COVID-19 Impact on Shareholder Activism: What Might the Future Hold?

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Table of Contents

1. Introduction and shareholder activism prior to COVID-19

1.1. INTRODUCTION

Activist investors are poised to capitalize on the most intense market correction since “Black Monday” in 1987. To date, the impact that COVID-19 has had on the economy, stock market and employment has not been seen since the Great Depression. Depressed share prices across the market have created an extraordinary buying opportunity for aggressive investors to buy into stocks at incredibly low levels.

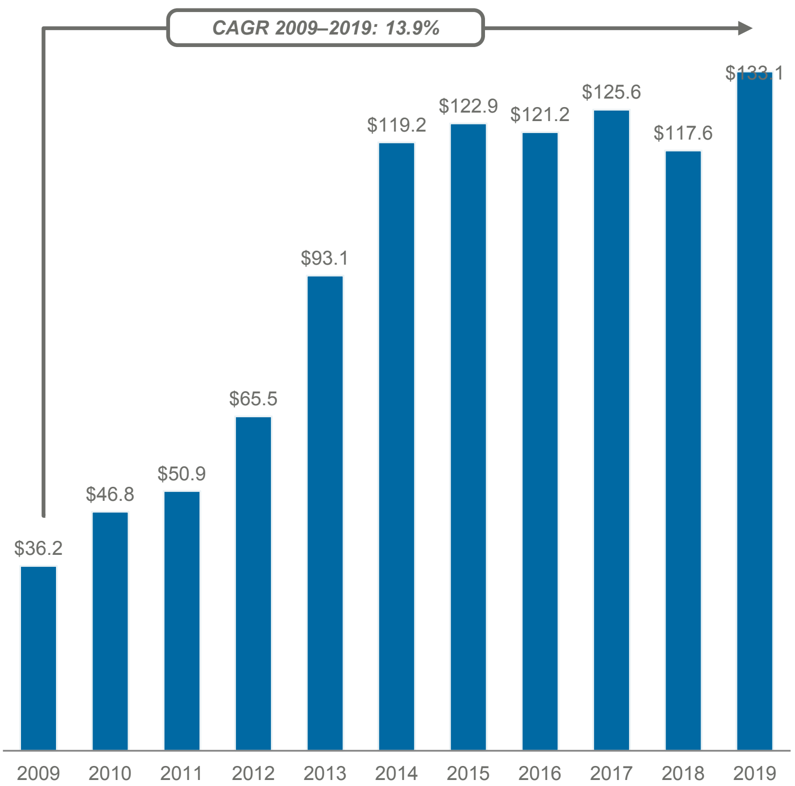
In particular, activist investors, whose market moves are typically monitored by the watchful eye of vigilant companies and stock watch firms, looked to exploit the high levels of trading volatility caused by the pandemic to enter now inexpensive stocks without detection. The resulting landscape will leave poorly performing companies with limited shelter as vulnerabilities, once concealed by the decade-long bull market, are more easily identified and emphasized by discerning activist investors.

Consequently, shareholder activism will increase significantly following the COVID-19 pandemic as stocks trade at meaningful discounts and activists are able to enter stocks under a cloak of volatility, while many companies will struggle to control the exposure of their increasingly noticeable vulnerabilities.

1.2. SHAREHOLDER ACTIVISM PRIOR TO COVID-19

Over the past several years, shareholder activism has established itself as a permanent fixture and asset class of its own in the global economy. Activists have continued to apply pressure to company boardrooms after the strategy’s surge to prominence following the 2008 global financial crisis. Activist hedge funds’ assets under management (“AUM”) increased rapidly following that financial crisis rising from ~$36 billion in 2009 to ~$119 billion in 2014, however, the sustained levels of AUM over the last 5 years is evidence of a paradigm shift rather than a temporary market reaction.

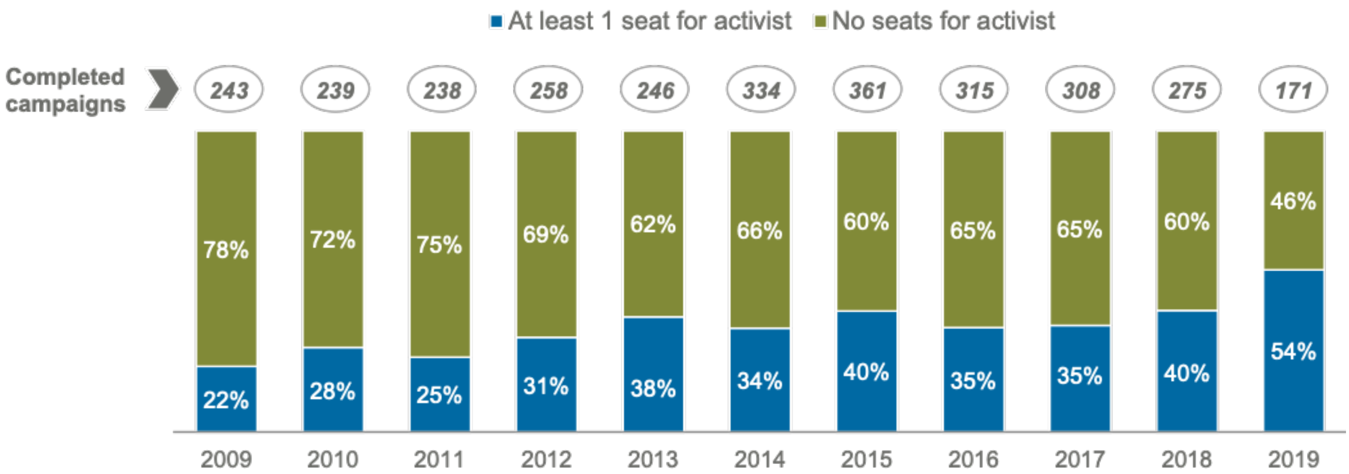
Total direct activist hedge fund AUM ($bn)



Sources: HFR Industry Reports © HFR, Inc.

Not only do activists have unprecedented levels of capital at their disposal, but they deploy it more successfully. Activists' effectiveness in gaining influence has increased over the years, and they have developed more sophisticated strategies for effecting change at a company. Today, the likelihood a campaign results in board representation for the activist has increased ~145% since 2009.

Activist campaigns resulting in Board representation as a % of completed campaigns, by announcement year*



Source: FactSet financial data and analytics

**Represents the following campaign types: Board control and representation, enhance corporate governance, maximize shareholder value, remove director(s) and remove officer(s) – Excludes: vote/activism against a merger*

Note: Completed campaigns is defined as a proxy fight that was withdrawnor settled or a winner was announced, or, for a non-proxy fight activist campaign, a logical conclusion (e.g., value demand was granted, activist withdrew demands or sold stake, etc.) was reached

2. Overview of COVID-19 disruption

At the outset of the COVID-19 pandemic, financial markets experienced incredible, near-unprecedented volatility as the S&P 500 suffered one of its worst market corrections in history, falling ~34% from record highs in roughly a month. Global social distancing mandates and stay-at-home orders brought much of the world and global economy to a halt. Many companies were forced to reduce or suspend operations, resulting in severe losses and a wave of bankruptcy filings. To date, the market has rebounded and recouped a significant portion of these losses, yet there still remains significant uncertainty surrounding the global economy and the full impact of the pandemic may have moving forward.

Unsurprisingly, we have observed a notable decrease in the number of new public campaigns launched by activists during the pandemic. Many activists have even settled or suspended their pending campaigns in light of the current environment. While these activists may have chosen to avoid expensive, protracted proxy battles under the circumstances, they most likely considered another powerful, underlying driver from a long-term strategic perspective – they do not want to be viewed as profiteers. In the post 2008 crisis era, activist investors were successfully able to re-brand themselves from reviled corporate raiders to defenders of shareholder value. This re-branding led to more credibility in the board room and, most important, with institutional shareholders. Over the last decade, this newfound credibility has allowed them to become much more effective at rallying shareholder support for their proposals, and institutional investors are more frequently siding with activists in proxy contests. Savvy activists are not willing to jeopardize that credibility and risk being viewed as a fund that opportunistically preys on vulnerable companies to the detriment of other shareholders. Make no mistake, however, that activists are planning their next move – they are for-profit organizations and it is their very nature.

Select institutional investors' voting behaviour at proxy contests (2015-2019)

Institutional shareholder	# of proxy contests voted	Support for dissident slate: Full slate	Partial slate	Total
BlackRock	95	7%	15%	22%
Vanguard Group	95	13%	21%	34%
SSgA Funds Management	84	6%	17%	23%
Fidelity Management & Research Co.	35	14%	6%	20%
BNY Mellon	63	14%	24%	38%
Goldman Sachs Asset Management	53	25%	34%	59%
T. Rowe Price Associates	51	29%	20%	49%
Norges Bank Investment Management	57	9%	9%	18%
Northern Trust Investments	84	14%	16%	30%
Wellington Management Co.	28	29%	18%	46%
Invesco Advisers	21	33%	19%	52%
Franklin Templeton Investments	21	29%	24%	52%
Dimensional Fund Advisors	99	24%	22%	47%
AllianceBernstein	74	18%	11%	28%
CalPERS	88	16%	22%	38%
TIAA-CREF Asset Management	76	12%	16%	28%
CalSTRS	71	23%	27%	49%

Sources: Proxy Insight and FactSet financial data and analytics – Support for dissident slate refers to Board-related proxy contests only

Note: Sample set shown here comprised of investors that voted in 10 or more proxy contests, includes non-U.S. proxy contests and campaigns

3. Rise in shareholder activism in the aftermath of COVID-19

3.1. MANY COMPANIES WERE TRADING SIGNIFICANTLY BELOW THEIR 52-WEEK HIGHS

COVID-19 created an extraordinary buying opportunity. Stocks across the market saw their valuations rapidly shrink from all-time highs during a month-long trading frenzy. The deflated share prices provided an opportunity for investors to purchase stocks at discounted prices and likewise presented activists with a wider range of targets. Blue-chip stocks, positioned to weather the COVID-19 pandemic, were expected to experience solid recoveries and activists were able to buy in at levels they did not think possible just a few months ago.

3.2. SURGING VOLATILITY DURING THE SELLOFF ALLOWED AGGRESSIVE ACTIVISTS TO BUY INTO STOCKS UNDETECTED

The COVID-19 market correction saw stock market volatility surge to levels not seen in decades. The widespread price declines coupled with heightened volatility and trading volumes, provided a unique opportunity for activists to buy into discounted stocks **largely undetected**. Multiple sources reported that activist investor Bill Ackman supposedly deployed upwards of $2 billion during the market selloff. Activists work incredibly hard to preserve their element of surprise. A well-timed public campaign disclosure can often catch sleepy management teams off balance, increasing the likelihood the company will acquiesce to demands. As a result, while certain activists may hold off on public agitation in the near term, companies should expect to see new activist positions and a resurgence of campaigns once the macroeconomic environment stabilizes.

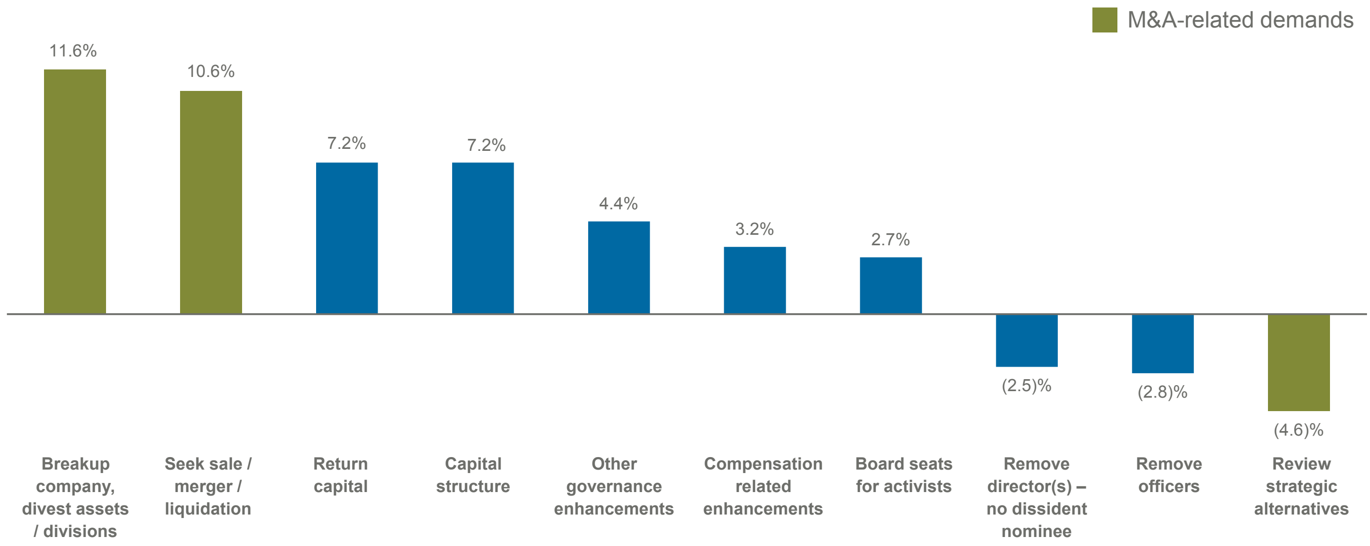
3.3. STRUGGLING COMPANIES HAVE NOWHERE TO HIDE

The decade-long bull market insulated a lot of companies through inflated valuations. Now, despite the recent price recovery, the protection of that historic bull-run has largely disappeared. Poorly performing companies and management teams have long benefited from the recent economic boom as profits and valuations routinely touched all-time highs, and the economic boom provided cover for lackluster companies that might otherwise have been the subject of an activist's attention. Moving forward, however, company valuations will likely align more closely with fundamental performance, which in turn will allow activists to identify vulnerabilities more easily.

3.4. ACTIVISTS LOVE AN M&A THESIS

Pushing for companies to sell themselves or engage in other forms of M&A have become leading campaign theses for activists over the past few years. Given this trend, some activists may see the Covid-induced uncertainty as an opportunity to push for M&A at vulnerable companies. Bear markets often spur consolidation within industries as stronger companies acquire troubled ones that lack the liquidity or prospects to continue on a standalone basis. The economic slowdown has already driven some companies into bankruptcy with more expected to follow. Some industries may be permanently disrupted at this point with only their largest companies able to survive due to their scale and strong balance sheets. In this environment, activists may seek to steer potential targets toward attractive transaction premiums.

Select value and governance demands growth over time in the U.S. (Q1 2010–Q1 2020 CAGR)*



Source: FactSet financial data and analytics

**Represents the following campaign types: Board control and representation, enhance corporate governance, maximize shareholder value, remove director(s), remove officer(s) and vote/activism against a merger. Individual campaigns may be classified under various value and/or governance demand categories; excludes the removal of takeover defenses.CAGR calculations include value/governance demands not listed herein.*

3.5. SOME ACTIVISTS STAND READY WITH DRY POWDER

Some more conservative activists opted not to buy into the volatile market, but rather accumulated significant amounts of cash during this period. Many activists, including some high profile funds, reportedly sought to raise additional funds during the selloff. Some activists sold into cash once the market turned, while others saw the downturn coming and appropriately hedged the impending market dip. However they accumulated these war chests, activists are currently planning when, where and how to deploy these funds.

3.6. ACTIVISTS WILL FOLLOW THE CASH

Some conservative companies accumulated significant amounts of cash during the pandemic. As the turmoil started to become widespread, many companies drew down on their revolvers or otherwise stocked up on cash to weather the storm. While this action by management teams seems prudent in the face of uncertainty, they should be wary of sitting on cash for too long. As the dust settles, companies will more accurately be able to assess their actual liquidity needs. Should companies on solid financial footing hold excess cash for too long, activists will target and demand that they return that cash to shareholders.

3.7. ACTIVISTS CAN NO LONGER RELY ON MARKET BETA TO GENERATE RETURNS

No longer will investors benefit from the notion that a rising tide lifts all boats and exiting an economic expansion, activist investors cannot rely on the momentum of the bull market to generate alpha. Unfortunately, while the market may stagnate, expectations on activists from their limited partners (“LPs”) will not. Activist investors are expected to generate returns no matter the macroeconomic environment. In such conditions, crafty activists understand the need to demonstrate value and look to create their own catalysts through public engagement and agitation.

4. Shareholder activism headwinds to consider as the world recovers from the pandemic

4.1. AMID THE TURMOIL, MANY ACTIVISTS SETTLED OR ABANDONED ONGOING CAMPAIGNS

As the market came to grips with the current and potential future impact of the COVID-19 pandemic, many activists moved to abandon or settle their ongoing campaigns. While one could conclude this was indicative of a fundamental change in activist activity, we believe it was a short-term adjustment. Understandably, activists do not want to be viewed as profiteers that distract companies from their COVID-19 responses, and activsts themselves are neither immune to the uncertainty nor their responbilities to their LPs. Many are trying to navigate the pandemic just like other investors. The pullback in campaign activity seems a sensible move in many cases since the state of affairs going forward is still largely unknown. Let there be no doubt, however, that these activists will resume agitating as soon as some sort of clarity emerges or even before as their LPs do not pay them to sit on the sidelines.

4.2. CAPITAL RAISING MIGHT BE DIFFICULT FOR ACTIVISTS

Activists may see a significant increase in redemptions following the COVID-19 pandemic. Investors may be reacting to poor performance or could simply want to secure their own cash balances. Whatever the reason, activist funds with short investor lockup periods will have to work overtime to retain and raise new capital. Activists will need to identify deep-pocketed, long-term LPs willing to give some leeway while they figure out the new landscape.

4.3. ACTIVISTS MAY HAVE A DIFFICULT TIME COMING UP WITH VALUE ENHANCING THESES

Many of the usual levers activists use to unlock shareholder value may not be available in the aftermath of the pandemic. Actions such as buybacks and special dividends may be frowned upon in the near term. Further, activists' criticisms might not carry much credibility with shareholders. How can they claim to have the answer to a company's problems when these are basically unprecedented times? No one has experience implementing operational changes on the heels of a pandemic of this magnitude. It may be difficult for activists to convincingly put forth that they have a better plan moving forward from COVID-19 than a company's management and board.

4.4. POORLY PERFORMING MANAGEMENT TEAMS MAY TRY TO SCAPEGOAT COVID-19

It may be difficult for outsiders to determine what portion of a company's undervaluation is attributable to COVID-19 market effects vs. a company's specific underperformance. Even if an activist believes they can clearly see flaws in the fundamental operations of the company, there will inevitably be certain management teams that try to hide behind the pandemic as a blanket excuse for poor performance. In anticipation of this, activists might integrate their principal demands with criticisms of the company's COVID-19 preparedness and response. Focusing criticism on the company's specific actions during the pandemic will make it more difficult for the company to claim impunity for preventable missteps.

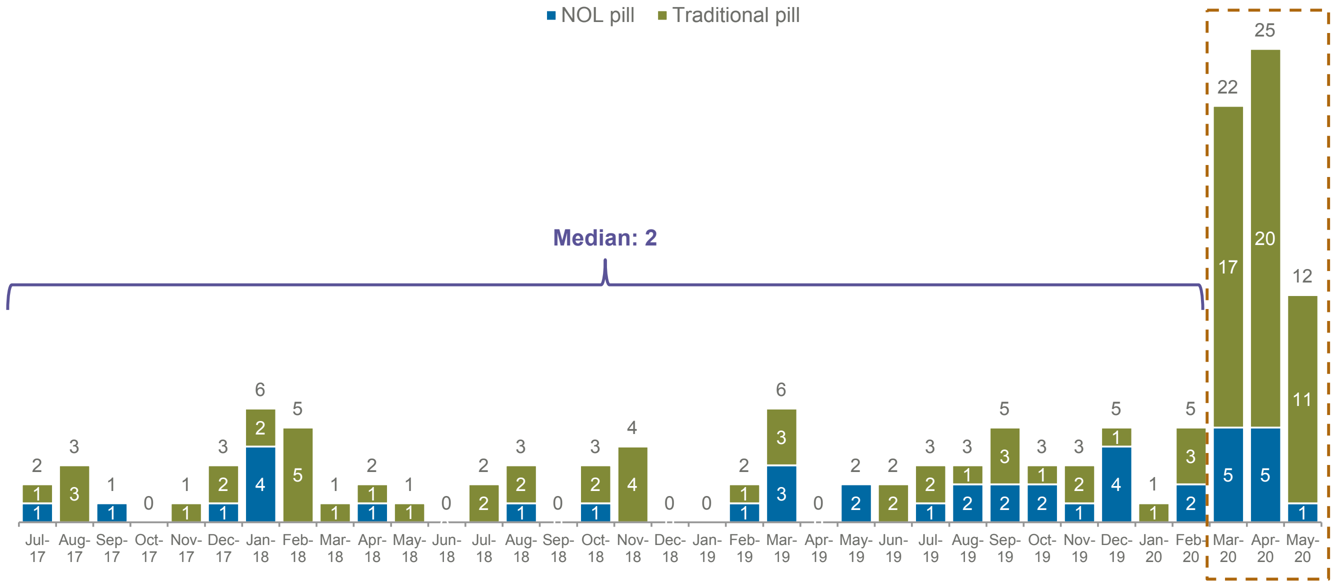
4.5. SHAREHOLDERS MAY BE RELUCTANT TO SHAKE THINGS UP IN THE WAKE OF COVID-19

An activist-driven board refreshment may be a difficult pitch in the wake of the COVID-19 pandemic. There will be a substantial need for experience and organizational knowledge as each company tries to navigate the new normal after the pandemic. For the foreseeable future, the tone surrounding the desirability of long-tenured board members may change as many companies may seek to leverage their experience and institutional memory.

4.6. THE RESURGENCE OF POISON PILLS MAY DETER ACTIVIST ACTIVITY MOVING FORWARD

After years of dismantling anti-takeover defenses, significant drops in share prices have led a number of companies to implement shareholder rights plans.

Shareholder rights plan adoption rates (July 2017–May 2020)



Source: FactSet financial data and analytics

Note: Includes original plans for all U.S. and Canadian headquartered companies

During the heart of the pandemic, shareholders were quite receptive to companies implementing short-term rights plans. In fact, Institutional Shareholder Services, a well-respected proxy advisory firm, published guidance affording companies the latitude to adopt short-term plans with reasonable triggers in response to active threats. Nevertheless, while the adoption of shareholder rights plans ballooned in response to the pandemic, it is important to understand their limitations. A rights plan provides a mechanism that discourages coercive offers and encourages bidders to negotiate with the board for a fairly priced deal. In an environment such as this, a rights plan provides the board valuable time to evaluate all of its options and alternatives but these protections apply principally to offers to take over the entire company. Activists need not purchase an entire company to influence change. In fact, activists today agitate while owning much smaller stakes than their corporate raider predecessors seeking to take control of companies. A rights plan is a convenient and perhaps necessary takeover protection in the current environment, yet it will not provide a full-proof shield for companies seeking to avoid drawing the ire of an activist investor.

5. Conclusion

The market disruption to date caused by COVID-19 gave rise to conditions that should lead to a surge in shareholder activism as the market begins to stabilize. Factors such as heightened volatility and a respite from all-time-high valuations provided ideal conditions for stake accumulations and generated a plethora of new targets for activists. Industries hit the hardest by the pandemic will experience periods of consolidation, buttressing the viability of activists' favorite thesis of pressuring for M&A. As the economy copes with the current and potential future effects of COVID-19, some sectors may permanently change as we know it; however, activist investors are here to stay and will only look to bolster their positions as the world adapts to a new normal. Though relatively quiet at the moment, activists do not get paid to sit on the sidelines and will continue to put money to work in the aftermath of the COVID-19 pandemic.

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