Shareholder activism in Australia

A review of trends in activist investing

Activist Insight

In association with

Arnold Bloch Leibler

Lawyers and Advisers

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About Activist Insight

Since 2012, Activist Insight has provided its clients with the most comprehensive information on activist investing worldwide. Regularly quoted in the financial press, Activist Insight is the trusted source for data in this evolving space, as well as a highly regarded publisher of bespoke reports and periodicals. In 2016, Activist Insight launched Activist Insight Shorts after acquiring Activist Shorts Research. Activist Insight currently offers three great products: Activist Insight Online, Activist Insight Shorts and Activist Insight Monthly.

Activist Insight has partnered with prominent Australian law firm, Arnold Bloch Leibler (www.abl.com.au), to produce this report.

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Note

All currency in Australian dollars unless otherwise noted. Public demands include financial or governance-related suggestions from shareholders. Environmental and social proposals and activist short sellers are not included in the dataset. All 2016 figures quoted in statistics are as of June 30, 2016 unless otherwise specified.

Activism is here

Jeremy Leibler—Partner, Arnold Bloch Leibler

Shareholder activism has begun to shake the foundations of the Australian listed company landscape. In recent cases (such as Brickworks and Antares Energy), demands from activists have been very public and very newsworthy. But more often than not, demands are being made behind closed doors.

There is no question that the global influence of activist investors is increasing, and that Australia's regulatory environment provides fertile opportunity for both homegrown and offshore activists.

This report, developed in partnership with global specialist firm Activist Insight, provides the first detailed analysis of activist investing trends and insights in Australia.

Arnold Bloch Leibler commissioned the report on the basis of our experience in advising both activist investors and NEDs in responding to activist demands. ASX 200 Boards are increasingly mindful of shareholder activism and are preparing their companies and management teams for the potential threat, and the inevitable consequences to business operations and to their reputation.

Boards that are not preparing in this way are ignoring the legal and structural reasons why the Australian market is so ripe for activism:

- The 'two strikes rule' which allows just 25% of shareholders to vote down a company's remuneration report and ultimately spill the board of directors (there is no such tool for activists in the U.S.)
- The relatively low threshold (5% of issued equity) required to call an EGM
- Recent amendments to regulatory guidelines clarifying that shareholders can communicate with each other about company performance
- The relatively high degree of institutional shareholdings due to the large superannuation fund pool, and
- A strong media presence which can quickly affect the reputation and share price of companies.

These levers are well understood by local activists and increasingly on the radar of major global activists diversifying their portfolios beyond the U.S.. The involvement of U.S. distressed debt investors in every collapsed company in Australia in recent years, is a clear signal that further inbound activity from activists is on its way.

The jury is still out as to whether activism is beneficial for companies and the economy. The detractors say activists just reinforce short-termism and excessive attention on financial metrics rather than on long-term growth and strategy. Supporters believe activists are necessary to shake up underperforming companies, hold boards to account and unlock shareholder value.

An emerging theme in the evolution of activism is the willingness of major institutional funds to back activists to achieve a better outcome for shareholders, and the recruitment of activists who can agitate for change where long-suffering shareholders have failed to gain traction.

Whatever the case, activism is here, it's increasing and it's set to transform the Australian business landscape.

Trends: Activism in Australia

In recent years, shareholder activism has come to dominate conversations worldwide in boardrooms, the media and the analyst community. With a thriving activist contingent and favourable legal system, the Australian market is primed for more activity.

Activist investors are no longer a mere corporate nuisance. In 2010, 184 companies worldwide were subjected to public demands. By 2015, that number had risen to 628. These investors have gained board seats at iconic companies, such as Microsoft and Rolls-Royce Holdings, removed entire boards, and called time on long executive careers. The mere threat of a proxy fight has pushed some of the largest companies to consider selling up, split complex businesses in half, and created billions of dollars in shareholder value.

The Activist Insight Index, which tracks a number of dedicated activist funds worldwide, has returned an average of 14.2% per year since 2009, against 14.5% for the S&P 500 Index and 9.5% for the ASX 200. In the U.S., assets under management for funds focused on activism swelled from $93 billion USD in 2012 to $156 billion three years later.

Activists can profit even when they fail in their main objective. In 2015, Trian Partners narrowly lost a proxy contest at chemicals company DuPont, winning 46% of the vote for its principal, Nelson Peltz. Within six months of the meeting, the company had fired its CEO and agreed to merge with Dow Chemicals, as a precursor to splitting in three. When Bill Ackman's Pershing Square Capital Management pushed for the sale of drugmaker Allergan to Valeant Pharmaceuticals, the company found a white knight in Actavis and Pershing Square made over $2 billion USD on its investment.

An average of 65% of all targets worldwide over the past six years have been based in the U.S.. Yet, driven by perceived overcrowding and fluctuating economic conditions, several funds have taken their approach abroad. Canada, Japan and Europe have seen spikes in activity, and Australia could be set to follow.

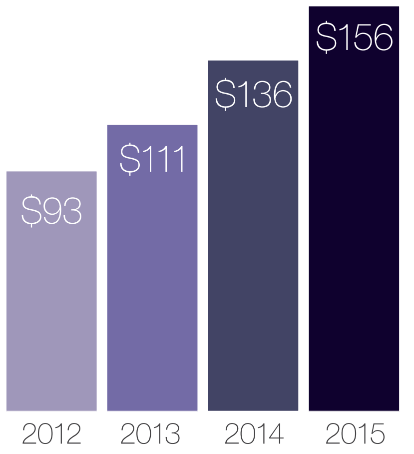
Activism in Australia

Australia is already no stranger to activism. In the 1980s, demerger proposals, takeover bids and restructuring plans were floated to promote the efficient ownership of corporate assets—a movement sometimes equated with the "corporate raiders" active in the U.S. during that period. Many of today's activists maintain links to those earlier days. Sir Ron Brierly, a leading member of the 1980s-style activist cohort, went on to invest in Guinness Peat Group in the 2000s, until it began returning capital in 2011. Brierly's current vehicle, Mercantile Capital, employs Sandon Capital's Gabriel Radzyminski as a non-executive director, while former Guinness Peat director Gary Weiss is now on the board of Alex Waislitz's Thorney Opportunities.

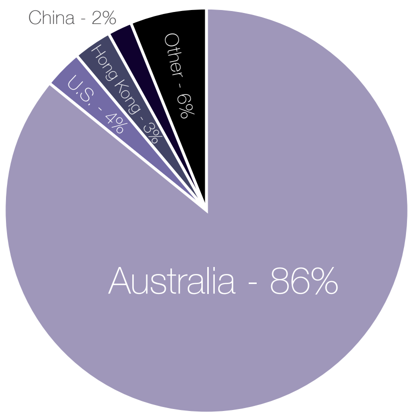
More recently, several foreign activists have visited Australia in the hunt for new opportunities: Coliseum Capital, Baker Street Capital, The Children's Investment Fund Management and Lone Star Value Management have all launched public campaigns. Local activists, such as Mark Carnegie, Waislitz and Radzyminski, all feature regularly in the financial press, indicating an increase in the level of interest and awareness.

Although stock market crashes in 1987 and 2008 hit Australian investors hard, activism has often bounced back, and now appears to be thriving again. Headlines predicting an influx of activists belie the amount of activity already undertaken. According to Activist Insight data, at least 50 Australian listed companies each year have received a public demand from investors since 2013. In the same short period, activists have won 113 board seats—around two-fifths of the total sought.

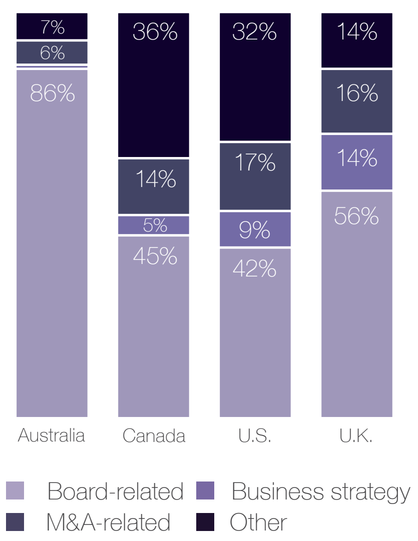
U.S. activist assets under management ($b USD)



HQ of activists publicly targeting Australian companies (2013-2016)



Public activist demands by category (2013-2016)



The lack of awareness is perhaps explained by the fact that 85% of companies targeted had a market-cap of less than $331 million AUD.

The capital available to Australian activists is scarce in comparison to that managed by U.S. activists—the most notable funds can call on around $6 billion. Even so, there is often talk of new activist fundraising; local private equity firm Pacific Equity Partners has been rumoured to be considering launching one. Several Australian activists told Activist Insight for this report that they are actively suggesting ideas to foreign funds with access to larger pots of capital.

“Pension funds are telling us that they’re not currently allocating to activist funds,” says Michael Chandler, director of governance at GPS Proxy, an advisory firm, “but as their assets and resources grow we think it’s inevitable, especially given the long history of superior performance from activist funds.”

Foreign capital would provide a welcome shakeup for Australia’s corporate scene. 86% of activist campaigns since 2013 have been led by domestic players. That compares to 59% in Canada, and 39% in Japan, which has become a favoured playing ground for foreign funds (the U.S., where most activists are based, saw only 4% of campaigns initiated by foreign funds over the period).

Gaining influence

In many ways, the Australian legal and regulatory landscape is favourable to activism. A group of shareholders owning 5% of a company’s shares can requisition a special meeting and nominate directors. As a result, investors band together to force change. In 2013, 95 entities waged public campaigns at 57 companies.

Moreover, a small stake does not necessarily limit an activist’s impact—in fact, there is little correlation between ownership and outcomes, according to Activist Insight data. At U.S. companies, activists have often been added to boards with ownership of as little as 1%, even when their stakes are relatively small in dollar-terms.

Levers for activists to pull are also plentiful. According to Macquarie Wealth Management research, the proportion of ASX 200 companies with more than one-quarter of votes cast against their remuneration policies has increased from 2.2% in 2014, to 6.5% in the first half of 2016. Two consecutive “strikes,” as such protests are known, trigger an automatic proposal to put the entire board up for re-election. So far, only one company has faced a second strike—with the “spill” resolution rejected by investors. Yet one in every ten meetings see at least a 10% vote against one or more resolutions, suggesting Australian investors are not averse to sending a message.

What activists require is support from other shareholders, and they often get it. The California teachers’ pension fund CalSTRS regularly supports activist campaigns, often forming groups with its favourite managers. BlackRock, the world’s largest money manager, has voted for activists in 38% of contests since

2012. Many institutional investors will issue "requests for activists," highlighting portfolio companies they believe could benefit from some attention.

In Australia, the real power lies with superannuation funds, which have lately begun to show signs of warming to activists. At Brickworks, where the activist Mark Carnegie was recruited by wealth manager Perpetual, half a dozen super funds supported the election of independent director, Elizabeth Crouch. A few supported Carnegie's shareholder proposal, before its withdrawal. Large numbers of super funds have also voted for dissident candidates in foreign contests at Darden Restaurants, DuPont, Carrefour and Telecom Italia.

"We've been approached by one of the largest institutions, which had its engagement efforts rejected," says Thorney Opportunities Chairman, Alex Waislitz. "That is an indication that change is on our doorstep."

At other times, investors can be unpredictable, particularly when a large component of the shareholder base is retail. The U.S. hedge fund Lone Star Value won support from proxy advisers Institutional Shareholder Services and Glass Lewis in its contest at Antares Energy, but lost the vote.

"The rules in Australia are very favourable to activism," says Lone Star's founder, Jeff Eberwein. "But the key is to find companies with lots of institutional shareholders, and particularly ones that vote with ISS and Glass Lewis."

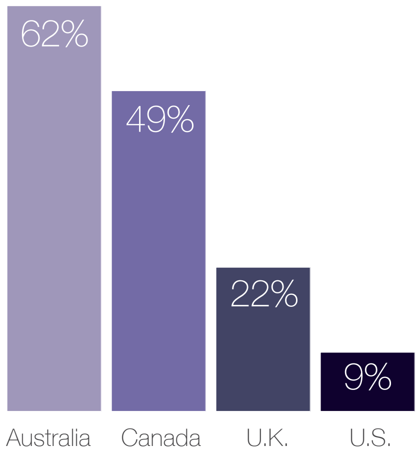
Where next?

Australia bares some similarity with Canada, another resource-heavy economy. There, activism has grown since a national champion, Canadian Pacific Railway, saw seven directors—many of them distinguished businessmen—replaced by Pershing Square in 2012. According to Ian Robertson of Kingsdale Shareholder Services, an advisory firm, which worked on the fight, the campaign "put every Canadian company on notice and said that no one is immune from shareholder activism," as well as sending a signal to the rest of the world that "Canada is open for activism."

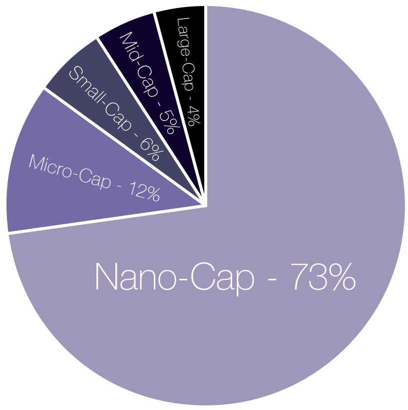
Australia is arguably already open to activism, but as Radzyminski puts it, the threshold for tolerating underperfomance among key investors has yet to be fully tested. Recent campaigns highlight sectors that might be vulnerable, including mining services companies (such as Fleetwood, which has attracted the collective force of Sandon Capital and Sir Ron Brierly), and China-exposed closed-end funds, such as AMP Capital's China Growth Fund where LIM Advisors successfully passed a proposal to liquidate the fund earlier this year.

To thrive, Australian activists need to convince the wider shareholding community they can turn larger companies around. Investors will have to conclude that executive teams do not always deserve a second chance, and that sophisticated activist campaigns can create value for all shareholders. In short, Australia needs its Bill Ackman. For larger Australian companies, the question is likely to be 'when', not 'if.'

% of publicly targeted companies in basic materials sector (2013-2016)



Market-cap breakdown of Australian targets (2013-2016)



Publicly targeted companies and active activists in Australia

Case studies

Examples of activist campaigns in Australia.

1 Unlocking hidden value

Activist:	Mark Carnegie/Perpetual
Company:	Brickworks
Company Industry:	Industrial goods
Company Market-Cap:	$2,180m AUD
Demands:	Gain board representation

Storied fund manager Perpetual had already tried persuading construction industry firm Brickworks to unwind its cross-shareholding in Washington H. Soul Pattinson ("Soul Patts") for two years before bringing in activist investor Mark Carnegie in 2013 to increase its fire-power.

The dissidents believed up to $1 billion could be unlocked by a merger or unwinding the agreement, but Brickworks claimed that unwinding the agreements would trigger hundreds of millions in tax liabilities. The two companies were accused of weak governance in the financial press, given that Brickworks' Chairman Robert Millner had made his cousin Deputy Chairman, and appointed his son Thomas to the board of Soul Patts.

A special meeting requisition by the activists in November 2013 landed in court amid competing lawsuits before Brickworks agreed to let Perpetual and Carnegie put their nominee, Elizabeth Crouch, before shareholders in late 2015. Despite Crouch blasting the company for having the "archaic approach and the mentality of a boy's club," over 70% of shares were cast against her election to the board—small wonder, given Soul Patts' 43% stake.

2 The strategic shift

Activist:	Janchor Partners
Company:	Medibank Private
Company Industry:	Financial
Company Market-Cap:	$8,450m AUD
Demands:	Remuneration

As a former portfolio manager for U.K. activist The Children's Investment Fund Management (TCI), John Ho is used to being described as an activist. In 2015, he pleaded his innocence after George Savvides stepped down as the CEO of Medibank Private, saying he had played no role in the transition.

Despite excusing himself from that decision, Hong Kong-based Ho has been a vocal advocate of the formerly state-owned enterprise transitioning to a nimbler, shareholder-directed company and says the stock is poised for great things. Already, things are looking up—Medibank stock rose 37% in the first half of 2016, and the company announced the appointment of Craig Drummond as its next permanent CEO in March.

Executives who have sat down with Ho talk of his focus on strategy, as well as remuneration. Janchor reportedly manages more than $2 billion USD, making Ho a powerful player in Australian markets.

3 The blocking stake

Activist:	Solomon Lew
Company:	David Jones
Company Industry:	Services
Company Market-Cap:	N/A (takeover)
Demands:	Oppose takeover terms

A $2.2 billion offer for Australian department store David Jones by South African retailer Woolworths ran high on personal drama, and saw investor Solomon Lew richly rewarded for exploiting minority protections in Australian merger law.

Lew had sat on an 11% stake in another retailer, Country Road, since 1997, preventing Woolworths from reaching the 90% threshold required to delist the company. Few had expected him to take the battle to another field, yet that is exactly what Lew did, eventually building a 9.9% stake in David Jones and implying he could block the takeover by Woolworths, which needed a 75% supermajority of shareholders on more than 50% turnout for the deal to pass.

Woolworths was initially reluctant to do a side deal with Lew, in case the Australian securities regulator applied a collateral benefits rule, increasing the cost of the takeover. In the end, it swallowed its reservations, paying Lew a 20% premium for his Country Road stake and waiting nervously before a judge ruled that other David Jones shareholders were aware of the benefits to Lew when they approved the deal. Commenting later, David Jones' Chairman, Gordon Cairns, paid the activist an unintended compliment, telling the Australian Financial Review, "it wasn't any old shareholder, it was Solomon Lew."

4 The board overhaul

Activist:	Lone Star Value Mgmt.
Company:	Antares Energy
Company Industry:	Services
Company Market-Cap:	N/A (in administration)
Demands:	Gain board representation

Antares Energy may have been listed on the ASX, but it was its assets overseas that caught the eye of a U.S. hedge fund. Activist investor Lone Star Value Management, run by Texan Jeff Eberwein, sought control of Antares's assets in the U.S. Permian Basin, nominating five directors to the board early in 2014.

Antares, which had only one independent director after nearly being wiped out in 2009 in the aftermath of the global financial crisis, fought back, arguing for the "whatever it takes" attitude of CEO James Cruickshank in the face of claims by the activist that the company had provided an interest-free loan to fund a house purchase.

At the end of a bruising campaign and after a phantom takeover bid from an unknown source, 65% of shareholders opposed attempts to remove three incumbent directors and replace them with the Lone Star nominees, despite ISS and Glass Lewis backing the activist. Sandon Capital later bought stock in the company, before it was placed into administration. Sandon admitted it made "a dud investment."

5 The asset sale

Activist:	Sandon Capital
Company:	Bluescope Steel
Company Industry:	Basic materials
Company Market-Cap:	$4,530m AUD
Demands:	Closure of business unit

BlueScope Steel has been on a tear since Sandon Capital launched its campaign in June 2015 with a presentation describing the firm as "the cheapest steel company in the world." Since then, BlueScope has upgraded its earnings guidance and shares have risen nearly 160%, yet management has not acted on the central recommendation of Sandon's thesis: mothballing the Port Kembla steel mill.

Right from the start, however, management was on board with Sandon's diagnosis, if not its suggested remedy. In an early response to the activist, BlueScope admitted its cost of production was too high—and severe cost-cutting has followed. The company's decision to buy-out its partner in a Cagill, U.S. joint-venture (BlueScope North Star) also won praise from the activist.

Although Sandon has said Australian steel-making lacks the scale to recover its former glories, it has been content to enjoy bumper returns from the stock over the last 12 months.

6 Takeover attempt

Activist:	Coliseum Capital Mgmt.
Company:	The PAS Group
Company Industry:	Consumer goods
Company Market-Cap:	$92m AUD
Demands:	Takeover company

U.S. hedge fund Coliseum Capital Management made a takeover bid for The PAS Group in October 2015, just over a year after the apparel retailer had gone public and ten months after Coliseum had first acquired a minority stake.

PAS, which owns a collection of brands, rejected the 20% premium Coliseum was willing to pay as inadequate, saying a 30-40% premium was more in keeping with deals in the Australian marketplace. That was the trigger for Coliseum to launch a tender offer, increasing its stake to 46% by November 2015.

Since then, the stalemate has seen Coliseum switch to a more conventional activist approach, accepting two seats on the board in February. PAS Chairman Rod Walker welcomed the directors, saying in a statement, "They will bring deep and relevant experience to PAS and they will be valuable additions to the board." Shares have continued to trade at an elevated level, likely anticipating another bid.

Roundtable discussion

Activist Insight conducted a series of interviews with leading practitioners in the field of shareholder activism in Australia, the U.S. and Canada. The following views are extracts from these conversations.

Participants

Jeremy Leibler and Leon Zwier, Partners of Arnold Bloch Leibler.

Michael Chandler, Governance Director of GPS Proxy

Australian activists: Alex Waislitz, Chairman of Thorney Opportunities; Mark Carnegie, Founding Partner of M.H. Carnegie; Gabriel Radzyminski, Managing Director of Sandon Capital

U.S. activist: Jeff Eberwein, CEO of Lone Star Value Management

Foreign advisers: Ele Klein, co-Chair of Schulte Roth & Zabel's shareholder activism practice (U.S. and U.K.) and Ian Robertson, Executive Vice President of Kingsdale Shareholder Services (U.S. and Canada)

What are activists and why have they become so successful?

Ele Klein, Schulte Roth & Zabel: "In the U.S., 'activism' has become more accepted as an asset class and as an approach to companies that are frequently underperforming and need a little help to get back on the right track."

Ian Robertson, Kingsdale Shareholder Services: "[In Canada,] both investors and companies are coming to realise that activists are not issues to be managed, but significant shareholders that need to be engaged. Activists have become more sophisticated in their approaches—by putting forward very credible theses and the fact they are delivering results, they are finding a sympathetic ear with some passive investors who are frustrated with management's ability or willingness to pull the right levers for value creation."

What is happening in the world of activism in Australia?

Jeremy Leibler, Arnold Bloch Leibler: "Over the last two to three years, there has been sustained interest in activism in Australia. The majority of demands are happening behind the scenes. Target boards are preparing for activism and are very keen to resolve issues behind closed doors."

Mark Carnegie, M.H. Carnegie: "Activism will come to the big end of town in Australia, there's no doubt about it."

Alex Waislitz, Thorney Opportunities: "People are realising that this is perhaps an easier landscape. Local ideas are seeking foreign capital."

Leon Zwier, Arnold Bloch Leibler: "Those shareholders who are up-to-date on the role of activist investors recognise that they highlight governance issues and sort things out."

Gabriel Radzyminski, Sandon Capital: "Not many people would want to be activists every day of the week. We are ultimately a small market, including fund managers and company management, that operates with one degree of separation. We're on the outside... But all of the reasons why activism isn't common are the reasons why we think the opportunity is so large."

What are activists likely to focus on?

Waislitz: "I'm not a big fan of the word 'activism' as it implies a hostile inference. I prefer 'constructive catalyst' for change, or extracting value. We've taken that approach at the board and management level for 20 years."

Zwier: "Activism in Australia is likely to focus on director duties and governance. Regulators and government are both hot on it, and the media understand corporate culture in big business is an issue, so will continually write about this."

Michael Chandler, GPS Proxy: "There's a perception that the markets are going sideways, so the activism we're seeing resonate with shareholders is a combination of value and governance."

Robertson: "We see 'say on pay' and pay for performance issues often used as an initial wedge for an activist and the canary in the coal mine for potential anti-management sentiment. With commodity prices and [total shareholder return] dropping rapidly, we see a lot of CEOs whose pay is put out of whack as their pay no longer is aligned with the company's performance, often for reasons beyond their control."

What tools might they use?

Leibler: "Quite a few aspects make Australia more favourable for activists. The most prominent is probably the 'two-strikes' rule. Although it's rare that a second strike results in a board spill given the 50% threshold, it's extremely impactful in terms of the leverage you can exert. There's an aversion to reputational damage. Directors really want to avoid a strike, even if their position is safe."

Zwier: "In one recent M&A transaction, a company had told shareholders it expected flat growth. When a U.S. investor then made a takeover offer with a small premium, the same company backtracked and said it had plenty of blue sky. We used that inconsistency to bludgeon the company into accepting the takeover."

How do Australian superannuation funds view activism?

Chandler: "There are lots of conversations between big shareholders and management behind the scenes, with funds prepared to give them the benefit of the doubt, at least the first time around. I expect more of these conversations are reaching the 'your time has run out' stage as shareholder patience continues to wear thin. We believe that traditional shareholder reluctance to jump onto the activist bandwagon will quickly fade once a few of the specialists prove that they can unlock value for ASX listed companies."

Waislitz: "Superannuation funds are pro-creating value. At this stage, they don't want to be activists themselves, but are more than happy to support others who want to be the public face of a campaign. They are changing their ways too; they're much more open than ten years ago. I think we'll see larger market-cap targets. Some are still run pretty poorly and are not taking responsibility."

Eberwein: "A country where most of the money is in pension funds is going to be more conservative, but when they break [ranks], it gives political cover to activists."

What do you think about the criticism that activists are short-term investors?

Radzyminski: "You can't use the argument 'we're a long-term investor' to justify always supporting management. If you can change the status quo, overcome inertia, then good things can happen."

Carnegie: "These things [campaigns] are a marathon and everyone thinks they're a sprint. If you look at the U.S., campaigns are becoming increasingly long-term."

What's the outlook for activism in Australia?

Leibler: "U.S. distressed debt investors have become involved in every collapsed company in Australia in recent years, and I see activism growing in much the same way."

Carnegie: "You need a period of difficult economic conditions. Australia was one of the most 'active' markets for activism in the world in the 1980s, and the backlash against that is why there has been a move to favour incumbents so much. Activism will inevitably come, but I'm just not sure how long it's going to take."

Waislitz: "For a pure activist play, funding is small but growing. I anticipate that it will grow with international capital and most U.S. or Asian institutions will want a local partner to navigate the market [in a campaign]."