REIT Wise® 2017

NAREIT's Law, Accounting & Finance Conference

March 22 – 24, 2017

Shareholder Activism

Andrew Goodman
Joseph L. Johnson III
Gilbert G. Menna

GOODWIN

Activism Overview and Trends

- **The number of companies subject to activism demands remains at a near all-time high.**
  - The total number of activist campaigns fell slightly in 2016 (277 as compared to 300 in 2015). This still far exceeds 272 campaigns in 2014 and 221 campaigns in 2013.[1]
- **In 2016, activist activity was driven by newly-formed and less experienced activists. The campaigns by these activists accounted for 66% of all campaigns in 2016, as compared to 53% in 2015.**
- **In contrast, historically active funds accounted for only 29% of campaigns in 2016 (as opposed to 46% in 2013).**
- **Activism remains focused on mid-cap companies with 60% of the campaigns involving issuers with market capitalization between $100 million and $1 billion in both 2015 and 2016.**

[1] Data used herein sourced from FactSet SharkRepellent, unless otherwise noted.

GOODWIN

Activism Overview and Trends

- **Activists' success in obtaining Board representation remains very high.**
  - In 2015 and 2016, activists succeeded in obtaining Board seats in 58% and 57%, respectively, of the campaigns they launched.
  - The primary reason for this trend is an increasing percentage of settlement agreements between activists and issuers. In 2016, 40% of all campaigns resulted in a settlement agreement and Board representation, as opposed to 24% in 2013.
  - Faced with the potential expense and distraction of a proxy fight by activists with a successful track record (e.g., Elliott, Starboard, etc.), companies frequently agreed to a settlement.
  - These settlements also occurred much quicker than in previous years, with 30% of all settlements concluding within 30 days of the initiation of a campaign in 2016 (as compared to 15% in 2015) and 57% in the first 60 days in 2016 (as opposed to 36% in 2015).

Activism Overview and Trends

- **Activists' campaigns have become more sophisticated and effective.**
  - Activist funds are willing to hire outside advisors and incur substantial expenses to succeed. In connection with its initial 13D filing for Citrix, Elliott Management disclosed that it had spent several million dollars to analyze the company. Elliott hired a team of veteran software executives, a consulting firm and two investment banks to advise it in connection with its investment.
  - Widespread use of derivatives to build substantial stakes quickly and with stealth.
  - Candidates nominated by an activist for Board seats have frequently been prominent figures in the relevant space with decades of executive experience. A list of activists director candidates includes Jeffrey Zucker (former CEO of NBC Universal), John Myers (former President and CEO of GE Asset Management), Eddy Hartenstein (former CEO of Tribune Company and Direct TV) and Gordon Bethune (former CEO of Continental Airlines).
  - Because activist investors have delivered significant returns that are independent of broader market conditions, institutional investors have been generally supportive of their actions. Institutional investors also have developed relationships with certain of these funds significantly increasing their chances of success in a fight.

Activism Overview and Trends

- **Management Victorious at the Polls.**
  - A positive trend for management has been their success in proxy contests which have gone to a shareholder vote. In 2015 and 2016, management was victorious in 65% and 55% of these contests, respectively. This compares to 37% in 2014 and 39% in 2013.
  - These strong numbers for management demonstrate that thoughtful engagement with institutional shareholders combined with a campaign highlighting the accomplishments of management and an engaged, independent Board is often successful. In 2016, iRobot (a Goodwin client) followed this blueprint to decisively win a proxy fight against a new activist (Red Mountain Capital) despite ISS and Glass Lewis supporting Red Mountain. Management is much more likely to engage in a fight with new activists who do not have a track record of success. Historically active funds accounted for only 5% of the proxy fights in 2016.
  - The composition of a company’s shareholder base also plays a major role in its likelihood of success in a fight which goes to a shareholder vote. Companies with a significant percentage of its shares held by retail investors are much more likely to be successful in a fight. While these types of fights are more expensive, retail investors are generally more supportive of management.

Activism Overview and Trends

- **Activist Hedge Funds Continue to Thrive.**
  - According to Hedge Fund Research, after growing at a compound annual rate of 23% from 2009 to 2015, total assets under management (AUM) for activists decreased by 9.2% during the first half of 2016 from $129 billion to $112.5 billion. This decrease is a result of both underperformance and outflows from the strategy. Several large public pension funds – CalPERS, the New York City Employees' Retirement System (NYCERS), and the Illinois State Board of Investment – divested their holdings due to lagging returns and high fees. Nevertheless, this asset class still held $112.5 billion in assets at the end of the second quarter of 2016, up significantly from $36 billion in 2009.
  - While activist funds struggled with an average return of 1.15% in 2015, the HFRI Event-Driven Index showed a 10.4% return for these funds in 2016, with numerous prominent funds like Elliott and Trian Partners exceeding this level and smaller funds like Engaged Capital and Raging Capital up 20% and 27%, respectively.
  - Thus, despite the decline in AUM and the poor performance of certain prominent funds such as Pershing Square, activism is here to stay as activist funds have become an established asset class.

Continuing Concentration of Ownership by Institutional Investors

- According to ProxyPulse, the percentage of shares held by retail investments has continued to decrease from 35% in 2012 to 30% in 2016**.**
- This shift has been accompanied by a shift away from institutions with active investment philosophies and towards index funds. According to *The Wall Street Journal*, in June 2016, these funds owned 11.6% of the S&P 500 up from 4.6% in 2006.
- At the same time, the percentage ownership of the largest institutional investors also has increased. Today, the average ownership stake held in S&P 500 companies by Vanguard, Fidelity, State Street and Blackrock, collectively, is 21.2% (up from 17.4% in 2012).
- In analyzing the impact of this change, it is important to note that voting participation by institutional and retail shareholders in 2016 was 91% and 28% respectively.

Institutional Investors Want Public Company Boards to Hear Their Voices And To Be Cautious In Reaching Settlements With Activist

- Over the last several years, Vanguard has directly and successfully engaged issuers to adopt majority voting and remove takeover defenses like staggered boards.
- In 2015, Larry Fink, the CEO of Blackrock, wrote letters to public companies urging them not to take short-term actions, such as buybacks and increased dividends, which may satisfy activists' demands but impair long term value. In 2016, he wrote another letter urging companies to articulate a strategic framework for long-term value creation to serve as a counterpoint to activist demands for actions with short-term benefits.
- In 2017, Mr. Fink again revisited the themes of his previous years' letters stating:
  - "For the 12 months ending in the third quarter of 2016, the value of dividends and buybacks by S&P 500 companies exceeded those companies' operating profit. While we certainly support returning excess capital to shareholders, we believe companies must balance those practices with investment in future growth. Companies should engage in buybacks only when they are confident that the return on those buybacks will ultimately exceed the cost of capital and the long-term returns of investing in future growth."
  - "As we seek to build long-term value for our clients through engagement, our aim is not to micromanage a company's operations. Instead, our primary focus is to ensure board accountability for creating long-term value. However, a long-term approach should not be confused with an infinitely patient one. When BlackRock does not see progress despite ongoing engagement, or companies are insufficiently responsive to our efforts to protect our clients' long-term economic interests, we do not hesitate to exercise our right to vote against incumbent directors or misaligned executive compensation."

Institutional Investors Want Public Company Boards to Hear Their Voices And To Be Cautious In Reaching Settlements With Activist

- In October 2016, State Street Global Advisors issued a market commentary raising concerns that, in connection with reaching quick settlements with activists, companies may be hurting the long-term interests of shareholders. In particular, SSGA noted:
  - Settlement agreements that are entered into quickly and without appropriate consultation with other shareholders deprive long-term shareholders of the opportunity to express their views.
  - SSGA's review of the actions of the largest activists identified several red flags that raise questions about the long-term effects of activism, including increases in CEO pay and tying CEO pay to earnings per share, as well as undue focus on share buybacks, spin-offs and other financial engineering.
  - Settlement agreements should include terms that protect the interests of long-term investors, which could include requirements that activists meet share ownership thresholds and hold shares for a defined period, as well as restrictions on share pledges by the activists.
  - SSGA also announced a policy of engaging with companies that pursue previously unplanned financial engineering transactions within a year of a settlement to better understand the reason behind the strategic change.

Perceived Undervaluation is the Trigger for Activism

- Activist demands generally fall under the following categories and address the following matters:
  - **Capital Structure Matters** – Claimed deficiencies in target capital structure which are used as a means of arguing for returning cash to shareholders, such as stock buybacks, increasing regular dividends or special dividends and increasing leverage.
  - **Operational/Strategic Matters** – Such as proposing specific programs for operational improvements (e.g., reducing costs, improving margins, etc.), recommending a sale or spin-off of non-core assets, pushing for an outright sale of the company ("exploration of strategic alternatives") and opposing an announced transaction or acquisitions generally.
  - **Governance Matters** – Such as eliminating or reducing takeover protections, changing the board composition or management, splitting Chairman/CEO roles and effecting changes regarding executive compensation.
- In their initial letters to a public company board, activists generally will touch on each of these three "buckets" in recommending changes which need to be made to avoid a fight.

Impact of Proxy Advisory Firms

- Proxy advisory firms, such as ISS and Glass Lewis, have a significant impact on public companies, especially in activist situations.
- In contests for board representation, ISS generally asks two key questions:
  - Has the activist demonstrated that change is warranted?
  - If change is warranted, are the activist’s nominees more likely to effect that change than management’s nominees?
- In contests where an activist is seeking board control, ISS will also review the activist’s business plan and identification of new management.
- Since 2013, ISS has supported one or more of the activist nominees in 57% of proxy fights.
- In 2016, ISS’ recommendations matched the outcome of a fight 63% of the time. This represents a significant decline from 77% in 2013 and 73% in 2014. This trend is mostly due to the development of internal proxy functions in larger institutional investors in recent years.
- Each company should analyze its own list of shareholders to determine how important the proxy advisory firm’s views are to them.

Activists Typically Follow Well-Established Escalation Strategy

- Activists generally travel together. The wolfpack follows the lead activist into the stock.
- Significant turnover of shareholder base following activist announcement of stake. With stock price increase following activist announcement, historic investors exit the stock and are replaced by "event driven" investors.
- Activists use the media (and social media) to communicate their case/intentions and put pressure on the company.

Increasing Active / Hostile

Accumulation of Stake	• Slowly accumulate initial stake to establish "toehold" without moving price • Often accomplished through derivatives to avoid public disclosure required by HSR and SEC rules • Once public disclosure of stake is made, the activist converts derivatives into actual shares
Public Announcement of Stake	• Announce position through filing a 13D • Depending on investment strategy, the 13D includes a presentation/letter to the Board explaining investment rationale • Request meeting with Lead Outside Director/Board
Public Campaign	• Solicit support of other shareholders • Public disclosure of letters or "white paper" further explaining investment thesis and/or attack "entrenchment"/nonaction by the Board
Proxy Fight	• Submission of nominees to replace existing directors • Proxy contest to elect activist nominees

Steps after an Initial 13D Filing Designed to Increase Pressure on Management and the Board

1. **Continue to accumulate shares.**
2. **Increase intensity of engagement with the Company.**
3. **Encourage current shareholders to support activist agenda.**
   - Cultivate sell-side commentary in favor of expanded capital return.
   - Develop and cultivate relationships with top institutional shareholders.
4. **Encourage other like-minded shareholders, including activist funds, to enter the stock.**
   - 13D filing will trigger significant churn in the shareholder base.
   - Activist may have numerous “followers” in the activist fund community.
5. **Continue to publicly attack the Company’s performance or failure to take action in response to activist’s demands.**
   - Directly or indirectly through media briefings, social media and sellside analyst notes.
6. **Publicly issue white paper or presentation highlighting their thesis.**
   1. Letter implies detailed presentation is already complete.
7. **Seek Board change by nominating directors at next annual meeting.**

GOODWIN

Dealing with a Situation Involving Activists: What's different about communications?

- **Remember the importance of "due diligence." Research the activist and its track record with other companies.**
  - Review tactics employed by activist in the past.
  - Identify activist's potential weaknesses and soft spots.
  - Explore structural defense measures that can be deployed.
- **Everything you say can and will be used against you.**
- **Activist may seek to solicit information or establish lines of communication with directors.**
  - Even the most innocuous communications can be damaging to a Company and its strategy.
  - It is critical that the Company adopt a communications strategy and determine who is allowed to speak for the Company (CEO, Lead Outside Director, etc.) and the message that should be sent.
  - The Company must deliver consistent messages and speak with one voice.
- **Monitor trading volumes and changes to shareholder base.**
- **Know your shareholders and meet with them (in good times and bad).**

Activism Defense Preparedness

- **Adopt a communications strategy and determine who will speak for the company (CEO, Lead Outside Director, etc.)**
- **Continued shareholder base monitoring**
- **Continued shareholder base engagement with specific communications with key investors on important issues such as capital allocation, margin analysis and longer-term targets**
- **Review capital structure and return of capital strategies**
- **Review existing takeover protections and deadlines for shareholder nominations and proposals**
- **Review Board composition, independence and corporate governance**
  - Consistently review composition of your Board and corporate governance policies.
  - Do you have correct skill set?
  - Shareholders expect regular turnover on Board.
  - If your directors have 10+ years on the Board, you are open to an attack by activists.

How to Win an Activist Fight

1. **Review existing communications strategy and determine who will speak for the company in the fight (CEO, Lead Outside Director, Nominees for Election at Annual Meeting**
   - A company must deliver consistent messages and speak with one voice.
   - Everything you say can and will be used against you.
   - Activist may seek to solicit information or establish lines of communication with directors.
   - Even the most innocuous communications can be damaging to a company and its strategy.
2. **Identify and address potential vulnerabilities.**
   - Consider counterstrategies for strategic, operational, financial and governance weaknesses.
   - It's OK to co-opt good ideas from your shareholders and make positive changes.
3. **Take the high road – focus on your company's strengths.**
   - Remember the goal – to win shareholder votes and their confidence.
   - Be measured in your response; not every argument requires a rebuttal.
   - Critical to stay on messages and control the forum for delivering the message.
4. **Define your core messages and repeat them.**
   - Shareholders are most focused on company performance – so establish clear proof on strategy, operational and financial success.
   - Get messages out/take actions that will disarm the activist before a public campaign begins.

How to Win an Activist Fight (cont'd)

5. **Create record of engagement with activist.**
   - The contest begins with first phone call/letter.
   - Engage the activist early on – don't go into the bunker preparing for battle without first understanding whom you're dealing with.
   - Show the company is willing to negotiate with activist and make "compromises" to avoid a fight.
6. **Monitor trading volumes and changes to shareholder base and keep your shareholders close.**
   - When it comes to your shareholders – communicate, communicate, communicate – but not always about the activist or its issues.
   - Face to face dialogue with your company's management team trumps phone or email exchanges.
   - Understand the factors that influence voting decisions of your key shareholders.
7. **Maintain a measured stance of business as usual.**
   - Settle in – contests can last a long time.
   - Be tactical in use of management's time; try to quarantine the issue.
8. **Keep your Board informed and constructively engaged.**
   - Lead Outside Director and heads of governance and finance committees may have special roles.
   - Prepare them for potential attacks on their track records.
   - Help foster perception that Board and management are working hand-in-glove.
9. **Be Nimble - Be prepared for rapid response.**
   - Adopt a process which allows for quick response to activist releases and other developments.
   - Form committee of "decision-makers" (Board and management) who have time and can make quick decisions.

APPENDIX

Names to Watch for: "Activist" Investors with Greatest Track Record of Pursuing Fights

Top Ten Activists (ranked by total assets managed)

	Elliott Management	Icahn Enterprises	ThirdPoint	ValueAct	Pershing Square
Principal:	Paul Singer	Carl Icahn	Daniel Loeb	Jeffrey Ubben	Bill Ackman
AUM ($bn):	$45.0	$33.0	$22.6	$17.5	$14.8
Founded:	1977	1987	1995	2000	2004

	Corvex Management	JANA Partners	Trian Partners	Sachem Head Capital	Starboard
Principal:	Keith Meister	Barry Rosenstein	Nelson Peltz	Scott Ferguson	Jeffrey Smith
AUM ($bn):	$12.6	$11.6	$13.8	$4.7	$4.7
Founded:	2010	2001	2005	2012	2011

Names to Watch for: The "WOLFPACK"

- Ader Investment Mgmt
- Biglari Capital
- Blue Harbour
- Breeden Capital Mgmt
- Bulldog Investors
- Cannell Capital
- Carlson Capital
- Cevian Capital
- Clinton Group
- Crescendo Group
- Discovery Group
- Eminence Capital
- Engine Capital
- Engaged Capital
- Franklin Mutual Advisers
- GAMCO Investors
- Glenview Capital Mgmt
- Greenlight Fund
- Knight Vinke
- Land & Building Investment Mgmt
- Laxey Partners
- Lone Star Value Mgmt
- Luxor Capital
- Marathon Partners
- Marcato Capital
- Matrix Capital
- Millennium Mgmt
- MHR
- Neuberger Berman
- Northern Right Capital
- Osmium Partners
- Owl Creek Asset Mgmt
- Paulson & Co.
- Praesidium Investment Mgmt.
- Raging Capital Mgmt
- Ramius Capital
- Red Mountain Capital Partners
- Saba Capital Management
- Sandell Asset Mgmt
- Sarissa Capital
- Scopia Capital Mgmt
- Snow Park Capital
- Soroban Capital
- Southeastern Asset Mgmt
- Spring Owl Asset Mgmt
- Stadium Capital
- Steel Partners
- Taconic Capital Advisors
- TCI Fund Mgmt
- Tenzing Global Investors
- TPG-Axon Capital
- Vertex
- Voce Capital
- Vintage Capital Mgmt
- Yucaipa

GOODWIN