CEO should be the one to discuss all other subjects. It is important to limit the number of people involved."

Elsewhere, the general consensus is that the chairman takes the lead except when the roles are combined, in which case this duty falls to the lead director. Whatever the circumstances, effective communication with shareholders requires a highly functional relationship between the board chairman/lead director and the CEO. "In the normal course of business, I don't think the board interfacing with shareholders in a way that is separate from management is productive," says Milchovich. "Exceptionally, a shareholder might ask to meet with the board without management present. It would be a mistake not to listen to such a request, but when that happens, it is usually a signal that something is wrong."

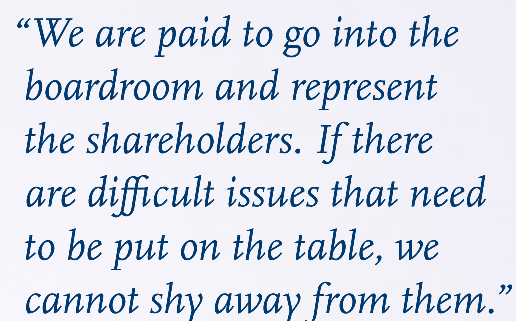
Stephen L. Brown, senior adviser for KPMG's Board Leadership Center, thinks that the board should get an update from the CEO at least once a year on how the company's governance staff engages with stakeholders. "Do they have a robust shareholder engagement program? Have they formed meaningful relationships not only with portfolio managers and analysts, but also with proxy voters at the investment firms? How does the staff stay apprised of the latest trends and initiatives within the investment community? How would the team discuss the board's role on investor hot topics such as oversight of strategy and ESG (environmental, social and governance) issues? If they were hired many years ago, do they have the right training or skill sets to do an outstanding job in today's environment? These are important questions for the board to be asking."

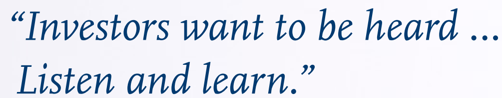
Sadan believes that the most underutilized person is the corporate secretary. He or she can play an important role behind the scenes, not only in keeping a formal record of conversations with investors but also in having the autonomy to find out what the issues are and ensure they get properly aired in board meetings. "One company secretary brought their remuneration committee chair to come and meet us, sensing they might have a problem even though the committee thought things were okay. We took another meeting even though we were busy, and I think that helped resolve what could have become a major issue."

Many companies have routines in place to ensure they meet with all their significant shareholders. "My experience is that some institutional investors are keen to see you every three to six months; for others, once a year is enough," says Alastair Kerr, board director of Fuller, Smith & Turner, Fenwick and J. Murphy & Sons. "And of course, the annual general meeting is another opportunity for dialogue. It is important that they have the opportunity to meet not just the chairman and CEO but the chairmen of the audit, remuneration and risk committees as well."

3 Prepare well

Preparation is something that activist investors do extremely well. They rarely make a move without first having built a case on very detailed research, and so it is incumbent upon boards to anticipate where the





company is most vulnerable and put initiatives in place to counteract possible action. Regular written reports from the head of IR and presentations from company-appointed brokers help boards understand shareholders' views. The rise of external advisers demonstrates how seriously boards are taking the need to develop an effective investor engagement strategy.

When meeting with a shareholder for whatever reason, a board director must prepare properly. The first step is to get well briefed by management on who you will be meeting and their likely motivation for talking to you. Using an agenda to structure the conversation is important, as is taking the time to rehearse once you have all the information at your fingertips.

"If a director is part of the engagement team, then that person should be independent, and also a good communicator," says Brown. "If they are not prepared, these meetings don't go well. As an investor, I expect the director to be able to answer my questions, do some reflective listening and take notes. One of the best conversations I ever had was with a director who walked in with our policy statement, dog-eared and underlined. That not only showed respect, but an understanding that our policies might differ from those of the proxy advisers."

Investor meetings can be rewarding, even if they are tough. Milchovich recalls how seriously some investment houses took these meetings. He would sit with his CFO and head of investor relations in a room with 20 people for two hours, working off prepared materials for 30 minutes, followed by Q&A. "You couldn't study for that test," he says. "You either knew what was going on in your company and could answer those questions or you couldn't — there was nowhere to hide. Those were good meetings and I always learned from them."

Take your investors seriously — and listen

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The questions raised by active and activist investors are often the same, but their methods are different. Active investors (institutional, long-term investors increasingly fall into this category) are more cooperative with the management team, willing to participate in discreet behind-the-scenes discussions, whereas activist investors want to go public quicker if their initial demands are not met.

Taking the time to understand what shareholders and proxy advisers are most concerned about requires a willingness to engage, good research and a lot of listening. Boards must take interventions by investors seriously or they may be caught off guard. "Engage in dialogue as early as possible," says Kerr. "They are not going to go away. The problem will get bigger if you leave it."

When activist investors end up launching a public campaign it can inflict serious damage on the company's reputation. Boards can avoid this happening by communicating their message clearly and systematically and then taking the attitude that investors who argue the case for change are effectively offering free advice. "Ultimately, shareholders are your boss," says Lafont. "Even if you disagree with their position you should think about why they promote it and what could come out of it." Jean-Martin Folz, senior independent director of both Saint-Gobain and AXA agrees: "In most cases when an activist intervenes, it provokes a useful debate because whatever question they are raising is usually worth being examined. Also, it tends to unify the board unless there was already a conflict among the directors."

Disappointing company performance or poor governance will prompt investors to scrutinize the quality and suitability of directors and press for change in the boardroom. The number of board seats won by activists in the U.S. has been on the rise and increasingly boards are settling in order to avoid a public proxy fight. In European and Asia Pacific countries, where it is already common for large shareholders to be directly represented on the board, nominations by activist investors are more likely to meet resistance. For Denis Ranque, chairman of Airbus, there is a trade-off: "Having a major shareholder's representative join the board can be an effective way to manage the relationship with this investor, but there might be an immediate effect on the atmosphere of the board and on its unity." Sir John Parker takes the view that shareholders appointed to the board cannot be independent and should be discouraged. "Why should one shareholder have an inside track on board information not available to all?"

5 Stay focused on the long term

While a board should keep an eye on short-term performance, any pressure to change course or make decisions to satisfy the short-term demands of investors must be countered with a clear articulation of the company's long-term vision. "Be honest and open and, if it's necessary, be conciliatory," says Kerr. "But if you are clear that your view is right and held by a majority of shareholders, stick to your ground."

SIX THINGS FOR BOARDS TO CONSIDER IN THE FACE OF SHAREHOLDER ACTIVISM

- **Be your own fiercest critic.** Anticipate the case that might be made against you, keep all your options constantly under review and prepare your response.
- **Think the unthinkable.** How does the board contemplate the kind of disruption that the objective, dispassionate outsider may envisage as necessary?
- **Be objective.** Disengage from your emotional investment in the status quo and the current strategy in order to match the objectivity of the analytically driven activist.
- **Take the investor-turned-activist seriously.** They will have done their homework. It is free advice.
- **Review board composition.** Increasingly, the focus of attention will be the board itself — its leadership, composition and effectiveness.
- **Be open-minded about board representation.** Each request should be considered on its merits. The board's response should be framed by the investor's attitude to the long-term health of the business.

> *“You have to assess whether the investors are considering the company’s interests or merely their own.”*

The board’s responsibility is ultimately to promote the long-term, sustainable health of the business. Directors should ensure that all board activities and interactions with management and investors are underpinned by a clear understanding and articulation of the organization’s long-term vision and values. Resisting short-termism can require discipline and nerve; chairmen in particular must have plenty of conviction, influence and resilience to stand firm under pressure. Fortunately, they have strong allies among long-only investors who prioritize alignment on long-term governance issues.

Conclusion

With many shareholders looking to increase the quality of their engagement with investee companies, boards must choose the right people to communicate a consistent and positive story to fund managers and their governance teams in a way that resonates with them and addresses their concerns. This is made easier by an honest appraisal of any weaknesses in performance and governance, good preparation and a willingness to listen. Boards that remain self-aware, communicate a compelling vision for the business and listen with an open mind to the concerns of shareholders can build constructive relationships with them and reduce the likelihood of being forced onto the defensive.

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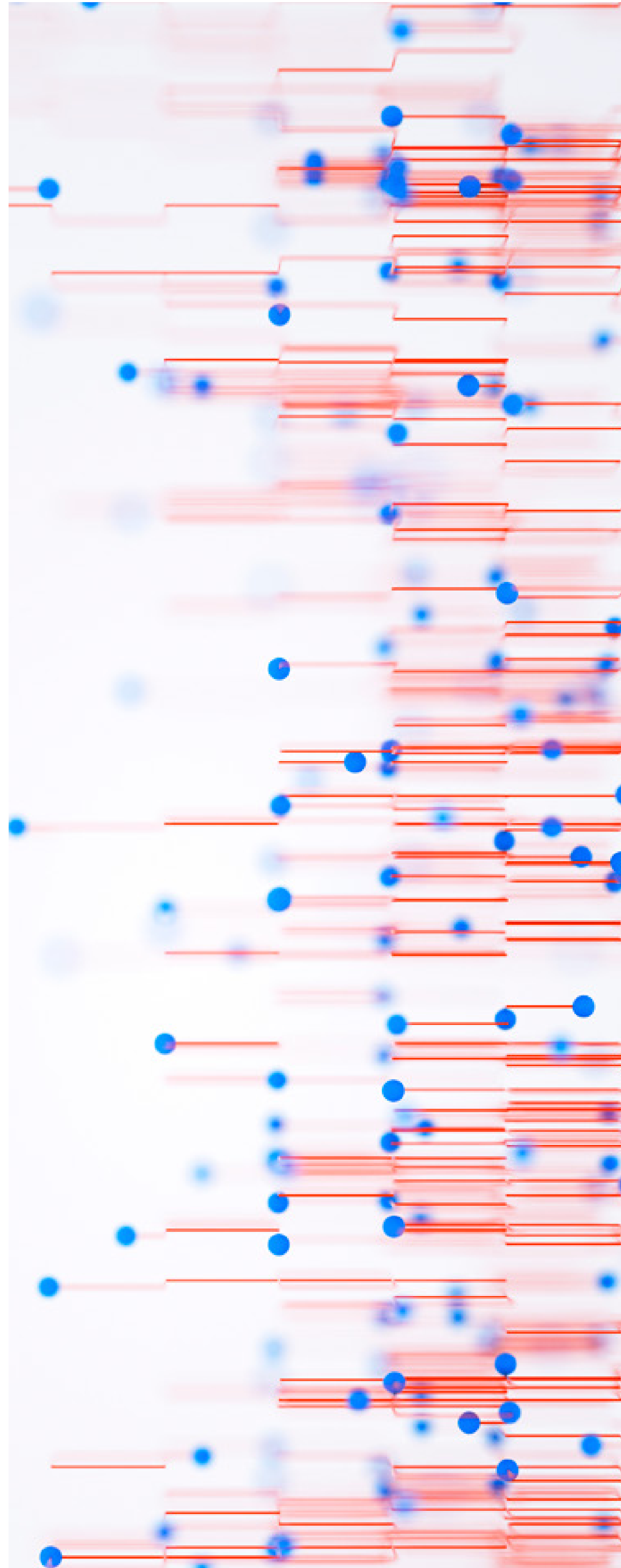

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