SHAREHOLDER ACTIVISM:

PROTECTING ENERGY COMPANIES FROM THE GROWING THREAT OF ACTIVIST INVESTORS

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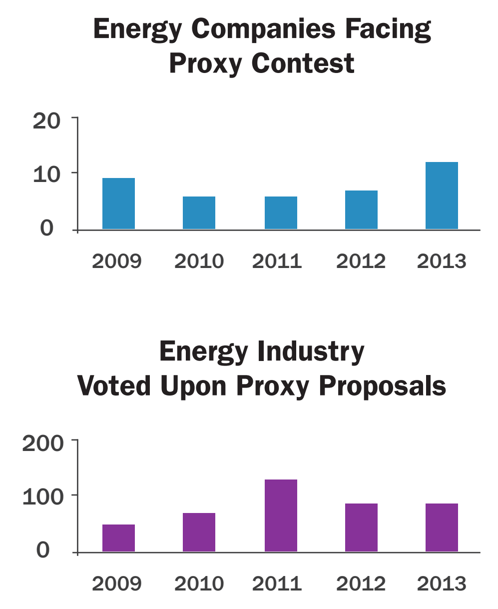
Over the past several years, energy-company shareholders have supported management teams and their massive capital expenditure programs in order to participate in the U.S. energy boom. Weak valuations and investment returns are now compelling investors to push back on spending, and demand sharp cost reductions, asset sales and lower executive compensation to make way for higher dividends and share buybacks. This pushback — often culminating in the form of shareholder activism — is not likely to ease anytime soon, as oil and gas (O&G) companies continue to underperform the broader marketplace. To protect against future activism threats, more energy companies need to develop a proactive strategy during the "proxy offseason" to strengthen their relationships with key investors, proxy advisors and the often overlooked media.

INTRODUCTION

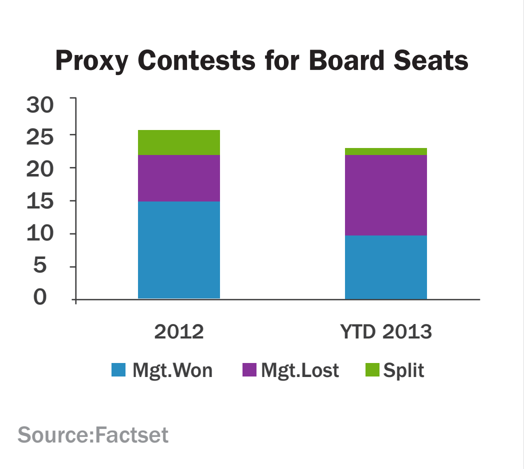
The annual proxy-season battle between certain shareholders and corporations reached a tipping point in 2013, particularly in the energy industry. Since 2009, there has been a 78 percent increase in the number of companies facing shareholder proposals, and a 76 percent increase in the number of shareholder proposals making it onto the proxies of O&G corporations. The need for companies to have a well-thought-out engagement strategy to defend against potentially contentious proxy fights continues to grow.



Source:ProxyMonitor.org

RECENT TRENDS

Activist campaigns and formal proxy fights have flared up across the O&G industry this year, including well-known names such as Hess, Nabors Industries, Occidental Petroleum, SandRidge Energy and Transocean, among other, and for every fight that goes public, there are many others that never see the light of day. A significant number of shareholder proposals are excluded by companies with the permission of the U.S. Securities and Exchange Commission (SEC), or are withdrawn after negotiations between corporate management and proposal sponsors. A survey of Fortune 250 companies conducted for the Manhattan Institute by the Society of Corporate Secretaries and Governance Professionals revealed that the number of shareholder proposals submitted to companies is 77 percent higher than those appearing on proxy statements.



Without question, public companies and activists alike would prefer the less-costly option of a non-public negotiation that results in an agreement palatable to both parties. Unfortunately, negotiations between "boards of directors" (board) and dissident shareholders don't always work, as activists push for more extensive change than boards are willing to accept. In total, 21 proxy contests for board seats have gone to a vote this year, 31 have settled, 12 have withdrawn and 14 are still pending. These numbers already surpass all similar contests in 2012.

What's more, activists have been successfully gaining institutional support by highlighting weak shareholder return comparisons and a "change" narrative that resonates with shareholders looking for improved returns. In fights that progressed to a vote, the 2013 results are reason for concern, as data shows activists are winning more and more contests via this method.

SHAREHOLDER-ACTIVISM SYMBIOSIS

So, what do these shareholder activists want? They largely can be segmented into two activist types:

- **Corporate-governance (or environmental) activists.** These activists rarely run for board seats, but often push for board independence and/or corporate action on environmental issues.
- **Economic activists.** The recent trend is for these activists to engage in "balance-sheet activism," which is a strategy designed to push for a dividend increase, share buyback, spinoff or conversion to a master limited partnership (MLP) structure. Economic activists typically use a proxy fight for board representation or the removal of directors to achieve their goal.

Unfortunately for issuers, these two types of activists intentionally or unintentionally have begun to work together. Economic activists screen companies based on many factors, but one key point of interest is whether a shareholder base may be receptive to change. When a board is faced with a vote on a governance issue, the voting result — even if unsuccessful for the corporate-governance activist — gives economic activists important information about the vulnerability of a company's shareholder base. This can greatly influence whether or not economic activists will start accumulating shares.

POWER IN NUMBERS

Activist funds have grown in scale to the point where there are very few companies beyond their reach. In addition to the traditional activists such as Carl Icahn, Pershing Square Capital Management and Trian Partners, several traditionally smaller activists such as Clinton Group, JANA Partners and Starboard Value are now able to target energy companies that were typically too large to fight through direct engagement. While the traditional activist players are back at it, even conventionally non-active funds such as First Manhattan and Glenview have conducted full-scale proxy fights this year.

Further fueling activism is the increasing involvement of large, formerly passive, mutual-fund firms that have been increasingly supporting activists in their campaigns. As these firms have invested in more sophisticated corporate governance teams, they have been more willing to vote against management and can no longer even be counted on to follow a favorable proxy-advisory firm recommendation.

> **"Last year, only 30 percent of major U.S. energy companies generated more cash than they spent – the lowest in five years."**
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> (Source: CapIQ)

ENERGY COMPANIES REMAIN THE FOREMOST ACTIVIST TARGET

Over the past several years, North American O&G companies have been at the forefront of opportunity in the minds of many investors. With high oil prices, recovering natural-gas prices and new routine discoveries of oil-and-gas-rich shale, investors have been patient, plowing cash into these companies with the hope of new discoveries and future growth. However, their patience has worn thin as companies fail to consistently turn their discoveries into profits and improved shareholder returns.

Last year, only 30 percent of major U.S. energy companies generated more cash than they spent — the lowest level in five years. A significant driver of the poor returns has been the increase in oilfield costs, propelled higher by companies bidding on the same acreage, hiring the same drilling rigs and competing for the same crude-carrying rail cars. This competition has squeezed profits, as have persistently low natural-gas prices.

STRONG OIL PRICES AND BALANCE SHEETS FUEL THE ACTIVISM FIRE

In the past three years, the O&G industry has underperformed the overall market by 25 percent. The O&G industry has a long history of dedicating itself to increased investments for future growth. However,

Consider This:

The price of oil has roughly doubled since 2004, but the returns on international O&G stocks were relatively static. This comparative underperformance is largely due to the fact that O&G companies have dedicated themselves to increased investment to fund the promises of future growth. Over this same time, capital expenditures increased dramatically while production fell and unit costs increased.

with oil prices sitting comfortably above $100, more and more energy-company shareholders believe the long term is now, and they are demanding their returns.

Another key characteristic among energy companies that lends them to activism is the fact that many O&G companies must maintain a strong balance sheet to fund future investments, as well as to protect themselves from potential operating and litigation threats in a high-risk operating environment. Activists target companies that have strong cash balances or easy access to the debt markets as opportunities to return value quickly to shareholders in the form of dividends or share repurchases.

Who will be the next activist targets? Here are a few significant themes to note:

- **Size does not matter anymore.** Activists manage more than $73 billion according to today's estimates, allowing them to target companies of all market capitalizations.
- **Quality returns and strong performance are key drivers.** Those companies that have spent or invested without producing quality returns, or have underperformed against their peers, will become potential targets of activism.
- **"Cash cows" are not immune.** The balance-sheet activism strategy has expanded potential activist targets to include well-performing companies that have the means to make a shareholder distribution through cash on hand or through leverage.
- **Past activism targets remain susceptible.** Companies that have already been targets of a corporate-governance or environmental proposal have put themselves on the activist radar.

Given this wide swath of potential targets, companies in the energy space must begin preparing for a fight well before a 13D is filed.

INFLUENCING THE PROXY DECISION-MAKERS

In the past, companies primarily engaged with broader teams at institutions during the mad scramble to get votes during proxy season – but the times have changed. Institutional investors are no longer predictable in their voting habits, opening the door for proactive companies to tell their story in the proxy offseason to an increasingly engaged investment community with the time and desire to listen.

Many corporations maintain an ongoing dialogue with their influential investors throughout the year, speaking to portfolio managers (PM) and analysts via conferences, one-on-one meetings and earnings calls. These interactions can go a long way to protecting a company during a proxy contest. While in some cases the PM is the decision-maker on all proxy-voting issues, in many cases he or she is not.

> **"The key to a successful proxy season is to prepare and execute on a plan during the proxy offseason..."**

A growing number of large institutional investors have developed a proxy-voting committee or corporate-governance team that accepts input from the PM, but retains the ultimate voting decision. With this in mind, O&G companies must know who the voting decision-makers are at each of their major institutional-holding firms along with an understanding of the voting procedures and the preferred engagement process. In essence, company outreach and relationship building with large shareholders must go beyond the usual suspects well in advance of a proxy fight to provide a given organization with the best opportunity to win.

This communications approach extends to the proxy advisors, as activists owe part of their success to firms such as ISS and Glass, Lewis & Company. Studies have found such proxy advisors can influence a significant percentage of the vote. What is disconcerting is often these proxy-advisory firms counsel in favor of the activists. Last year, ISS endorsed the dissidents in 52 percent of its campaigns. So far this year, that number has increased to 73 percent. The proxy advisory firms' recommendations matter, but forward-thinking companies are taking the steps necessary to minimize the damage they can inflict.

THE BEST DEFENSE IS A GOOD OFFENSE

The key to a successful proxy season is to prepare and execute on a plan during the proxy offseason that broadens a company's relationship with influential investors (and their compliance/governance officer counterparts), proxy advisers and the media. Interactions with these parties must reinforce key messages that support management's strategy and other significant near-term initiatives. These efforts must be taken to define a corporation's position before its future opponents define it.

CRITICAL ACTION ITEMS FOR PUBLIC COMPANIES

In addition, any public company – and particularly those in the energy space – should activate all of the communication, reputation management and proxy-defense items below to ensure it's ready for a potential activist fight.

Communicate internally and be prepared:

- **Monitor activists, industry and media.** Have an enhanced monitoring system in place to identify and track potential activists buying the stock, activist interactions within the industry, and commentary in the media signaling potential threats.
- **Elevate the company's digital platform.** Have an established online presence, and construct a comprehensive digital and social media strategy. This allows the company to quickly and easily combat activists engaging via an online medium.
- **Leverage proxy specialists.** Identify proxy experts that can provide ongoing counsel before, during and after a proxy contest.

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>
> -Steven Balet

- **Establish an issues and crisis management team.** Have a rapid-response team in place, with a developed protocol (e.g., crisis preparedness plan) to respond to an activist filing a 13D, publishing a board letter, tweeting about the stock or commenting in the media about driving company change.
- **Educate the board on shareholder activism.** Ensure the board has an ongoing understanding of the inherent risks regarding the entry of activists and their demands.
- **Engage leadership on cash-usage policies.** Board and management must define the use-of-cash policy that will best resonate with investors.

Improving the shareholder base and messaging:

- **Regularly perform a perception audit.** Conduct a perception audit to ensure the organization has a thorough understanding of its vulnerabilities within the shareholder base (not just among top investors).
- **Identify the emerging shareholders.** The company (not the sell-side analysts) must target and engage the next-generation shareholders that can support the organization in a proxy fight.
- **Engage institutional decision-makers.** Develop relationships with the voting decision-makers — who are often not the PM or analyst — among the company's key institutional shareholders. Understand their voting processes and who their key influencers are.
- **Analyze the retail-shareholder base.** Have a firm grasp on the retail-shareholder makeup and what influences these investors.
- **Communicate path to drive value for shareholders.** Formally lay out a plan to drive shareholder value — including progress made against this plan — and clearly articulate the thought process behind the company's use-of-cash strategy.

Relationship building with key influencers:

- **Build a strong media network.** Have "go-to" relationships in the media (e.g., print and online journalists, bloggers) that understand and support the organization's strategy.
- **Establish the CEO with external audiences.** The CEO must have a profile in the media which would lend itself to garnering external support.
- **Have key advocates in Washington, D.C.** Energy companies must have a presence and relationships in Washington, D.C. that can advocate on the organization's behalf should regulatory or environmental arguments arise in a proxy conflict.

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