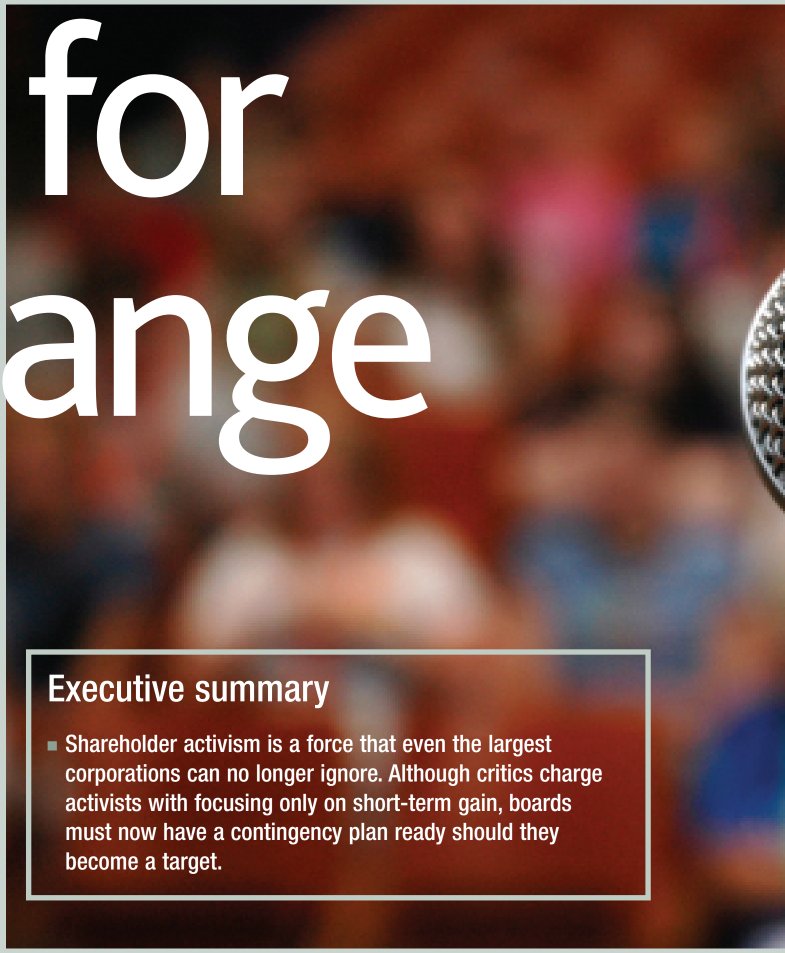
Agents for change



Executive summary

- Shareholder activism is a force that even the largest corporations can no longer ignore. Although critics charge activists with focusing only on short-term gain, boards must now have a contingency plan ready should they become a target.

Shareholder activism has regularly made headlines this year and even the stalwarts of the FTSE100 have felt its impact. Barclays' proposed merger with ABN Amro was opposed by Atticus Capital, which claimed that the union was unlikely to create value, mobile phone giant Vodafone continually faces pressure to dispose of its stake in US operator Verizon Wireless, while Cadbury Schweppes' decision to demerge its drinks business was widely believed to be a concession to activist shareholder pressure.

The most recent example at the time of writing is US-based investor TPG-Axon's threat to oppose Akzo Nobel's £8.1bn purchase of ICI, which it says will destroy shareholder value for the Dutch company.

According to analysts at Citigroup, other UK and European blue chip companies, including Ericsson, Royal Dutch Shell, GlaxoSmithKline and Henkel, represent potential targets for activists. Each fits the model that activist groups are drawn to – a large, undervalued company with low debt levels and strong cashflow that is better protected against bid speculation because of its size.

In the case of ABN Amro, it was investor activism that triggered the initial break-up of the Dutch bank. The Children's Investment Fund claimed that its competitive position was in decline and lobbied for the break-up, spin-off, sale or merger of the bank's businesses – either separately or as a whole – to create shareholder value. This led directly to the agreed bid from Barclays.

At Vodafone, activist investor Efficient Capital Structures, which is backed by Marconi's former Deputy Chief Executive John Mayo, wants the group to dispose of its 45% holding in US mobile phone operator Verizon Wireless.

Although Vodafone's stake in Verizon has proved a good investment, having risen sharply in value to an estimated $58bn, Efficient Capital Structures describes it as "passive", and complains that Verizon operates independently of Vodafone's management, pays no dividend and operates a different network technology to the UK group.

Yet Efficient Capital Structures' own holding in Vodafone represents a mere 0.0004% of the group's £83bn share capital. It has still been able to maintain pressure, with claims that Vodafone could release up to £38bn to return to its shareholders, and has gained support from some of the group's main investors for initiating a debate about its corporate strategy.

The saga has underlined the fact that activist investors that represent only a very small percentage of a company's total shareholder base can exert a disproportionate influence on management to change strategy.

At Cadbury Schweppes, the group's announcement of its demerger plans came only two days after US investor Nelson Peltz bought a 3% stake. Veteran fund manager Anthony Bolton felt the two events were clearly linked and criticised Cadbury's management, which responded that the demerger had been planned for some time and was unconnected to Peltz's stock purchase.

WHY THE TREND? So what has driven the activism trend? In part, it reflects the changing shareholder profile over the past decade. Pension funds and, to a lesser extent, insurance companies have steadily reduced their holdings in UK companies while hedge funds and internationally based institutional investors have moved in to fill the gap.

And as the investor base has changed, so has the character of those investors, according to Josh Critchley of Goldman Sachs. He says that smart investment managers have joined hedge funds or set up their own investment boutiques, where they have utilised the skills they developed working for banks. This new breed of shareholder has proved far more ready to challenge management.

Activism is usually spearheaded by an individual who has the backing of a small cabal which, in turn, reaches out to a broader group. These activist individuals are regarded as agents for change and the group is usually willing to let them take the lead.

The trend has extended as far as Japan where, until quite recently, shareholder activism was virtually unknown. However, even in Japan, funds have built up stakes in companies regarded as undervalued and put pressure on managements, traditionally averse to mergers and acquisitions, to consider potential deals.

It's a development that places board members in a difficult position. Many of them are only just waking up to the "seismic shift" that has occurred with the spread of US-style activist intervention beyond North America, says Critchley.

He adds: "Many boards have a relatively low level of knowledge regarding hedge fund activity and are under attack on two fronts, with bids on one side and activism from shareholders with only a small stake on the other."

A FORCE FOR GOOD? So has the impact of activism been positive? There is an argument that stirring things up is good for a company and forces it to reassess itself. Managers have the task of ensuring that the activists do not convert other shareholder groups; if activists are able to establish a common cause, then the case for a change of strategy is strengthened.

And the type of involvement represented by a well-established and long-term investor such as Hermes is to be welcomed, says Bernard Taylor, Director of the Centre for Board Effectiveness at Henley Management College. The Hermes Focus Fund adopts a collaborative approach, working with the management of underperforming companies over a timeframe of two or three years to turn them around.

By contrast, hedge funds tend to be less transparent or well-regulated operations, which may prove willing to back the company but are also alert to (and eager to exploit) situations in which they can make short-term gain. This is often achieved by exerting pressure on the chief executive for a change in corporate policy – a disorienting experience for the company, which needs to have allies with a genuine interest in the long-term success of the business.

Taylor says that Henley has studied the question of how a company creates value and takes the view that it does so by developing a mutually beneficial long-term relationship with investors, employees and suppliers.

"Cadbury could extract cash in the short term through cutbacks and sell-offs but in doing so risks marring its reputation for social responsibility and dealing fairly with employees," he adds. "A danger of activist shareholders seeking short-term gain is that it can undermine or destroy a reputation that the company has spent years in building up."

Rating agency Moody's supports this viewpoint, observing that, in the majority of cases, the most common demands made by activists are motivated by short-term gain rather than longer-term considerations and include the following:

- strategic changes;
- acquisitions, asset sales, sale of the company;
- share buybacks, increased dividends;
- cost reductions, implementation of operational changes;
- board representation, governance changes, or removal of the chief executive.

A similar view was expressed by the European Central Bank in June, when it warned that shareholder activism from hedge funds and private equity groups could be detrimental, and applying pressure to change corporate strategy "might often be excessively oriented towards the short term".

Moody's says that corporate governance reforms in the US, where activist investors such as Peltz, Carl Icahn and Kirk Kerkorian have taken on major corporations, have strengthened shareholder rights and enabled short-term investors to force major strategic or financial changes on companies.

The agency notes that activist campaigns usually centre on demands that a company sell off subsidiaries or return cash to shareholders. Most activists are media- and PR-savvy and "know how to get the biggest bang for their buck", says Jonathan Slade, Director, Capital Markets & Corporate Finance, of drinks group Diageo.

The media assault publicises the fact that the activists have an alternative future mapped out for the company. This makes it imperative that the board responds – hoping that the threat will go away is not an option. It must have a programme or strategy available that can be used to repel the activists. If their demands are turned down, activists will attempt to oust the existing management by appointing their own directors to the board.

KEEP OPEN LINES So how can boards of directors best respond to shareholder activism?

"Personally, I think the key is keeping open lines of communication with all shareholders and judging all strategic options in terms of value creation – all pretty basic stuff really," says Karl Fenlon, Head of Tax and Treasury at Hanson.

It's important for the board to understand who its shareholders are and to develop a relationship with them, adds Taylor. Will they work in partnership with you or are they only interested in short-term gain? You need to develop a rapport with those who take the long-term view, so that you can count on their support if a hostile bid develops.

It should also be stressed that opposition to activists' proposals may not always be appropriate, suggests Slade. The board's primary duty to a company's shareholders is to obtain best value for them, so a 'poison pill' defence would be an inappropriate reaction to a move that has the potential to create benefits for the company.

If, as in the case of an approach from a private equity firm, the aim is to take over the company, break it up or install its own managing director, a valid turnaround plan that can convince the company's allies is imperative. Potential allies are not only those investors who are in it for the long term, but also individual shareholders, who will often be customers or employees.

A classic case was provided by retail entrepreneur Philip Green, who attempted to capture Marks & Spencer after the retail giant slumped alarmingly in the late 1990s.

M&S's response was to bring in Paul Myners, who mobilised the company's long-term shareholders, put in his own team and set out a new programme. The company had a new chairman and virtually a complete new board.

"The ideal, for an underperforming company, is finding a white knight, who can turn the business around," suggests Taylor. "Unfortunately, there are relatively few individuals of this calibre."

THE TREASURER'S ROLE The business of the treasurer is to ensure that the board is fully aware of the company's finance capacity and the credit rating options that are available to it, says Fenlon.

"One element of some recent UK defence strategies has been the suggestion of a share buyback and a consequent potential reduction in credit ratings," he says.

"As a result, I'd be surprised if there's a treasurer or finance director who doesn't know the size of share buyback they could finance, if required."

The new activism has also put more pressure on the role of chief financial officer, says Critchley. Company boards must now be prepared to think the unthinkable, and potential targets need to have a contingency plan ready for use if needed. Some CFOs can offer a private equity background, making them well placed to consider and assess the full range of alternatives to accepting a takeover bid.

So is the phenomenon of the hyperactive shareholder set to continue? Possibly, but as Fenlon points out, the deals of recent years have reflected a number of factors – with much of the merger and acquisition activity fuelled by easy access to cheap money, low interest rates and new debt derivatives that banks have been able to use to reduce risk.

Now that interest rates are rising, debt is becoming more expensive just as the easiest targets have already been taken out. Recent difficulties experienced by banks in interesting investors in loans to finance two of the biggest proposed deals – the buyouts of Alliance Boots and Chrysler – have intensified fears of an impending credit crunch. It could be that the recent bout of activism marks a peak and it will now begin to wane.

But it would probably be wise not to rely too heavily on this outcome, suggests Critchley. He says that despite the recent market jitters, there is still a huge volume of liquidity out there and the pace is likely to pick up again this autumn.

"Potential activists are looking around and will be encouraged by the real – or perceived – successes by other activist individuals and groups," he adds.

"As deals get bigger and structures grow cleverer, so the fruit gets more low-hanging."

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Small fish in a big pond

Executive summary

- While the treasury management system (TMS) market has been consolidating, the international marketplace remains fragmented.
- With the smaller players continuing to provide stiff competition – particularly at a regional level – the larger players cannot afford to take anything for granted.
- Experts describe the marketplace as 'interesting' and the good news for treasurers is that there should be able to find a technology match to suit their requirements.

After a year of acquisitions and mergers, SunGard and Wall Street Systems are the leading treasury management system (TMS) suppliers in the market. But keeping up to date with technological innovations is not always so easy for larger TMS companies, and smaller vendors can react more swiftly to changing market demands and technology.

IN THE MARKETPLACE Dimos Dimitriadis, Head of Treasury IT Practice at Deloitte, believes that the TMS market has suddenly become more interesting. "There's been a lot of consolidation in the market over the last couple of years due to mergers and acquisitions," he says. "There are three main players dominating the market since being owned by private equity houses: SunGard, Wall Street Systems and IT2 Treasury Solutions. This was not the case a few years ago and the market has become suddenly interesting now there is clearly money to be made."

From an outside perspective, Misys, a global application software and services provider, says that the mergers have allowed more flexibility when dealing with the specialist vendors.

Neil Macro, Product Manager for Misys Treasury Plus, says: "The TMS market is saturated. There's obviously been a lot of

THE RIGHT TMS PROVIDER FOR YOUR ORGANISATION ISN'T NECESSARILY ONE OF THE BIGGER NAMES. **JENNIFER CARRUTH** INVESTIGATES.

"THE LARGER VENDORS CAN BE OUT OF THE LOOP ON WHAT CLIENTS WANT WITH REGARDS TO TIMESCALES. HAVING SMALLER COMPANIES IN THE MARKET KEEPS US ON OUR TOES."

consolidation with Wall Street Systems absorbing Trema and SunGard remaining inquisitive. But it does make life easier for us. With fewer vendors to deal with it makes it easier to have relationships with the vendors."

SMALLER PLAYERS But while the bigger players have been affected by the consolidations, there are still smaller vendors who remain untouched by merger and acquisition. "It is currently a fragmented market," says Thomas Bergqvist, Chief Marketing Officer for Wall Street Systems. "There are the smaller more local vendors in places like Germany and the Nordics, which have not been affected by the consolidation because it has not gone down to that level yet."

But even SunGard admits that if it weren't for the smaller players the marketplace wouldn't be so competitively healthy. When asked how important it is for the smaller TMS vendors to remain in the marketplace, Trevor LeFleche, Director of Product Marketing at SunGard, says: "There will always be a place for a new idea and it is the smaller vendors that are more likely to create these. If another company wants to use it then the smaller vendor will grow. There will always be a need for new ideas and processes."

LOSING OUT Yet, despite the recent consolidations in the market, companies like Wall Street Systems and SunGard are still prone to losing clients to the smaller vendors. "SunGard has conducted a lot of analysis as to why it ever loses a client to the smaller vendors, and also as to why it wins," says LeFleche. "We often lose to new releases, which merely boils down to timing, and sometimes the smaller vendors can be more astute when it comes to supplying newer products. Sometimes it just depends on whether it's a better fit for the client – we often lose or win by the narrowest of margins. The larger vendors can be out of the loop on what clients want with regards to timescales. Having smaller companies in the market keeps us on our toes."

Although smaller companies are often seen as more vulnerable than bigger companies to going out of business if they lose money, this may be less likely in the TMS market. According to Bergqvist, the question of what would happen if the smaller vendors were to go bust is not relevant.

For TMS clients there is always a degree of speculation as to whether the provider is making or losing money, and financial strength from the customer perspective is seen as one factor in whether clients choose to stay with the current provider or move on to a different vendor. But for the TMS providers the key question is not financial stability, rather it is their ability to predict market movements, and the associated upgrades in technology and required TMS changes.

According to Dimitriadis, even though many corporates prefer to fine-tune existing systems and find it hard to use their current system to its full potential, a more pressing concern than financial soundness is keeping TMS offerings updated. Meanwhile, peer pressure in the market creates an impression that TMS vendors are seeking continual improvement.

Bergqvist says: "The bigger technology companies will use the smaller vendors to get the latest technology and become the biggest client of that particular vendor. What inevitably happens is that the bigger companies obtain a grip over the smaller ones. This can often suffocate the smaller vendor. This is typical in financial software when dealing with smaller companies of 30 to 50 people."

LOOKING AHEAD The TMS market is livelier than ever. The latest rounds of consolidations need to settle down, yet the market is expecting more corporate moves. As Dimitriadis says: "There is still much to be taken into consideration for corporates – assessing their IT treasury needs, comparing them with what currently exists in the market, as well as looking at what may be available."

At present small, medium and large companies are all involved, or potentially involved, in the market consolidation. In every software market, people, companies and solutions emerge from nowhere and change the dynamic. Rather than perceiving this as an obstacle, users and potential users should see it as a positive.

For the moment it seems the smaller vendors have their part to play within the TMS market for the benefit of the end-user. Dimitriadis says: "What you get with the smaller companies is customer contact; you are more likely to speak to the same person with the smaller vendors. Along with cheaper software, the smaller vendors provide TMS software for those with a budget – something the larger companies cannot promise."

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