IR Insight

Prepared by Tokyo consultancy Investor Impact, Inc., **IR Insight** provides analysis about the latest IR trends and recommendations on communications strategies that positively impact corporate value.

April 2014

INVESTOR IMPACT

# How IROs in the U.S. Are Thinking about Activism: Implications for Japanese Companies

This and the previous issue of *IR Insight* address some of the main points discussed at the annual U.S. National Investor Relations Institute (NIRI) Senior Roundtable Conference, which was held from December 3–6, 2013. Attendance at the annual roundtable conference is limited to NIRI members with 10 years or more experience in investor relations (IR). Increasingly, the NIRI roundtable is playing a leadership role in the IR profession and providing guidance to the U.S. Securities and Exchange Commission (SEC) and other public and private institutions on the proper course of development of IR practices. Topics discussed at the conference, which were covered in the February 2014 edition of *IR Insight,* were evolution in reporting styles (the rise of integrated reporting) and the role of outside directors in communicating with institutional investors. This edition summarizes the discussions at the Senior Roundtable Conference that dealt with activist shareholders and with putting the maximization of shareholder value in proper perspective.

**What can you do when activist investors call?**

By general agreement of the participants in the conference, one of the most-important topics for IR officers (IROs) in 2013 was dealing with activist investors. Some of the background reasons for this have been:

- **A general rise in the level of activity** among activist investors, as evidenced by the increase in the number of investments by funds classified as "activist"

- A reported **increase in the volume of funds** entrusted to activist investors, which is encouraging them to broaden the range of companies they target. Estimates of the current funds available to investors range widely, and some are in excess of US$100 billion, but all estimates point to a marked rise in funds since about 2008. One source reported identifying 205 firms around the world that have “activist investment tendencies” and calculated their assets may add up to as much as US$1 trillion.

- Activists are **investing in virtually all industrial sectors**. Activity is not concentrated in any particular industry or group of industries, but is across the board. Activists tend to target companies within a range of sectors that have management issues to address. For activists, this represents an opportunity to invest and earn a return by influencing company management decisions.

- Reportedly, activists are **now turning to smaller companies,** and some may have investment agendas for foreign (non-U.S.) companies as well, since the number of likely investment candidates remaining in the large-cap category has, reportedly, diminished.

Speakers and discussants at the conference emphasized that activism is not likely to diminish in importance for IROs. Representative comments were “You may not know it now, but your company is probably already targeted or at least has been fully reviewed as a target by the activists,” “Activism is not going to go away,” and “The question you have to face is how to deal with activists effectively.”

Another basic point expressed at the conference is that activists span a wide range. At one extreme are those with good intentions who want to see better corporate governance, more emphasis on long-term strategies, and other corporate reforms that will lead to an increase in corporate value in the medium-to-long term. This group of “activists” includes pension funds, such as CalPERS, that have already committed major sums to some companies and want to see long-term appreciation in stock values. At the other extreme are those activists that some called “dissidents,” whose aim is usually short-term gains. The dissidents take moderate-to-small positions in companies and may make suggestions for ways to raise stock prices in the short-to-medium term, such as stock buybacks and raising dividends.

Conference participants were quite forthcoming with suggestions for dealing with activists. These included

- **Analyze the shareholder base** to determine the presence or absence of activists

- **After identifying any activist funds, classify them** along a continuum ranging from those with largely good, long-term intentions congruent with those of shareholders in general to the so-called dissidents

- Based on the results of the analysis of the shareholder base, **analyze your own company's vulnerabilities** as seen from the point of view of activists

- With this analysis done, **prepare plans for dealing with your activist investors** most effectively

Points emphasized by IROs with considerable experience in activist handling included "In meeting with activists, especially those with a long-term perspective, be relaxed and thoughtful, not dismissive, and work to be constructive rather than defensive."

Prior to meetings with activists, companies should be sure they understand their own weaknesses and prepare a good investment story or a series of answers to investor concerns that is thorough and convincing.

**Implications for Japanese companies**

Although relatively few Japanese companies have been under attack from activist investors recently, the global trend is toward more shareholder activism. Returns of many activist funds are above the average for hedge funds in general, which means they will be attracting more and more funds over time. Japanese companies will need to do their homework, as we have outlined above: Detect the presence of activist investors, analyze their likely objectives and behavior patterns, analyze your own potential vulnerabilities as a possible target company, resist the temptation to lump all activists into the "bad actor" category, and prepare carefully for meetings with activist investors. Particularly, from long-term activist investors, Japanese companies may benefit from hearing views about their performance and strategies that they may not have heard before. Getting ready for dealing with activists will also require more attention to IR programs and more-proactive approaches to current investors.

**Why did GE's Jack Welch say, "Shareholder value is the dumbest idea in the world."?**

While only partly true, Jack Welch's comment is a hyperbole designed to shock and make us think. Articles of faith espoused by NIRI and similar organizations in other countries include the point that the mission of the IRO is to maximize shareholder value. One of the speakers at the conference, Lynn Stout, who holds the position of Distinguished Professor of Corporate & Business Law at Cornell Law School, has published a book with a title that has startled the IR community: *The Shareholder Value Myth: How Putting Shareholders First Harms Investors, Corporations, and the Public*[1].

The basic message of Stout's book is that "running a company strictly to maximize shareholder value as measured by its share price may be harmful to shareholders" (Please note that quotations are taken from Stout's book, cited above, and an interview article with her published in NIRI's *IR Update* (March 2014). Again, this is only partly true. According to Stout, "I believe that shareholder value thinking leads management teams to focus primarily on quarterly results, and discourages the type of research and development and capital investments necessary for long-term corporate health." Stout also makes the strong statement, "...the notion is false that corporations ought to be run to maximize shareholder value." The meaning of "ought" here is "that there is a legal basis that requires companies to maximize share price or profits." According to Stout, there is no basis in U.S. corporate law that requires companies and their Boards of Directors to maximize either share price or shareholder wealth.

Since the birth of U.S. public companies, there have been two schools of thought about the way corporations should be managed. One is the "shareholder primacy" argument that holds that publicly held corporations should serve only the interests of the shareholders and that directors and executives should focus solely on maximizing shareholder wealth through the payment of dividends and through raising their stock prices.

The other school of thought, described as the "managerialist" view, holds that corporations have a broader social purpose beyond simply maximizing shareholder wealth. In other words, corporations should also serve the interests of other stakeholders,

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1 Berrett-Koehler Publishers, May 2012

including customers, employees, and society as a whole. The managerialist view was generally predominant in the first half of the 20th century.

According to Stout, the shareholder primacy view, which was championed by the Chicago School of free-market economists, took firm hold in the 1970s, and was accepted generally by academia, business schools, government regulators, and by corporate boardrooms. Shareholder primacy is now firmly rooted in corporate and investor thinking and practice. For example, management compensation is generally linked to stock prices. The U.S. SEC has made a number of moves that give shareholders more power over corporations, including the detailed disclosure of executive compensation.

**Implications for Japanese companies**

While the best approach probably involves a melding of both schools of thought, the managerialist view of the raison d'être of corporations seems to be drawing more followers of late. Evidence of this includes the rising interest in corporate social responsibility (CSR), integrated reporting, and, as championed by Harvard Professor Michael E. Porter, creating shared value (CSV). As we noted last month, the growing interest in the integrated reporting process in Japan might present an opportunity for Japanese companies to position themselves more advantageously to obtain funds from long-term investors around the world. However, this is going to require more-robust, top-quality IR programs. Investor Impact, Inc. is doing its utmost to provide Japanese clients with value-added consultancy solutions in areas spanning IR, integrated reporting, CSR, and CSV.

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