

Shareholder Activism Adds Value

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The basic hypothesis that I want to suggest is that a corporation having informed and involved shareholders is worth more than one without. This proposition creates several immediate problems: first, it is counter to the conventional wisdom which dictated simply If you don't like the management, sell the stock; secondly, it threatens to founder on the collective action dilemma that which is in the interest of the class as a whole may not be cost / effective for the individual components; and finally, many shareholders are burdened with conflicts of interest and are inhibited in activist involvement by concern that so doing would penalize them commercially.

We have to start by asking why is it so important who the owners are and whether they are active. Not very long ago in this country, many of the largest industries were owned by the state. The privatization process was widely heralded. Why? What was the importance of substituting private ownership for public? One might ask in passing whether private ownership has lived up to its promise. What did private owners do that made them preferable to the state ministries? In a world where change is the only constant; where business prospers by rapid and accurate response to opportunity, the state is predictably a very poor owner due to its tendency to resist change. Beyond this simple dynamic, there ought to be much clearer recognition of the worth of informed and effective owners.

Shareholder involvement is possibly the most important single element in informing the scope of a non-executive director's responsibilities and authority. It has always been clear in theory that a director is elected by and is responsible to the shareholders, but the identity of the owners has been diffuse and the accountability unasserted. The ultimate objective of effective shareholder involvement is to provide definition and backing for the directors. Oftentimes, when I first meet the CEO of a LENS focus company", I say that we recognize the many claims on a CEO's attention and that we attempt to represent the viewpoint of ownership in the knowledge that this is rarely presented in a pure form (of course, with public companies, ownership response is immediate through movements of market price).

Nobody wants shareholders to be determining the color of the paint on the walls in the rest rooms. Discipline and restraint must define the scope of the ownership agenda. The Companies Acts spell out specific areas where shareholders must be involved. Within the general framework of ownership, there are some questions that are uniquely appropriate what business the company is in; whether doing business as a single corporation is the best way to maximize the value of multi business companies; levels of risk in the ratio of equity to debt. Ultimately, owners must determine in the case of unacceptable performance to change the board of directors. This is what has recently happened in the case of British Brazilian Smaller Companies Investment Trust.

A R/G We are not trying to run their companies for them, but we are trying to suggest strategies that give us more confidence. We want to be more pro-active in our relationships than we have been until now. In the past we tended to get involved when things went wrong, but that is leaving it too late.

[A]t the same time, fund managers realized they were sacrificing much of the value that would result from a management change to the bidder, when they could capture it for themselves by exercising their power as owners to replace the board.

The message that activism can improve returns has encouraged fund managers to broaden their attacks. Lord Thompson of Strand Life says: ' As responsible shareholders, we are expected to take an interest in all the affairs of a company. That includes such things as their rate of research and development spend [sic] and their environmental policy' [1]

Hampel Report 5.7 Several institutions have recently announced a policy of voting on all resolutions at company meetings. This has yet to be reflected in a significant increase in the proportion of shares voted, which has risen only marginally in the last five years and remains at less than 40%. The right to vote is an important part of the asset represented by a share, and in our view an institution has a responsibility to the client to make considered use of it. But we do not favor a legal obligation to vote. No law could compel proper consideration.

I am not a chemist and Sir Ronald is not a lawyer. When he says and I repeat - that the right to vote is an important part of the asset represented by a share[2] he makes clear that voting is a trust asset which must be managed with the same fiduciary prudence as all other trust assets. There is, therefore, some of the self contradicting in the report. He states the precise legal basis for the imposition of fiduciary responsibility and, then, in the next breath says we do not favor a legal obligation vote. It would appear as if exactly this legal obligation has been created, but not by the Parliament which is the subject of Sir Ronald's concern, but by the equity branch of the Common Law courts - the Chancellor sitting on the woolsack. Possibly, Parliament would have trouble crafting a law combining sufficient precision and flexibility, but those are exactly the time-honored characteristics of the English Chancery courts. So, unnoticed and uncommented upon, we are at the threshold of a new era in which the obligation to vote will be monitored carefully by the courts.

Lets consider what proofs exist for the alleged correlation between activism and value. Because corporate managements have tended to be threatened by the prospect of owner activism and because activists have been anxious to generate statistical confirmation for their commitment, one must consider carefully the sources of purported proofs. The most widely cited evidence for the efficacy of corporate governance are a series of reports generated by Stephen Nesbitt, a respected professional from the consulting firm Wilshire Associates, showing the positive impact of many years of targeting of poorly governed companies by the Public Employees' Retirement System of the State of California. Unhappily, we must note that CalPERS is one of the most significant clients of Wilshire. A far different prospect emerges from the work of McKinsey, one of the most respected management consulting firms in the world. If McKinsey says something that might be offensive to corporate managements, one should pay attention:

Believing in the value of corporate governance should no longer be a question of faith. Some investors will pay a significant premium for good governance. And though it is more important in some circumstances than in others, and more important to managers of some types of funds than others, it remains clear that good board governance can serve as a tool for attracting certain types of investors, as well as influencing what they will pay for stock. [3]

The McKinsey report was based on a survey of fifty investors with \$840 billion under management and 69 CEOs of FORTUNE 1000 companies with an average \$2.3 billion of annual sales. For purposes of the survey, well-governed companies were defined as having as a minimum: A clear majority of outsiders on the board; Truly independent directors with no management ties; Directors who hold significant stock holdings and who are paid, to a large extent, in stock; Directors who are formally evaluated; and Boards that are responsive to investor requests. The average premium that such a company would command in the market was 11% (including in the sample those who would pay no premium, 16 % if they are discarded).

Another way of looking at proofs of value is to look at the market place. A recent edition of the ECONOMIST has a chart showing the increasing rate of new International listings on the New York and NASDAQ exchanges, averaging 125 over the last three years. Why does Daimler Benz

subject itself to a new accounting regime requiring the posting of over \$1 billion in losses when it could have simply charged a reserve and reported untrammelled earnings had it not sought listing on the NYSE? Why does the proud Mitsubishi corporation have as one of its objectives that it be accepted for listing? Very simply, capital costs less where governance is best. Accountability and transparency these are the keys to investors enthusiasm, these are the essentials for the lowest cost of capital.

In all modesty, I would refer for a final proof to the operations of LENS, the activist value partnership that we have run for institutional investors for the past five years. I will not hold you to a prolonged description that might strike some as a sales pitch. I simply ask that you consult our home page on the INTERNET and inform yourselves as to what we have done and how well it has worked out for our investors. <http://www.lens-inc.com>.

Endnotes

[1] Mathew Lynn and Andrew Lorenz, Investor Invasion, The Sunday Times, 21 July 1996, p. Business Focus 3.

[2] The explanation of ownership responsibility as being a plan asset of the trust holding the securities is best set forth in the July 1996 Release of the Pension and Welfare Benefits Agency of the United States Department of Labor.

[3] The McKinsey Quarterly 1996 Number 4, p.l 175.