Investors Mutual Market Musings

January 2015: Shareholders at the Gate

IML INVESTORS MUTUAL LTD

"*As an institutional shareholder of Lion Nathan, we remain concerned regarding the company's attitude towards shareholder wealth. Over the last few years the board and management must take the "credit" for successfully destroying shareholder wealth through the company's forays into China, Pepsi and more recently pubs in Victoria ... Please forget about Argentinean wine assets or any further wonderful ideas such as China, Pepsi or pubs. Just continue to run your beer business as well as you have and reward shareholders such as us through increased dividends*."

Letter dated 16 November 2001 from IML's Anton Tagliaferro to Lion Nathan's then Chairman Geoff Ricketts

To what extent should the owners of a company get a say in the way it is run? Historically, very little; but a trend is now developing for shareholders to increasingly get involved in a company's affairs. No longer content to trust the company to do the right thing on their behalf, shareholders are increasingly agitating for change on a wide range of issues fundamental to growing shareholder wealth. An example is seen in the above quote. Investors Mutual advocated against Lion Nathan's ill-conceived strategy in the early 2000's, which strategy we considered was tantamount to "diworsification". The company ultimately retreated from this strategy, and indeed sold off or trimmed down many of the businesses bought, with shareholders enjoying the fruits of the about-face.

Shareholder activism, as it is known, is becoming increasingly more common and successful in effecting change. It brings with it an increased level of democracy in the running of public companies and raises the accountability of boards that have long enjoyed a cosy existence far removed from the owners whose interests they are employed to serve. This edition of *Market Musings* examines the global trend of shareholder activism and how it is playing out in Australia.

What is Shareholder Activism?

It seems something of an oddity that the owners of a company should have so little control over the way it is run. Possession is however nine-tenths of the law, and in the long tradition of the public company, it is the board who holds possession. Theoretically at least, the board is there under a fiduciary duty to serve shareholders and to further their interests. Sometimes, shareholders believe that a board is failing to uphold its duty – for example, by squandering shareholder funds on ill-conceived acquisitions – and shareholders may take it upon themselves to do something about it. This typically starts out cordially enough, based around a constructive and private dialogue between the activist shareholder and the board. It is only in very rare instances that disagreement ensues, shots are fired and the matter spills out into the public.

Shareholders have only limited means by which to force change. The most fundamental is the right to choose directors, which at the extreme gives shareholders an ability to unseat the board and put in place one more complicit with their agenda. In Australia, this requires just a simple majority of votes cast, a hurdle that is in theory easily attainable. The threat of unseating a board will often be enough to encourage the board to fall into line, at least when the agenda sought has support from a sufficient core of shareholders. Broader shareholder support is not a given of course, and getting the numbers often proves much more difficult than first thought. A registry of shareholders is very often diverse in its views and interests and apathy often rules amongst most. Other legal means are available to force change, but these generally involve higher thresholds of shareholder support and are less effective, thus being relied on generally only as back-up[1]. In addition to legal channels, it is also possible for shareholders to advocate their agenda through the media, with the idea of pressuring the board to reconsider its stance, as well as to garner broader shareholder support.

All of the options just discussed are however only a means to an end. Shareholder activism invariably has a goal of effecting change that enhances shareholder wealth. A few common examples will suffice:

- Advocating for the sale of a division, a break-up of the company, a demerger, or the outright sale of the entire company.
- Advocating industry consolidation:

  "*We are concerned about the long-term prospects of Foodland given its significant scale disadvantage ... Given the increasing competition, it appears to us that for Foodland to remain viable in the Australian market, it needs to gain a recognisable 3rd player status. We would thus like to suggest that the board of Foodland consider a merger with Metcash to achieve this aim ...*" (Letter of 21 May 2004 from IML's Anton Tagliaferro to Foodland's Chairman Len Bleasel)

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[1] An example is last year's failed attempt to block Roc Oil's merger with Horizon Oil. The merger was effected without the need for Roc's shareholders' approval. Roc's largest shareholder called an extraordinary general meeting to change Roc's constitution to allow shareholders to vote down the transaction down. The resolution required the support of 75% of votes, and while a majority of votes was achieved, it fell short of the 75% threshold.

- Seeking capital management, whether by way of a capital return, a buyback, the payment of a special dividend, a change in dividend policy or the release of franking credits:

  "[W]e believe the time is right for the company to significantly increase dividends to shareholder in the next few years... With the expected reduction in debt levels from the increase in cash flows from Pluto we encourage the board of directors to increase Woodside's dividends to at least match its historical payout ratio of 60% - although a higher level may be justified given the bulk of the capital expenditure is now behind the company... While we cautiously support some increase in exploration spending to provide long term growth options for Woodside, a more balanced approach would involve consolidating your achievements of the last few years and being fully focused on getting the Pluto 2, Sunrise and Browse projects to fruition and to utilise the growing cash flow to increase dividends and reduce company debt further." (IML letter of 20 July 2012 from IML to Woodside Petroleum's Chairman Michael Chaney)

> *"[t]he Board has concluded that it would be appropriate to pay a special dividend to shareholders now and increase the company's dividend payout ratio … These initiatives reflect the Board's commitment to disciplined capital management and a desire to distribute franking credits to our shareholders."*
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> Quoting Michael Chaney in an ASX announcement from Woodside on 23 April

- Seeking management change:

  "What appears to perhaps be lacking is expertise at the 'front end' of the store at Coles Myer. This is something which is critical to the success of the company moving forward. There are currently plenty of Australian candidates who have a proven track record of success in retailing in this country who we believe would contribute greatly ... Importantly, some of these people may over time help build the right culture within Coles Myer's retail operations, something that appears distinctly missing at Coles particularly when compared to the likes of Woolworths and Foodland." (Letter of 22 September 2002 from IML to Coles Myer's Chairman Stan Wallis)

The Trend of Increasing Activism

Shareholder activism is not a new phenomenon of course. Investors Mutual, for example, has relied on shareholder activism with regular consistency since starting up in 1998. What is new however is the vigour, frequency and breadth of its general use.

The origins of shareholder activism are found in the ashes of the Great Depression when investors took it upon themselves to attempt to improve corporate performance largely out of a sense of despair. Their attempts were often unsuccessful as they were unable to muster sufficient support from other shareholders. Instead, shareholders' only option was to sell their shares in what became known as the "Wall Street Walk". Shareholder activism started to gain traction in earnest in the 1970's beginning with the rise of the institutional investor – in whom voting power became much more concentrated and who had greater time and interest in pushing for change - as well as a result of the loosening of shareholders' rights. The 70's also heralded a new breed of menacing and disruptive investor, including Carl Icahn in the US, the grandfather of activist investing, and closer to home, the likes of Sir Ron Brierley and Gary Weiss. Their careers were characterised by corporate raids and confrontational activism. While a rare breed back then, they remain around today to occasionally share in the fun, albeit in a more crowded space.

Up until recent history, shareholder activism had largely been reactive in nature. Predominantly large institutional shareholders who had suffered from a company's long-term underperformance sought to intervene out of a sense of frustration. Today, the shareholder activist movement has progressed to the point that activist investing has become an investment strategy in its own right, with dedicated activist funds attracting an increasingly larger share of fund inflows following strong returns over the last decade. Reflecting the style of Sir Ron Brierley and other pioneers, these dedicated funds are proactive in nature. They actually seek out underperforming companies at which they can invest and then immediately employ activist strategies to try to quickly turnaround performance and make a quick buck. According to estimates by investment bank Credit Suisse[2], activist investors now have over $200 billion globally in funds at their disposal, up from less than $10 billion at the turn of the century. Indeed, the largest IPO in Europe last year was Pershing Square Holdings Ltd, a listed investment company that raised US$2.7 billion and that was set up by Bill Ackman's Pershing Square to focus on activist opportunities. While seemingly large numbers, the amount dedicated to activist investing is still a mere drop in the ocean in the context of the broader funds management industry. However, what they lack in financial ammunition, they make up for in other ways.

2 "Activist opportunities in Australia", Credit Suisse, 18 November 2014

In 2013, Carl Icahn announced via Twitter that Apple, the largest company in the world and a company in which he had just built up a mere 0.4% stake, was undervalued and could be worth significantly more if the company bought back more stock. The immediate reaction from the market was to add US$17 billion to Apple's market value - such is Icahn's following and the respect he has built up from past successes - and the stock's value only climbed higher as the board ultimately gave in to the larger buybacks that he instigated. Activists like Icahn clearly benefit from new social media outlets such as Twitter that give them a broad voice, on top of the keen interest from old media. Increasingly supporting their efforts is the institutional investor, who is under pressure to produce short-term results and who is increasingly giving its support to an activist investor's campaign. In some cases, institutional investors are even approaching activists looking for their help to turnaround underperforming companies.

Once considered with disdain, activist investors are now starting to gain the respect of the boardrooms of even the largest companies. Activist campaigns have proven to be able to succeed in unlocking shareholder value, and this fact has encouraged some boards to more sincerely engage with activists, which in turn has ensured greater success and encouraged more activity. This has allowed shareholder activism to build a momentum all of its own, at least in the US. Once only employed as a strategy at smaller companies where change has been easier to coordinate, a band of high profile activist investors have also taken aim at mega-caps such as Apple, DuPont, Microsoft and Pepsi.

Shareholder Activism Gone Too Far?

Activism is also broadening in terms of the change sought. Previously, most activism was aimed at simple financial engineering, a move that often had the aim of a one-time share price fillip, but which arguably had less long-term value add. Now activists are campaigning to replace management, to direct business strategy and to even change the way a restaurant should cook its pasta.

In support of its efforts last year to overthrow the board of US-listed restaurant company Darden Restaurants, Starboard Value gave a now customary 300-page PowerPoint presentation on the reasons behind the operational and other changes it sought at the company. In it, the firm wrote "Shockingly, Olive Garden [a restaurant the company owns] no longer salts the water it uses to boil the pasta, merely to get a longer warranty on its pots … We believe this results in a mushy, unappealing product that is well below competitors' quality despite similar cost."[3] Interestingly, Starboard Value eventually succeeded in its assault on the board whilst owning just 9% of the company, leading Fortune magazine to just pronounce Starboard Value's Jeff Smith as "the most feared man in corporate America"[4]. Let's hope for Darden's sake that he knows how to cook a mean spag bol!

Shareholders are of course not always best placed to dictate these types of changes. In recent years, Bill Ackman's Pershing Square took an activist position in US-based retailer JC Penney and instigated sweeping changes that included replacing the management team and radically up-ending the business strategy[5]. The changes failed miserably and the once iconic department store now finds itself on its knees with a third less sales and half the market valuation. Meanwhile, Pershing Square has moved on and indeed prospered despite the permanent damage done. A more extreme example is social activism, which seeks to push a social agenda that may even detract from a company's business. In 2012, a social activist group called GetUp! forced Woolworths to put a resolution to shareholders that would limit the bets allowed on poker machines the company ran to $1. The resolution gained only 2.5% of votes cast but cost Woolworths $500,000 to deal with. These examples show that some limits on shareholders' powers are warranted.

The Australian Experience

The US is clearly leading the charge in the rise of shareholder activism, but as with most developments in the finance industry, what works on Wall Street will soon enough make its way offshore, and it seems the trend is slowly making its way to Australia. Public displays of activism, in the mould of the US model, have been rare in Australia but there are instances that suggest it is beginning to take hold.

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[3] See page 163 and on in Starboard Value's presentation found at http://www.shareholderforum.com/dri/Library/20140911_Starboard-presentation.pdf

[4] See http://fortune.com/2014/12/03/starboard-capitals-jeff-smith-activist-investor-darden-restaurants/

[5] See presentation on the changes sought at http://av.r.ftdata.co.uk/files/2012/05/ira-sohn-pershing.pdf

Last year, US-based fund Lone Star sought to effectively overthrow the board of Antares Energy, an oil and gas exploration and development company listed on the ASX, and a company in which Lone Star held just 6%. Its premise was to correct what it considered were management failures and problems with the company's corporate governance. Lone Star undertook a very aggressive activist campaign that even included personal attacks on Antares' personnel. Lone Star ultimately failed, but the saga evidenced that the Yanks are looking across to our shores for targets, and that they will bring with them their brash tactics.

As in the US, a handful of dedicated activist funds have been set up in Australia in recent years. These funds - Thorney Opportunities, Cashel Capital Partners, Sandon Capital and the Companion Fund – are however comparatively small with about $300 million between them. They have generally targeted small companies in which they can build up reasonable stakes from which to launch activist campaigns, and they have yet to take any landmark scalps. Mark Carnegie via his Companion Fund has sought out larger targets including Fairfax, Qantas and Soul Patts, and he has skillfully been able to leverage off the much larger shareholdings of others to claim more sizeable shareholdings. Even still, his efforts have so far been largely unsuccessful, with many institutional and other shareholders unwilling to get involved.

In contrast to the US experience, it seems the inability of activists to make inroads may discourage future efforts, at least to the extent it involves going public. This would be an interesting result given that Australia has one of the most accommodating legal frameworks with which activists can actually work with globally. For example, in contrast to many overseas jurisdictions, shareholders in Australian-listed companies with just 5% can call a general meeting to vote on any resolution and can force the company to send out to shareholders whatever supporting materials they wish[6]. This includes putting forward arguments to ouster current directors, who are limited by the law in what materials they can provide in defence[7]. A simple majority of votes cast is all that is then required to appoint or remove any or all directors. Then there is the two-strikes rule that can lead to a spill of the board if the company's remuneration report is voted down by a mere 25% of votes at the annual general meeting two years in a row. This is the lowest threshold globally for leverage against a board.

The Collaborative Approach of Shareholder Activism in Australia

Part of the difference in the role of shareholder activism in Australia comes down to culture. Far less brash than the US, Australians, like the Europeans, tend to seek change in a more consultative manner and behind closed doors. The experience of Investors Mutual is that this approach is significantly more effective, and it is thus our preferred approach. Indeed, according to recent research by McKinsey, collaborative activism results in the greatest subsequent long term returns for shareholders[8].

Last year, the US-listed Coca Cola put to shareholders a vote on a controversial remuneration plan. Wintergreen Advisors ran a very public campaign to vote down the plan but it nevertheless went through. Warren Buffett, who owns 9% of the company, abstained from voting on the plan, despite later calling it "excessive". To this he said: "I don't think going to war is a very good idea in most cases". Subsequently, Buffett was seemingly able to work behind-the-scenes and ultimately the company dropped the plan a number of months later. In our experience, a public attack on a board tends to invite a defensive posture and often ensures a board stubbornly digs its heels in to save face.

The advantageous legal framework referenced above is actually helpful when it comes to a collaborative approach to activism. Directors are far more willing to engage with shareholders who are more easily able to vote them out. We have found that the two-strikes rule discussed earlier, which commenced only in 2011, has encouraged many boards to engage more frequently with its larger shareholders on all sorts of matters, not just remuneration reports. This has been a helpful development in the collaboration between shareholders and boards. Providing this collaboration continues, it will be very rare that activism will spill out into the open in Australia.

The Value of Shareholder Activism

The issue arises whether shareholder activism is actually a good thing for the long term benefit of a company. After all, for long term orientated investors such as Investors Mutual, it is contradictory and indeed counterproductive to seek out short term gains at the expense of seeking out longer term shareholder value.

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[6] It is currently also possible for 100 shareholders to band together to also do so, but the so-called "100 member rule" is getting scrapped.

[7] The law is unclear here but the 1987 decision of Advance Bank v FAI has been taken to mean that there are constraints on what the board can do in guiding shareholders how to vote on their re-election.

[8] http://www.mckinsey.com/insights/corporate_finance/preparing_for_bigger_bolder_shareholder_activists

It is understandably considered questionable when a short-term orientated hedge fund looks to make a quick buck by adopting what is quite an obvious but common strategy of buying an undervalued company and soon after advocating that the company put itself up for sale. On the other hand, and to take the same agenda, it may be that long-term orientated shareholders such as Investors Mutual see potential in the company but take the view that it is unlikely to be realised whilst public. Such shareholders may then force the issue, and rightly so.

An example is that of Spotless Group, the cleaning and outsourced facilities management business that was taken over in 2012 by private equity firm Pacific Equity Partners and re-floated last year. Investors Mutual had owned a significant shareholding in Spotless for some time. This investment was premised on its strong cash generation and an ability to grow earnings over time, in particular through a cost-out programme that had the potential to raise margins to those enjoyed by industry peers. By 2011 we had become frustrated with the continuing inability of the then current board and management team to realise its potential, and as a result, we sought to extract value through encouraging a takeout of the company. The board initially resisted such overtures but IML, together with a few other investors, were able to put enough pressure on the board to force the company to ultimately engage with the proposed suitor Pacific Equity Partners. Our position was strengthened by an ability to call a meeting to install a more receptive board. Spotless eventually opened up its books, garnered a bid and crystallised value for shareholders through a takeout. The Spotless example evidences the advantage that private equity has in effecting change out of the spotlight when that change involves significant short term pain that public boards are generally unwilling to take.

> *"[W]e believe it is incumbent on the board to allow Pacific Equity Partners access to the information deemed material to perform full due diligence following their bid ... if the board does not grant access to due diligence, we will support any resolution put to an Extraordinary General Meeting that moves to put in place directors who will support access to due diligence."*
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> Letter dated 16 January 2012 from IML to Spotless' then Chairman Peter Smedley

To be sure, agitating for a takeover is an easy way to make quick returns, but is not always the right course of action. In 2010, Investors Mutual worked with the board of Energy Developments, a company in which we held a stake of more than 10%, to knock back a takeover bid from Pacific Equity Partners. The move involved giving up what were certain short-term gains, and indeed the share price predictably fell once the takeover ended. We did however hold on to capture the long term value we saw in the company, with the stock having almost doubled since and now paying strong dividends. The example shows that shareholder activism is not always about making a quick buck; it is about ensuring a company does what is right for shareholders, and at least as far as Investors Mutual is concerned, this means doing what is likely to maximise possible returns over the long term.

Investors Mutual has been involved in a number of examples of activism over the years. In most cases, our involvement has indisputably been for the long term betterment of the company and it has enhanced shareholder value. The opening example of Lion Nathan is just one. From time to time, there are instances where we are invested in companies at which shareholder funds are being poorly used, corporate governance is weak, some management decisions appear inept, or the company or a division of the company is more valuable in the hands of others. In these instances, there is an opportunity for Investors Mutual to get actively involved with the company to steer it towards a brighter long term future. Too often shareholders take the easy decision and simply sell out, rather than doing something about it. Getting actively involved allows us to unlock a company's potential, albeit often with hick-ups along the way, and this process allows us to earn additional returns as the potential is realised in time. Supporting the case for activism, the McKinsey research referenced earlier shows that such successful shareholder activism generates excess shareholder returns that persist for at least 3 years, and often much longer.

Conclusion

The aggressive US model of shareholder activism that plays itself out in the public has attempted to enter Australia but has yet to gain traction. Outbursts of activism of this type are likely to remain infrequent and generally in reaction to certain events such as takeovers. Activism is noticeably on the rise in Australia but the trend is a gradual one. In our view the development is a positive one, for shareholders and the market overall. At the very least, shareholder activism is helpful in keeping boards and management teams on their toes.

At Investors Mutual, we do not shy away from whatever it takes to maximise the long term returns we can achieve for our investors. We engage closely with all companies in which we are invested, and where we see something that is fundamentally wrong, we will agitate for change. The fiduciary duty we owe to our investors demands it of us.

Julian Beaumont
21 January 2015