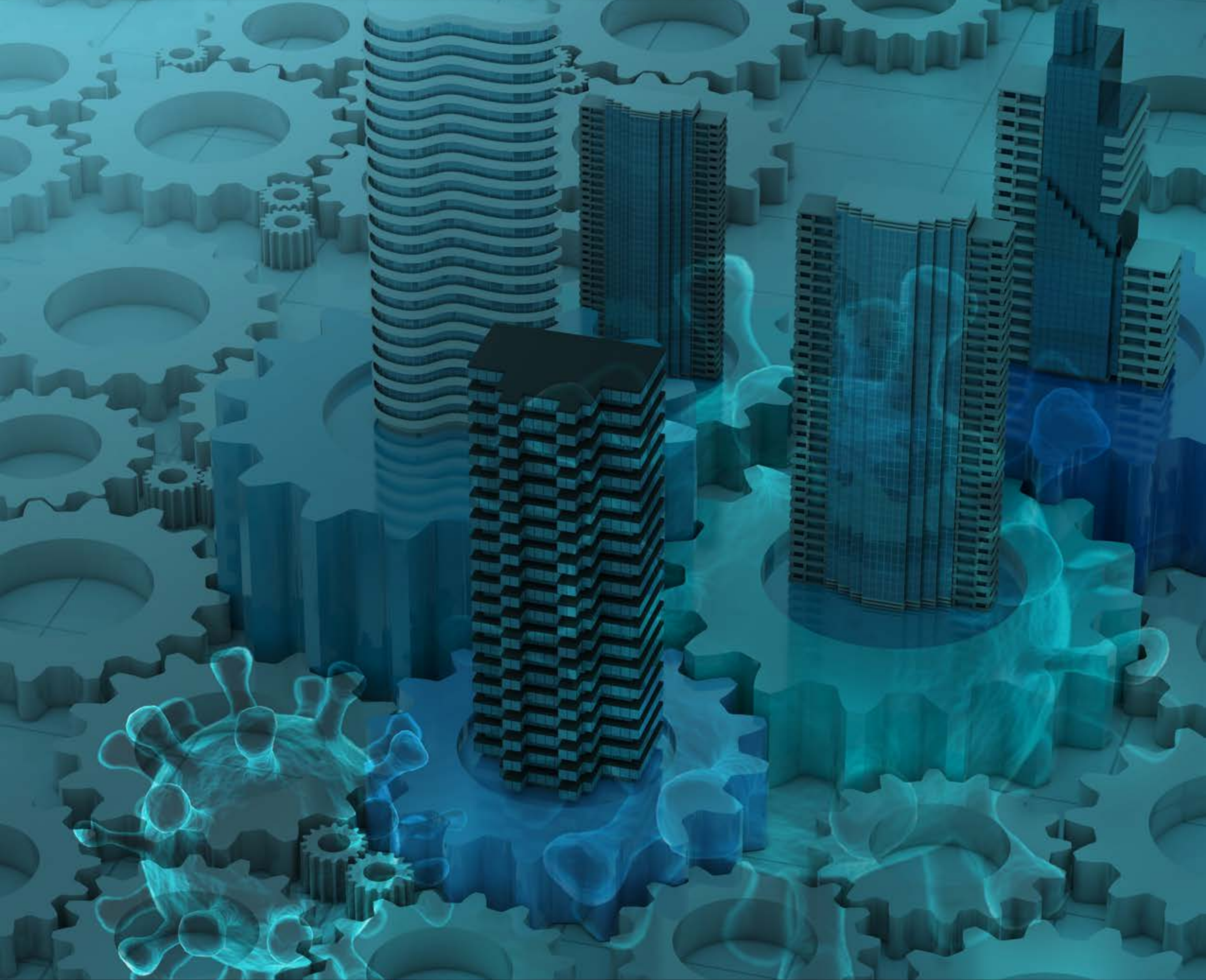
A Corporate Board Member / Shearman & Sterling LLP Research Report



EFFECTS OF COVID-19 ON SHAREHOLDER ACTIVISM AND M&A:
Views from Corporate Boards and the Market

CORPORATE BOARD MEMBER®

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AS WE CONTINUE TO NAVIGATE THESE UNCHARTERED WATERS, Corporate Board Member and Shearman & Sterling LLP surveyed 250 public company directors over the summer of 2020 on their outlook for shareholder activism and M&A activity in the Covid environment. The survey included large and small public companies in a wide range of industries, with questions ranging from impact of the pandemic on corporate strategies to details of activist campaigns and the types of M&A transactions companies are considering.

Drawing upon the responses, the cumulative data was both eye-opening in some regards and predictable in others. It is undeniable that the Covid environment has shaken up shareholder activism and the M&A market, but the valuable insights gained from the survey data can be used to shape strategy and evaluate the evolving landscape in the most desirable way onward. We hope you draw on this analysis and outlook in leading your organizations through the pandemic and preparing for a new era after we come out of it.

KEY FINDINGS

- The early days of Covid (March-April) and the large-scale market volatility tested shareholder activism and have shown that companies and industries had different experiences with campaigns and different responses
- Issues that present significant risks or material weaknesses for companies operating in an unprecedented environment may be opaque and not always understood, so open lines of communication between companies and shareholders are essential
- Defensive tactics, such as poison pills, came to the forefront after many dormant years at a number of companies experiencing effects of market volatility
- Boards continue to be interested in M&A long-term, and management has been identifying opportunities, as companies and investors adapt to the new normal
- Evaluating an M&A opportunity, on the other hand—particularly the ability to assess whether changes that business experienced as a result of the pandemic are temporary or long-lasting—and the resulting challenges with valuation have been one of the major hurdles for M&A activity in 2020

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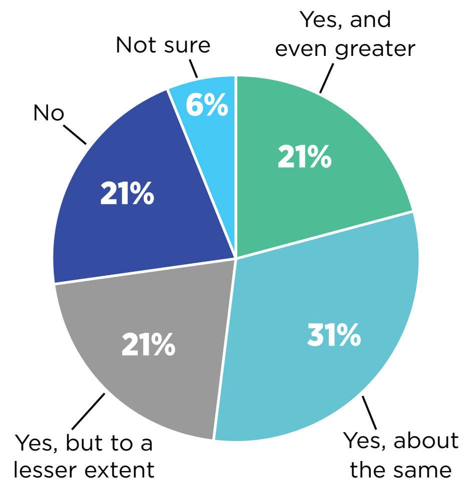
OPPORTUNISTIC STAKEBUILDING AND TAKEOVERS ARE NOT A STRANGE OCCURRENCE in market downturns; yet activist activity abated in the first half of 2020, at a time when stock market valuation of public companies declined—in some cases by 50 to 90% during the March troughs. Notwithstanding that some activist funds saw an opportunity to build significant positions in their targets, other activists paused to understand if the drop presented an opportunity or was potentially a reflection of a fundamental change in the company's business. The reflex to pause seems to have prevailed, as the number of campaigns launched in the first half of 2020 were down 10 percent year-on-year from 2019, with the most significant drop occurring in April.

The potential reasons for this decline abound. Of course, the sudden shutdown of the economy and the enormous volatility in the stock market, including so many companies pulling their guidance, was at the heart of the issue. But some also say that the high sensitivity of the situation—the way it has affected individuals and communities around the world in such a profound manner—has led activists to assess their tactics, at least until there is more stability and a clearer view of the future. Others believe that because governmental aid programs have helped artificially prop up suffering companies, activists may have been waiting for the effects of the stimulus to pass to better assess areas of vulnerability.

Percentage of directors anticipating an uptick in shareholder activism similar to the financial crisis post-Covid?



Then the stock market dynamic changed. The markets turned bullish again, with the S&P 500 and Nasdaq both breaking new records. People and companies started to adjust to the new "normal" of the pandemic, and there was an uptick in activist campaigns. Contrary to the liquidity crunch of 2008-09, there is also significant amounts of cash and financing available, which could further support activism. Nearly three-quarters of public company directors surveyed say they, indeed, expect an increase in shareholder activism, with more than half (52 percent) saying it will be as or more intense than what was experienced during the Great Recession.

But the unprecedented nature of Covid-19 has also created a new reality that makes it difficult for activists to operate: no one really knows how to navigate these waters effectively yet. The situation is still evolving, no one has a solution to surmounting the obstacles of Covid, and there is great uncertainty about what a post-Covid business environment will even resemble. Remote work is seemingly here to stay, what impact will that have? Is commercial real estate on a steady decline? Are bricks-and-mortars on an accelerated path to obsolescence? When will people be back on planes and at hotels for business and pleasure? Activists, like corporate leaders, don't have much historical data to rely on to draw the best strategy to move forward. Peer comparison will likely remain the best benchmark in assessing success, and that is unlikely to be feasible until we emerge on the other side of this crisis.

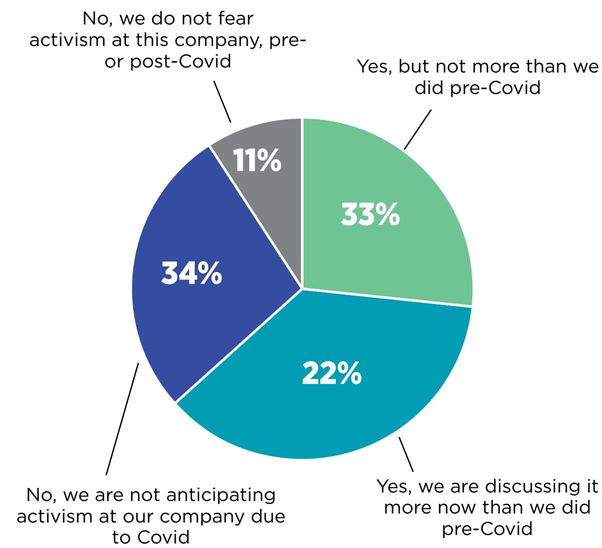
Yet, boards should not ignore the potential for surging activist movements. Directors and their companies must stay alert to vulnerabilities that would open the door to activism. In an environment as volatile and as unpredictable as that of 2020—and one that is seemingly set to continue as such into 2021—numerous companies can, in fact, find themselves in a vulnerable position at the turn of a headline.

At the time of polling, the majority (55 percent) of corporate directors said their board had brought up the increasing risk of shareholder activism since the onset of the pandemic. This is not surprising considering that more than a third say their board has identified new significant risks or material weaknesses as a result of Covid-19 that could be flagged by shareholders or activists. The data also highlights certain industries' heightened vulnerability and susceptibility to activism, with 40 to 50 percent of respondents in each of the Real Estate, Hospitality & Construction, Technology and Telecommunications industries saying they are now discussing the risk more than they did pre-Covid.

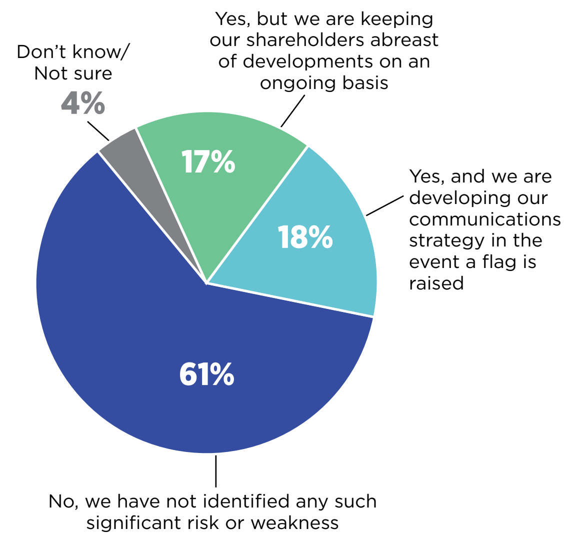
While there was a relative dip in activism during the first few months of the crisis, the recent uptick in campaigns shows that activists won't remain on the sidelines for long and are actively reviewing opportunities, including those created by both the short- and long-term effects of the pandemic. In fact, we expect that there will not only be a continuation of the recent uptick in activist campaigns, but new, first-time entrants will be joining as well. The percentage of first-time campaigns during the pandemic has been surprisingly consistent at roughly 30 percent of the total campaigns.

For that reason, discussing the risk of activ-

Has your board discussed the risk of shareholder activism since the pandemic hit?



Has your board identified any new significant risks or material weaknesses as a result of Covid-19 that could be flagged by shareholders or activists?

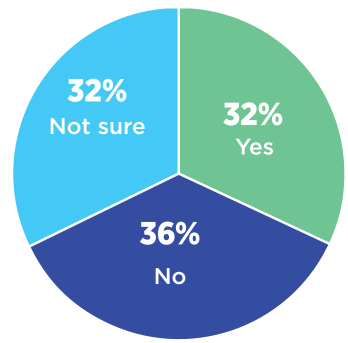


ism at the board and management level and maintaining ongoing communications with shareholders are always best practices—particularly so in the current climate. Boards must make sure that their companies are getting ahead of the issue before an activist comes knocking by communicating with their shareholders regularly and engaging in discussions to stay attuned to their concerns. The more openly and the more regularly the company communicates with its shareholders and shows that it considers shareholders' concerns, the less of an impetus for shareholders—whether institutional or activists—to start putting public pressure on the company or advocate board or CEO level changes. Setting aside the aggressive tactics of some activists, shareholders often feel that they need to escalate if they get a sense that they are not being heard.

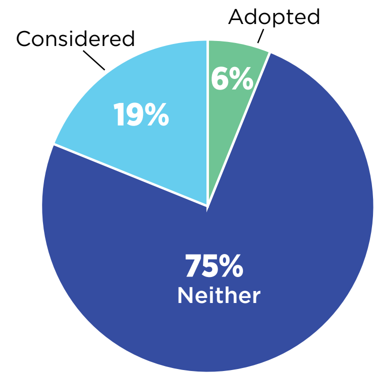
What's more, boards need to consider the use of temporary measures if they believe the risk is heightened. For instance, in March, when valuations for a number of companies dropped by as much as 50 to 90 percent of pre-Covid levels and signs emerged of opportunistic buyers trying to take advantage of highly depressed market prices, there was an increase in the adoption of poison pills. Some boards were very concerned that with the dislocation in the stock market and the precipitous drop in their stock price an opportunistic buyer could acquire control of the company without paying a control premium. In reaction to that threat, many started considering poison pills to protect the company and its long-term shareholders.

Many poison pills adopted during that time had typical features, such as a bifurcated trigger (10 percent for activist investors, 20 percent for institutional shareholders) and short duration (under one year), so they were not opposed by shareholders and were consistent with Glass Lewis and ISS guidance. Poison pills that came under scrutiny, however, were those that had more aggressive

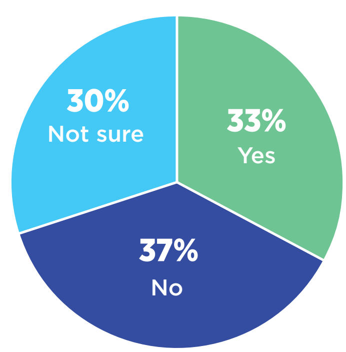
Percentage of directors who believe there will be an uptick in hostile takeovers as a result of the crisis



Percentage of companies that have considered or adopted a poison pill as a result of the Covid-19 crisis



Percentage of directors anticipating an increase in poison pill adoptions within the next 12 months



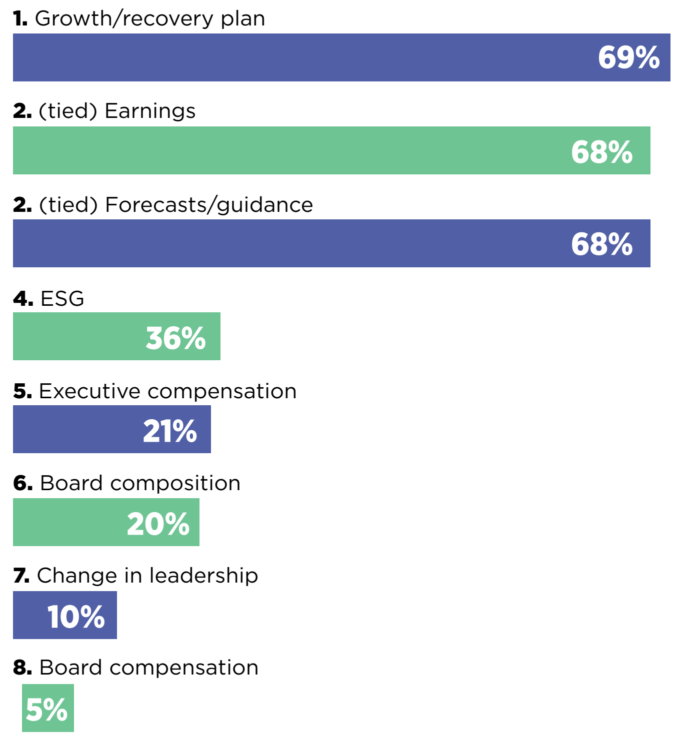
features, for example a 5 percent threshold, which is more typically reserved for so-called "NOL poison pills" (to protect tax assets including net operating losses [NOLs]), which some companies started considering as well.

According to our study, the number of directors who expect an uptick in hostile takeovers and those who don't are relatively similar, but the data indicates these views are likely shaped by industry perception, as there is a significant plurality of those in Consumer Products & Retail, Financial Services, Health & Life Sciences and Telecommunications anticipating an increase. One-quarter of respondents say their company has considered or adopted a poison pill as a result of the crisis, and one third expect an increase in the adoption of such measures in the months ahead, as it remains to be seen whether another market downturn is on the horizon.

There is no doubt that the savviest boards are looking at all factors—their business, their people, their customers and suppliers, their shareholders and their stock price—in an effort to maintain proper governance and evaluate different tactics in a highly challenging and quickly evolving environment. For now, though, shareholders are focused on getting back on track. Seven directors out of 10 say their company's discussions with investors have so far been focused on growth and recovery, as well as earnings and guidance—logically.

We also see a continuation of focus placed on prominent market trends that emerged prior to the pandemic, including ESG and other corporate governance-related issues. While investors seemed to pause on these topics as well in the first few months of the pandemic, we could now see an accelerated or shifting cadence in how these issues are approached by companies, directors and shareholders alike as they react to the turbulent market landscape.

Percentage of directors anticipating an increase in poison pill adoptions within the next 12 months



TAKEAWAYS ON THE CURRENT CLIMATE OF **SHAREHOLDER ACTIVISM**

- While activism during the first half of 2020 declined year-on-year, as soon as the market turned bullish, activity rebounded. Boards and management teams would be well-served to think proactively how to deal with an activist campaign—foreseeable or not.
- Boards should be prepared to react quickly to an activist "sweeping" the market and accumulating a potential controlling position and the threat that such action poses to the company and its shareholders. They should also be prepared to engage with an activist who raises business concerns, as lack of engagement on the company's side may prompt even long-term institutional shareholders to back an activist campaign.
- Ongoing communication with shareholders is a priority. Boards should remain flexible in the evolving business environment but also have a formulated plan forward in the face of uncertainty. While difficult, a lack of communication of the plan and the underlying assumptions about the future could leave shareholders frustrated and open to supporting an activist.
- In this highly unusual environment, defensive measures, such as poison pills with standard features, have been generally accepted by shareholders and proxy advisory services.
- Companies view growth and a recovery plan to business disruptions from Covid-19 as the leading topics of conversation with shareholders but should not lose sight of other topics that shareholders are focused on, such as earnings, executive compensation, ESG and others. Those are all bound to resurface as investors adapt to the Covid environment.
- ESG, social justice, along with broader stakeholder responsibilities, are top of the mind for many boards and shareholders but have become an even bigger focal point during the pandemic and will guide boards' discussions coming out of it.

> **"While there was a relative dip in activism during the first few months of the crisis, the recent uptick in campaigns shows that activists won't remain on the sidelines for long."**

M&A

With an economic shutdown bringing valuations to record lows, the market unveiled significant opportunities for companies to further strengthen their portfolios or gain market share. Nevertheless, very few market participants have taken advantage of low valuations. According to Mergermarket, global M&A activity in the 1H of 2020 was down 53 percent year-on-year by value compared to 2019.

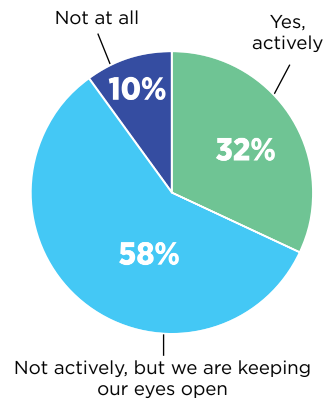
Our survey of public company boards further confirmed it: less than a third of directors reported engaging in M&A activity during the first half of 2020, and only 8 percent said that Covid-19 had unveiled M&A opportunities for them.

The significant drop in M&A activity in the first half of the year is likely a symptom of an unprecedented disruption in the economy and the business environment. As companies were rushing to boost their liquidity and raise financing, many of them also reduced to a minimum their spending on anything but the most necessary business needs. M&A transactions for many were not at the top of the list. It is important to note, however, that this was not an indication of a change in M&A strategy or in the desire to pursue M&A generally, as directors have highlighted, with 90 percent of companies in the survey keeping their eyes open for M&A opportunities. When asked what boards were looking for in M&A, the respondents highlighted operational synergies, gaining market share and revenue growth.

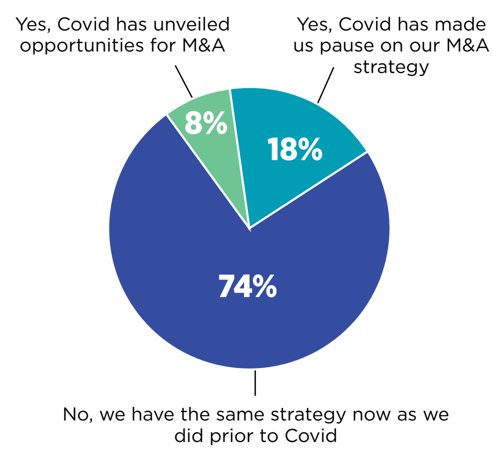
If more companies haven't taken advantage of valuation discounts, directors say it is mostly due to the enduring uncertainty. Many say they prefer to lose an opportunity for a deal at a discounted price to avoid the risk of making a bad one.

While valuations and projections are always significant challenges of M&A transactions, those concerns are, indeed, heightened in times of crisis, and the economic uncertainty brought about by Covid makes it particularly important to understand the business that

Is the company currently pursuing potential mergers or acquisitions?



Has the company's decision to pursue (or not) an M&A changed due to the Covid crisis?



you are buying and to be able to adequately assess and form a view on how the target company is going to come out the other end of the pandemic. The unprecedented nature of the pandemic made valuations and the underlying assumptions and projections for many businesses particularly difficult.

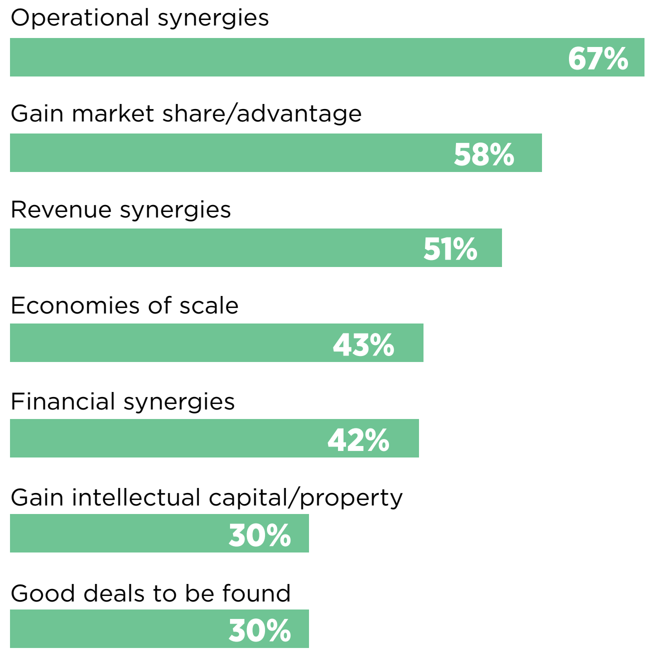
There is also the issue of time constraints, with so many aspects demanding the time of the executive team just to try to recast a lot of the planning. Adding to that the fast pace of change, and the future has become all the more unpredictable, as companies are propelled into the digital age—ready or not.

Certain industries' business and growth strategies have been disrupted more than others due to Covid-19. A majority of the Automotive & Transportation, Consumer Products & Retail, Financial Services, Media & Entertainment, Mining & Metals, Oil & Gas, and Real Estate, Hospitality & Construction industries all indicated that their boards' growth strategy had been affected to at least a considerable extent.

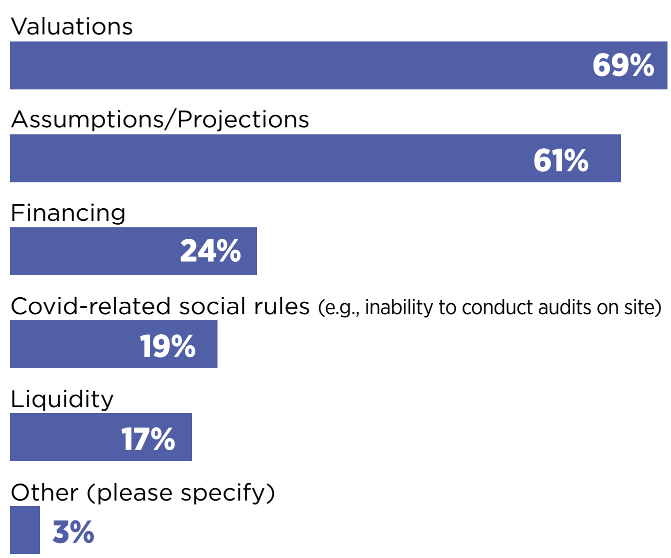
But there is also risk inherent to waiting out the climate until things improve. Proponents of the idea of seizing opportunities when they arise, as opposed to waiting out until the recovery, could build a leg up on their competition at once-in-a-lifetime valuation levels. The argument that competitors are most likely not sitting still and that the external environment is always changing may put pressure on and force a company to act. And while an acquisition may not be the best path forward for some, other transactions such as trimming the business portfolio, divesting unprofitable businesses or merging with a stronger company may drive M&A for some companies during the market downturn.

The balancing act of when and how to pursue deals is never an exact science, but those who stay focused and adapt to market conditions often benefit over the longer term.

What are (or would be) your primary reasons for pursuing an M&A?



Biggest challenges to pursuing M&A in the current environment



**Respondents were asked to select top 2*

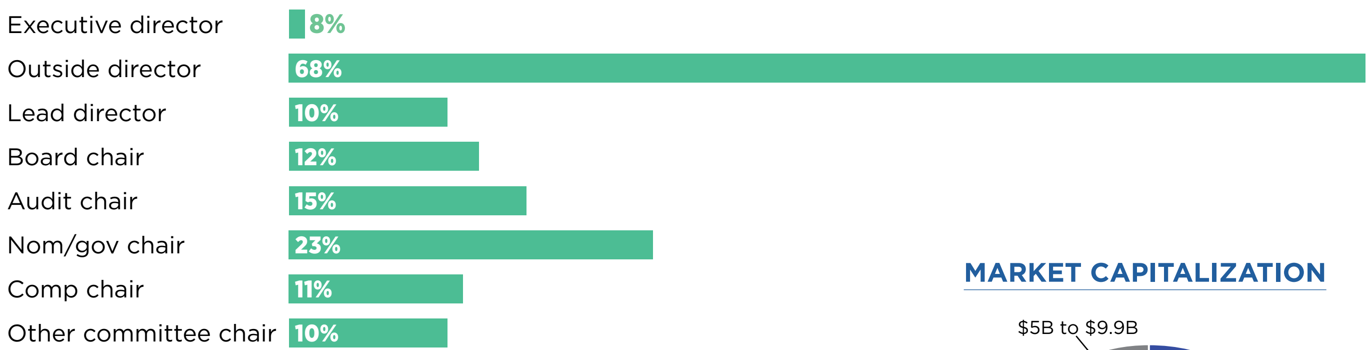
TAKEAWAYS ON THE **CURRENT M&A CLIMATE**

- Overall, directors indicated that their M&A strategy hadn't changed significantly, but execution has been met with a predictable hesitation. M&A activity stalled during the first half of 2020, as buyers and sellers evaluated the landscape and organizational focus turned toward internal business operations and the disruption caused by the pandemic.
- The inherent risk of a second wave and the valuation implications caused by the pandemic present both risks associated with the unpredictable outlook for the business to be acquired and opportunities to capitalize on historically low asset prices in some industries.
- Boards and management should gauge the health and prospects of the company's various business lines in an effort to stay nimble in a constantly changing environment.
- Certain industries have shown higher degrees of volatility throughout the crisis, and boards should remain extra diligent in evaluating opportunities and how the targets may perform in a potentially reshaped sector. A deal that looked attractive 6-12 months ago may have drastically shifted.

> **"The balancing act of when and how to pursue deals is never an exact science, but those who stay focused and adapt to market conditions often benefit over the longer term."**

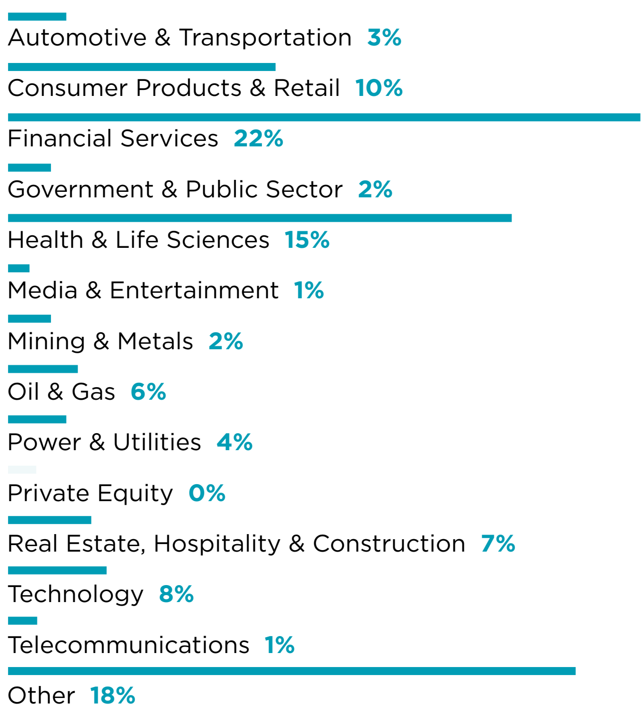
Demographics

TITLE

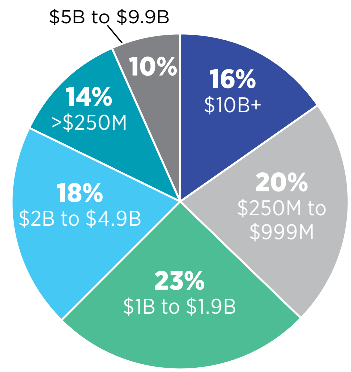


*Respondents were asked to select all that apply.

SECTOR

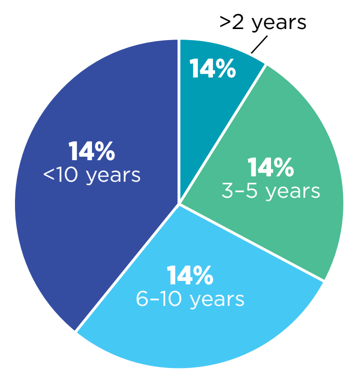


MARKET CAPITALIZATION

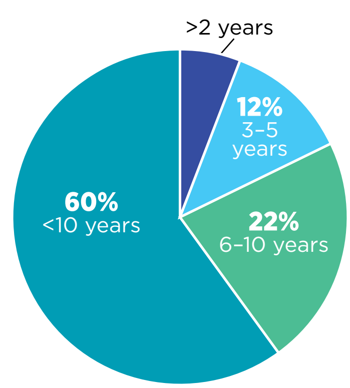


*Percentages may not add up due to rounding

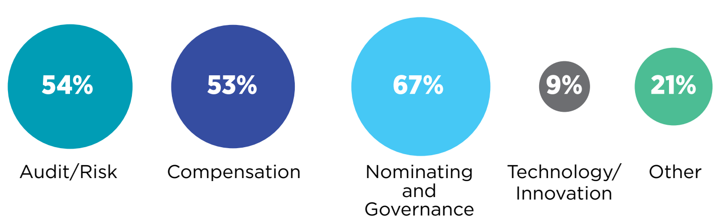
TENURE AT CURRENT BOARD



PUBLIC COMPANY EXPERIENCE



COMMITTEE REPRESENTATION



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George Casey, Global Managing Partner of Shearman & Sterling, who led the work on the survey with the Corporate Board Member and the Chief Executive Group, is a highly recognized long-term advisor to boards and management of major companies on corporate governance, shareholder engagement and strategic M&A. Shearman.com LinkedIn