

# Institutional Shareholder Activism: an alternative to traditional value-based investing

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# Institutional Shareholder Activism

Opportunities sometimes arise to make spectacular returns from investing in fundamentally sound companies trading at quasi-bankruptcy valuations...

Such extreme valuations can be due to reasons such as:

- Inefficient/ opaque corporate structure
- Management destroying value
- Shareholder control issues
- Accounting mishaps; or
- Market overreaction/ hysteria

**... but it can take years for confidence to be re-established.**

# Unlocking Value

- The portfolio investor can only wait for the market to close the discount.
- The active shareholder has the added comfort of being able to **initiate** the process to unlock value (if management does not do so itself).

# Limiting Risk

- The passive investor limits risk through portfolio diversification.
- The active investor limits risk through intensive due diligence and a highly focused, active approach.

# Outline

- I. Board independence – when things go wrong
- II. The case for shareholder intervention
- III. What can active shareholders really do?

# I. Board independence – when things go wrong

# Legislative Response

Public outrage in the United States following the collapse of Enron resulted in a flurry of new rules (Sarbanes-Oxley etc) attempting mostly to:

- Repress white collar fraud/ Improve disclosure
- Tip the balance of power in favour of shareholders

Similar legislation is also being introduced throughout Europe.

# Value Destruction

- **Fraud/ deceit** (which is illegal).
  - **Mis-management** (which is entirely legal).
    - Inappropriate acquisitions
    - Overpaying for acquisitions
    - Radical corporate transformations
    - Over-leveraging
    - Borrowing with over-restrictive covenants
    - Refusal to consider takeovers seriously
- **An ineffective board can (legally) lead to serious value destruction.**

# “Boards Need to be Independent”

Within public companies, the separation of ownership and management control creates a need for an independent board

- to set the strategic objectives of the company
- to determine how best to raise capital
- to hire (and fire) the CEO and fix remuneration

➤ **Board members need to be independent of management.**

# Independence With Respect to Shareholders?

- NASDAQ proposed listing standards
- Rhodia: ISS view vs Proxinvest view

**... but does this make sense for the shareholders?**

# Shortcomings of the Existing System

How effective are “independent” directors who:

- Have no relevant industry experience
- Have limited time to devote to this function
- Are not paid enough
- Often have little or no money at risk in the Company
- Receive selected information in their board packages
- Are handpicked by the CEO or his friends on the Board

## II. The Case for Shareholder Intervention

# Institutional (In-)activity

Despite the potential benefits of intervention, the range of actions traditionally undertaken by large institutions with respect to individual portfolio companies usually goes no further than:

- Buying the stock
- Monitoring developments
- Meeting with management (sometimes)
- Voting at annual meetings (rarely) and, if so, generally as directed by proxy advisors such as ISS; and
- Selling the stock.

➤ **However, there are perfectly legitimate reasons for this.**

# Why Are Institutions So Passive?

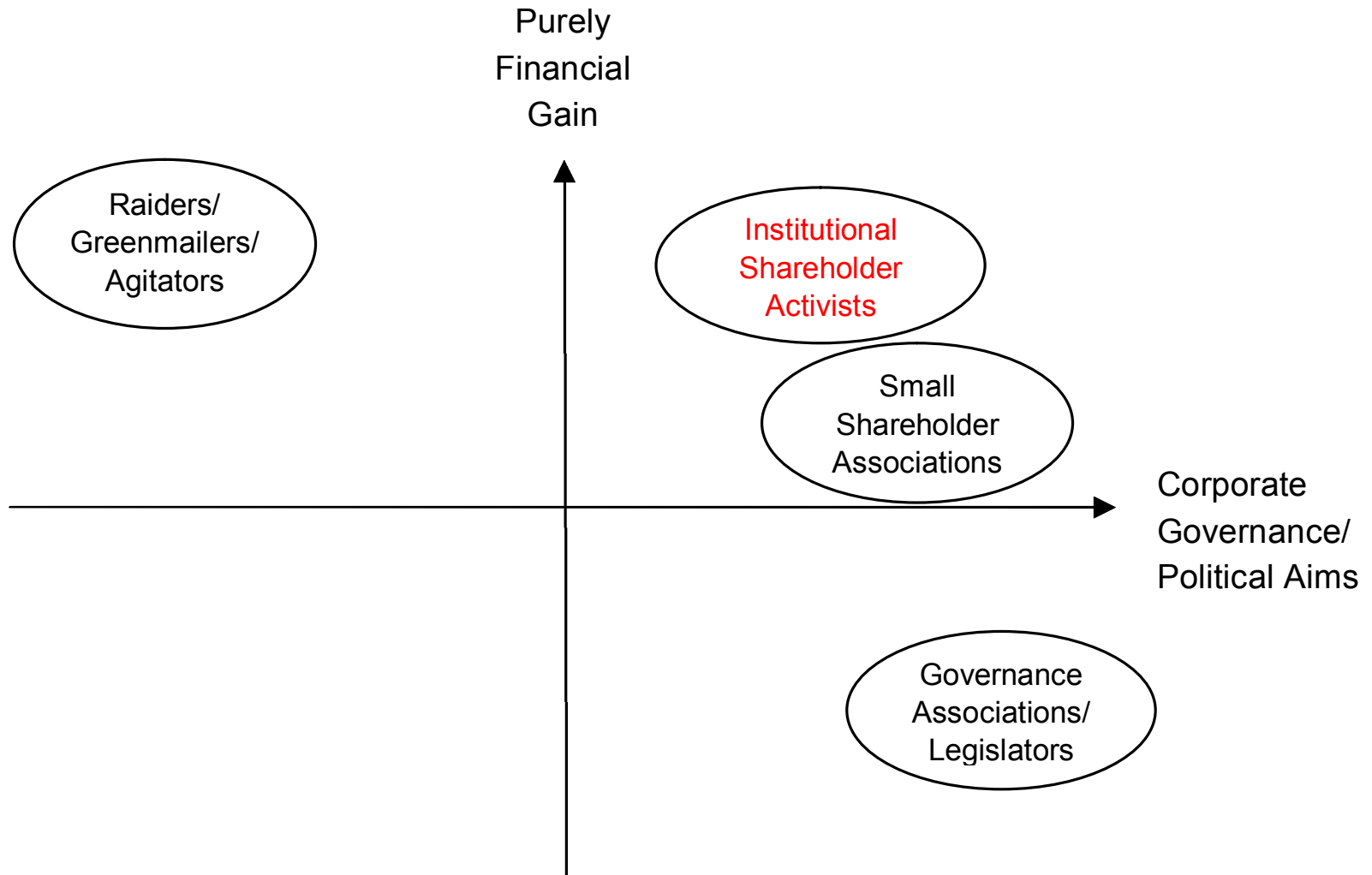
- Portfolio approach
- “Let the managers do what they are paid to do”
- Reputational risk of becoming too active
- Conflicts of interest
- Financial cost of becoming active
- Risk of litigation
- Time, effort and other resources required
- Perceived difficulty of overcoming obstacles to change

# The Opportunity

- Many large institutions (index funds) are obliged to own certain stocks, regardless of how well – or in whose interests – the underlying company is managed.
- These institutions can only benefit from responsible and effective shareholder activism and improved corporate governance.
- Other active managers will also benefit – to the extent that they hold the stock.

➤ **The door is wide open for certain shareholders to take the lead.**

# Spectrum of Activists by Priority



# Implicit Contract

There has to be an implicit contract between the Institutional Shareholder Activist and the other institutional shareholders of a Company:

- willingness to “do whatever it takes”
- professionalism
- integrity
- avoid conflicts of interest (eg greenmail)

**... in exchange for the institutions' support.**

### III. What Can Active Shareholders Really Do?

# Pre-requisites

The requirements for institutional shareholder activism are more restrictive than for portfolio investing. At a minimum:

- Significant discount to intrinsic value
  - Ability to unlock value/ Credible business plan
  - Sufficient stock liquidity to make a substantial investment
  - Workable shareholder structure
  - Ability to overcome legal and other impediments
- **Not all potential investments will be suitable projects for activist investors.**

# Establishing a Plan of Action

Perhaps the most important part of the strategy – often overlooked – is the establishment of credible plan of action.

This always involves:

- Thoroughly understanding the reasons for stock price underperformance
- Listening to the views of the Company's shareholders and management
- Identifying and appraising alternative courses of action
- If possible, establishing a consensus;
- Overcoming the obstacles to the implementation of the Plan; and (sometimes)
- Assisting management with the implementation.

# Research

This may involve:

- Commissioning industry and/or management consultants to review the Company's strategy and alternatives;
- Hiring investment bankers to prepare fairness opinions or underwrite financing alternatives and advise on debt structure and covenants;
- Hiring industry executives as project-based consultants;
- Engaging local law firms to review contracts, fiduciary duties etc
- Investigating potential tax, litigation and/or environmental liabilities;
- Reviewing anti-trust issues with specialist advice;
- Hiring pension consultants/ actuaries to review pension plan and employee benefits.

# Tailoring the Strategy

- In order to be effective, activist strategies need to be tailored to suit market practices and individual circumstances.
- The Anglo-Saxon approach to institutional shareholder activism depends very much on the implicit threat of a proxy contest.
- But there are many shades of intervention and high profile public activism can sometimes be counter productive.

# Examples of Pro-active Engagement

- Writing open letters to management and/or the Board, using web-sites, press contacts, regulatory filings.
- Holding public meetings (“town hall meetings”) inviting large shareholders, board members and management to attend.
- Requesting special disclosure by the Company and/or a special audit.
- Suing one or more of the directors/ trustees (including by means of class action lawsuits).
- Conducting a proxy contest.
- Contacting potential acquirers for parts (or all) of the business and making their interest known to the Board, to the press, and/or to other large shareholders.

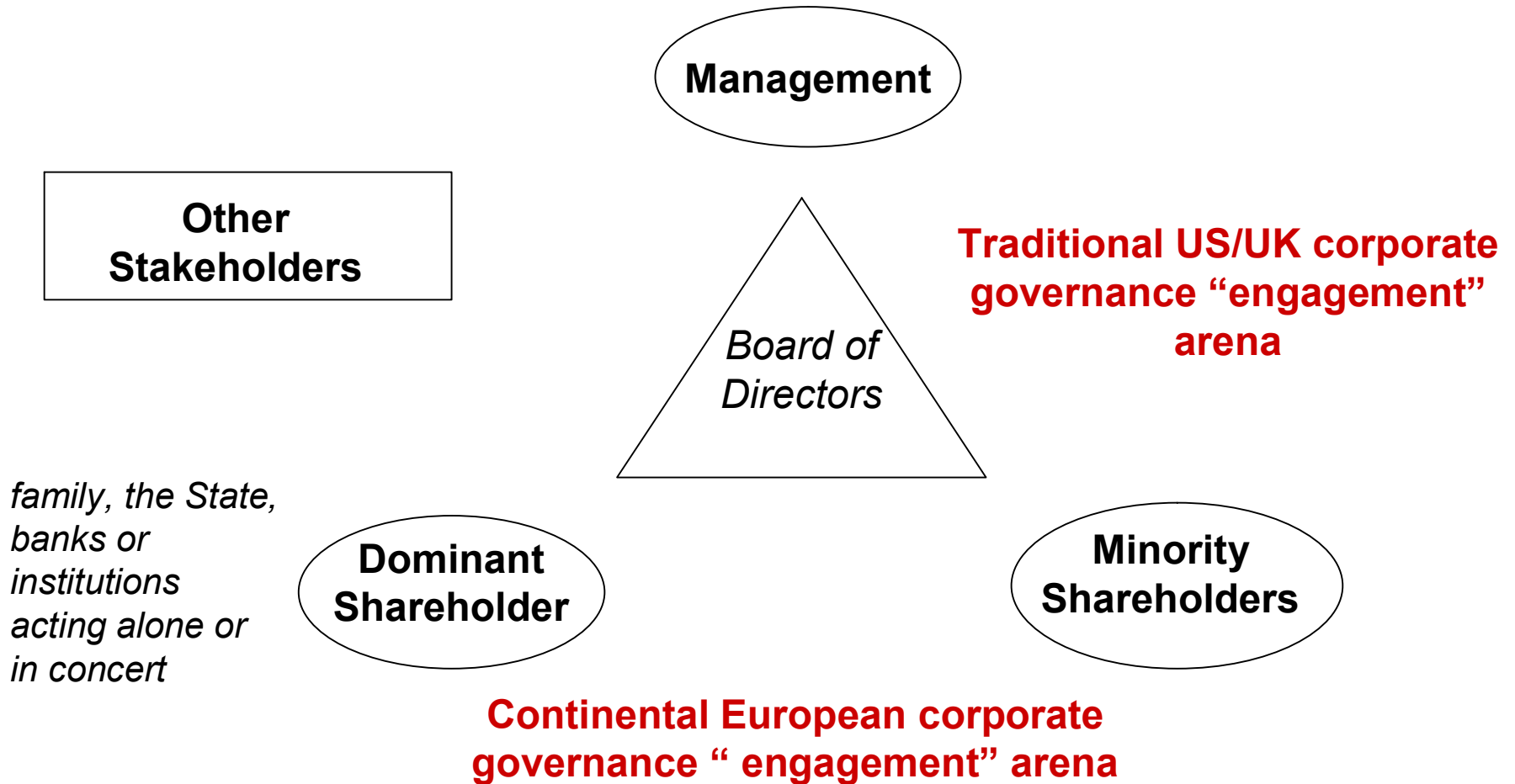
# Control Issues

Control mechanisms legally available to managements and controlling shareholders in each specific country need to be taken into account. Eg:

- Restrictions on calling shareholder meetings
- Dual class shares with differing voting rights
- Voting trusts and foundations
- Pyramid structures
- Cross shareholdings
- Restrictive proxy voting techniques
- One shareholder one vote structures

- **These represent some of the more difficult challenges for the activist.**
- **But these are often associated with a large block of stock ...**

# Shareholder Engagement



# Controlling Shareholders

Are typically seen as an obstacle to shareholder activism **BUT**

- Can be instrumental in unlocking value.
- Have a strong vested interest (although not always aligned with other shareholders).
- Have become more responsive to external stimulus following recent stock market losses.
- May themselves be susceptible to shareholder pressure.

➤ **Friend or foe?**

# Appendix: European Data

# US Institutional Holdings

## U.S. Institutional Holdings of European Equities

	U.S. Holdings (\$ Billions)			Market Penetration (%)	
	1997	1999	% Change	1997	1999
<b>Market</b>					
United Kingdom	218	334	53.2%	10.9	11.7
France	85	165	94.1%	12.6	11.0
Netherlands	107	128	19.6%	22.8	18.4
Germany	65	125	92.3%	7.9	8.7
Sweden	39	78	100.0%	14.7	20.9
Switzerland	62	64	3.2%	10.8	9.2
Italy	42	53	26.2%	12.1	7.3
Spain	25	35	40.0%	8.7	8.1

Source: KVAM Research.

Derived from the U.S. Treasury Report on U.S. Holdings of Foreign Long-Term Securities, April 2000

# Share ownership in Europe

<b>Companies with Market cap of €250 - €5,000 million</b>				
Country	Free Float			Total Companies
	<u>&lt;50%</u>	<u>50-75%</u>	<u>&gt;75%</u>	
France	88	35	20	143
Germany	89	38	13	140
Italy & Spain	98	40	23	161
Netherlands	23	36	17	76
Scandinavia	56	73	48	177
Switzerland	42	26	27	95
Other	106	22	44	172
<b>Total</b>	<b><u>502</u></b>	<b><u>270</u></b>	<b><u>192</u></b>	<b><u>964</u></b>
<i>% of total</i>	<i>52%</i>	<i>28%</i>	<i>20%</i>	<i>100%</i>

(1) Data: Salomon Smith Barney, April 2001 reproduced by Hermes European Focus Funds, February 2002

# Share ownership in Europe

Companies with Market cap greater than €5,000 million				
Country	Free Float			Total Companies
	<50%	50-75%	>75%	
France	9	13	12	34
Germany	9	6	8	23
Italy & Spain	8	8	13	29
Netherlands	2	3	8	13
Scandinavia	5	5	15	25
Switzerland	4	1	9	14
Other	4	3	8	15
<b>Total</b>	<b>41</b>	<b>39</b>	<b>73</b>	<b>153</b>
<i>% of total</i>	<i>27%</i>	<i>25%</i>	<i>48%</i>	<i>100%</i>