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BEYOND GOVERNANCE

A CANADIAN PERSPECTIVE ON PREEMPTING ACTIVISM THROUGH VALUE CREATION

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Canadian companies' boards have steadily intensified their focus on good governance practices. They spend an increasing number of hours on oversight of internal controls, performance measurement, and corporate disclosure. For many companies, this emphasis has been driven by a belief that good governance alone can deter criticism by activist shareholders. And it's easy to understand why. Proxy advisory firms, sophisticated institutional investors, and regulators routinely introduce new criteria by which to assess the quality of a company's governance practices. Credit-rating agencies have also incorporated assessments of governance into companies' credit ratings, resulting in new layers of industry standards and higher levels of scrutiny. Management teams and boards that get high marks for meeting these governance standards would understandably think that they are also excelling in their efforts to protect the company from aggressive shareholders.

Indeed, good governance is an important element of an overall defense against activist intervention, and in several instances poor governance practices have been among the issues cited by activists targeting Canadian companies. But more can be done. The best defense is to create sustainable shareholder value. Companies must therefore move beyond governance and implement procedures to ensure that their boards provide strong and active oversight of value creation alternatives and strategy development. Board members should engage regularly with senior managers to critically examine those alternatives in much the same way that an activist investor would, and then pursue the ones that generate the greatest shareholder value. Such collaboration has the potential not only to unlock shareholder value but also to equip management teams and boards to respond more effectively if an activist intervenes. Armed with a detailed understanding of the value creation alternatives, senior managers and board members can credibly assess an activist's proposals. (For more about institutionalizing the activist playbook, see "Do-It-Yourself Activism," BCG article, February 2014.)

Enhance the Board's Role in Value Creation

Board members who take a strong role in overseeing shareholder value creation can be powerful allies of the CEO. Many board members are current or former corporate executives, making them well suited to serve as thought partners with senior managers by challenging their assumptions and offering innovative ideas. And, because board members are removed from day-to-day operations, they can offer a fresh perspective on the company's approach to value creation. This would represent a much-needed change from those cases in which boards have been passive recipients of management's five-year strategic plan or have relied solely on quarterly or annual measures of total shareholder return to assess the company's value-creation strategy.

The board as a whole can increase its engagement with value creation or the company can form a committee of board members with oversight responsibility. The oversight activities and the nature of the interaction with management should be analogous to the role played by members of the audit committee with respect to financial matters. Board members must understand the value creation alternatives available to the company and be comfortable with the specific opportunities that management recommends pursuing. To ensure that board members can provide effective oversight, the management team should rigorously evaluate and clearly present the company's value-creation alternatives and be receptive to the board's guidance. For an example of a charter setting out the mandate for a value creation committee, see Norton Rose Fulbright's Special Situations Law site at specialsituationslaw.com/resources.

Provide Oversight of Three Primary Responsibilities

The board should ensure that the management team carries out three primary responsibilities with respect to value creation.

Assessing the Full Suite of Options for Value Creation. Board members should require senior managers to evaluate and present the full suite of alternatives for creating shareholder value. These options might include acquisitions or divestitures, significant investments to accelerate organic growth, cost reductions, alternative capital strategies, or transformational programs. Board members should be sufficiently engaged to understand the sensitivities, risks, and opportunities related to each option.

Board members should apply the insights gained from their collaboration with management to encourage bold moves to transform the company's stand-alone operational performance. By benchmarking its operations against those of its peers, the company can understand where to cut costs or simplify products and processes, as well as where innovation efforts are lagging. Cost cutting, of course, must be considered in the context of a business unit's overall strategic value. For example, meeting cost benchmarks by indiscriminately slashing investments in innovation and R&D will not promote the long-term interests of shareholders.

To adopt an activist's mind-set, board members must scrutinize the company's capital efficiency. For example, does the company possess significant assets or business segments that are not considered strategic or core to the achievement of its primary business objectives? Giving due consideration to the company's ongoing free cash flow, board members and senior managers should make fundamental decisions about how to optimize capital structure, dividend policy, and share buyback policy. Understanding the expectations of the investor base and the broader investment community is essential to selecting the right financial moves, such as higher dividends, special dividends, or share buybacks.

Evaluating How Strategic Options Affect TSR. To truly think like activists when assessing potential value-creation alternatives, board members and senior managers should consider how a particular strategic option would affect TSR. A clear view is needed of what the basic strategic plan will deliver in terms of TSR if executed successfully. Consideration should also be given to how the company's various capital and transaction alternatives would affect TSR and how those returns compare with internal and market expectations. Management and board members can apply this evaluation to defend the company's chosen strategy as the best option to unlock long-term shareholder value. Successful companies also embed the TSR lens into their corporate culture through target setting, planning and budgeting, resource allocation, incentives, and training.

A change in a company's valuation multiple is a critical component of TSR. Consequently, understanding which variables (such as operating margin, top-line growth, and capital allocation decisions) have the most impact on the multiple can help management select the value creation moves that capital markets will reward most highly. A useful source of insight for this inquiry is an understanding of how the research-and-investment community values the company as a whole. For example, is a sum-of-the-parts approach applied and, if so, does the company trade at a discount to its intrinsic net asset value? Investigating how management's opinion about the company's valuation differs from that of the research-and-investment community can provide a critical input in selecting the path forward.

Understanding Long-Term Shareholders' Views on Value Creation. Management teams would never ignore the views of the biggest customers for their products or services; however, they sometimes ignore the views of the biggest customers for their capital—that is, their major shareholders. If the first time a management team reaches out to its major shareholders for advice and support is when an activist attacks, it probably has already lost the battle.

Board members should ensure that management is diligently conducting dialogues with major shareholders and using the feedback to inform themselves of possible value-creation opportunities. These dialogues should be conducted as a matter of routine practice. Management, specifically the CEO and the CFO, should understand major shareholders' investment theses for the company, their views about the company's direction, and which "buy" and "sell" triggers they are tracking. Shareholders will typically communicate their expectations regarding growth, yield, and other sources of value. Knowing these expectations helps the management team understand whether the company has attracted shareholders who will support its strategy. If support is lacking, migrating the shareholder base to a different type of investor should be explored.

For companies that effectively promote strong board oversight of value creation, the effort will be worth the rewards: superior long-term shareholder value and a strong defense against activist intervention.

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