Paving a path toward peaceful shareholder engagement
How next-generation corporate reporting can mitigate risk of shareholder activism

By any measure, shareholder activism has surged in recent years. Examples abound of activists engaging with companies and their investors, and their demands run the gamut from requesting more dividends, changes to management and boards, divestitures and all the way to a breakup of the company in question. Not surprisingly, at the same time, the following macro trends can be seen throughout the markets:

• Questions about the right frequency and content of financial reporting
• Persistent utilization of non-GAAP measures
• Calls from more and more mainstream and passive investors for greater focus on long-term value creation and increased sustainability reporting at companies
Project Embankment brought together asset creators, asset managers and asset owners to identify outcome metrics that can be used to show progress toward long-term value creation

Embankment Project for Inclusive Capitalism: https://www.epic-value.com/#report

What do shareholder activism, the frequency of financial reporting, non-GAAP measures, and sustainability reporting all have in common?

They all relate to the when, how, what, with, whom, and why companies communicate with their broad stakeholder group. First and foremost of which are those providing capital to the company. When the story being told about prospects for long-term value creation is not transparent, well-designed, appropriately compelling and consistent across investors’ communication channels – both inside and outside of the financial statements – an activist can much more easily make a compelling case.

Shareholder activism itself is certainly not new. However, in the last several years, the trends among even passive investors to engage in the conversation about long-term value creation heighten the risk to companies. Management and boards should now understand that even index funds at asset managers like Vanguard, Blackrock and State Street could very easily side with activists if the companies are not effectively and transparently articulating their long-term value story. It might seem counterintuitive to think that indexers would have a view about sustainability reporting, since they are going to own the index irrespective of the reporting. However, in written public statements and in speeches, many of these asset managers have pointed out that those companies that set forth a strategy for their long-term value creation, and measure and report on their progress, perform better.

How is the strategic story best told?

To be properly positioned to mitigate the risk of an activist, management and boards should make sure that they have a well-thought out, well-articulated strategy of how they plan to create value over the long term. That includes not only financial value, which will be obvious in the financial performance and position presented by the company in its financial statements, but also the off-balance sheet value creators. These include the value being generated by its workforce, the value being created by the relationships with their customers, and the value created by the impact the company is having on society and its community.

From the long-term strategy, the company then should decide upon shorter-term goals and milestones to be sure it’s on the right path. In order to measure whether or not it is progressing, a critical component is to develop the right set of key performance indicators (KPIs) that should be tracked. Lastly, the management team should be able to articulate the risks associated with achieving goals associated with each of the KPIs.

While it may seem a daunting task to identify all the right nonfinancial KPIs to measure progress on the path to the long-term value strategy, much can be leveraged from the work performed in the Embankment Project for Inclusive Capitalism (EPIC), spearheaded by EY and the Coalition for Inclusive Capitalism. EPIC brought together 30 blue chip organizations representing the various players in the capital markets: asset creators, asset managers and asset owners.

After significant effort as the market participants effectively launched a series of work streams, a final report was released in November of 2018. This report seeks to identify outcome metrics that can be used to show progress toward long-term value creation. There’s an acknowledgement that some metrics are universal in nature and can be used across sectors, such as employee engagement. For example, if two peer companies have different strategies toward attracting and retaining their people, investors will clearly want to understand metrics that indicate the levels of employee engagement. Other metrics will be better suited to different sectors, such as the ideation rate and funnel at technology companies. Yet other metrics will likely be unique, based on the specific elements of a company’s purpose and strategy.

The outcome metrics revolve around several pillars, such as financial value, consumer value, employee value and societal value. While metrics around financial value are common and mature, it’s clear that the proliferation of non-GAAP measures implies that management views bespoke metrics as critical to the communication of their financial performance and financial position. The importance of communicating around consumer value, employee value and societal value are just as critical as they are embedded in the multiples that the capital markets apply to company valuations. The biggest difference is that the metrics to evaluate performance and position in these areas are less developed and mature.
The path forward

Many suggest that mainstream analysts do not seek out or use metrics around consumer value, employee value or societal value. However, recent experience has shown otherwise. Investors are keen to understand the engagement level of a company’s workforce so they are poring through third-party information, like employee blog sites or Glassdoor. In fact, a recent Wall Street Journal article* in January 2019 found that some companies have noted this and have attempted to find ways to sway their ratings. In other words, investors are increasingly combing the internet and big data to find information relevant to their analysis. Companies are better positioned if they control the narrative through their own metrics and related narrative that are in-line with their strategy, purpose and vision.

Putting all the metrics together to tell the company’s story about how it is progressing along the path toward long-term value creation necessitates rethinking the traditional corporate reporting model. A common myth is that investors are not delving deeply into the regulatory filings at companies and thus many consider those documents to be exercises in compliance rather than vehicles of communication. However, either through outsourced accounting analysts, their own research or, increasingly, through electronic consumption of both quantitative information and narrative, the regulatory filings have always been involved in presenting the story of the company’s performance and position. In fact, many activists have gleaned further information from companies’ broader disclosure documents, among other sources. As a result, it is incumbent upon the company to make sure that the story being told within the management discussion and analysis (MD&A), the financial statements and footnotes is consistent with the story being told outside the footnotes in the huge variety of communication channels.

The companies that excel at developing, articulating, measuring progress against and reporting on their long-term value strategy will be better positioned to avoid being targeted by activists. Even more importantly, they will also be better positioned to create the long-term value they seek. It is not possible to manage a business to sustainably grow without the right information to measure their progression against their plan, and adjust as required.

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