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Shareholder Activism Rises Down Under

There's a big opportunity for activist investors to generate superior returns in Australia, says Gabriel Radzyminski

Shareholder activism is well established in North America and throughout Europe, yet remains in an embryonic form in Australia.

Shareholder activism can take many forms. It can range from voting against a board remuneration report at annual meetings, targeting underperforming boards and management teams, suggesting capital management or corporate transaction initiatives, or individuals and interest groups actively voting on environment, social and governance (ESG) issues.

We believe shareholder activism is best applied where shareholder value is being destroyed as a result of persistent failures by a company's board and management in one or a combination of three areas – strategy, governance and capital management. As part-owners of a company, shareholders have rights and we believe all shareholders should actively use those rights where appropriate to bring about the necessary changes to maximise shareholder value.

We are confident that momentum for shareholder activism in Australia will continue to build from its current low base. Compared to many countries, Australia has an environment conducive to shareholder activism:

1. A large and rapidly growing pool of superannuation savings[1]
2. One of the most shareholder-friendly regulatory frameworks in the world[2]
3. An institutional shareholder base that has historically been very passive

A large and rapidly growing pool of savings

Australia has the fourth largest pension savings pool in the world, at approximately A$1.8 trillion, with a forecast to be circa A$6 trillion by 2035. Government, industry and corporate funds account for two thirds of the market, with self-managed superannuation funds (SMSF) making up the balance.

Historically, Australia's institutional investors have largely avoided allocating funds to Australian activist investors. With the growing awareness of the value created[3] and attractive investment returns available, we expect Australia's institutions to increasingly support activist campaigns and allocate funds to this strategy of management.

A shareholder-friendly regulatory framework

Australia's Corporations Act (2001) is possibly the most shareholder-friendly legislation in the world. Important aspects of this legislation are those that provide shareholders with rights to affect the composition of the board and the agenda of general meetings. In broad terms, a shareholder (or group of shareholders) owning more than five per cent of the issued capital of a company can:

- Call for a general meeting
- Put forward shareholders' resolutions
- Require the company to distribute a shareholder statement
- Seek the removal of directors
- Nominate directors

Compared to many countries, Australia has an environment conducive to shareholder activism and will not be exempt from the global activist trend

In 2011, an amendment called the Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act 2011 was enacted. Better known as the 'two strikes rule', this amendment meant that if a listed company's remuneration report was voted down twice, a full board spill would be required following the second strike. The voting threshold for the remuneration report is set low at 25 per cent, meaning that a 'strike' can be recorded with only 25 per cent of those voting shareholders casting their votes against the report.

Using the shareholder rights granted by the Corporations Act is the public face of investor activism. The reality is that much of Sandon Capital's work takes place behind closed doors and it is a tactical decision if and when we move the engagement to the public arena.

A passive institutional shareholder base

The opportunity for activist investors to generate superior returns in the Australian market is assisted by the passive indexation and benchmark-aware investment styles adopted by many institutional investors. As a general rule, institutional shareholders will typically hold an underweight position or no position at all in a company where persistent failure by the board and management results in shareholder value being destroyed. Even when the board of an underperforming company is confronted, most investors have little appetite for imposing real change. These situations often provide fertile hunting grounds for investors like us.

The influence that shareholder activists are having in offshore equity markets has never been greater. Globally, company boards are increasingly aware of and are being subject to shareholder activism on many fronts. The value created and investment returns derived from activist investing are seeing increasing amounts of capital allocated to this strategy. Australia has an environment conducive to shareholder activism and will not be exempt from the global activist trend.

Pioneering activist investing in Australia

Provocatively, if company boards were performing their role there would be no opportunity for activist investors, such as Sandon Capital[4]. When companies persistently fail, they generally do so because of a failure of one or a combination of the following areas of broad responsibility of the board – strategy, governance and capital management. The majority of company boards perform their role with distinction and, as activist investors, we typically only come into contact with companies that are failing in these areas. In the context of the market, they are relatively few in number.

Our aim is to have influence over the company that is proportionately greater than our economic investment. After formulating our strategy, we will usually engage with fellow shareholders to gauge their likely support for the changes we believe are necessary.

When boards see there is broad support for the changes that we are proposing, a negotiated agreement usually prevails.

The canvassing of our proposition will typically assist us in refining the proposal, lessening the implementation and execution risks.

[1] Superannuation assets totalled A$1.87 trillion at the end of September 2014, according the ASFA, the peak industry body. http://www.superannuation.asn.au/resources/superannuation-statistics Superannuation assets are forecast to grow over the next 20 years to more than $6 trillion (http://www.supersystemreview.gov.au/content/downloads/final_report/part_one/Part_1_Overview_Recommendations.pdf). [2] Corporations Act 2001. http://www5.austlii.edu.au/au/legis/cth/consol_act/ca2001172/ [3] There are many academic studies that cite the investment benefits of activist investing. A recent example is *Long-Term Effect of Hedge Fund Activism*, December 2014 Columbia Law Review http://www.columbia.edu/~wj2006/HF_LTEffects.pdf. [4] We've taken the liberty of paraphrasing this wonderfully apt quote "If boards were doing their job, there'd be no need for activists" by Professor David Beatty in an interview for McKinsey & Co's Insights series entitled: *Are You Getting All You Can From Your Board Of Directors?* http://www.mckinsey.com/insights/corporate_finance/are_you_getting_all_you_can_from_your_board_of_directors

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CHANGING LANDSCAPE
With attractive investment returns available, shareholder activism is on the increase in Australia