Shifting Tides of Shareholder Activism: What's Ahead

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With an improving global economy as a backdrop, increasingly competitive returns for activist strategies are driving elevated activist activity. In a seismic shift from what we've seen in the past, the range of targets is widening and larger companies are being targeted more frequently. Simply delivering on financial performance and expected financial metrics is no longer a barrier to entry for activists who have other ideas.

Going forward, we anticipate significant shifts in the activist landscape, encompassing unconventional targets and innovative strategies. The activist world as we know it is evolving faster and in ways that were previously considered unconventional.

Successful activist campaign themes are changing. For example, merger and acquisition (M&A)-centric strategies, once the darling of activists, have become less common in a depressed M&A market. Similarly, environmental, social and governance (ESG) themes have become harder for activists to lean on. Cost reduction for margin improvement, however, is in vogue.

We're also seeing a shift in who is willing to act as an activist. Activists

are finding much more receptive partners among traditional active long-only managers. We are seeing active managers engage in discreet partnerships, leveraging private channels to shape corporate strategy. As a result, while public proxy battles are less frequent, the pressure for change behind the scenes has intensified.

In the face of these changes, CEOs and boards must evaluate the key trends and outlook in activism, reassess their potential vulnerabilities and refresh their strategic defense plans.

Margin Mania: Profitability as an Activist Theme

We will continue to see a paradigm shift with activists moving away from an M&A-centric approach toward campaigns emphasizing opportunities to enhance profits. Elevated interest rates and risk aversion are forcing investors to be more tactical in their approach to sustainable long-term value creation. It is not enough to push for a deal like they could in a bull M&A market with historically low interest rates. This shift is manifesting itself in several ways:

- **TARGET SELECTION**
Rather than targeting underperforming companies with clear divestiture opportunities, activists are setting their sights on established, well-performing, previously untouchable blue-chip names. Recent campaigns by ValueAct at Salesforce and Trian at Disney exemplify this trend as both activists have advocated for board representation and operational optimization measures.

- **INVESTMENT HORIZON**
Unlike the rapid-fire deal chasing of M&A activism, margin-focused campaigns naturally take a longer time horizon. Expect engagements to span 1-3 years (including tenure on the board) characterized by deep operational analysis, strategic partnerships with management, and a gradual unlocking of value through sustained cost-cutting and efficiency initiatives. These campaigns create more pressure for CEOs to balance the quarterly earnings cycle with strategies geared toward medium- and long-term value creation. CEOs can get ahead of these threats by engaging proactively with activist investors, understanding their perspectives and collaborating on operational optimization measures. Furthermore, CEOs should be prepared for more in-depth scrutiny of their companies' operational performances and a commitment to implementing gradual but impactful changes over the extended investment horizon.

- **BOARDROOM INFLUENCE**
Unlike their M&A counterparts who typically exit after securing a deal, margin-focused activists seek board seats to exert direct influence on strategy, oversee cost-reduction initiatives and ensure long-term profitability improvements. This shift underscores the critical need for CEOs and boards to meticulously evaluate and refine their board composition. Striking a balance between bringing in new appointments with fresh perspectives and expertise and maintaining a cadre of independent directors becomes pivotal. The selection process should align with the company's long-term vision and the specific skills required to navigate the intricate landscape of operational enhancement and sustained value creation.

This focus on margin improvement signifies a maturing market where sustainable value creation takes precedence over short-term windfalls. Companies can navigate this landscape by proactively addressing operational inefficiencies, fostering open communication with investors and demonstrating a commitment to long-term value creation. Embracing data-driven scrutiny and addressing margin gaps can help companies avoid confrontations with their investors and drive growth for all stakeholders.

High Valuations No Longer a Defense

Once deemed unassailable given their high valuations, Silicon Valley tech giants are now in the crosshairs of activists. Investors like Elliott (Salesforce) and TCI (Google) are exploiting lagging total shareholder returns despite sky-high valuation multiples. These activists are targeting board composition to shift the focus from growth (and unregulated investment into growth) toward operational efficiency, higher margins and free cash flow.

Fragmentation within some recent growth markets is also creating opportunity. Third Point's advocacy for Peloton to push more broadly into digital fitness is a good example. Peloton makes its money through monthly subscriptions, but as the pandemic subsided and active users began selling off their Peloton equipment, Third Point advocated for a shift to an ongoing fitness program to help sustain its subscription model. The hedge fund's previous activist work at Disney also pushed the entertainment giant into what turned out to be a successful streaming business. This approach represents a significant change versus traditional activist break-up strategies.

Boards and CEOs need to recognize that strong share price performance alone no longer deters activists. In the past, mega-caps often dismissed the concerns of smaller investors, assuming their large size and market dominance provided sufficient insulation. Amidst potential headwinds including generative AI, increasing competition, a shifting regulatory environment and a rerating of multiples, Big Tech is susceptible to activism from various angles.

Fortunately, there are steps large companies can take in response. Companies should conduct thorough vulnerability assessments, enhance communication with shareholders, develop agile response plans and stay legally prepared for action. Additionally, leaders should consider board refreshment, including keeping a strong bench. Finally, they should engage stakeholders and continuously monitor the landscape to stay ahead of activist demands. This proactive adaptation is crucial in fortifying defenses against potential activist interventions.

Active Managers on the Hunt: Intense, Covert Activism on the Rise

In 2023, long-only investors explored discreet engagement with activists as a spectrum of agitators, spanning smaller event-driven funds to newcomers, marked the rise of "covert activism." Notably, institutional shareholders proactively crafted frameworks for heightened engagement, publicly endorsing activism in certain cases.

This signifies a broader shift, with active strategy managers like Fidelity, Capital Group, T. Rowe and Morgan Stanley Investment Management adjusting their approach given the shifting activist landscape. These managers not only established frameworks for increased engagement with portfolio companies but also publicly expressed support for activism in specific instances.

Increasingly, active managers and activists are forming discreet partnerships, using private channels and behind-the-scenes influence to shape corporate strategy. This engagement has its benefits for leadership teams: Public proxy battles become less frequent, replaced by collaborative problem-solving and mutual value creation.

Traditional methods of dealing with activism may need to adapt to this new paradigm. Boards and CEOs need to acknowledge this collaboration between active managers and activists. A proactive approach to engaging with shareholders, understanding their concerns, and being open to collaborative solutions is essential.

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Looking ahead, the industry is likely to see a sustained uptick in collaborative efforts as active managers strive to achieve stronger returns in a competitive landscape. As investor demands evolve and performance scrutiny intensifies, this trend will be a focal strategy of active management firms.

M&A Targeted Campaigns are Back

While activism will be less M&A-centric in the near term, there will still be an M&A component to some activist campaigns. We expect a more dynamic future, marked by increased transaction-focused engagement as the M&A market recovers. We also expect activists to play a prominent role as "soft catalysts," strategically investing in companies poised for M&A activity.

Anticipating an eventual rebound in M&A activity, there are two distinct opportunities for value creation for activists:

1. **MID-CAP TARGETS:** Activists are seeing untapped potential and synergy-driven prospects among mid-cap targets. These companies, often fragmented, offer opportunities for activists to drive consolidations, unlocking latent value as M&A activity picks up.

2. **LARGE-CAP RESHAPING:** Activists are identifying hidden value within conglomerates and large caps and advocating for strategic divestitures. As companies navigate portfolio optimization, activists push for streamlined portfolios through strategic spin-offs. Private equity, which sits on record amounts of dry powder, offers an additional channel for these divestitures.

Activist pressure will grow, fueled by an improving economic landscape and accessible capital. As the market embraces consolidation opportunities, activists strategically position themselves to influence transformative transactions.

CEOs need to acknowledge the growing influence of activists as "soft catalysts" in M&A activities. As outlined above, both mid-caps and large, diversified companies need to be prepared, recognizing that activists aim for value creation through strategic interventions. Taking a proactive stance in evaluating operational and strategic options and being responsive to activist engagement becomes crucial. CEOs must assess the potential for value creation in consolidations or divestitures and remain open to streamlined portfolios. This adaptability is essential for successfully navigating the evolving landscape of activist involvement in M&A.

ESG: From Spotlight to Due Diligence Filter

Recently the north star of activist strategies, ESG in activism is undergoing a nuanced transformation driven by a recalibration of market realities and shifting investor priorities. The surge in commodity prices and inflation concerns after 2022 intensified economic pressures, prompting a reevaluation of priorities toward financial fundamentals. In this landscape, companies are navigating a renewed emphasis on cost optimization and profitability, temporarily overshadowing the exclusive focus on ESG-driven initiatives. The evolving market dynamics highlight a strategic realignment where returns take precedence over ESG optics.

Activists, prioritizing returns, are actively reshaping their use of ESG within campaigns, especially as recent proxy initiatives focused on ESG have not received a majority of shareholder votes. In 2023, activist investor Jeff Ubben shut down his social investing fund amid some of these headwinds. While acknowledging ESG's importance, activists have shifted to strategically targeting impactful environmental controversies or instances that threaten financial viability. This shift emphasizes the imperative for companies to genuinely commit to transparent ESG improvements aligned with financial objectives – including breaking up environmental, social and governance initiatives into separate buckets that more closely reflect business needs. Investors, in turn, need to discern genuine concerns from the optics of ESG as a rallying cry to win support for their campaign.

ESG's relevance will persist, but its influence is being recalibrated in response to economic factors. Companies and investors must adapt, ensuring transparency, tangible progress and alignment between financial and social goals.

Preparedness is the Best Form of Defense

With such a shift in approach to shareholder activism on the horizon, CEOs and boards need to be prepared for new approaches to activism – from altered M&A strategies to demands to improve profitability.

Moreover, they need to expect activism from nontraditional sources. Even traditional shareholders whom CEOs didn't engage with

often (e.g., Fidelity and other active managers) are demanding more detailed information, bringing ideas and following activist proposals. Leaders need to expect these sizable shareholders to be more engaged in the future.

These trends necessitate a proactive approach from companies, including vulnerability assessments, agile response plans, strategic option evaluation and demonstrably impactful ESG initiatives. By adapting to this evolving landscape, companies can position themselves for success in the face of changing investor demands and unlock long-term value for all stakeholders.

Activism is not going away, but it doesn't have to be a downfall for CEOs and boards. Strong communication with investors, selective understanding of activists' proposals and measured responses to activist demands, when needed, will help CEOs stay prepared and vigilant for activism defense.

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