In our world of investor relations the concept of a Wolf in Sheep's Clothing will typically conjure up a number of uncomfortable images, most obviously and frequently, they might include:

- **A hostile shareholder appearing on your register with plans to launch a takeover**
- **A competitor or private equity investor,**
- **A short seller launching an attack on your stock**
- **A well-known activist investor stepping out of the shadows and asking for a seat on the board or for the resignation of the CEO.**

These are frequent realities and all are appropriately scary. Generally, the responses are typical and predictable. For instance, one of the first things you will probably do is to look to your shareholders, particularly your larger, long-term institutional investors for their support. That, of course, dictates a critical necessity – namely that, under threat of any kind, you must know who all your shareholders are both at the fund manager and at the beneficial owner levels. Until you do, developing open lines of communication with them is rather difficult.

In truth, companies that do not invest time and effort in establishing these connections will pay a price when times get tough – the earnings downgrade, the hostile takeover, the activist shareholder. It's hard to ask for support when your shareholders barely know you or because you've made it difficult for them to stay in touch – but most of you here know that already.

In Australian investor relations, we've taken comfort from the fact that institutional shareholders are generally supportive and prefer to engage directly with management. Usually, they will air their grievances behind closed doors, seeking to effect change quietly.

But, times have changed. In the past 5 to 10 years, but particularly post GFC, institutions, and I include here both superfunds and fund managers, have started to flex their considerable muscle and to exert their rights as part owners of the company. Hold that thought, it is important and I'll come back to it.

I know some of you will be thinking, “I’ve heard about this emerging threat of activism for years now but I’m still waiting to see it happen in any serious way – it’s not how we do things in Australia, it’s more of a US thing”. And, if you are an ASX200 company, you’d be right.

Research by Activist Insight over the past three-and-a-half years reveals that while 50-60 Australian companies are targeted by activists each year, fewer than 5% are large cap. Around three quarters of the activity has been in nano-cap stocks (less than $50m market cap) and nearly two thirds of those targeted have been in the basic materials sector.

But, are you genuinely confident that this is where it will stop; that there will be no entry on your register of US style activism? And is there anything you could, or should, do to prepare?

When we are analysing registers for our clients, once we have identified the beneficial owners and attributed an investment style to the holding, we then scan for activist tendencies including whether they have a history of getting involved in proxy fights.

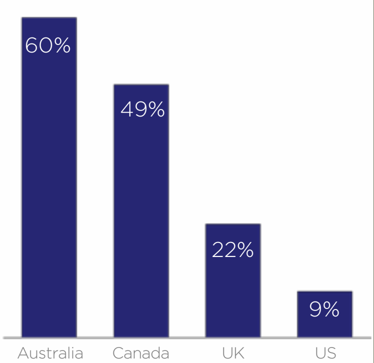
To date 86% of activists targeting Australian companies are home grown, most of their names will be familiar to you:

- Sandon Capital’s Gabriel Radzyminski,
- Alex Waislitz through his Thorney Opportunities Fund,
- Geoff Wilson’s Wilson Asset Management,
- Sir Ron Brierley’s Mercantile Capital,
- Mark Carnegie, and
- fund manager Allan Grey.

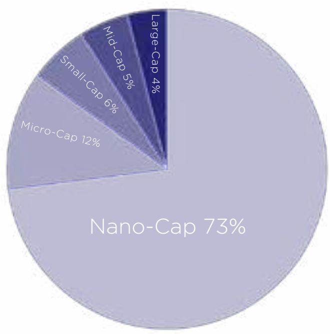
That’s sobering enough but add the further reality that Australian companies are also firmly on the radar of activists from the US, Asia, the UK and elsewhere. Overseas entities that have all launched campaigns in Australia in recent years include:

- Coliseum Capital [The PAS Group],
- Fortress Investment Group [Ainsworth Game Technology],
- Coastal Investment Management [Billabong and Spicers],
- Janchor Partners [Medibank] and
- Lone Star Value Management [Antares Energy]

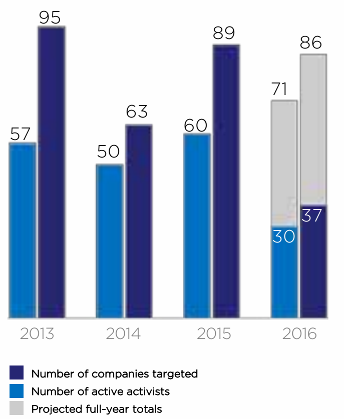
% of publicly targeted companies in basic materials sector (2013-2016)



Market-Cap breakdown of Australian targets (2013-2016)



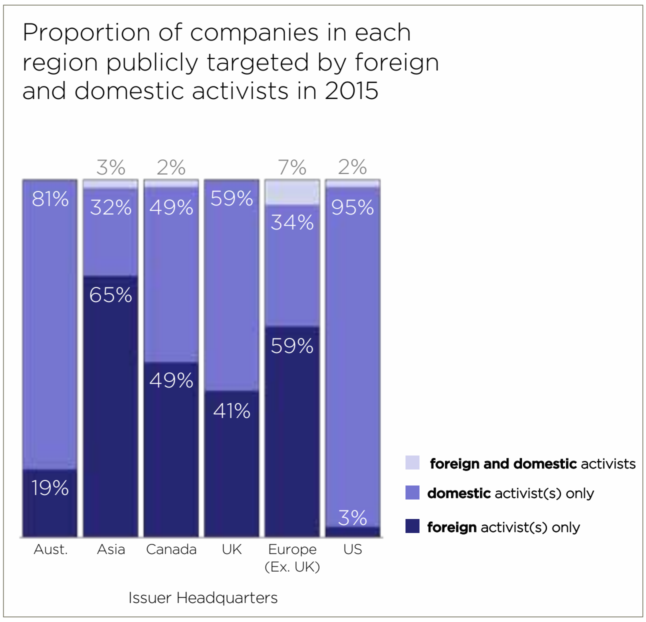
Publicly targeted companies and active activists in Australia (2013-2016)



Source: Activist Insight September 2016

To make early identification more difficult, only 14% of the 43 offshore activists in Australia over the past 4 years had activism as their primary focus. In other words, most campaigns came from fund managers who do not necessarily present as activists.

It is estimated by Activist Insight that there is currently US$179bn invested in specialist activist funds, almost double that recorded 4 years ago. As a result the activist trend is moving beyond US shores and Australia is now among the most-cited non-US jurisdictions for future shareholder activism.



A contributing factor is undoubtedly the fact that globally, Australia has one the lowest rates of foreign activism at 19% compared with 40-65% across the UK, Asia and Europe.

Which brings me back to the sheep in disguise.

Activists do not operate alone. They require the support of other shareholders and by that I mean those institutional shareholders that you go out of your way to always call first when there is a material announcement or a roadshow to be organised.

Pre GFC, Australian superfunds and fund managers generally adopted the position of 'interested observers'. They would make an investment based on their view of earnings growth and valuation, engage with management and occasionally the board, monitor performance closely and track execution of strategy. Issues relating to governance were outsourced to proxy advisers, leaving fund managers to focus on the buy/sell decision and maximising portfolio returns. I'm not saying this approach doesn't still exist but it is getting increasingly hard to defend.

In the past 5-10 years, as the weight of money invested in superannuation assets has come to be measured in the trillions, the focus is increasingly on how superfunds, as major shareholders in Australian corporations, choose to exercise their influence. Society will hold them to account if they are seen to be investing in companies whose operations appear to play a little fast and loose with their licence to operate: think Broadspectrum, any coal company, and more recently, the banks.

In that context, most companies will admit that behind-the-scenes activism has been here for a while - a shareholder, let's say a hedge fund will make demands of the board, perhaps imply threats, in order to get deals done. The surprise retirement of the Medibank CEO, announced just 10 months after the IPO, is widely speculated to have been at the insistence of a major offshore activist shareholder.

But, acting behind the scenes is not always an option. It is becoming more difficult by the day for institutional investors to distance themselves publicly from poor decisions by boards and management or to suggest that it is someone else's problem. So the issue then becomes how to manage the conflict of needing to maintain good relationships with the companies in which they are invested but at the same time be seen to flex their muscle, to speak up and hold companies to account when that is required?

Let's look at some of the strategies being employed by institutional shareholders as they grapple with this problem. A useful analogy is the music industry, so think of a rock n roll band – Crowded House, the Rolling Stones, INXS – but most likely, an all male band.

First we have the charismatic front man – he is out there, front and centre, making plenty of noise, often in the paper, standing up at public meetings, happy to be interviewed – these are the fund managers most easily identified as activists and I have mentioned a few already – Alex Waislitz, Mark Carnegie, Gabriel Radzaminsky.

Then we have the band – musicians and singers who make it all happen, all equally talented and no less important in terms of the role they play. Occasionally they step forward and take the spotlight, for a short period of time, in command of both stage and audience. These are the occasional activists who engage with companies every so often or they may be concerned shareholders who are galvanised into action by something unexpected.

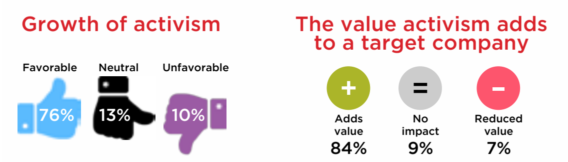
Research by Activist Insight earlier this year classified two thirds of activists who made public demands in 2015 as shareholders simply deciding to take a stand on a particular issue. Examples of this in Australia would be LIM Advisors action against AMP Capital China Growth Fund earlier this year; or First Samuel and Black Crane's action as concerned shareholders against Emeco in 2015 which resulted in a planned acquisition being cancelled.

And finally we have the roadies – always in the background but without them, there is no show. They tend to be loyal but are also very mindful of the power they hold – typically happy to let the band take the glory but profiting from their success. These are the fund managers that support the activists behind the scenes, sometimes actively engaging the front men to prosecute their agenda, at other times being available to lend their support.

Mark Carnegie for example was recruited by Perpetual to wage the very public and ultimately unsuccessful campaign from 2013 to 2015 to unwind the Brickworks cross shareholding with Soul Pattinson.

So, from all that, we know that institutional investors are willing to let activists take the running to push for change. And, frankly, most people welcome this development.

An overseas study of institutional investors attitude to activists conducted in 2014 revealed that 76% of those surveyed had a favourable view of shareholder activism and 84% thought that it added value to targeted companies.



The difficulty for companies is that the roadie and the backup band, for the most part, look like your friendly long-term supportive shareholder. Often there are no obvious early warning signs that something is brewing because they are either in plain sight or the activist has a shareholding that is so small that it has not attracted any particular attention.

James Dunphy's position on the Spark register springs to mind as one such example where a small 'retail' shareholder suddenly became very problematic, waging a high profile campaign to spill the board.

Another example is of a longstanding large shareholder who has had ongoing robust discussions with the company but has no history of activism. Often, they are viewed as a bit of a whinger and simply to be humoured – UNTIL, suddenly, the docile, non-activist shareholder loses patience and decides to go off piste, so to speak.

CVC Limited's campaign against the Bionomics board in response to a highly dilutive, placement of shares and 5 year Warrants to a group of 4 US investors late last year, is a particularly interesting example. Following a 40% collapse in the share price, they galvanised shareholder support, both institutional and retail, to vote down the resolutions that required shareholder approval for the issue of the Warrants. CVC then announced its intention to call a meeting at which it would seek changes to the board. The company responded by instigating a process to change the composition of the board which included setting up an advisory committee of institutional shareholders to assist them in the selection process. Ultimately both CVC as the occasional activist and the institutional shareholders who participated in the process achieved the desired outcome without CVC having to requisition the meeting.

It is clear that Institutions are becoming more willing to roll up their sleeves to ensure that their voices are heard when something needs to change. The institutional involvement in the Bionomics example was relatively benign compared to the recent stoush between AMP Capital and the institutional investors in its China Growth Fund.

In something akin to a David and Goliath show-down LIM Advisors - a longstanding, patient and supportive shareholder – decided that after 10 years of the Fund trading at a discount to asset backing of up to 35%, that enough was enough. LIM took on the activist role and, over a period of six to nine months, marshalled support amongst the major holders on the register for the proposition that the Fund was no longer fit for purpose and should be wound up. Against all odds LIM succeeded.

So what are the three things you should think about when planning how to prepare for and engage with activist investors?

First, in addition to knowing who your shareholders are and their style of investing, it also pays to do some research on their activist mindset.

Second there is no substitute for communicating often and actively with your shareholders, but I would also recommend that you check in periodically via independent perception research on what they are thinking about your strategy and performance. In each of the scenarios just outlined, a common theme was ultimately a failure to communicate effectively on strategy or capital structure.

Thirdly when an activist shareholder knocks on your door with some ideas for how things might be improved, listen to what they have to say and talk to them. An activist campaign only tends to go public when management or the board is seen to be either uninterested or unresponsive. Other institutional shareholders tend to take a dim view of such behaviour which only works to the advantage of the activist.

Finally when it comes to the wolf in sheeps clothing, I leave you with this thought:

"it is advisable to pay as much attention to the sheep as you do looking out for the wolf, they will most likely be one in the same".