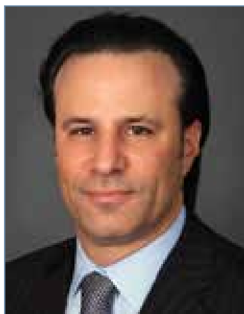
Shareholder Activism Creates Unique Challenges for Smaller Companies



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The well-chronicled rise in shareholder activism has precipitated countless "best practice" bulletins from professional service providers in their efforts to assist directors when they are faced with such overtures. While many of the oft-repeated axioms apply to public companies large and small, some of the board advisory in this regard fails to take into account unique challenges faced by the vast majority of directors—those who govern small public companies. For example:

- Analyzing the corporate changes sought by activist investors is often more vexing for officers who might be new to public company stewardship, and less experienced directors who might also lack appreciable capital markets experience.
- Creating a special board committee to address shareholder activism can be of limited value in many small public companies that only have a handful of independent directors.
- Organizing a team of lawyers, crisis communication experts, bankers, proxy solicitors, and other paid advisors to address activists is undoubtedly wise under certain circumstances, but for the 40 percent of companies listed on Nasdaq, the New York Stock Exchange, and NYSE MKT that have market capitalizations beneath $250 million, the capital required to do so is nonexistent.
- A thorough assessment of the company's shareholder base can be an important tool to gauge which institutional investors, if any, might be sympathetic to activists' demands. For the 76 percent of public companies with market capitalizations below $500 million, such an analysis can be unhelpful, since most stock in small public companies is owned by retail investors (i.e., individuals).

Directors of small public companies need to be nimble, to do more with decidedly less, and to shepherd companies against long odds for risk-embracing shareholders—the essence of entrepreneurial governance. The white-knuckle combination of ubiquitous enterprise risks and thin capitalization requires informed, frank, and focused boardroom dialogue, and reacting to shareholder activism is no exception. Since many of the "best practices" developed for director-activist discourse are, unfortunately, one-size-fits-all, here are some discussion points specifically for directors of small companies to consider when faced with activist shareholders.

Ignoring Them Is Not an Option

Easily one of the biggest complaints of micro- and small-cap activist investors is that their outreach to officers and directors is often all but ignored. In fairness to the investors, many such advances receive conspicuously short shrift, and here's why. Nearly one-third of companies listed on Nasdaq, NYSE, and NYSE MKT have no equity research analyst coverage. Put differently, an enormous number of public companies toil in virtual obscurity.

Unlike larger companies that are covered by more than a dozen sell-side research analysts, present at national conferences numerous times a year, and have daily discourse with investors, there are literally thousands of public companies that have minimal contact with the Street. Many of these companies operate more like private companies (that happen to also have stock ticker symbols), and their reaction to "outsider meddling" is more like what you'd expect from a private company.

Understanding why this regularly happens, though, is not to say it's acceptable—far from it. Ignoring investors, whether they are supporters or detractors, is never a viable option for any public company, regardless of size. This is especially true with activist investors because they are not going to be the least bit dissuaded by silence. To the contrary, silence will often needlessly inflame activist settings. Regardless of how regularly they interface with the Street, small public companies need to have mechanisms in place for adequately addressing shareholder concerns.

Directors should consider

routinely evaluating whether the "tone at the top" is conducive to the same both inside and outside of the boardroom.

Activists Have Shown Up for a Reason

An outgrowth of the "private company" syndrome that can populate small public company boardrooms is a reflexive dismissiveness of anything that disgruntled shareholders have to say. The reality, though, is that activists tend to single out particular companies for a reason. That is, in the history of capital markets, governance scrutiny tends to be inversely proportional to corporate performance. At a minimum, officers and directors should consider activist approaches as catalysts to scrutinize how and why their companies might be underperforming peers (i.e., make lemonade out of lemons).

This is not to say, of course, that activist proposals are presumptively prudent. When you strip away the "activist" nomenclature, such investors likely aren't any more "right" or "wrong" about what ails a particular company than any other capital markets participants. That said, activists typically don't waste their time with well-performing companies, so boards of small public companies in particular should consider starting out in "listen" mode as opposed to "dismiss" mode.

Be Objective

Even well-functioning small public company boards can be more susceptible to the dangers of "groupthink" due to their characteristically smaller board sizes. Skeletal infrastructure also raises the likelihood of asymmetric information flow from management to the board. Taken together, boards of these companies must focus relentlessly on independent thinking, especially in the context of shareholder activism. Since many small companies can't afford to hire outside advisors to analyze typical activist proposals (e.g., share repurchases, cash dividends, compensation, M&A, spin-offs, board declassification, poison pill removal, add/change directors, business strategy overhaul, etc.), boards should, at a minimum, consider asking and answering a series of straightforward questions designed to objectively evaluate the company's strategy for delivering long-term shareholder value, and its execution:

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- Has the company articulated and adequately communicated its strategy for delivering long-term shareholder value? Put another way, if you randomly reached out to 5 of the company's 20 largest outside investors would they each be able to substantially recite the same? This question is important because some small public companies operate so close to the vest that even if they were executing well on their long-term strategy, it still might be a well-kept secret.
- Are the company's income statement metrics (particularly those involving SG&A) consistent with its peers? This question is important because a hot button for micro- and small-cap activists is so-called "lifestyle companies"—companies with chronically stagnant stock prices and comparatively high salaries.
- What's the average tenure of directors on the board? Reasonable people will differ, but if the average tenure is greater than 10 years, a refresh might be in order. And has the board's nominating committee updated its composition "wish list" in the past 12 months to reflect the company's current and prospective risks and opportunities?
- What is the stock ownership profile (i.e., shares owned, not options granted) of officers and directors compared to peers? This question is important because micro- and small-cap activists routinely take issue with officers and directors that have no "skin in the game."
- Has the company delivered value to shareholders during the past one-, three-, and five-year periods that is equal to or better than its peers or other applicable benchmarks? If not, what are the root causes, and are the activist proposals aligned with those problems?

Perspective

Just saying the word "activist" in a room full of corporate directors is enough to raise collective blood pressures. Lost in the reaction, though, is the reality that activist investors are not all the same. Some activist investors are perceptive and expert when it comes to driving corporate change to benefit long-term shareholder value. Other activist investors opportunistically manipulate companies and the capital markets principally to capture near-term stock price movement.

Activism as a buy-side strategy is not only here to stay, but it's on the rise in public companies of all sizes. Particularly for small public companies, diminished resources, small boards, thin capitalization, and myriad enterprise risks all make dealing with activist investors more challenging. But underperforming small companies also sometimes contribute to their tough sledding by treating dissatisfied shareholders with contempt as a matter of course.

Labels notwithstanding, each activist situation is novel, so the best boardroom approach is to listen and be objective. D