The heat is on!

Update on shareholder activism in Germany

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The summer of 2015 in Germany has been one of the hottest of all time. While the temperatures are cooling down heading into the fall, the heat from another powerful source exacted on German public company executives will likely persist, and may even rise. A new breed of bigger and bolder activist shareholders has emerged and is increasingly targeting corporate Germany.

Over the course of the past 12 months, Swedish activist fund, Cevian Capital, for example, managed to secure seats on the supervisory boards of ThyssenKrupp and Bilfinger, respectively. In Bilfinger's case, even the CEO was removed and the chairman of the supervisory board replaced by Cevian partner and former Metro CEO, Eckhard Cordes. Other recent examples include the (reported) campaigns by US and UK activist funds Third Point, Knight Vinke and TCI against Adidas, Dutch hedge fund PGGM against GSW Immobilien and US hedge fund Elliott's engagements in the realms of Celesio, Kabel Deutschland, DMG Mori Seiki, Schuler and Medion.

Shareholder activism has reached a new dimension

Shareholder activism has been a common phenomenon in Germany for decades and comes in many different shapes and sizes. On the one side of the spectrum are the modest institutional investors and minority shareholder associations, while the other one sees the aggressive predatory shareholders, professional plaintiffs and activist hedge funds. The common opinion had been pretty clear with respect to the latter group of activists: corporations need to be protected from those activists that would seek short-term profits at the expense of a company's long-term value. However, there has been a change of paradigm when it comes to the perception and acceptance of activist hedge funds. Some of the recent activist campaigns in Germany were not only welcomed, but actively supported by major institutional investors and proxy advisors that gave

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the activist funds much more influence than their positions in the targets suggested. Certain activist hedge funds seem to have re-branded themselves from raiders to rescuers.

The heat is on and boards of German public companies can no longer ignore activist funds. Activist funds do not want to speculate about future performance, they want to impact future performance and they are growing massively both in size and number. Between 1999 and 2011, 253 potential activist campaigns at 140 publicly-listed companies were counted in Germany. In 2014, 257 companies were targeted by activists in the United States alone. And as of June 2015, 519 activist →

hedge funds were said to collectively manage over US$140 billion in assets. The pressure to put this capital to work quickly is tremendous as the campaigns tend to get larger and larger, making one thing quite obvious: activism is here to stay and will most likely become the new normal.

Different categories of activist funds and their objectives

There are several categories of activist funds. Firstly, there are the well-established US mid- and large-cap activists who have become household names (such as Paul Singer of Elliott Management, Carl Icahn of Icahn Associates, Daniel Loeb of Third Point, Nelson Peltz of Trian and Bill Ackman of Pershing Square), a group where size seemingly does not matter, as recently demonstrated by Pershing Square's US$5.5 billion position in US foods company Mondelez or Icahn's stake in Apple, estimated at a value of over US$6 billion. They keep pursuing larger and larger companies and each one of them is capable of moving the stock price simply by disclosing the fact that they have taken a position. Secondly, there are the small and mid-cap activists who tend to be the most active in terms of number of campaigns and who are often multi-strategy funds (such as Starboard Value or Clinton Group). Next, there are the sector specialists that are very targeted in their focus, and lastly, the (relatively) new activist funds that are being launched constantly in the U.S. and internationally, some of them coming out of established activist funds, pushing aggressively to build their track records (including the likes of Corvex Management, Marcato and Cevian Capital).

Activist hedge funds need to generate significant, what modern portfolio theory calls "alpha" (that is, risk-adjusted excess returns) for their investors. Although their recent tactics of impacting their targets' business decisions are reminiscent of the strategies used by private equity investors, activist funds are not interested in taking over and running companies on a daily basis. Activist funds as a group have generally outperformed the market. However, neither all activist funds nor all of their campaigns are successful. Activist funds that made headlines in the German market in the past (such as Atticus in connection with Deutsche Börse or PGGM in connection with GSW Immobilien) have shut down in the interim. Thus, when confronted with an activist campaign, the target's management needs to be aware that activist funds pursue strategies with volatile outcomes that should put some of the activist's demands in perspective.

Who is vulnerable to activist attacks?

Activist funds usually look for a range of particular weaknesses, for example (a) the target has underperformed relative to its peers or the market, (b) the capital structure is such that the target either has large cash reserves or is under-leveraged, (c) the target has the potential to divest or spin off one or more of its business units or assets, including real estate, (d) there is a widely spread and susceptible shareholder base, (e) the target is perceived to have no clear strategy, and comments by analysts and the press have been negative, (f) there is a weak management and/or supervisory board, (g) the target has serious corporate governance issues and (h) there is a low presence at general shareholders' meetings.

Resulting from those perceived weaknesses, common activist demands include pushing for (a) a return of capital either through dividends or share buybacks, (b) asset sales and spin-offs, (c) the removal of weak or renitent members of the management and/or supervisory board, (d) a change of the capital structure (debt equity ratio), (e) a reform of the target's corporate governance and (f) the implementation of cost cutting measures, including the reduction of executive compensation.

The activist fund's toolkit

Activist funds do not solely play by the playbook prescribed by the German corporate and securities laws that offer only limited minority shareholder rights and means. Instead, they use a broad and sometimes unconventional set of tools that many German companies are not familiar, and tend to struggle, with. They contact investor relations departments as part of their background diligence and information gathering. They call, demand one-on-one meetings with, and/or write private letters or emails to, individual members of the management and/or supervisory board to articulate their requests, engage in a discussion and gain valuable insights. Either as part of the mandatory disclosure process or by way of press releases, activist funds publicly disclose their positions. At the latest when they reach or exceed the 10% threshold for a substantial interest, activist funds also (have to) disclose the strategic objectives they are pursuing →

and whether they intend to change the composition of the boards and the target's capital structure. In many instances, they will also use other forms of public communication, including the general press, social media or websites especially set up for the specific campaign. Activists in many cases prepare and sometimes publicly disclose very detailed and well-researched white papers setting forth the target's weaknesses and the activist's criticism and proposals.

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One thing should be vividly clear, and that is that these measures are generally not aimed at convincing the target's management of the changes that are warranted according to the activist. The activist's main objective is to convince and gain the support of co-shareholders and their proxy advisors. While it is difficult, and sometimes impossible, to identify other co-shareholders under German law, activist funds have found ways of overcoming this obstacle. International activists have become very sophisticated and are well-familiar with applicable laws in Germany, including the rules governing acting in concert and how to avoid the attribution of voting rights that could trigger disclosure requirements, the (temporary) loss of voting or dividend rights when violating such disclosure requirements or the obligation of making a mandatory takeover offer.

What should German corporations do?

Firstly, act, don't react. Many of the strategies proposed by experts focus solely on the response to an attack and the preparation thereof. This alone, however, is too short-sighted. In addition to the response plan, corporations should establish teams that think like and regularly take a look at the company through the eyes of an activist fund to identify weaknesses. Activist know-how needs to become an inherent part of the management's strategic and financial decision-making process. In doing so, management's main driver should not necessarily be to defend attacks by activist shareholders, but to avoid them by continuously seeking to identify and unlock hidden value.

A second important aspect is not only the effective communication internally, but also continuous dialogue with major institutional investors and proxy advisors. Management needs to keep the stakeholders informed about the management's business strategy and build or maintain their confidence in it. While activist shareholders focus on unlocking shareholder value quickly, institutional investors pursue long-term investment strategies and generally understand that management's overriding responsibility is to act in the best interests of the company, meaning the company's sustained prosperity. Generous salaries to the workforce, low dividends or a low leverage, for example, may come at the expense of the shareholders, but might be well-founded and in the best interest of the company at a given time. Management needs to make a compelling case that is regularly communicated to major institutional investors and proxy advisors. Rest assured, if management doesn't do it, the activists will.

Finally, a company needs to monitor and regularly analyze its existing shareholder base (identifying unusual trading and activist positions before public disclosure) as well as review its articles of association and corporate governance policies for best practices.

When corporations successfully integrate the above measures into their business routines, no executive should be afraid of activist funds, but actually be grateful to them for having helped to initiate a valuable reform process that benefits all. <–

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