CORPORATE TRANSFORMATION SERVICES
FROM THE INSIDE OUT

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Changing Priorities: Activists' Focus Shifts to ESG, Board Diversity and New Sectors

At the annual 13D Monitor conference in New York in April, one of the year's key gatherings for the industry, activist investors set out new priorities for their investment decisions, including greater diversity on boards, environmental, social and governance (ESG) standards at target companies, and an increasing interest in the energy sector.

Some of the most high-profile and long-established shareholder activists spoke at the event, including Bill Ackman, CEO of Pershing Square, Jeff Ubben, CEO of ValueAct, Jeff Smith, CEO of Starboard, and Jesse Cohn, head of activism at Elliott.

ESG in Focus
Activists have traditionally pushed companies they invest in to focus relentlessly on the bottom line in order to drive shareholder returns. That can mean operational efficiencies, mergers and acquisitions (M&A) or better use of capital. They seek board representation in order to increase their decision-making influence. However, the large institutional investors that allocate capital to activist funds are giving increasing weight to ESG factors and diversity. This reflects a growing belief that companies can operate with the highest environmental and ethical standards without diminishing shareholder returns and become more resilient in the long term.

"At the same conference 10 years ago, the words environmental and social did not come up," says Nate Dwyer, Managing Director with Alvarez & Marsal (A&M)'s Corporate Transformation Services practice in San Francisco. "However, the large public pension funds, for example, are very concerned with these elements and are setting up guidelines for the capital they allocate to hedge funds and activist funds."

Recent activist campaigns highlighting this shift include Barington Capital's call for better independence and more women on the board at L Brands, the owner of the Victoria's Secret lingerie brand. The activist fund said the brand had been "tone deaf" on "women's evolving attitudes towards beauty, diversity and inclusion" while rival retailers had kept pace with the shift, contributing to Victoria's Secret's underperformance. Recently, it also admitted to rethinking the annual fashion show.

At the time, only three of 12 board members were women and one of them was CEO Leslie Wexner's wife. However, L Brands last month appointed Barington as a special adviser and added two women to its list of board nominees for election at this year's annual meeting.

Energy Renaissance
In addition to these new governance priorities, some activist funds who took part in the conference are also looking at different sectors for potential investment. Notably, energy is back on the radar, as commodity prices have recovered from their lows of 2016.

"Activists tend to stay away from sectors like commodities where things are beyond their control – you can have the best operating strategy in the world but if the oil price falls to $20 a barrel, then it makes no difference," says Jim O'Donnell, Senior Director with A&M's Corporate Transformation Services business. "However, as prices have stabilized, energy is starting to come into focus."

Occidental's $55 billion takeover bid for U.S. oil producer Anadarko, which swept aside an earlier $50 billion offer from Chevron, is also expected to spur further deals for producers in the Permian Basin, the oil field at the center of the U.S. shale boom.

Keith Meister, Managing Partner at Corvex Management, told the 13D conference that Permian Basin producers Diamondback Energy, Concho Resources and Pioneer Natural Resources are “must-own” takeover targets. Corvex owns more than 3.5 million Diamondback shares, according to Bloomberg.

“However, activists’ recent focus on the consumer sector is not going away,” says Mr. O’Donnell of A&M: “We’re working through a consumer company revolution - American consumers are still there, they’re just in their houses, on their computers. Yet companies with board members who’ve been in the industry since the 1960s are in paralysis about where to go – they’re making adjustments without looking at the new reality.”

Bed, Bath & Beyond is the latest high-profile target in the consumer sector, with three activist funds seeking to replace the entire board and CEO after the company’s stock lost more than 80 percent of its value since 2015.

Streamlining Proxy Votes

Two other key takeaways emerged from the conference: growing support for a new way of gathering shareholder votes during proxy battles over board members, and the rise of traditional long-only funds taking lessons from the activist playbook.

The first relates to increasing demands from the largest mutual and index funds for universal proxy voting. As things stand in the U.S., when activists go head to head with target companies over board nominees, the company will send out its list of proposed names to shareholders with a proxy voting card, allowing the shareholder to vote by mail. The activist fund must also send out its slate of nominees on a separate proxy card, and shareholders must then choose one or the other. A universal proxy card would instead put both lists on the same piece of paper and allow shareholders to choose names from either.

Companies have opposed the change because they fear it may result in more activist picks coming on to boards. However, in situations where activists are seeking the removal of the whole board, or a majority, the universal proxy would protect them from the big upset that occurs in the current system when the activist’s slate wins out. It also makes voting more transparent, cuts out duplicates and saves a lot of money in mailing.

“The way proxies are mailed out and the way shareholders vote is very dysfunctional right now,” says Mr. O’Donnell. For both the activist and company side, there is a risk that shareholders large and small vote the wrong way because of the confusing amount of paper and forms they receive in the mail. Regulators have not mandated universal proxies yet, although the Securities and Exchange Commission (SEC) proposed a change back in 2016. Instead, the biggest investment groups are bringing pressure to bear on companies.

Learning from Activists

Finally, company boards can no longer rely on traditional long-only mutual funds to vote their way. “The buy-and-hold fundamental guys see they have to generate alpha to justify their fees, and taking an activist stance is one of the key ways they can do that,” says Mr. O’Donnell.

In addition, when companies fail to make the necessary changes to transform shrinking returns, the interests of long-term shareholders and activists are aligned. “If the incumbent management team continues to destroy value, both mutual funds managers and activist hedge funds realize the company could create value by selecting the right management team, the right board or the right capital allocation – it becomes a symbiotic relationship,” according to Mr. Dwyer.

Activist investors think like Alvarez & Marsal. They focus on what operational changes can be made at public companies and this is our area of expertise. They look to leadership from the board or an advisor like A&M to effect change in a timely manner and bring measured results to their portfolio companies.

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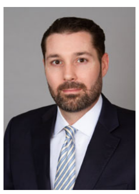

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