Heidrick & Struggles

Global Technology & Services Practice

Activist investors and boards of directors in the semiconductor industry

2012 was an exceptional year for activist investors, as they ousted boards, pushed for corporate breakups and challenged management teams. Many activists succeeded in pressing companies to return cash or do a deal, and some of the biggest brand names in the United States came under siege. According to *The Wall Street Journal*, several activist funds produced investor returns of more than 20% for the year, and cash flooded into the sector as a result.

In 2013, Heidrick & Struggles had planned to update its 2002 study of boards of directors within the semiconductor industry. Since that original study the industry had undergone significant change, and we saw the need to revisit old issues and explore some new ones. One of the topics that received the most comments from board members and generated the most intense discussions in 2013 was activist investors. With that in mind, we sought to understand how boards of semiconductor firms met the challenges from activist investors and how they are preparing for future engagements.

This paper is a summary of our findings from the 2013 study. While it focused on the semiconductor industry, we believe it has value for any corporate boards that may be dealing with similar issues.

Experience with activists

Our study was based on interviews with 20 board members representing 23 semiconductor device and equipment companies, including 16 of the top 25 US-based public companies by revenue. Six served as CEOs, either currently or within the previous year. Three sat on the boards of three semiconductor companies, nine sat on two boards and 10 sat on a single board. Several also were board members for public companies outside the semiconductor sector.

Eleven of the 20 board members we interviewed reported having a personal experience with activist investors. Even those who had not had a personal experience said they had been affected, or seen their board's behavior affected, by activist activity at other companies.

One of the most common effects of investor activism cited by our respondents was a reluctance to show any substantial amount of cash on the company's balance sheet. While a cash stockpile might be part of a prudent cash management plan by a semiconductor firm or any company operating in a similar cyclical industry, some board members viewed it as an enticement for activists to seek share buybacks or dividends.

Another concern mentioned by more than one board member was a reluctance to engage in acquisitions that take time to show their value. If activists are looking for a rapid run-up in stock price, an acquisition that may take a year or two (or longer) to show its full value, even if right for the company in the long term, may be a risky strategy for management.

One of the board members we interviewed said, "Investor activism is the toughest problem boards face today." Several who had been through more than one activist experience said that not all boards realize how disruptive the effects can be. One who had gone through the process noted, "The board can become less open, more suspicious. The CEO may become less secure, less confident, even may hide behind a façade." Some board members had seen situations where the activist wants to interview all prospective board members. According to this individual, the interview process became very intimidating for potential members and some candidates declined to take part.

The board members interviewed in the Heidrick & Struggles study did see some positive effects of investor activism, which can weed out lower-performing or unengaged directors and focus the board on serving shareholders. But they also pointed to several negative consequences:

- Chilling effect on boardroom discussion.
- Decisions made on the basis of short-term results rather than the company's long-term best interest.
- Unwise reduction of cash cushions.

Types of activist investors

There was general agreement among the board members we spoke to that activists fall roughly into two camps:

LONG-TERM

Investors who are genuinely seeking what is best for the company and looking to the long-term interest of shareholders.

SHORT-TERM

Investors who are primarily interested in a short-term run-up in stock price so they can realize a quick gain for their fund.

Needless to say, most board members, CEOs and chairmen prefer the first category to the second.

Our study participants acknowledged that some companies they had observed needed the first type of activist investor. They saw the need for a driving force from outside to shake up the company and hold the board and management accountable for results. However, many respondents believed the second type was more common and generally had negative effects on the industry. Several indicated that they prefer investors with a specific investment thesis over those who simply say, "You're underperforming."

We also heard that investors interested in short-term gain often don't want to be insiders – they don't want to be hampered by serving on a board and being subject to trading blackouts. According to some participants, dealing with these investors requires a different strategy than those who demand board seats.

'Big hug' strategy

The board members we interviewed voiced a broad range of thoughts and opinions about how to deal successfully with activist investors. Although in the minority, some expressed the view that no special strategy or approach is needed. Not one suggested that a pitched proxy battle is the best strategy, and even those who contended that proxy battles often can be won still argued that they should be avoided. Several thought that small companies approached by well-funded activists might as well

“Don’t give them cause for righteous anger. Acknowledge that they have valid points and work to understand their views.”

accept the outcome as a foregone conclusion. One of our respondents suggested that the best advice for CEOs in that situation is to “Start tuning up your résumé.”

There was one idea we heard over and over from many of the board members we talked to: “You have to listen first. You have to engage.” The more experienced participants were in dealing with activist investors, the more they emphasized the need to sit down, talk with them and take their views seriously. Most had learned that treating activists with disdain in the early stage of discussions is likely to lead to a heated battle in which the activists are typically on more familiar ground than the board and company management. One piece of advice repeated by several participants can be summed up as “Don’t give them cause for righteous anger. Acknowledge that they have valid points and work to understand their views.”

More than one board member said the strategy that had been most successful for them in practice was to bring activists onto the board and let them see how difficult the real choices were for the company. One who suggested this approach said, “Once they’re part of the board, human nature takes over. They may need to be coached by the general counsel, but they will come to see that they are now personally liable for the corporation.”

However, those suggesting this approach said it is not enough to simply give an activist investor a seat on the board. The investor has to be actively involved, even embraced, as a participant in board deliberations and processes. One board member called it the “big hug” strategy. (However, several also talked about the need to put any new board member through a rigorous selection process and not just accept an activist’s choices without questioning and pushing back on qualifications.)

Some participants in the Heidrick & Struggles study espoused another view altogether: that activists are poison on the board and their inclusion should be actively fought. Some cited instances when boards with activist members became paralyzed by paranoia and broke into battling factions. While this was clearly a minority view, it was deeply held by some. These participants suggested trying to work out a one-year pause in which the activists agree to hold off seeking changes for a year after discussions.

One of our respondents, who had been the chairman of a board that was approached by an activist investor, offered the following example. After winning a proxy battle, the investor got his slate of candidates seated on the board, doubling its size. The activist was then able to get chairmanship of a special committee that was charged with looking at strategic alternatives for the company. The committee even had its own counsel, which operated separately from the corporate counsel. The result for the company was that costs shot up, everyone on the board quickly sought legal representation and the ensuing meetings were tense and unproductive. It took constant work over the next three years to make the board functional and productive again, without infighting, suspicion and mistrust.

Outlook for the future

Our study participants generally believed that there is no near-term end in sight for activist investors on the boards of semiconductor companies. Several cited the Dodd-Frank law as a regulatory statute that makes board activism much easier to carry out. One participant said that because of the current regulatory environment, “The playing field is tilted toward the investor and against the company.”

Pointing to the cyclical nature of the semiconductor industry, some participants argued that it is an inherently incompatible business model for activist shareholders because the activist strategy is unlikely to have a positive influence on business results or shareholder value. Others stated further that activists can sometimes appear to make a positive impact solely because they invest at an opportune moment in the cycle.

Although most participants believed that investor activism is a reality that all companies will be dealing with for the foreseeable future, a small minority held a different view. They thought they had seen a two-year trend of lower returns for activist funds. They held that over the previous 10 years, activist investors had harvested the "low-hanging fruit" of mismanaged companies that could be transformed easily. They argued that the companies that are left face intractable problems that are not susceptible to easy, short-term solutions. In the view of these board members, this scenario has led to a down cycle in which funds are less likely to embrace activism as a strategy. As one participant pointed out, "The activists become vulnerable if they're not making the returns."

Acknowledgments and disclaimer

We want to thank all of the board members who participated in our study for generously offering their time and insights. It was a privilege for us to have the opportunity to discuss these timely topics with some of the most distinguished board members in any industry.

Heidrick & Struggles is solely responsible for the interpretations and analysis offered in this paper. Our findings should not be attributed to any of the individual participants.

Bruce Kimble
Principal, Global Technology & Services Practice

bkimble@heidrick.com

201401JNTSDG108