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HOW TO DEAL WITH ACTIVISTS

The old days' harmonic picture of shareholders proving their loyalty to the management has changed over time. This is best shown by the various disputes between owners and management we have witnessed recently. When adopting different positions on a company's strategy or for instance good practice of corporate governance, shareholders do not just simply accept positions of the management anymore. Today's shareholders rather manifest their own interests and organise themselves.

Increased shareholder activism builds on the ground of the investors' modified recognition of ownership responsibility in the companies they hold. Engaged investors adjudge themselves a right to be heard and ask for high-level negotiations with senior decision makers. If their interests are not met they build alliances with social movements or look for support by large institutional investors. Powerful communication campaigns, including media outreach and shareholder education, put additional pressure on a concerned corporate management team.

How to deal with activist groups? In order to reach a fruitful interaction between both parties, profound knowledge of an activist's motives and goals is the starting point for the arrangement of an adequate set of strategies and tools. In this 12th issue of "The Financial Communications Journal", the different types of activists, characterised by unequal motivations, are presented.

The contributors to this journal approach "shareholder activism" from different angles and present their views. Besides the investor's perspective, media, law and communications specialists expose their analyses and opinions.

We would like to draw your attention particularly to the contribution of our international business partner Financial Dynamics. It talks about how to handle activists from a communications point of view and explains who activists are, where they come from and how companies should deal with them. A special overview table outlines the dos and don'ts. Another article draws parallels between experiences with societal and environmental activists. In addition, recent examples of widely discussed debates between specific groups of shareholders and corporate management are presented.

Enjoy the lecture!

Michael Düringer, Partner,
The Investor Relations Firm AG, Zurich

Shareholder activism

As shareholders are increasingly exercising their rights as part owners of companies asking for more shareholder value, businesses need to learn how to deal with this new activism. Georg von Wyss, Partner at Braun, von Wyss & Müller, talks about shareholder activism in Switzerland, whether it makes economical sense to be an activist shareholder and what role the media plays.

Illustrations: Paolo Friz, Illux

Not all shareholders seek short-term profit.

Interview with Georg von Wyss, Partner, Braun, von Wyss & Müller, Zurich

In Switzerland, activist shareholders are a rare species. Why?

Georg von Wyss: There are not that many independent money managers. To a large extent assets are controlled by big banks. They are not interested in being activist shareholders, where they risk being called the bad guys by clever companies and their IR consultants and losing business.

One would expect to see more pension funds being active, following the example of the Californian pension fund Calpers.

Where there is political pressure, institutions like the AHV fund (swiss national pension scheme) behave in a similar way. They speak up for themselves, recently together with Ethos. Also, it is just not true that everything is better for activist shareholders in the U.S.A., given its antiquated corporate governance regime. An investor in a public company has neither the right to put an item on the AGM's agenda, as he does in Switzerland, nor the possibility to vote against election of a board member. American activists are really not as numerous as one might think, if one bears in mind how many institutions there are.

From an economic viewpoint, thinking of the theory of the free ride theory, it looks irrational to be an activist shareholder.

Please turn to page 2

Value-seeking vs. value-based activism

Talking about shareholder activism, one can distinguish between the value-seeking and the value-based approaches. Whereas both try to influence the company management or board of directors, their goals as well as their methods are very different. Businesses need to understand the difference and recognise the help value-based activists can bring them.

Roby Tschopp, Managing Director, ACTARES – Shareholders for a sustainable economy, Geneva, Bern

Within the full scope of sustainable and responsible investment, Peter Kinder, cofounder of KLD, a U.S. corporate social responsibility research agency, distinguishes two philosophically distinct approaches of shareholder activism: the value-seeking approach and the value-based approach. Each has its own methods and effects.

The value-seeking approach uses shareholder activism to maximise profit. This may include manoeuvres to increase the share price of the stock, to obtain a significant share buy-back or to cause an important merger. Private equity or hedge funds for example are likely to engage in this type of operations.

Conversely, a value-based approach seeks by means of shareholder activism to improve the company's behaviour in a broader perspective. On the one hand, all shareholders benefit from such action, not only a few, as can be the case for the value-seeking approach. On the other hand, the other stakeholders are not excluded. ACTARES – Shareholders for a sustainable economy – is an organisation of this type. Inspired by the Bruntland report, the association advocates a balance between the three aspects of sustainable development: the ecological, the social and the economic. The members of ACTARES are convinced that the companies which find the best balance between these three objectives will be capable of creating the best value on the long term.

In any case, shareholders activists seek to influence companies and consequently to question the absolute power of the management or the board of directors. It is not astonishing that good corporate governance is their overriding demand, whatever their other goals. Under this kind of pressure, management must integrate a fiduciary outlook to which the Swiss leaders, in particular, will have to get accustomed. Ultimately, they manage their company in the name of the shareholders.

For the management, shareholder organisations and activist institutions will become increasingly important partners. Their contribution as advance indicators of upcoming tendencies is invaluable for leaders who give the necessary attention to them. The history of ACTARES, for example, shows that various questions it raised turned into real problems for those companies which did not pay attention to them. This is not surprising, when several hundreds of motivated shareholders share their intelligence and energy and take an interest in how their property is looked after.

The work of shareholder activists starts in the normal manner with information and analysis. Not only the publications of the companies, but also those of non-governmental organisations and the press, must be monitored in order to cross-check the sources. An active dialogue with the companies can then take place, to verify and refine information on the one hand, but also to share the conclusions and the wishes of the share-

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Continued from page 1

It is part of daily business and not that time-consuming. We voice our opinion during regular discussions with management. If they do not listen to us, we write a letter and vote against board recommendations at the shareholders' meeting. Don't forget that, given the usual participation rate, investors owning 4 % of a company have 10 % of the votes at an AGM.

Many U.K.-based companies and more recently also Swiss companies talk to key investors when dealing with controversial issues, i.e. regarding executive compensation or in takeover situations. A clever management should always do this. Indeed, I am surprised that so few Chairmen speak to their key investors. I would think it is in their interest to do so in the ordinary course of business, not only during a takeover or in crisis situations.

Does the regulatory framework, i.e. the adhoc publicity rules of the SWX Swiss Exchange, not make such kind of intimate discussions more difficult?

The rules are clear enough and do not prevent companies and investors from having serious discussions. Should it be necessary we would even sign a confidentiality agreement and stop trading in the respective shares. We are long-term investors, so that does not bother us.

This seems not always to be the case. You played a key role in the merger of Unaxis and Esec, where you publicly opposed the terms of the deal proposed by Unaxis. But your arguments were not always well received by the media, and you lost the court proceedings. What did you learn?

Hang on! In the case of Esec, Unaxis forced us to react to a coercive deal, which is by definition a short-term thing. We wanted to stay invested in Esec, if necessary for a long while. Anyway, we have built a reputation for doing as we say. The investors of our fund strongly appreciated us assuming an active role for them. We would do the same thing again, if we had to, though we are certainly not looking for such situations. We would certainly do things differently, including hiring specialised public relations advisors. We underestimated the impact the media coverage had on the judges, who had a hard time understanding the facts of the case and depended partly on the press reports. Also, I have the very dim hope that institutions delivering fairness opinions and suchlike will act more carefully next time. To put it very mildly, I was surprised by their quality standards.

Media do like quarrels between shareholders and companies. It comes close to a medieval tournament, boosting circulation. At what stage of uneasiness do you get in touch with journalists?

We contact journalists once it's clear that the company is not being constructive. Usually you have to be proactive. For example, in the case of U.S.-based Lear Corporation, where our funds hold almost 5 % of the shares, we lost our patience with the directors, because they were ignoring us, so we sent a copy of a critical letter addressed to the board of directors to key media such as Bloomberg and the "Wall Street Journal".

How do media react when being approached by activist shareholders?

In the case of Esec and Unaxis, I was surprised by the credulity of the journalists, also from high-quality publications, and at how unwilling they were to hear our arguments, which admittedly were somewhat technical. There is a fair amount of scepticism against activist shareholders, even if they are long-term oriented, as we are. I guess we should have hired you guys.

Nonetheless activist shareholders looking for quick flips are on the rise. The recent boom in the private equity markets has increased this trend.

Well, the first part of your question is about as true as saying that all corporate managers are long-term oriented. Of course, they want you to believe that, while painting activists as the bad guys, but … The fact is, you have to look at the deals one by one. Most of the serious private equity funds are still long-term oriented. The fact that some questionable characters have appeared on the scene is a sign of the end of the boom.

With the Austrian investment company Victory we have seen such a highly leveraged financial wizard churning up the Swiss corporate landscape. What is your view on this type of investors from your perspective as a fund manager?

We have a responsibility to our fund investors to focus on the intrinsic value of a stock rather than on our personal opinions. We hold a stock if it is cheap. Once it reaches our intrinsic value, whether for fundamental or speculative reasons, we sell. Boards do the same thing with their companies, if they are thinking about their shareholders. Saurer's board got a great price for the shares, even though its decision puts the company and the employees at some risk under the new owners.

You are surprisingly quiet in the current discussions revolving around excessive pay for top managers. Why do you not make the case for more power for shareholders against egomaniacal managers, on the back of this public criticism?

Well, we do not really go public about it, but we vote against excessive compensation packages when we get the chance and we tell managers when they are overreaching. Personally, I have a problem with people earning tons of money without sharing the risk shareholders have, and I have to question their other intentions. But I do not have a solution for this problem at hand. More transparency does not cure the problem either, as experience in the U.S.A. shows.

THE ESEC – UNAXIS CASE

In fall 2003, Unaxis, a Swiss technology company recently re-branded Oerlikon, announced its plans to get full control of Esec, a semiconductor company of which Unaxis held a majority stake, via a merger. At that time, Classic Fund Management was the largest minority shareholder of Esec, owning close to 10 % of the company. Following unsuccessful talks with board and management, Classic Fund Management publicly opposed the merger, claiming that the price offered for Esec was too low, and initiated a lawsuit. The merger was delayed by six months but eventually the court lifted the injunction against it.

GEORG VON WYSS

Braun, von Wyss & Müller, founded in 1997, is investment advisor to the three funds managed by Classic Fund Management. These are managed in the value style and have combined assets of CHF 2,8 billion. Georg von Wyss, 42, one of the three partners, is responsible for asset management and research. Before founding Braun, von Wyss & Müller and Classic Fund Management, he was a securities analyst in Switzerland and the U.S.A. He gained an M.B.A. at the Tuck School (Dartmouth College). He also wrote for the newsletters of Institutional Investor for two years in the U.S.A.

holders represented on the other hand. An important part of the dialogue remains bilateral and is not vented in the marketplace.

At the time of the annual general meeting (AGM), the shareholders have to take a certain number of decisions, which are far from being formalities. The election or the re-election of members of the board of directors, modifications to the statutes and even granting the discharge to the responsible bodies can involve major issues, as can shareholders' proposals. In Switzerland, the majority of listed companies have uneventful AGMs, which is not the case in every country. In the U.K., for example, remunerations are submitted to an advisory vote. In Germany, alternative candidatures for the board of directors are a reality. Even in Switzerland one can remember that in the recent past the discharge was refused within a company like SGS or that Nestlé barely refused a shareholders' motion to prohibit dual mandates.

The AGM also provides an opportunity to speak publicly to the assembly of shareholders. According to Swiss law, shareholders have the right to ask questions. Those which were not answered in bilateral discussions can be asked at the AGM, so that they are shared with the shareholder community. The votes also provide the opportunity to give voting recommendations, which are particularly important for value-based shareholders, since their goal is to convince a majority and not to carry out a tactical manoeuvre aiming at rapid profit taking. This is the reason why ACTARES, for instance, presents its voting positions on its website.

Is it necessary to mention that the recourse to the law courts always remains available to the shareholders when they are convinced that their rights are not respected? In spite of the discretion in this field, many cases become public. It is the ultimate stage of a divergence between the shareholder and the company leadership.

In conclusion, one can retain that shareholder activism should increase in the years to come. However, since it is not a homogeneous movement, it may lead to a certain politicisation of the economy. Companies will have to adjust to this situation and to develop the fiduciary side of their management approach. Leaders who will be able to take intelligent advantage of this situation to improve their vision of the future will give without any doubt a competitive advantage to their company.

ACTARES

ACTARES – Shareholders for a sustainable economy – grew out of the experiences and ideas of two associations of ethical shareholders: the "Convention des actionnaires de Nestlé" (CANES, Convention of Nestle shareholders), and the "Verein kritischer Aktionärinnen und Aktionäre der Schweizerischen Bankgesellschaft" (Association of critical UBS shareholders). ACTARES provides voting positions for over 20 Swiss companies yearly.

You will find more information about ACTARES under www.actares.ch, info@actares.ch

A plea for pay for performance

Management compensation is one of the most forceful tools to make managers do what investors would like to achieve and receive. Pay for performance – rather than the competitive pay strategy still predominant in Switzerland and other European countries – is best suited to align interests of managers and shareholders.

Pay for performance aligns interests of managers and shareholders.

Stephan Hostettler, Managing Director, Hostettler & Partner AG, Zurich, and visiting professor for Corporate Governance at the University of St. Gallen

It is everything else but a new conclusion that such alignment of interests is a delicate issue. A fair amount of suspiciousness is inherent in the relations between shareholders and managers. It was none other than Adam Smith, the godfather of economists, who wrote in its "Wealth of Nations" in 1776: "The directors of such companies, being the managers rather of other people's money than their own, it cannot be expected that they would watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch their own. Like stewards of a rich man, they apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company." It still is one of the arguments of today's private equity funds that they run companies more effectively than a public shareholder base because of the better selection and control of top management.

Please turn to page 4

Continued from page 3

Others have made the case for the effectiveness of public companies and markets. Today, it is widely believed to be the most effective system in terms of allocation of capital. The selection and control of management, though, has remained one of its problems. Pivotal questions remain: How do the suppliers of finance get managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply or invest in bad projects? How do suppliers of finance control managers?

A potent way of controlling this, involves the company's compensation scheme to link wealth and salary of top management directly to the long-term value creation – in absolute, not relative terms, neither linked to budgets nor to the implementation of the strategy. As for the latter, direct links between strategy, its implementation and compensation are more often than not a reason for a constant change of the payment criteria. From a shareholder perspective, a fixed, long-term deal with management is more efficient.

It can only be explained by the economist's free-riding theory that not more shareholders of public companies get more actively involved in questioning and shaping incentive and performance schemes. More often than not it is still very much an affair discretely handled by the company's board of directors and top management. Shareholders typically believe in the benefits of free markets and self-regulation. Thus, a general appeal that shareholders themselves should become more active in this process seems to be the appropriate solution. Shareholders should more often question the ways and means how excess returns are being distributed to management, employees and shareholders. Shareholders should stipulate and ask for a minimal return on their investment they expect management to deliver. Shareholders should speak up to receive more information about executive compensation than typically provided by European companies in their corporate governance reports. Shareholders should have a closer look at the mechanics of the salary schemes, and be less dazzled by the shear size of compensation packages and numbers.

And companies successful in the world of tomorrow should rethink the design of their pay schemes, and how they communicate it to the financial community. How strong is the link between pay and performance in your company?

WHAT SHAREHOLDERS SHOULD DEFINE

- *Clearly defined long-term minimal return on the market value of the investment*
- *Define the portion of value creation to be shared with executive management*
- *Define the portion of value creation to be shared with other employees*
- *Ask for a reconciliation between actual pay and the share of value creation*

Shareholder rights under Swiss corporate law

So far, Swiss listed companies have not been confronted with much shareholder activism. At the shareholders' meeting of most Swiss listed companies resolutions are regularly approved by more than 90 %. Nevertheless, Swiss shareholders do have rights they are increasingly willing to assert.

Jakob Höhn, Partner, Pestalozzi Lachenal Patry, Attorneys at Law, Zurich, Geneva, Brussels

Only very few shareholders make really use of their shareholders' rights despite the fact that Swiss corporate law provides a number of shareholders' rights:

- A shareholder may speak at the shareholders' meeting and bring motions related to the business to be transacted. E.g., if directors are up for election, any shareholder can propose other candidates.
- At the shareholders' meeting, a shareholder may request information about the business of the company from the board and the auditors. The board or the auditors must provide the information requested except in cases where they can show that it is important that the information be kept confidential.
- Any shareholder may propose at the shareholders' meeting that the shareholders resolve that certain matters shall be investigated by a special auditor.
- A shareholder may challenge a shareholders' resolution in court arguing that the resolution breaches provisions of the law or the articles. If the resolution needs to be registered with the commercial register, any shareholder can simply notify the office of commercial register and require that the registration be blocked.
- A shareholder may bring a liability suit against directors, officers or, in some cases even majority shareholders and argue that they have breached their duties.
- Shareholders holding shares with a total nominal value of CHF 1 million (or even a lower amount in many listed companies) may request that a business item be put on the agenda of the shareholders' meeting.
- Shareholders holding 10 % of the share capital or shares with a total nominal value of CHF 2 million (or even a lower amount in some listed companies) may request that a shareholders' meeting be called and certain business discussed and resolved.
- Shareholders holding 10 % of the share capital may request the court to appoint a special auditor to investigate certain matters of the company.
- Shareholders holding 10 % of the share capital may request that the court order the dissolution of the company or other appropriate measures. They must show to the court that they have important reasons for their request (e.g. continuous unequal treatment by the board).

Reasons for low shareholder activism in Switzerland

If shareholders use the above remedies, they can put significant pressure on the board and the management of a company. So, why do shareholders not make more use of their rights and put more pressure on Swiss listed companies? To the writer's knowledge, there are no studies in Switzerland to answer this question. However, it is likely that the following reasons have helped to keep shareholders' activism at a low level:

- Perhaps shareholders are not so unhappy with their board and management as one would assume when seeing all the media attention certain topics such as top executive remuneration are getting.
- The exercise of shareholders' rights is not for free. Active shareholders have to spend their own time and their own money, but the benefit goes to all of them. Therefore, for most shareholders it is easier to sell their shares if they are dissatisfied than exercising their rights.
- It is very difficult for shareholders to coordinate their actions with other shareholders. Shareholders have no access to the shareholders' register and, thus, do not know the addresses of the other shareholders.
- Up to now, it is generally believed that the existing shareholders' rights are not very effective. While this is not really true, it is still the prevalent view and few shareholders bother to consider to exercise their rights.

Because of this situation, there exist several initiatives to improve shareholders' rights. A revision of Swiss corporate law shall bring more effective information rights for shareholders, lower thresholds for the exercise of certain rights, improvement of the action to request the repayment of undue payments and separate elections of directors. However, these amendments of the law will not come into force before 2010 and it may very well be that at that time, shareholders will have become more active and simply will make more use of the rights to which they are already entitled today.

Delicate handling of the public opinion

At a conference on merger and acquisition tactics for CFOs, a leading Swiss bank recently made eight recommendations on how to prepare to be well enough armed against an unsolicited takeover approach. The banks first and foremost advice: "Have a good relationship with the press."

Markus Gisler, Partner,
Gisler.Meier.Repele.Z'Graggen, Zurich

This tip comes as no surprise. Within the last twelve months hedge funds and private equity funds have taken a much more aggressive approach when targeting a listed company. Unsolicited offers have become more fashionable and they now count for almost 40 % of all takeovers in Switzerland. The reason for this is tougher competition between hedge funds. On top, hedge funds managers confirm a continuous abundance in money that is sought to be invested in such financial vehicles. To raise enough money is almost never an obstacle for hedge funds and private equity. And not least does the increased pressure on performance force fund managers to take a tougher stand. While hedge and private equity funds come into their years they have learnt all the tricks and avoid mistakes when it comes to takeovers. They do know how to play the game.

At the core of the M&A business lays the fight for the better strategy to develop the company's future. Raider and defender usually come up with quite different visions on what is supposed to be the most appropriate choice. Defenders will do all they possibly can to keep large shareholders such as pension funds on board, raiders will try to convince them to switch side. The crucial question is how to convey either story to the shareholders. Hence in a takeover battle it's almost all about communication. Psychology plays a crucial part in the fight for control. Although both raider and defender usually talk personally to large shareholders, the impact of a favourable article in one of the leading papers has an immensely stronger impact on public opinion than any one-to-one discussion can ever have. The thumbs up or thumbs down of an influential commentator make the life of a pension fund manager difficult, if he wants to convince his investment committee to follow an alternative path.

Public opinion is a key element in winning the battle. Therefore both raider and defender court the press. Journalists themselves can get into a very difficult situation when they are supposed to give an opinion on what is best for the company. Staying neutral sometimes seems almost impossible. Is it for instance in the company's best interest to stay independent or would it be more successful if integrated in a larger organisation? Often the depth of information available is not sufficient to make up one's mind. Media people realise that they depend on statements they cannot possibly verify. Journalists are not handed out internal papers or figures. Therefore it is often the case that people matter more than facts. The strong and convincing personality of a CEO or chairman can be more influential than actual facts and figures. This of course can undermine the rational.

In the case of Converium for instance CEO Inga Beale managed to win the hearts of the media easily. The simple fact of being one of the very few female heads of a listed company in Switzerland offered her a natural advantage. She proclaimed independence for her company pointing out a whole series of possible drawbacks for shareholders if Converium were taken over by the French rival Scor. Whoever followed the story in the media was made to believe Converium was a rock-solid reinsurer with optimal perspectives and a bright future and the one and only choice was to remain independent. Not a word about the fact that the company's overheads were expensive and technically the insurer wasn't even balanced. Yet in early May, quite contrary to what had been proclaimed in the past weeks was swept off the table although Scor had increased its offer by a meagre 8 %. Later as the SEC filings became public it turned out that two key people, the CEO and the CFO were granted large incentives. That appeared to be a difficult message for the media to swallow. No wonder some commentators expressed their frustration at being fooled.

A similar story is true for SIG. After a Scandinavian competitor had acquired a large stake of some 30 % of its shares, the board of directors came (rightly or wrongly) to the conclusion that a fight for independence was going to be a lost battle. In order to get an optimum price for the company the board incentivised its management with some CHF 12 million if they managed to find a buyer who was ready to pay at least CHF 400 per share. That of course was not made public and the true motivation for the apparent willingness to give up independence was disguised.

Playing with public opinion is a very delicate matter. Some managers may argue that a takeover battle for them is a once-in-a-lifetime story. But be aware: the media's memory is now digitally available at all times to virtually anybody. And the database is immense and only a few clicks away.

Dealing with the activists

The recent excitement surrounding ABN Amro has once again put shareholder activism centre stage. Every underperforming company – which by definition is approximately 50 % of the market – is now a potential activist target. Who are these investors? Where have they come from? And how should you deal with them?

Edward Firth, Managing Director,
Financial Dynamics, London

The motivation of activists is clear: value created by any business is generally shared between customers, staff and shareholders. Deciding that split has always been the role of senior management. However, activists have now forced themselves into the equation, generally (although not exclusively) with the aim of increasing the proportion allocated to shareholders.

The activist shareholder movement started with generally conservative, long-only funds looking to make full use of their rights to maximise performance. Calpers led the way in the U.S.A., Hermes in the U.K. These investors identified that management could abuse their power given the traditionally passive and fragmented nature of their shareholders. This often led to too much value being left with both customers (continuation of unprofitable businesses) and/or employees (senior management). As a result, these first activist shareholders performed an extremely valuable service, giving shareholders a voice at the board table. In particular, they led the charge on executive accountability, best practice corporate governance, internal checks and balances, and countless other measures that ultimately ensured companies were managed in the long-term interests of their owners.

However, it is clear that in recent years there has been an increasing level of more contentious activist interest. These investors are less worried about whether shareholders as a group are receiving their share of value relative to customers or staff, but more focused on ensuring that any value being invested for the long-term benefit of the business is released for shareholders today. Typical demands from these investors include cutting investment spend, closing divisions that drag short-term earnings, increasing gearing and maximising short-term distributions to shareholders.

Communicating with activists

The first rule of dealing with activists is that under no circumstances should they be dismissed as short-term idiots. They will almost certainly have invested significant resource in examining the business before making an approach and may well have made a sizeable investment. That should be respected.

Secondly, insofar as the proposals are a surprise, management should be confident in the use of holding phrases whilst taking the time to consider ideas – "We are always focused on delivering results for our investors and are interested in all proposals to enhance shareholder value". Management should not be rushed into taking a confrontational or a dismissive stance prior to a full examination of the issues. Nothing destroys management credibility more rapidly than taking a strong position against activists at the start, only to reverse it later when the heat builds up.

Thirdly, take immediate steps to gauge the extent to which the proposals have broader shareholder support. An immediate, independent and non-attributable perception study covering the largest shareholders is crucial. If possible, this exercise should be used to identify investors who would consider going public in support of management.

Responding to activists

It is perfectly possible that the points made by activists are financially and strategically sound – and may well already be part of a company's thinking. If that is the case, accept them and take whatever steps are necessary to address the issues. Statements of intent are as valuable as concrete actions.

However, if the points are misguided, management must be seen to respond clearly, comprehensively, and with intellectual support for their position. Simply ignoring the points or issuing an unsubstantiated rejection will only spread the discontent further into the shareholder base. If management is confident of broader shareholder support, then that should be made clear.

Please turn to page 6

Continued from page 5

Where possible, differences of opinion should be highlighted as just that. No one knows the future, and it is perfectly possible for two intelligent parties to differ over an optimal strategy. However, if management adopts good arguments and a clear roadmap for delivery, activists will generally either adopt a "wait and see" approach or move on to alternative opportunities.

Management must always be clear. It is their responsibility to run the company in the long-term interests of the business. The role of institutional investors is to deliver the maximum possible returns for their funds. The two roles are not the same.

Taking the battle to activists

However, in certain relatively rare cases the differences of opinion can lead to a public and prolonged battle between company and activist. In this case, companies should not be afraid to take the battle to the activists, who do generally have a number of weak spots in their armoury.

I) Short-term vs. long-term

Firstly and most obviously, activists are highly susceptible to claims of a short-termism. By nature, few are long-term investors with many having an annual portfolio turnover in excess of 200 %, as they focus on maximising investment returns for their clients.

Their modest size (relative to the market) allows them to be highly selective in their stock picking and free to liquidate a position once the share price achieves their target fair value. Given the commission that their high turnover generates, it is no surprise that activist hedge funds are amongst the investment banks' favoured trading clients. However, what is equally clear is that an excessive focus on the short-term outlook can prove catastrophic for the long term well-being of a business.

Examples are numerous. Lloyds TSB was the darling of the market in the late 1990s, with an activist style strategy focused on maximising short-term return on equity that at one point put its shares on over 20 times of prospective earnings. However, within five years it was clear that this approach had led it into a strategic dead-end. By 2002 the shares were down over 70 % and trading on less than 8 times of earnings.

II) Use of on-side shareholders to publicly support management

Activists use the press extensively to highlight their issues with management. Whilst management can counter the arguments, by far the most compelling way of moving sentiment is persuading large investors who support the management to go public with that support.

III) Activists are not always right

Activists are excellent self-publicists and will lead with extraordinary tales of exceptional value creation. However, they are not always right. The most celebrated example of this remain the actions of The Children's Investment Fund (TCI) in preventing Deutsche Boerse from acquiring The London Stock Exchange (and ousting the CEO Werner Seifert in the process).

Whilst one can argue the relative merits of the subsequent share buy-back programme, there is little doubt that with the benefit of hindsight, the 530-p offer made in January 2005 would have been a massive creator of value. The London Stock Exchange is currently trading at well over 1,300 p.

IV) Activists do not always practice what they preach

Finally, perhaps the greatest paradox of the activist investor movement is that whilst they demand ever more open and rigorous disclosure from the companies in which they invest, their own governance is positively mysterious.

As unregulated businesses, disclosure requirements for the activist hedge funds are largely absent. This is further exacerbated by the tendency of many to base their businesses offshore. Who is ultimately behind the funds, their aims and objectives, etc., is all largely unknown.

Take the recent example of ABN Amro. The hedge fund that crystallised the downfall (TCI) is an institution based in the Canary Islands with no website or other formal public disclosure. The analysis behind TCI's original letter was provided by Merrill Lynch, the same investment bank that now advises the RBS consortium in its bid for ABN Amro – a bid that would not have been possible without the original letter.

When you add that the principal supporter of TCI was the hedge fund Tosca, whose chairman, Sir George Mathewson, was chairman of RBS Group only twelve months ago, the arguments for greater accountability become overwhelming.

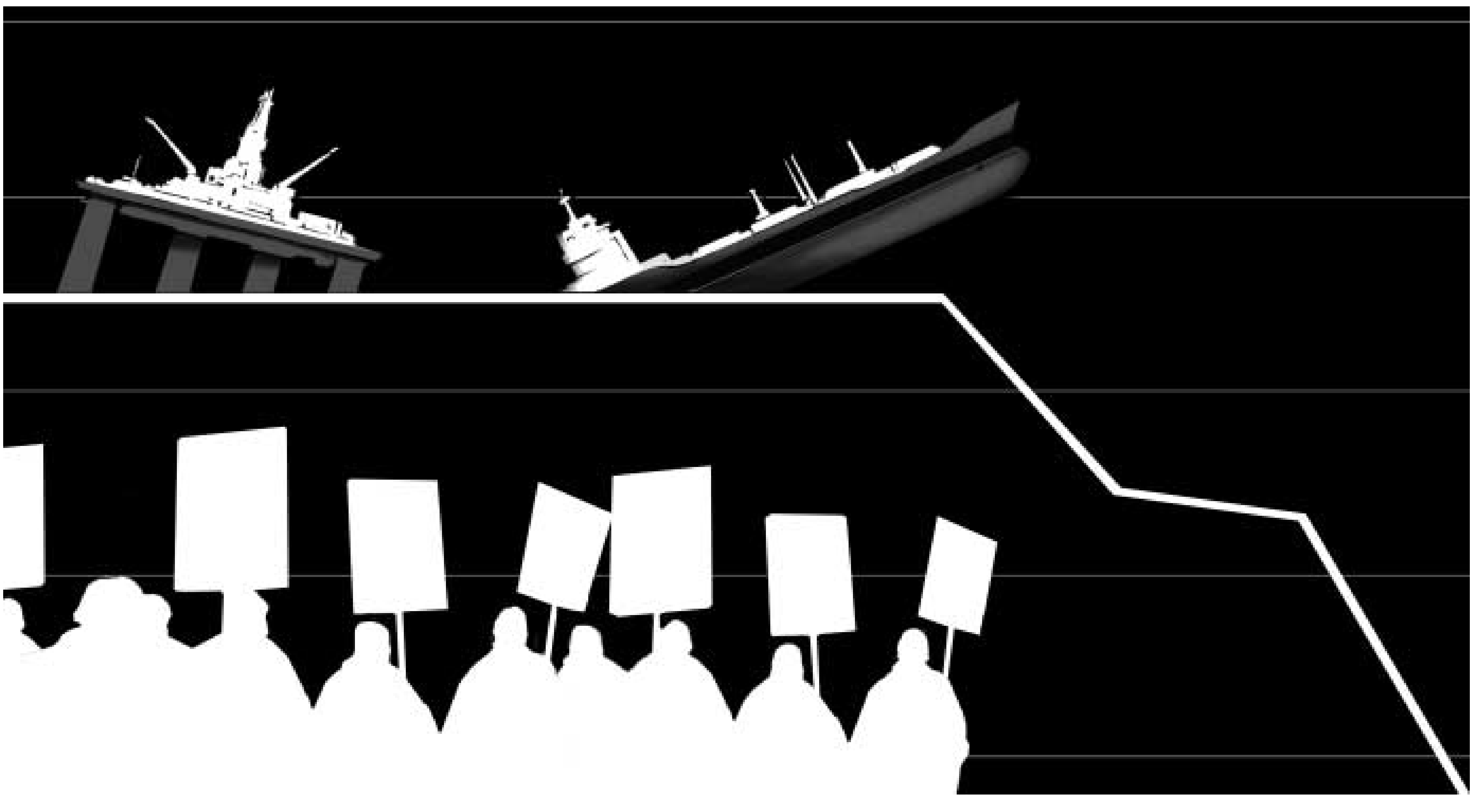
DEALING WITH ACTIVISTS

Dos

- *Review proposals in a mature and measured fashion*
- *Be absolutely sure of your position before answering the criticisms*
- *Articulate clearly the management's position and the intellectual basis for that stance*
- *Undertake an objective audit of your main institutional shareholders to ensure that you have a good understanding of whether the broader shareholder base is behind you*
- *State clearly the time horizon over which the business is managed*
- *Highlight the different skill sets required to manage a business vs. investing funds*
- *State clearly that if the proposals added long-term value to shareholders they would be pursued*
- *Do not be afraid to take on the activists (secrecy, performance, etc.)*
- *Put pressure on activists to make public commitment as to how long they will retain their investment in the company*

Don'ts

- *Ignore activists and hope that they will go away*
- *Be defensive, suggest that activists are ignorant, etc.*
- *Characterise activists as "wrong" and management as "right". There is always room for differences of opinion*
- *Use emotive arguments: "the history of this great company", "hundreds of years of independence", etc.*
- *Dismiss arguments as ill-founded only to subsequently agree (e.g. share buybacks)*
- *Change the correct long-term strategy to satisfy the short-term goals of a given activist*
- *Imagine that activists are interested in anyone but themselves*



Activists can shape share prices.

Smart ways of dealing with different breeds of shareholder activists

With NGOs and campaigners, the business community often associates their fundamental opposition to capitalism and globalisation. Meanwhile, many NGOs have turned into respected partners of corporate management teams. Today's shareholder activists have learned from these organisations' experiences and are now deploying similar tactics regarding their interaction with business leaders: they combine their powers in order to best defend their rights and, more importantly, develop an active – some would say "activist" – ownership approach.

Interview with Peter Zollinger, Senior Vice President and Member of Executive Team, SustainAbility, London, Washington, Zurich

On the opposite side, what can managers who are confronted with campaigners learn from their own experiences with environmental and societal activists? IR Firm talked to Peter Zollinger, at SustainAbility, a strategy consultancy and independent think tank.

What are the main characteristics and goals of today's NGOs? Do you see any parallels with the tactics of today's shareholder activists?

Peter Zollinger: Successful NGOs have become respected partners for businesses seeking financial value while keeping their focus on societal and environmental value. Their activities are no longer perceived to be a nuisance or a reputation risk only. As the NGOs expertise and contacts evolve, they are seen by thoughtful business leaders, investors and government agencies as a source of alternative market intelligence. As stakeholders, they share a long-term view on sustainable development.

I see different categories of shareholder activists. First, there are groups whose primary goal is to achieve social change. Using the investor's tool box is simply another form of increasing their influence. Second, there are groups who focus on corporate governance reforms, e.g. they fight excessive remuneration packages, option plans diluting earnings or dual mandates of chairman and CEO violating the fundamental principles of good corporate governance. These activists, among them many private investors, organise themselves in groups in order to concentrate their interests. They often present their ideas at the annual general meetings of shareholders in order to initiate a public debate on the issues raised. The third group are influential shareholders often only focusing on the short-term but holding significant stakes in selected companies. They identify unexploited shareholder value and believe that the targeted organisations could be managed more efficiently in order to swiftly increase profitability. These groups ask for direct participation and demand a position on the advisory board in order to influence the organisation's activities. Should the management not follow the activists' views and not implement the measures proposed, the company may run the risk of turning into a takeover target. A fourth category of activist shareholders, for me the most important one, takes a mainstream and long-term approach. These are often large institutional investors or asset managers for whom the integration of environmental, social and governance (ESG) factors into equity research and valuation is simply an additional aspect to assess management quality.

Each group of activist shareholders requires a very specific response from management.

In confrontations - often covered in the media - what are your recommendations on how management should respond to shareholder criticism based on your experience in the ESG sector?

First, I have to point out that companies should engage with investors before a crisis situation happens. An on going open dialogue allows for timely identification of controversial interests and effectively reduces the risk of any escalation.

If there already is a nasty quarrel, the various groups mentioned above require different approaches, always based on the primary interest of the opponent. Simply put, those who want to polarise will not be interested in partnership, those who seek integration will. Management should respond selectively and engage primarily with those parties who seem to be willing to find common ground.

Isn't this a dangerous strategy? Aren't there any opportunities to calm down the situation even with polarising activists?

You would not be well advised to swim in a pool with sharks. Certainly, sharks are highly intelligent creatures but have proven to behave unpredictably. They are unwilling to change their minds once they have defined their strategy. In contrast, dolphins learn quickly and adapt their behaviour according to the actual situation. They never would assume biting the hand that feeds them were a sensible strategy. Different groups of activist shareholders fit similar behavioural patterns requiring flexibility in our approach towards them.

If management decided to enter into a dialogue, what are ingredients for success?

First, companies must be clear on the purpose of such talks, decide the scope of the discussion and self-explore their willingness for change. Second, the leading interlocutor must have both the personal attributes and the decision-making powers to build trust and speak on behalf of the company. Third, in order to ensure an open dialogue the company must be ready to accept constructive criticism. Fourth, the scope of the engagement must go well beyond general, one-way communication purposes. Only entering into talks because the communication professionals would like to be friendly is a waste of time for all parties involved and could easily backfire. We have to accept that good engagement has become a competitive practice. Today, professionally managed NGOs have the edge on their side and can choose with whom to interact. They will always ask what is in for them.

CASE STUDIES

The Shell – Brent Spar case

As of 1991 with the completion of a pipeline connection to the oil terminal in Shetland, the storage and tanker loading buoy Brent Spar had continued in use but was considered to be of no further value. Brent Spar became an issue of public concern in 1995, when the British government announced its support for Shell's application for disposal in deep Atlantic waters (approximately 250 km from the west coast of Scotland). Greenpeace organised a worldwide, high-profile media campaign against this plan, including calls for boycotts of Shell service stations. Its activists occupied Brent Spar for more than three weeks. In the face of public and political opposition, Shell abandoned its plans to dispose of Brent Spar at sea. Much of the main steel structure was reused in the construction of a new harbour facilities.

Since this conflict, Shell has made a serious effort in improving its approach to how to address environmental and social concerns that matter most to its stakeholders, its reputation and its business. Today, Shell collaborates with local residents, NGOs and governments to understand concerns, mitigates negative effects and maximises its contributions to the communities in which it operates.

The BP – Texas City Refinery case

On March 23, 2005, a major explosion occurred in an isomerisation unit at BP's Texas City Refinery site killing 15 workers and injuring more than 170 others. A report investigating the incident identified numerous failings in equipment, risk management, staff management, working culture at the site, maintenance and inspection and general health and safety assessments.

As a consequence of additional safety incidents including the shut-down of the Alaska pipeline BP intensified its initiatives in order to best ensure the safety of its employees and contractors along with the integrity and security of its plant and equipment. Among other measures, BP headquarters commissioned an independent panel lead by former US Secretary of State James Baker III to investigate the safety culture and management systems at BP North America. The panel also created and administered to all five of BP's North American refineries an employee survey focusing on various aspects of process safety.

The Nike – sweatshop case

Nike has been criticised for contracting with factories that allegedly use sweatshop labour in countries such as Vietnam and Cambodia. The company has been subject to heavy critical coverage of the often poor working conditions and exploitation of cheap overseas labour employed in the free trade zones where their goods are typically manufactured. These campaigns have been taken up by many colleges and universities, especially antiglobalisation groups as well as several anti-sweatshop groups.

Today, Nike has an independent commission in place representing various UN and non-government organisations that regularly visits numerous sites every year. The commission testifies Nike's compliance with good employment condition standards in the company's annual report every year.

PETER ZOLLINGER

Peter Zollinger is Senior Vice President of SustainAbility and Member of the Executive Team at SustainAbility, a strategy consultancy and independent think tank helping business leaders create and deliver new forms of value. The organisation works at the interface between market forces and societal expectations. It advises companies on how to embed environmental, social and governance (ESG) factors into their daily business. Peter Zollinger is responsible for Client Services and leads work in the Finance and Capital Markets sector on corporate governance and risk.

Swiss corporate landscape under pressure: a few examples

Traditionally, shareholders have demonstrated great loyalty to corporate management. In more recent years, however, this paradigm, which suggested a harmonic relationship with stakeholders on the definition and implementation of corporate strategies, has changed. Debates between organised groups of shareholders speaking up for their rights and corporate management teams have become frequent, as the following Swiss case stories show.

Michael Düringer, Partner,
& Andrea Ullmann, Consultant,
The Investor Relations Firm AG, Zurich

Martin Ebner contra UBS, 1991 ff.
Martin Ebner, a pioneer shareholder activist in Europe, challenged various corporations by acquiring a significant stake in their share and voting capital in order to add weight to his interests and enforce management to improve shareholder value.

In 1991, Martin Ebner founded BK Vision AG, which became an important shareholder of the old UBS. In 1993, BK Vision opposed the management proposals to create authorised and conditional capital. After the approval by the general meeting, the decision was challenged in court by BK Vision, which in the meantime had become the largest shareholder. This lawsuit was the beginning of numerous legal proceedings between the two parties. Further, BK Vision opposed Robert Studer's election as a member of the board of directors in 1996. Martin Ebner's key demand of optimising shareholder value was met by the merger of the old UBS with SBC announced in December 1997. Through this merger, UBS became the world's largest private banking and asset management institution as well as one of the four largest financial services companies. On the other hand, Martin Ebner lost a significant portion of his money and influence in the stock market turmoil following the Internet downturn in early 2000.

René Braginsky contra Sulzer, 2001
René Braginsky, head of the Zurich-based investment company Incentive Capital, was, with a 15 % stake, the biggest shareholder of the industrial conglomerate Sulzer. In February 2001, he announced through the media his intention to make a public offer for all outstanding Sulzer shares with a goal of acquiring at least two-thirds of the company. At the same time, the investment company presented its plan for a successful takeover. Braginsky planned to spin off the medical technology business and focus on the company's industrial business portfolio. Furthermore, he proposed to replace the board at the general meeting. The latter rejected the offer claiming it did not reflect the intrinsic value of the company nor its perspectives.

At the general meeting in April 2001, shareholders approved all resolutions proposed by the Sulzer board, including the spin-off of Sulzer Medica, whilst rejecting the InCentive's proposals.

Even though InCentive's public tender offer was not successful, a year later, the Sulzer board proposed to the general meeting to renew itself comprehensively by adding four new members. The change should provide the Sulzer management with the knowledge and experience to support it in the implementation of the company's strategic realignment.

After the spin-off from Sulzer and following a class action settlement agreement with patients concerning a major hip and knee prostheses recall in the U.S.A., Sulzer Medica was renamed Centerpulse. In September 2003, Centerpulse was taken over by Zimmer creating an orthopaedics powerhouse with leading market positions, cutting-edge technology and global scale.

Tito Tettamanti contra SIG, 2006/07
SIG, a Swiss-based packaging technology group, was criticised by Sterling Investment Group, the investment vehicle of Swiss financier Tito Tettamanti, for not having seriously reviewed several offers from interested buyers. The SIG board argued that these inquiries did not meet formal requirements and that continued independence was in the best interest of shareholders.

Subsequently, Sterling proposed an extraordinary shareholders' meeting to attempt to force management to open its books for a due diligence by potential buyers. SIG's board rejected the proposal claiming that Sterling's registered voting rights were below the 10 % needed to call an extraordinary general meeting.

In September 2006, FERD, the owner of Elopak and CVC Capital Partners, submitted a joint proposal to acquire SIG. The board publicly rejected a first takeover bid on the grounds that the offer did not reflect the fair value for the company's shareholders. In February 2007, the board refrained from making a recommendation in favour of or against a second January FERD/CVC offer amounting to CHF 400 per share.

In March 2007, SIG management welcomed the takeover offer of New Zealand's holding company Rank Group Ltd and unanimously recommended its shareholders to accept a bid amounting to CHF 435 per share – after having previously rejected a first offer at CHF 370 per share. A substantial number of SIG shareholders followed this recommendation and tendered their shares to the Rank Group. Together with the shares already in possession of Rank, the group managed to take over SIG.

Laxey contra Saurer, 2006
The 2006 general meeting of the textile machinery and automotive parts maker Saurer elected Preston Rabl, Chairman of British hedge fund Laxey Partners, to be a member of the board. Ahead of this meeting, in July 2006, Laxey Partners reported that they managed funds exceeding 25 % of Saurer's total share capital. At the end of August 2006, Saurer heard through the press that Laxey Partners held a press conference announcing their requesting an extraordinary shareholders' meeting to replace four of Saurer's board members, amongst them the president of the board, Giorgio Behr.

Laxey did not wait for these changes to happen and tendered its stake in Saurer to the Swiss technology conglomerate OC Oerlikon, which secured the rights for an additional 21 % stake via call options. After that, OC Oerlikon made a public tender offer for all remaining publicly held and registered Saurer shares. This resulted in the formal control transfer of Saurer's operating management to OC Oerlikon as from January 1, 2007.

Ethos contra Novartis, 2007
Ethos – Swiss Foundation for Sustainable Development – was founded in February 1997 by two Geneva-based pension funds. The company built a reputation for challenging Swiss companies on corporate governance and sustainability issues. For a long time, the pharmaceutical company Novartis had been their target. Ethos regularly expressed its concerns about Novartis' remuneration policy and Daniel Vasella's double function as chairman and CEO. Despite the measures put in place to offset the concentration of power in the chairman's hands, Novartis did not send out any signals regarding its willingness to change its practice. Consequently, at Novartis' annual shareholders' meeting in March 2007, Ethos did not support the re-election of Daniel Vasella as a Chairman.

By doing so, Ethos did not question the competence of Daniel Vasella, but expressed the disagreement of numerous institutional shareholders unsatisfied with Novartis' corporate governance and remuneration policy.

Regarding executive pay, Ethos acknowledged Novartis' improvements in transparency in the latest annual report. Nevertheless, Ethos clearly stated as unacceptable that Daniel Vasella and four other senior executives should be entitled to severance payments amounting to three years' pay, or five years in case of a change in control. Ethos sees these golden parachutes as being against corporate governance best practice. As a reaction to various shareholder groups' pressure, Daniel Vasella announced at the 2007 general meeting that the severance payments clause will be annulled by the end of his current working contract in 2009.

Victory contra Ascom, 2007
In February 2007, the board of the Swiss telecommunications supplier group Ascom unanimously decided to discharge CEO Rudolf Hadorn from his duties and released him with immediate effect. He was said to have held discussions with a group of activist shareholders, thus violating corporate governance rules, instructions of the board, and the principle of equal treatment for all shareholders.

A few days later, Ronny Pecik, co-owner of the Austrian investment company Victory, who bought a stake in Ascom of at least 20 % in early 2007, told at a news conference that Ascom could not remain independent in the long term. He also criticised the board for dismissing CEO Rudolf Hadorn and asked to put him back into office.

At the general meeting in April 2007, shareholders approved all of the board's proposals and re-elected chairman Juhani Antilla. Before the meeting, there had been wide speculations that Ronny Pecik may use the event for a showdown with the group's board. But Pecik, who was not even present at the meeting, opted to support the company's board, which in turn supported his motions to reduce the board's size and omit dividend payment.

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