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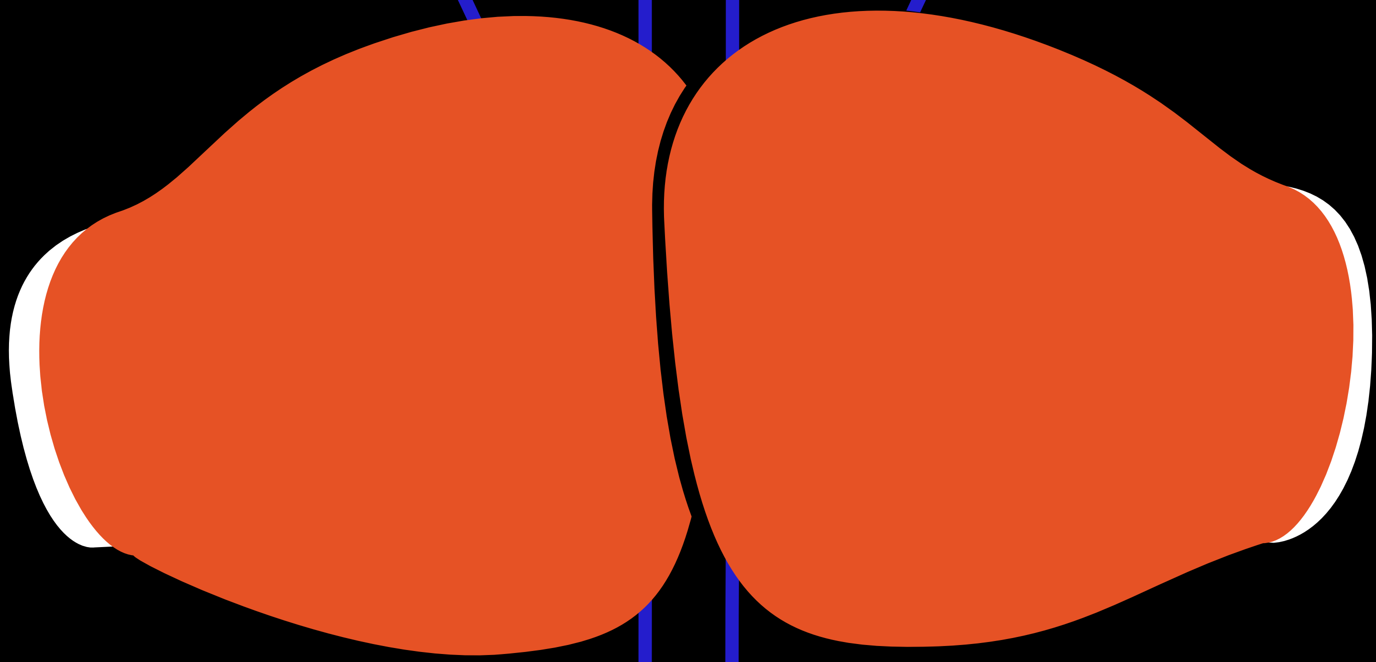
NOT YOUR FATHER'S PROXY FIGHT

In the energy and industrial sectors, activist funds are having more success re-making boards and influencing corporate strategies than ever before. Size is no defense; performance is no defense. The only real defense is a response plan that assumes your company eventually will become a target.



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It used to be that large institutional investors that lost patience with a company's business plan or growth model simply sold their stock and moved on. But today, with so many large investors locked into an index fund investment approach, they increasingly are interacting with boards of directors and company management or are supporting the activist shareholders that do. These activists, primarily hedge funds, are not only supported by these large institutions and pension funds, but, in many cases, the institutions are direct investors in those funds.

In the past, activists most often appeared when a company underperformed. Today, activists also target performing companies. Usually, the activists disagree with a company's capital allocation strategies and push for a higher return of capital to shareholders. This type of balance-sheet activism particularly is prevalent — and successful — in the energy and industrial sectors, in which companies generally hold large cash reserves and hard assets that lock up potential shareholder value that activists propose to liberate. As a result, performance and size no longer should be thought to provide protection against activist interest. As such, all companies should have detailed activist response plans and should incorporate activism defense strategies throughout the investor relations (IR) and communications programs to discourage activist interest. And should activists emerge, companies need to have a base of support in place to defeat an activist's agenda.

This Is Not Your Father's Proxy Fight

Activist hedge fund Elliott Management argued this year that Hess Corporation should spin off assets in the Bakken, Eagle Ford and Utica in order to focus on developing new and unconventional energy resources in other regions of the United States while also divesting downstream assets to free up cash. Elliott insisted that streamlining what would remain of Hess would increase its multiple and improve the company's share performance.

Elliott also accused the company (in which Elliott holds a 4.5 percent stake) of bad management, citing the fact that over the past five years, Hess shares trailed its peer group by more than 30 percent and that Hess' directors had consistently received high withhold votes, indicating shareholder disapproval. Under pressure from Elliott , Hess' board eventually was remade, with eight new members out of 14, three of them nominated by Elliott. John Hess, Hess' Chairman and son of the company's founder, had to give up his position.

This hardly was an isolated occurrence in the energy sector this year, which especially is vulnerable to balance-sheet activism as energy companies hold large tangible assets (refineries, real estate, machinery, etc.) that can be converted to cash relatively easily. These companies also maintain large cash reserves and conservative balance sheets. With oil prices rising, and new discoveries of oil-and-gas-rich shale, investors have plowed cash into these companies with the expectation of large returns. They have been disappointed. Last year, only 30 percent of major U.S. oil and gas companies generated more cash than they spent — the lowest level in five years. This has provided an opening for activists to argue that this underperformance, and those cash hoards the energy companies have built up (which the companies insist are needed to fund future investments, maintain good credit ratings, and mitigate regulatory, operational and environmental risk in what, by definition, is a risk-filled business), constitute a failure to reward investors fairly. Also, there has been a tendency within the energy sector to allow dominant CEOs and founders to exercise significant influence over their companies' boards, raising corporate governance questions that become grist for the activists' mill.

This past May, activist investor Carl Icahn pushed for a large dividend and board changes at Transocean. Although he failed to get the dividend he wanted, he did succeed in electing one director. At roughly the same time, Occidental Petroleum's chairman stepped down in the wake of an investor backlash surrounding the proposed dismissal of the company's CEO. Chesapeake Energy's founder also was forced out.

Last year, activist hedge funds Mount Kellett Capital Management and TPG-Axon Capital Management won four seats on SandRidge's board, and the company's CEO currently is under fire.

Just recently, Oil States International, a Houston, Texas, provider of housing at oilfields, responded to pressure from JANA Partners (which had increased its stake in the company to 11.7 percent) by selling its tubular services business and increasing Oil States' authorized share repurchase program from $200 million to $500 million. The company also acknowledged it was looking into a possible real estate investment trust structure.

Not all the pressure has come from hedge funds, and not all of it is in the energy sector. This year, The Timken Company, a global steel and bearings manufacturer and supplier, responded to Relational Investors LLC, as well as the California State Teachers' Retirement System, by announcing plans to spin off the company's steel business from its bearings and power transmission business.

These are all large, market-leading enterprises with vast resources. And yet their leadership and business strategies were seriously disrupted by activists.

If this could happen to these companies, it certainly could happen to yours.

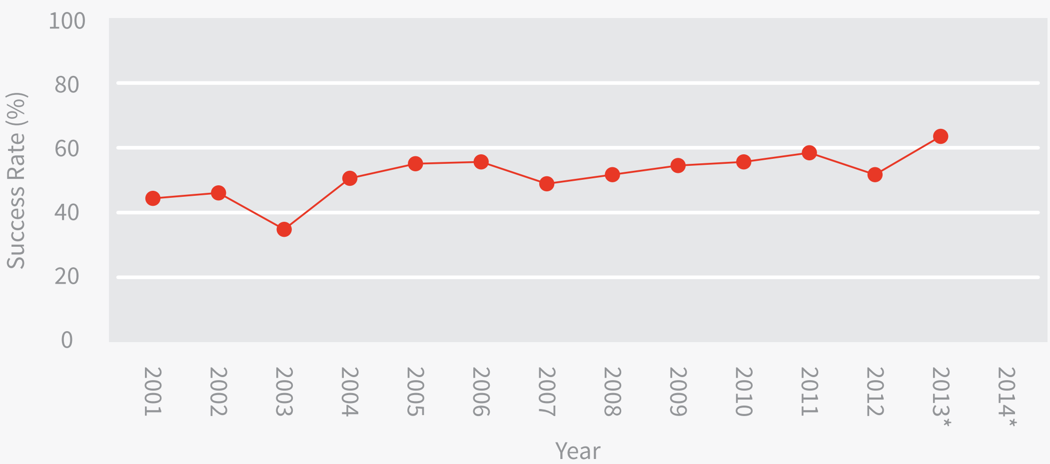
Unfortunately, just as companies became used to the outsized influence in proxy contests of advisory firms, such as Glass Lewis and ISS, and learned how to engage with them, their influence has begun to decrease. Proxy advisory firm recommendations still are very important, but they are not determinative. Today, institutional investors, especially the larger ones, are performing more thoughtful company analyses. Consequently, the landscape of influencers in takeovers and proxy fights has become increasingly complex, extending beyond Glass Lewis and ISS to include the media and sell-side analysts, to name a few. Even among institutional shareholders, the proxy voting decision may rest with a proxy voting committee or a corporate governance professional the company's investor relations officer (IRO) never may have met — not the analyst or portfolio manager he or she knows so well. It has become difficult for many companies to say with certainty with whom and how they should engage in a proxy contest. And by the time the activists gain traction, it usually is too late to build the necessary alliances with the right influencers and decision makers who can turn a proxy contest in management's favor.

Meanwhile, activist funds have more assets under management than ever before. According to Hedge Fund Research, assets managed by activist funds have more than doubled over the past five years to about $73 billion in the first quarter of 2013 as opposed to $32 billion in 2008. That money has become a powerful force. According to Activist Insight, gaining seats on corporate boards to influence structural change has become the primary goal of activist investors, not simply distributing returns to shareholders. Activists are advocating for broad structural changes in companies, and they now can afford to hire better and highly sophisticated advisors, bankers and law firms to press their agendas.

And they're succeeding.

Of the 23 proxy fights for board seats at U.S. corporations in 2013 (as of April 30) that went to a vote, 13 resulted in seats for the activists. Thus, the percentage of proxy fights that management won in 2013 was less than 50 percent, and boards are losing even more seats to activists through the settlement process [see chart below].

Dissident Success Rate, Proxy Fights 2001—Present



Number of outright victories, partial victories or settlements by the dissident as a percentage of all proxy fights where an outcome has been reached.

*Based upon scheduled or anticipated meeting date.

Source:
Alston & Bird LLP, "2013 Proxy Season Outlook,", P.51 and www.SharkRepellent.net

Through April 2013, activists have been successful in attaining at least some of their goals in 64 percent of all contest situations.

Again, this especially is true in the energy and industrial sectors. And a recent Moody's Investors Service report predicts that the surge in investor activism in the U.S. energy sector will continue in 2014.

In some cases, the actions of activist investors have improved shareholder return, at least in the short term. However, the question remains as to whether strategies that encourage leverage and de-emphasize investment in growth will be good for the long-term health of these companies.

Traditional defenses against activists — poison pills, staggered boards, dual classes of stock and so on — have become rarer over the years. Glass Lewis and ISS have recommended against adopting such actions, and shareholders have passed proposals eliminating some of these tactics. Even with these defenses in place, activists still have been able to effect change simply by publically challenging a board or electing a minority slate.

Activist investors, however, are not invincible. Last spring, JANA Partners lost a nasty and protracted proxy fight for five of Canadian chemical company Agrium's 12 board seats because, in part, the company received recommendations for all 12 of its directors from three of four proxy advisory firms, and JANA's slate of director nominees was widely criticized for receiving compensation from JANA.

But even with this help, the vote was very close.

However, with a forward-looking approach to assessing its vulnerabilities and strengths and a properly sequenced response plan, a company can preserve its strategic goals, protect a quality management team from being forced to be overly focused on the short term and allow its board to concentrate on steering the correct course rather than slaloming from obstacle to obstacle.

The FTI Toolkit

How to prepare: Know the activists, know yourself

Energy and industrial companies should understand that their size or market position will not protect them from becoming targets of activist funds, especially if the recent financial or shareholder return performance is lagging behind a company's peers. Furthermore, the traditional strategy of telling a company's story primarily to portfolio managers and analysts at conferences and earnings calls no longer is adequate. Many large institutional investors now have proxy voting committees or corporate governance teams that solicit input from the portfolio manager but control the ultimate vote.

As a result, companies must develop new intelligence and monitoring processes, as well as broader communications strategies.

The first step is to form a preparedness team that should include board members, management, the investor relations officer and the IR team, communications experts and outside advisors (bankers, legal counsel, public relations and social media supporters). This preparedness team must be able to identify the activists in a company's sector and know whether they — or the investors they influence — are taking a position in the company.

The team must be knowledgeable about the activists' track record and which institutions have supported such activities in past proxy contests. Knowing who is lining up against a company dictates how the company will respond. Companies should vet candidates on opposing slates to identify conflicts of interest and other possible weaknesses, as Agrium did in its contest with JANA. In other words, companies must develop an intelligence capability. If activists increasingly are looking to place their own candidates on corporate boards, the quality of those candidates becomes the point where activists may be most vulnerable.

Companies also should continually evaluate the threat landscape. What is the media saying? What are online communities discussing? Who are the activists in your sector? What are they doing? What new investors are acquiring significant stakes in your company? What are the agendas of these new investors? Who influences them? Companies must attempt to identify the true influencers in the respective sector. This is where having an empowered, informed and top-level IRO is critical.

The preparedness team should be designed with clear-cut, documented roles for who should call whom and who is in charge of posting (and vetting) appropriate information on the corporate website when the time comes to take action.

Finally, companies should prepare an internal leak audit to try to control information about unpublicized company activities that could fuel the activists' arguments — paths not chosen, deals not made, etc. Activists generally do not rely upon publicly available information to mount their attacks; they get information from ex-employees and, in some cases, current ones.

Getting Your Story Out: The Three Cs

Transocean, the world's largest offshore drilling company with a market value close to $19 billion, struggled in the aftermath of 2010's Deepwater Horizon disaster. It owned the BP-leased drilling rig that blew up and caused the worst oil spill in U.S. history. Compared with Deepwater Horizon's peers, the company's growth was slow.

In January 2013, Carl Icahn revealed he had purchased a large stake in Transocean, accused management of losing billions in shareholder value, and called upon the company to issue a $4-a-share dividend and to elect three new directors.

Articles in the business press that month, and in the months that followed, featured

Icahn's charges but didn't immediately showcase Transocean's side of the story. Getting a company's story out in this era of social media and the 24-hour news cycle is more complex than it once was. But if companies engage proactively, they will have an easier time of it.

There are three elements to communicating a company's story: content, conversation and collaboration.

Content begins with the IRO and chief communications officer making sure the corporate website says what the company wants it to say, as that's where shareholders, journalists, allies and adversaries first go to learn about a company. According to a 2012 Thomson Reuters survey, 84 percent of institutional investors use the IR website as a source of research information. Clearly, that information must be carefully molded by IR and communications and vetted by legal. And if a company wants the message it posts to be broadly shared, studies indicate that adding images and video make the website far more likely to be viewed.

After the website is optimized, the conversation can begin. Companies should examine their social media policies and strategies to make sure everyone knows what can and cannot be communicated, what's public and what's privileged. Then the company can begin to engage.

Many executives are leery of social media. They're right to be cautious. Social platforms are not without risk. Companies can't control the conversation on social media platforms vs. on a company's own website. But if companies don't engage, their voices won't be heard.

Transocean created a Twitter account, not simply as part of the proxy contest but as another way to tell the story to the investor community, as well as to analysts and journalists. The company brought IR and communications into that channel and used it to leverage the information that already was on the corporate website. (Ultimately, in 2013, shareholders rejected Icahn's proposal to have the company issue a $4 dividend and voted in only one of his three board nominees. And between January and April 2013, Transocean's shares gained 21 percent.)

Increasingly, journalists at mainstream publications are turning to social media to find leads and sources. If a company is not participating on social platforms, it is creating an out-of-sight, out-of-mind risk and is increasing the chance that its viewpoint will not be reflected in the journalists' articles.

Once the corporate message is defined and disseminated to as many influencers as possible, the company can begin developing influencers of its own through the third C: collaboration.

Bloggers, who sometimes have greater sector expertise than traditional journalists, are the oldest part of the social media spectrum and, therefore, are the most easily forgotten — until needed in a crisis. However, it is a best practice to engage with bloggers before they are needed.

Engaging with bloggers does not mean sending them press releases. If a company can cultivate an influential blogger by offering that person exclusive information or access to executives, and by so doing raise the blogger's profile, the company can create a powerful ally in a contest with activists. And a blog can inform mainstream articles that can move minds and votes.

Today, stakeholders are living online. Therefore, companies should have their online strategies baked into the broader communications strategy.

They're Not Going Away

Success breeds success, and the success of activist funds in the energy and industrial sectors will encourage future attempts to bend companies to the activists' will. Companies not meeting their shareholders' expectations, and underperforming in comparison with peers, will become targets.

And perhaps this is fair. If a company is not serving its shareholders' interests, changes should be made. But if a company has a viable plan to change on its own timetable based on the company's judgments, it must be proactive. That means having a response plan in place, deep intelligence about the investors and about the activists, a comprehensive communications plan that ensures the company's story is getting through to its investors directly and through key influencers, and an equally complete understanding of with whom to engage and how to interact with them.

Companies that acknowledge these realities, and take these steps, will be far better prepared to respond to the challenges mounted by activist investors.

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