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Activists at the Gate:
The Continuing Evolution of Shareholder Activism in the U.S.

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Over the last several years, in light of the significantly higher activity levels of activist investors, U.S. public companies have begun to spend more time both preparing for possible advances from activist investors and communicating with their shareholder bases. According to Hedge Fund Research, total assets under management by activist hedge funds have doubled in the last four years to $84 billion today, and, according to FactSet Research Systems, in the last five years activists have initiated campaigns (or otherwise publicly advocated for change) at over 20% of the industrial companies in the S&P 500. As a result, it is much more common today than it was several years ago for companies to regularly update their directors on developments in the area of activist investing, to conduct periodic internal reviews aimed at identifying, in advance, issues at the company that activists may raise, and to regularly meet with their largest institutional shareholders.

Even in this environment of heightened awareness, however, the recent and highly publicized campaigns by activist investors at several high profile U.S. companies, including Apple, Dell, DuPont, Microsoft, PepsiCo, Procter & Gamble and Safeway, are a stark reminder that shareholder activism has become an issue that directors and management of larger U.S. public companies should be aware of and prepared for – in other words, these U.S. public companies should now think of an approach by one or more shareholder activists as a real, although not inevitable, possibility.

Shareholder activist investing – where, in its most basic terms, an investor takes a position in a publicly traded company and then seeks, usually quite soon after making its investment, to exert influence over the company to make changes that the investor thinks will result in a higher company stock price – is now a stand-alone investment strategy in its own right that is being pursued by both established activists and other money managers that had not previously employed this strategy. In light of the returns that activist hedge funds have generated over the last several years (according to The New York Times, activist hedge funds were up 9.6% for the first half of 2013, and returned an average annual return of nearly 13% between 2009 and 2012), it is likely that there will continue to be a meaningful expansion of the types of companies and issues that may be the subject of shareholder activist interest. It is in this context that we examine notable aspects of recent activity and the implications for many U.S. public companies.

“Mega”- Cap Companies Are No Longer Immune. Until relatively recently, many assumed that the largest public companies were effectively immune from being targeted by activist investors. In more traditional situations, the investor leverages a significant investment position in the target (relative to the market capitalization of the target, and to the size of positions held by other shareholders of the target) to promote its agenda. Under this paradigm, the investor will usually be a significant shareholder of the target, a position that affords it meaningful influence at the company both in general terms (because public companies are usually inclined to engage with their largest shareholders) and in terms of the ability to influence the outcome of shareholder votes (including those concerning the election of the directors and the approval of mergers). The challenge for an

activist in taking this approach with a large U.S. public companies is obvious – it is, practically speaking, impossible to amass a position that is significant relative to the company's market capitalization.

A select (but growing) group of notable activist investors now appear to be attempting to surmount this challenge by leveraging their reputations, instead of the size of their investment positions, and seeking to use detailed analyses to persuade companies and their shareholders that changes are warranted. Recent examples of this approach include:

> **PepsiCo.** In May 2012, Relational Investors disclosed an approximately $600 million investment in PepsiCo (representing approximately 0.6% of PepsiCo's market capitalization at that time), fueling speculation that Relational wanted PepsiCo to split into separate food and beverage companies. Nelson Peltz's Trian Partners subsequently disclosed in July 2013 an approximately $1.3 billion investment in PepsiCo and publicly called for the company to either merge with food and beverage company Mondelez International (a company in which Mr. Peltz also has a sizable investment) or split into separate food and beverage companies. In January 2014, Mr. Peltz was appointed to Mondelez's board of directors and announced that he would no longer be pushing for a merger between PepsiCo and Mondelez; however, the following month Trian Partners issued a public letter to the PepsiCo board of directors renewing its call for the company to be split into two. The PepsiCo board subsequently responded to Trian Partners via letter, noting the "seriousness with which [the PepsiCo board] examined" the Trian Partners proposal and "the firmness with which" the PepsiCo board rejects that proposal.

> **Procter & Gamble.** In July 2012, Pershing Square Capital Management disclosed an approximately $1.8 billion investment in Procter & Gamble (representing approximately 1% of P&G's market capitalization at that time). Subsequent press reports indicated that Pershing Square met with P&G board members and suggested replacing current Chief Executive Officer Bob McDonald and the implementation of other changes to improve the company's profitability. In May 2013, P&G announced that Mr. McDonald was retiring and was being replaced by his predecessor, A.G. Lafley. Pershing Square subsequently sold more than three-quarters of its investment in P&G.

> **Apple.** Beginning in early 2013, Greenlight Capital publicly called on Apple to issue shares of perpetual preferred stock (dubbed "iPrefs") as a means of utilizing Apple's very large cash balances (Greenlight's investment of approximately $696 million represents approximately 0.14% of Apple's market capitalization as of December 31, 2012). In March and April 2013, Apple announced dividend and stock repurchase programs that would return $100 billion in total (with $60 billion coming through stock repurchases) to shareholders by 2015 – making this the largest stock repurchase program ever announced. Four months later, long-time activist Carl Icahn announced via Twitter that he had taken a large position in Apple and communicated to Apple's CEO that the size of the stock repurchase program should be increased. Mr. Icahn subsequently met with Apple's CEO in October 2013, and then in December 2013 submitted a proposal for inclusion in Apple's 2014 proxy statement that called for Apple to commit to completing at least $50 billion of share repurchases in fiscal year 2014 and increase the existing $60 billion authorization under its existing buyback program accordingly (at the time of Mr. Icahn's submission, Apple had already completed approximately $23 billion in buybacks).

In January 2014, after Apple recommended that shareholders vote against Mr. Icahn's buyback proposal, Mr. Icahn issued a public letter in which he called Apple "perhaps the most overcapitalized company in corporate history," and announced that he had further increased his stake in the company to an amount in excess of $3.5 billion. The following month, influential proxy advisory firm ISS and some institutional investors (including New York City Comptroller Scott Stringer, who oversees pension funds holding approximately $1.6 billion in Apple shares) expressed their support for Apple's announced stock buyback program and also recommended that Apple shareholders vote

against Mr. Icahn's proposal. A short time later Mr. Icahn issued another public letter acknowledging Apple's "aggressive" repurchase of shares in the market and announcing that he would not persist with his proposal.

Mr. Icahn has announced and reported on these events via his Twitter account and newly-launched website Shareholders' Square Table. Mr. Icahn's use of Twitter and his new website may be a sign that activist investors will increasingly utilize "new" media to communicate with investors and advance their agenda (Mr. Icahn himself stated as much in a recent Wall Street Journal opinion piece, and his Twitter account had approximately 147,000 followers as of February 2014).
? Microsoft. In April 2013, ValueAct Capital announced a $2 billion investment in Microsoft (representing approximately 0.7% of Microsoft's market capitalization at the time). Discussions between ValueAct and Microsoft culminated in the August 30 announcement that they had signed a cooperation agreement that, among other things, affords a ValueAct principal the option of joining the Microsoft board.

While the true extent of the influence that the activist investor will wield in these "David vs. Goliath" situations remains to be seen, it seems that well-known activist investors can generate "outsize" reactions and interest following their decisions to invest in and engage with these very large U.S. public companies, and that, accordingly, these companies should consider themselves "fair game" for an approach from activist investors.

Operational and Strategic Activism. Activist investors frequently seek to influence the operational or strategic direction of public companies. In the case of operational activism, the investor acts almost as a management consultant to the company, and proposes, often publicly, changes to the company's operations (such as a reduction in certain expenses, or an allocation of the company's capital from one use to another) that the investor believes will benefit the company's business (and stock price). Trian Partners has taken this approach in a number of situations, including in connection with investments in securities administration firm State Street (proposing, among other changes, a reduction in certain expenses; a different approach to capital allocation; and a decreased focus on acquisition transactions), investment bank Lazard (advocating for the continued implementation of an operationally-focused strategic plan prepared and announced by company management), and French health and nutrition company Danone (proposing, among other things, a reduction in certain expenses and an increase in investments in research and development and marketing activities). It is interesting to note that the many months (or years) that it usually takes to successfully execute on operational changes is not consistent with the conventional wisdom that activist investors are primarily interested in immediate changes that will produce a short-term rise in the target company's stock price. In that regard, this form of activism is sometimes considered "friendlier" than other forms and has been referred to (including by Mr. Peltz) as "constructivist" investing.

In the case of strategic activism, the investor is usually seeking to cause the break-up or sale of the target company. For example, Mr. Icahn has in recent years sought to force the sale of a number of companies including Netflix (still independent), Amylin Pharmaceuticals (acquired by Bristol-Meyers Squibb in August 2012) and Clorox (still independent). Mr. Icahn also recently successfully negotiated to appoint two directors to the board of speech recognition software maker Nuance Communications, resulting in speculation that Mr. Icahn will press for Nuance to be broken up or sold.

Recent years have also seen a number of instances of investors pursuing strategic activism by advocating for the sale or spin-off of individual businesses. While a number of these situations have been "successful" because a sale or spin-off transaction did occur, it is common for the target company to state that the transaction was the result of an internal strategic review and not pressure or input from the investor. Recent situations include Jana Partners' 2011 campaign for the separation of McGraw-Hill's education and finance businesses (the company announced in

September 2011 that it would spin-off its education unit); Relational's 2011 campaign for the separation of a number of businesses held by conglomerate ITT (the company announced in January 2011 that it would split itself to three separate companies); the 2012 campaign of John Paulson (the hedge fund manager noted for his successful bet against the housing market in advance of the financial crisis of 2008, but a relative newcomer to the world of activist investing) for the sale of the Hartford Financial Services Group's life insurance unit (the company announced in September 2012 that it had agreed to sell the unit to another insurance company); Trian Fund Management's 2013 campaign at DuPont (the company announced in October 2013 the spin-off of its performance chemicals segment); and Mr. Icahn's recently launched campaign aimed at forcing eBay to spin-off its online-payments unit PayPal.

Opposition to Announced Transactions. While not an entirely new phenomenon, there has recently been an uptick in instances of significant announced transactions being opposed by activist investors. Examples of this approach include:

> **Dell.** In February 2013 a consortium led by its founder Michael Dell and Silver Lake Partners agreed to acquire Dell's publicly held shares. The transaction was almost immediately opposed by Southeastern Asset Management (one of Dell's largest shareholders at the time the transaction was announced, with a holding of approximately 8.5%) and, joining a short time later, Mr. Icahn (who acquired a significant position in Dell following the announcement of the transaction, and subsequently became Dell's largest outside shareholder following the acquisition of additional shares from Southeastern). In the course of their opposition, Southeastern and Icahn sent and published letters to both Dell and its shareholders, and also proposed a slate of directors (including Mr. Icahn himself) for election at Dell's next annual meeting. Mr. Icahn also submitted acquisition proposals to Dell, and filed a lawsuit against Dell challenging certain aspects of the transaction.

Amid this opposition from Mr. Icahn and Southeastern, as well as other shareholders, Dell and the consortium negotiated and announced an increase in the consideration payable to Dell's public shareholders and certain related amendments to the terms of the original transaction. On September 9, 2013, Mr. Icahn announced that he was ceasing efforts to oppose the consortium transaction, which was approved by Dell shareholders on September 12. Mr. Icahn also announced that he would be exercising appraisal rights under Delaware law, which allows a shareholder that has not voted in favor of a merger to have its shares appraise d by the Delaware Chancery Court at their "fair value" (Mr. Icahn subsequently announced in October that he was withdrawing his demand for appraisal). The incidence of shareholders exercising appraisal rights for their shares in Delaware companies has historically been low, and it remains to be seen whether the use of appraisal proceedings will be a strategy pursued by activist investors in the future.

> **MetroPCS.** In February 2013, Paulson & Co. announced its opposition to the announced merger between MetroPCS and Deutsche Telekom unit T-Mobile (Paulson was MetroPCS's largest shareholder with a 9.9% holding). Paulson and other MetroPCS shareholders were critical of a number of aspects of the transaction, including the amount and terms of the debt that the combined company would carry. Reacting to these criticisms, Deutsche Telekom subsequently improved the terms of the proposed merger and obtained the approval of MetroPCS shareholders.

> **Smithfield.** In June 2013, Starboard Value announced its opposition to the acquisition of Smithfield Foods by China-based Shuanghui International Holdings Limited. Starboard (which held a stake of approximately 5.7% in Smithfield at the time it announced its opposition) believed that Smithfield could achieve greater value for its shareholders by selling its three operating divisions to separate purchasers, and hired financial advisors to assist it in identifying alternative purchasers for Smithfield. In early September, Starboard published an open letter to Smithfield shareholders that reported that Starboard and its financial advisors were working with "numerous parties" to formulate an alternative proposal to acquire Smithfield at a substantially increased value; however,

Smithfield shareholders voted on September 24 to approve the sale to Shuanghui.

While adverse shareholder reaction to an announced transaction is not a new issue for public companies, the Dell, MetroPCS and Smithfield situations are timely reminders of the significant obstacle that activist investors can present to completing announced transactions.
Although U.S. public companies are not involved, another interesting development in oppositions to an announced transaction occurred when sovereign wealth fund Qatar Holding was successful in causing Glencore International to raise the price it paid to shareholders of Xstrata in Glencore's May 2013 acquisition of the 66% of Xstrata that it did not already own. Following the announcement of the transaction, Qatar Holding (an existing shareholder in Xstrata) purchased additional Xstrata shares so that it held approximately 12% of the outstanding shares. This made its approval necessary for the transaction to proceed, because the merger required the approval of the holders of 75% of the shares not held by Glencore. Dissatisfied with the terms of the transaction, Qatar Holding requested that Glencore improve the terms by increasing the number of Glencore shares to be received by Xstrata shareholders. Following a meeting between Qatar Holding and Glencore in early September 2012, the two parties agreed upon an increase in the number Glencore shares to be exchanged for each Xstrata share, and the Xstrata board of directors recommended that shareholders approve the revised terms. Qatar Holding's role in Glencore's bid for Xstrata has been described in the media as "something of a watershed moment when a sovereign wealth fund acts like an activist shareholder."

Implications of the Current Activist Investing Environment. In light of the broad scope of companies and issues that activist investors are targeting, U.S. public companies, at least those of significant size, should be proactive in preparing for engagement with an activist investor and examine their business, strategic plan and governance practices with a view to identifying issues that activist investors may raise. These companies should be cognizant of the increasing media exposure that activist investors and their investments are receiving, and be prepared for some level of media and investor scrutiny of the company, directors and senior management in the event that the company becomes the subject of activist investor interest. One needs to look no further than the events at nutrition company Herbalife to comprehend how quickly these types of situations can escalate – although Herbalife was particularly unlucky to be caught in what appears to be the cross hairs of historical business relationships.

Steps that U.S. public companies can – and should – take to bolster preparations for an approach from an activist investor include periodic reviews of how the company is perceived by securities analysts and the media; monitoring its shareholder base (including whether anyone is acquiring or disposing of significant amounts of the company's stock); and consistently engaging in dialogue (including through periodic physical meetings) with the company's largest shareholders.

Although it is increasingly unlikely that any company of significant size can rule out the possibility of interest from an activist investor, experience suggests that there are companies that are more likely than others to be targeted. This group includes companies that (1) have a stock price that has significantly underperformed market benchmarks and industry peers; (2) are perceived as having "misallocated" capital – for example, by having large cash balances where the need for that level of cash is not clear, or are not comparing favorably to their industry peers in metrics relating to the return of cash to shareholders; (3) are perceived to be "conglomerates" or otherwise hold a number of different businesses that do not, at least on a superficial level, fit together (and therefore could be sold or separated without affecting the target's "core" business); and (4) are contemplating, or have announced, a significant M&A transaction.

Recently, the increase in activist activity has ignited a debate in the media and among academics, investors and corporate advisors around activist investing, including whether the activities of activist investors are beneficial for U.S. corporations and equity markets. While these questions are good ones, they are unlikely to be resolved in the near future, and so, at least for the time being, each U.S.

public company of significant size should assume that it is likely to attract the interest of one or more activist investors and prepare accordingly.

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