Shareholder activism in Canada

Why you need to act now

Activism is here to stay in Canada

Data from Deloitte's recent global report on shareholder activism, *Be your own activist*, overwhelmingly suggests that activism is not a trend but a force that's here to stay in global capital markets. Activist campaigns have been particularly active in the US, Australia, and Canadian markets. In this paper, the Deloitte's M&A Institute explores how shareholder activism has played out in our country, and how executives and boards can to reduce their company's vulnerability while driving shareholder value. Investment capital is plentiful in current markets. This interest in Canadian companies by foreign and local investors coincides with our favourable capital market structure for investment, and mounting shareholder expectations about corporate transparency and accountability.

Against this backdrop, Canadian public companies could easily fall under the gaze of both domestic and global shareholder activists. Canadian executives know this. More and more, the concept of adopting a proactive activist mindset is at the centre of executive-level conversations.

Adopting such a stance on strategy, value, and the reduction of vulnerability to activist strikes benefits the overall market and enables companies to act from a position of strength should activism arrive at their doorstep.

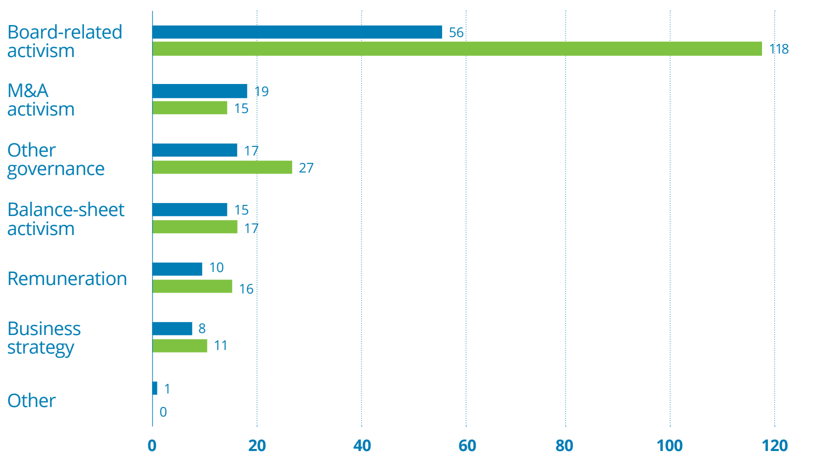
In addressing how Canadian companies can position themselves to become proactive regarding shareholder activism, this report aims to dispel several misconceptions about activism in the Canadian market and show companies can embrace opportunities in this new reality to drive courageous and positive change.

Ultimately, the focus is on creating value for all shareholders

While some activist campaigns profiled in the media tend to edge on hostility and antagonism, true shareholder activism centres on grievances related to how management and the board are running the company, their lack of accountability and alignment ultimately negatively affecting shareholder value.

While there are certainly times when such demands are at odds with the longer-term strategic vision of a company, some activist demands are in fact quite congruent with what all shareholders are ultimately looking for—value creation, good governance, accountability, and performance.

Number of demands made by Canadian activist campaigns related to:



Source: Activist Insights

Common misconceptions about shareholder activism here in Canada

Myth 1 Activism does not really happen much in Canada.

Fact Corporate Canada has been the third-most-frequent global strike zone for activist campaigns after the United States and Australia in 2018.

Although high-profile activist shareholder campaigns in the United States often command attention from global investors and corporate leaders alike, activism has also been a steady force here in Canada. According to Activist Insights, the number of Canadian companies subjected to activist attacks was 75 in 2018, the highest volume since 2013. 2017 had been relatively quiet, with 57 campaigns.

To put this into perspective, Canada ranks third globally in the number of reported activist campaigns, behind the United States and Australia, as of 2018.

While our resource sectors were the most affected, the real estate, consumer, and cannabis sectors, among others, were also targeted. The rationale of activist demands in Canada are consistent with campaigns launched the world over. This underscores the convergence of high shareholder scrutiny on corporate accountability and value creation, and also points to capital backing—which knows no geopolitical borders—that these campaigns have. Activist capital is always searching for opportunities—including those involving Canadian companies.

	2017	2018
Number of companies	57	75
Number of campaigns	127	204

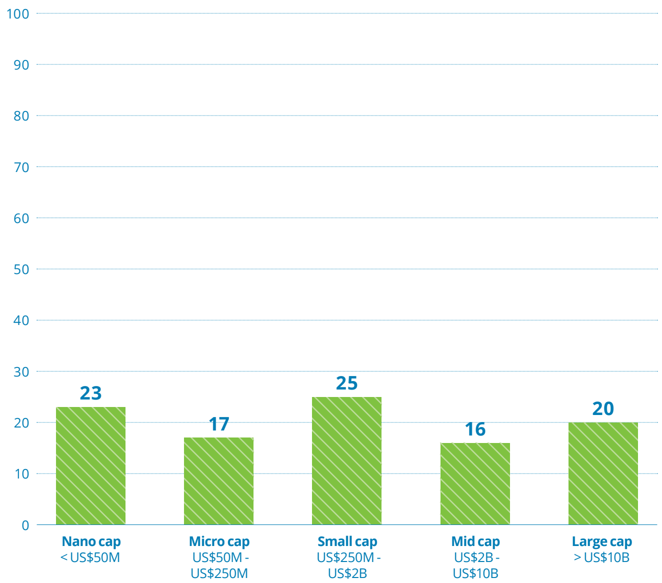
The similarity of the Canadian regulatory and governance framework to that of the United States makes Canadian companies potentially more prone to advances from activists.

Myth 2 Canadian companies fly under the radar due to their size.

Fact Activist campaigns have been more frequent in companies with market capitalization of less than US$10 billion, which correlates to a significant segment of companies listed on the TSX.

Breakdown of global activism targets (by US$ market capitalization)

% of activist targets by market cap

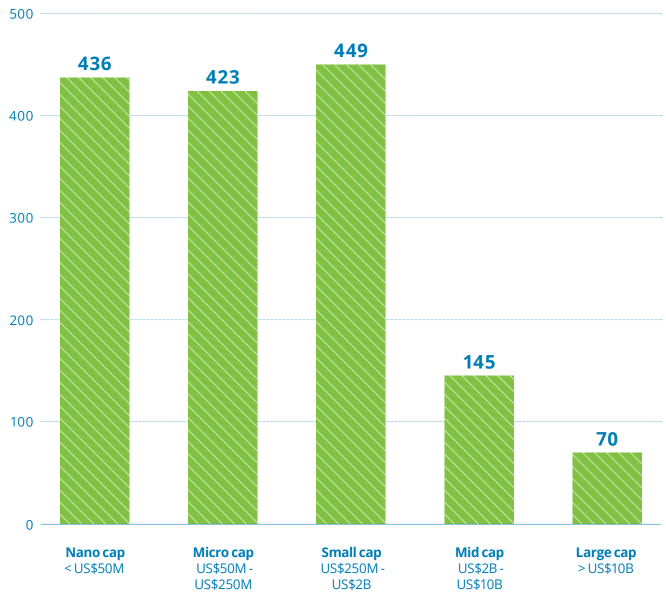


Source: Activist Insights (Market capitalization defined as: 1) nano cap: < US$50M; 2) micro cap: US$50M–US$250M; 3) small cap: US$250M–US$2B; 4) mid cap: US$2B–US$10B; and 5) large cap: > US$10B.)

As shown in the chart above, approximately 80 percent of activist campaigns target public companies with market capitalization of less than US$10 billion.

Breakdown of TSX-listed companies (by US$ market capitalization)

of TSX-listed companies

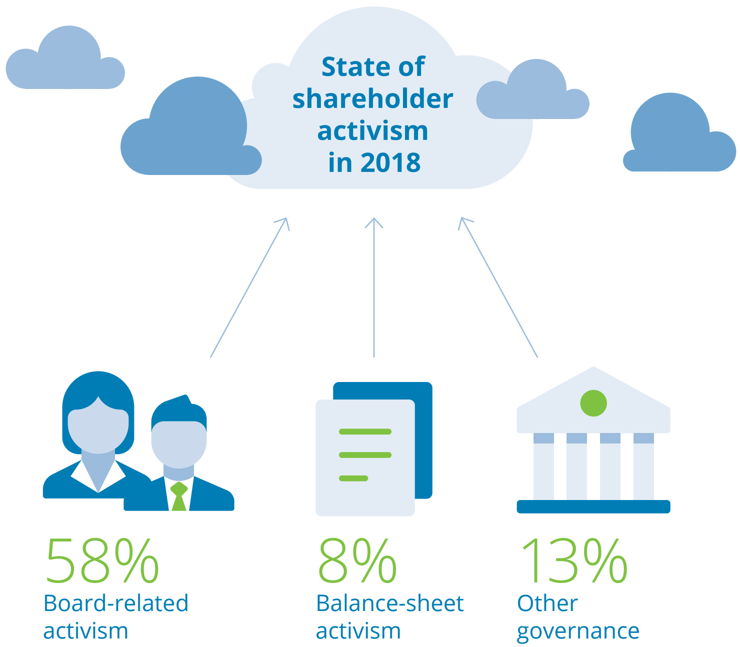


Source: TSX (Market capitalization defined as: 1) nano cap: < US$50M; 2) micro cap: US$50M–US$250M; 3) small cap: US$250M–US$2B; 4) mid cap: US$2B–US$10B; and 5) large cap: > US$10B.)

When overlaying the strike zone in terms of size of activist targets against the market structure that we have here in Canada, there is an unsettling conclusion: approximately 95 percent of Canada's publicly listed companies (by count) are less than US$10 billion. This should motivate most Canadian corporations to pay even closer attention to the potential threat of shareholder activism here in Canada.

Myth 3 Activists are only the hedge-fund type.

Fact The face of activism has changed to include a diverse group focused on common themes.



The face of shareholder activism is changing. In the current business climate, all Canadian corporations should be rethinking the very definition of shareholder engagement and what that needs to look like in the future. This is due in part to the importance of environmental, social, and governance activism, as well as the influence of proxy firms.

Perhaps most importantly, the significant ownership interests that large institutional investors manage in passive index funds, including the likes of Blackrock and Vanguard, and these investors' influence on voting outcomes are becoming increasingly important in terms of how public companies are thinking about their shareholder engagement strategies.

Highlights from the global report: *Be your own activist*

Our global report on shareholder activism offers a blueprint on how corporations can use the activist mindset as another lens through which to review its governance framework, strategy, and day-to-day management. The goal is to be objective, and to be transparent in how you measure your organizational goals.

Key findings from the report include:

Activism and its impact is **growing across the globe**. In the 12 months ending September 2018, the number of **campaigns surged to more than 850**.

The US share of the **largest activists' interest fell from almost 70 percent in 2014** to just **over 50 percent in the last 12 months**. In many other countries, including Canada, the United Kingdom, Australia, Japan, and China, **more companies were targeted in the first nine months of 2018 than the whole of 2017**.

Activism is becoming **more localized**. Our analysis demonstrates this **this home advantage for activists is also apparent in US and Asian markets**.

In Europe, regulatory change in the legal environment is going the activists' way. As the law firm Schulte, Roth and Zabel's 2018 annual review points out, the **European Union has adopted shareholder rights directives that encourage long-term shareholder participation**.

Highlights from the global report: Be your own activist

According to our analysis, **more than half of the campaigns** run by large activist investors are in the **consumer, financial services, and energy and resources sectors**.

Activists aren't usually **looking for a proxy fight in which shareholders decide**. They prefer to negotiate to get what they want.

Activists use a bottom-up approach, when they first think about what they want to change.

There is **always some truth in the activist's plan**; there is something management is doing that is not in the interest of shareholders or not resulting in optimal shareholder return. Ideally, the management of the target company should implement changes proactively to avoid any contest or loss of control.

One of the **big areas of strategic risks** companies now face is their **inability to deliver the change that was part of their strategy**.

Common aspects of the activist's mindset

The activist approach is driven by a number of beliefs, inherent skepticisms, and features of the activist's mindset, such as:

1.
Few board members truly seek to drive a management team toward a superior path of return, because that comes with risks and boards are by design averse to risk.

2.
Tough choices are often delayed by boards and their management teams.

3.
Past successes often create complacency; just because it was smart then does not make it best for now.

4.
Boards and executives often have a positive bias to size over margin and underestimate the "corporate discount." The activist gives preference to "small and valuable" over "big and average."

5.
Sub-optimal portfolio decisions erode significant shareholder value: solutions often sit at sub-division level, but often assess portfolios at the business unit level (i.e., division and corporate level).

6.
Even well-considered strategies many not reap the highest returns; sometimes tactical and more basic interventions deliver superior shareholder value.

7.
Energy is best spent on transformation rather than hostility.

8.
Facts don't lie. Too few boards let the facts tell the story, and listen instead to management teams' explanations and narrative.

9.
Few boards have real transparency on the true economics of their business.

How to be your own activist: A rigorous self-assessment

Coming from outside a company, activists are unencumbered by inertia, vested interests, and emotional attachments. Their gaze is dispassionate, analytical, and calculating. Companies need to look at themselves in a similarly detached way, spotting weaknesses or opportunities and rooting out inefficiencies that detract from shareholder value. The following represents a systematic and comprehensive self-assessment you may consider undertaking:

1. Shareholder returns
Does the business deliver low shareholder returns, especially relative to the performance of peers and benchmarks?

2. Capital structure
Are complicated or over-leveraged capital structures creating potential ways in for activists and options to exert influence?

3. Commercial positioning
What should growth, market share, pricing, and market leadership be, and where should growth investment be allocated?

4. Less than the sum of the parts
Disaggregated, do divisional EBITDA and valuation multiples indicate a conglomerate discount?

5. Business unit performance
Do particular business units demonstrate poor margins, growth, returns on assets, or returns on capital?

6. End-to-end operational potential
What full profitability potential exists through structural change, cost reduction, and improved productivity?

7. Cash focus
Do we use cash correctly, with efficient operational use of capital?

8. Value creation plan, communication, and delivery
What is the quantifiable value? How will the plan be communicated and delivered?

9. Board composition and governance
Are changes required to ensure the experience, capabilities, and incentives to execute on the company's vision and strategy? Are the appropriate governance structures in place?

The courage to be proactive

Why not be proactive? We call on Canadian corporate leaders to proactively address the opportunities an activist mindset can bring to your organization.

In order to understand and manage shareholder expectations, and thus effectively respond to the increasing risk of shareholder activism, Canadian industries should turn their attention to adopting the activist mindset.

Our global report, *Be your own activist*, highlights some of the areas where management could adopt an outside-in view of the organization and offers a blueprint on how corporations can use the activist mindset as another lens through which to review its governance framework, strategy, and day-to-day management. Objectivity is key, along with the transparency of self-diagnostic measurement against your organizational goals.

Facing the challenge of shareholder activism: Opportunities for action

The creation of shareholder value often requires challenging the status quo and implementing bold strategies at a fast pace.

Bold moves intended to drive step function change in shareholder value can be at odds with our seemingly risk-averse, conservative business culture here in Canada. Of course, Canadian companies do make bold moves—but there is a call to action for us to do more.

In response, Canadian companies have two clear lines of action:

Adopt an activist mindset

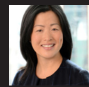
Activists are objective, analytical, and keenly focused on driving returns for their own investors. When faced with disappointing profits, underperforming divisions, or weak stock performance, companies should adopt a similarly dispassionate and analytical point of view to analyze their vulnerabilities and options. They should keep their eye on the end goal: to unlock additional shareholder value.

Rethink shareholder engagement

Opening effective lines of communication during a proxy fight is often too little, too late. Companies should instead aim to keep the lines open at all times, communicating clearly, frequently, and proactively to provide meaningful insights and reinforcing investor confidence in the abilities of management and the board to drive the company forward and deliver long-term value.

Companies should be considering how they can develop resilience to activism. It's not only a strong defensive tactic, it also stands to create massive value for shareholders of companies across Canada.

Contacts



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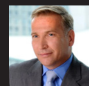

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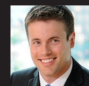

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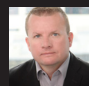

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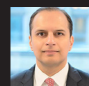

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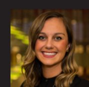

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