



UNIVERSIDADE CATÓLICA PORTUGUESA

The Role of Activism in Corporate Restructuring

The Case Study of Elliott-EDP

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Católica Porto Business School
2021



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Trabalho Final na modalidade de Dissertação apresentado à Universidade
Católica Portuguesa para obtenção do grau de mestre em Finanças

por

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sob orientação de
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Março 2021

ABSTRACT

The recent growth of activism in the corporate landscape has presented itself with a change of paradigm in the governance of firms. In that sense, the literature on the topic is not unanimous regarding the creation of value driven by activism.

This research aims to explore this topic, expanding on the dynamics of the relation between management and activist investors, as well as its effects on the targeted companies. Through the review of academic research and basing on news as sources of information, the multitude of outcomes from past activist campaigns in terms of its success suggests a practical example of the lack of consensus in the literature.

Taking focus on the campaign run by the American fund, Elliott Management, on the Portuguese company, EDP – Energias de Portugal, supported by public information available in news sources, reports and presentations this research develops an analysis on its determinants and reflects on the overall success of the operation.

The result of this research suggests activism may create value, yet its successfulness is contingent on a set of variables worthy of further analysis. Among these, there is an intrinsic component to be considered in an activist campaign which can be simply defined as the established dynamic between the activist investor and management of the targeted company. In this context, the background of the targeted company, motivation and size of the activist investor, as well as the level of cooperation between both agents are some of the determinants deemed most influential on the overall success of activist operations.

Keywords: Activism, Corporate Governance, Value-Creation

RESUMO

O crescimento recente do investimento ativista na realidade empresarial criou uma mudança de paradigma na gestão de empresas. Neste contexto, a literatura não é unânime em relação à criação de valor como consequência deste fenómeno.

Este trabalho de pesquisa pretende explorar este tópico, abordando as dinâmicas de relação entre a gestão e os investidores ativistas, bem como os efeitos nas empresas-alvo. Através uma revisão de literatura e baseado em notícias como fontes de informação, a diversidade de resultados de casos práticos reflete a falta de consenso na literatura em relação ao tópico.

O trabalho aborda a campanha realizada pelo fundo Americano, Elliott Management, na empresa Portuguesa, EDP – Energias de Portugal, considerando fontes de informação pública e desenvolve uma análise sobre os determinantes e o sucesso geral da operação.

O resultado da pesquisa sugere que o ativismo pode criar valor, mas que está dependente num grupo de variáveis. Entre estas, existe uma componente intrínseca a ser considerada em qualquer campanha que pode ser simplificada como a dinâmica estabelecida entre o investidor e a gestão da empresa-alvo. Neste sentido, o passado da empresa, motivação e dimensão do investidor, assim como o nível de cooperação entre os dois agentes são alguns dos determinantes mais influentes no sucesso de campanhas ativistas.

Palavras-chave: Activism, Corporate Governance, Value-Creation

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INTRODUCTION

This research aims at evaluating the purpose of activism and its implication in terms of value creation for companies through the analysis of the activist campaign driven by Elliott Management Corporation on EDP - Energias de Portugal. The relevance of the topic lies in the growth of activism for the past years, imposing itself as a reality of the present corporate landscape with several implications in what concerns the governance activity of companies and investor relations, specifically for companies who establish firm managerial centric forms of governance.

In this context, due to the nature of the topic - namely the determinants of value-creation associated with shareholder activism -, this research follows a variant of the case-study form by providing a mostly qualitative research on the topic and, as such, having a limitation in terms of quantitative evidence and its applicability regarding the generalization of cases. This research does not intend to propose an answer which can be applied to every activist campaign, as its nature is dependent on far more variables than what can be addressed in this work. In that sense, the outcome of this research suggests a perspective on the topic, attempts to foster the investigation of different hypothesis and, lastly, attempts to answer an intrinsically binary question which is controversial among the authors who have researched the topic: *Does shareholder activism create value?*

The structure of the research intends to embrace several types of readers – familiar with the subject or not – by providing a review of academic work written on the topic and a collection of thoughts on its application in real cases of activist investing before addressing the analysis of EDP-Elliott case-study. The research takes a starting point with a literature review on the essence of activism, in particular its definition, growth, effects and criticism. It proceeds to an overview of several practical cases of shareholder activism, supported by public sources of information, in order to illustrate key points concerning the dynamic between activist and management to be taken for

later application in the main case-study. The final stage of the research takes focus on the EDP-Elliot case-study and is divided in two chapters: the third chapter which comprehends a contextualization of the activist campaign, namely in terms of the investor, the company, considerations on the campaign itself as it progresses over time, as well as what are deemed most relevant points of the alternative strategic plan addressed by the activist in the form of a letter. This section is complemented with the fourth chapter which intends to present, in a form of essay, reflections on the outcome of the campaign considering its development and sustained on information gathered in previous chapters. The research ends with the concluding chapter which mentions the determinants considered to be the most influential on activist campaigns and suggestions for future research.

1. LITERATURE REVIEW

1.1 Definition of Activism

While there might exist slight variations regarding the concept of the term, activism is generally defined as an acquisition of share capital in a company, by a private investor, with the intention to influence the operations of the company (Pound, 1992). As with any investment, the process involves an analysis, prior to engagement, in which the investor reaches the conclusion of whether to invest or not. However, the fundamental difference to other forms of investment lies in how, during the analysis, the investor takes into consideration a plan to act towards aspects which, from his standpoint, are in need of change. In the mind of the investor, by exercising some form of influence in the target company, he is able to shape its strategic plan in order to meet certain criteria and maximizing potential in his perception or, in other words, create value (Klein & Zur, 2009).

1.2 Growth of Activism

In that sense, investors have been increasingly resorting to activism - the general consensus in the literature and data points to a growth for the past 20 years (Flugum & Howe, 2020). Not only has it grown in total capital deployed, but also in number of sectors in operation, reflecting the importance of the topic in today's corporate landscape¹ (Bebchuk, Brav, Jiang & Keusch, 2019; Hamdani & Hannes, 2019). The impact is also far from geographically limited, suggesting a worldwide expansion through a stabilization of the U.S. market and a steady increase in the European and Asian markets². In the U.S., the stabilization process can be explained by a record level

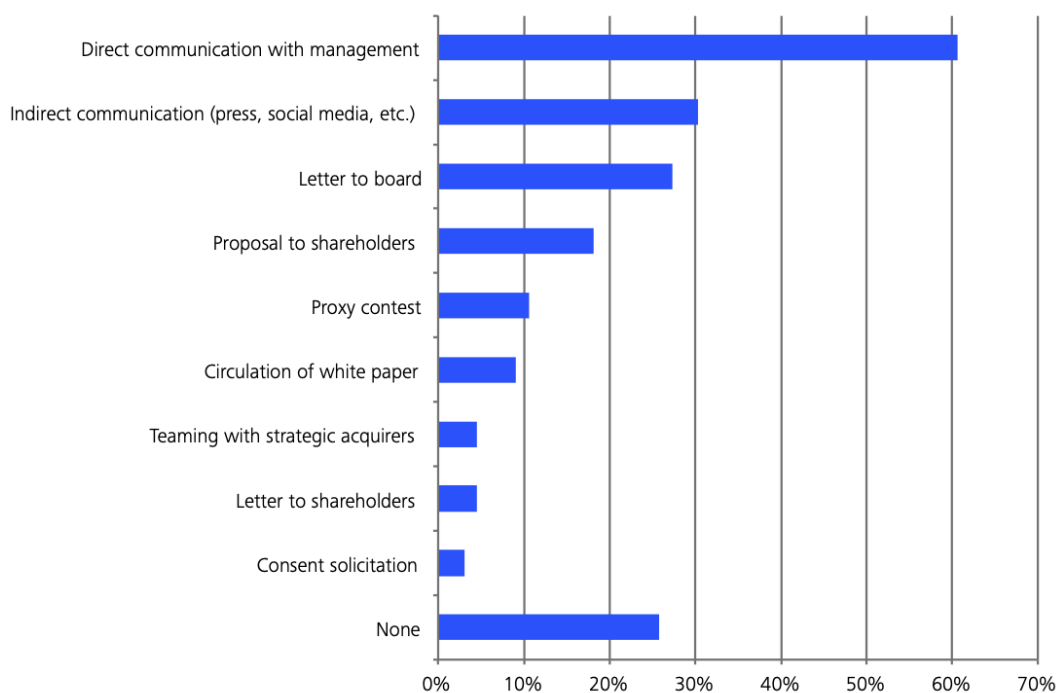
¹ According to JPMorgan's report "The Activist Revolution: Understanding and navigating the new world of heightened investor scrutiny", assets under management by hedge fund activists has increased from \$12 billion in 2003 to \$112 billion in 2014, available at: <https://www.jpmorgan.com/jpmpdf/1320693986586.pdf>

² According to Shark Repellent and Activist Insight platforms as of 30 June 2019, in 2012 only 30% of the global activist campaigns were non-US, while in 2019 this number grew to 48%.

of capital in the market at the beginning of the growing phase. This led to a growth supported by the pressure on investors to outperform and obtain above-average returns, which in turn decreased the number of activism opportunities as a consequence of increased competition (Cyriac, De Backer & Sanders, 2014).

These numbers are consistent with a Deloitte CFO survey of 2015 in which it was reported that around three quarters of U.S. companies have experienced some form of activism and half of them have made one significant change due to it³.

Percent of public company CFOs who indicated having experienced the following activities (n=66)



Source: *CFO Signals*, Q1 2015, CFO Program, Deloitte LLP

FIGURE 1

Forms of activism in targeted companies

4

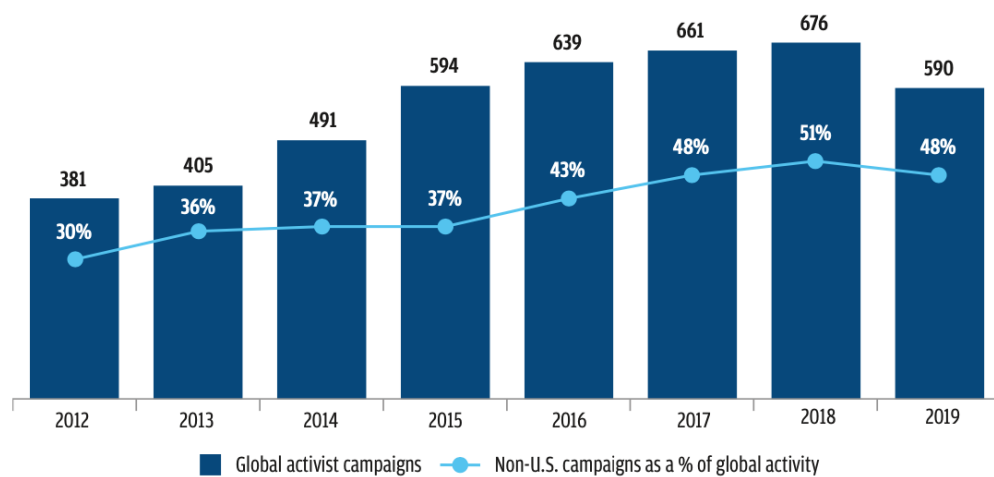
Despite this, according to JPMorgan’s annual report on activism, in the 2019 proxy season there was a slight backdrop on the ascendant progression of the past years to

³ Deloitte survey ‘Activist shareholders: how will you respond?’ available at: <https://www2.deloitte.com/content/dam/Deloitte/us/Documents/finance/wallace-cfo-insight-activist-shareholder.pdf>

⁴ Source: Deloitte survey report

a total of 590 new activist campaigns launched worldwide⁵. There has been research and historical data available that suggests a wave-like progression of the activism phenomenon (Krishnan, Partnoy & Thomas, 2016). Even though it's been growing at a sustained pace, activism is not immune to exogenous conditions and events that influence the market in general. For this research, however, it is more relevant to analyze the determinants behind the motivation of an activism campaign and its undeniable impact on nowadays corporate landscape rather than discussing the factors of its volatility.

Shareholder activism campaigns globally^a



Sources: SharkRepellent, Activist Insight and Activist Monitor as of June 30, 2019. Represents the following campaign types: board control and representation, enhance corporate governance, maximize shareholder value, remove director(s), remove officer(s) and vote/activism against a merger.

^a U.S., Europe, Asia and Australia.

FIGURE 2

6

Yearly evolution of activism

⁵ Source: JPMorgan 2019 Proxy Season Review report, available at: <https://www.jpmorgan.com/jpmpdf/1320747618625.pdf>

⁶ Source: JPMorgan 2019 Proxy Season Review report

1.3 Activist Campaign

In essence, an activist campaign takes origin in a misprice of “undervalued” assets in a corporation which creates the opportunity for large-sized profits with relatively low risk, from the perception of the investor (Carlisle, 2014). Activism fills a gap in an investors’ arsenal by expanding the investment possibilities and allowing investors an attempt to outperform the market and obtain above-average returns through identification of companies with a profile of recent underperformance. Factors such as a recent form of lag relative to industry peers, anemic revenue growth or a lag in the shareholder returns are among the aspects that lead to the identification of potential in corporations which activists seek (Cyriac, De Backer & Sanders, 2014). In one way or another, these levers are related to the core areas in which activists act when engaging in an activist campaign: Corporate governance, through board and governance changes, which ultimately pretends to implement the influence of the investor within the company and establish changes in the organization by pushing for change of management or adjusting incentive structures; M&A Activity in terms of acceptance or declination of potential transactions of the company as a whole or specific assets which activists see as noncore or lower margin; Strategy and Operations regarding concepts of increases in margin performance, reducing corporate costs or a shift in the strategic focus towards the core business by divesting certain businesses; Capital Structure and the different capital structures which companies aim for, whether in terms of repurchasing common shares, increase in dividends by reduction of cash balances and debt restructuring or recapitalization⁷.

In summary, when a company is identified, activists take actions in order to change management, obtain board representation, reallocate resources, demand changes in

⁷ Mckinsey podcast ‘The pros and cons of activist investors’, available at: <https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/the-pros-and-cons-of-activist-investors>

the capital structure or even force the firm in to a takeover (Clifford, 2008; Brav, Jiang, Partnoy, and Thomas, 2008; Greenwood and Schor, 2009).

1.4 Management and Activists

An essential aspect of an activist campaign is the inter-dynamic relation between management and the activist investor. In every business, a considerable source of potential for conflict emerges from a milestone in corporate research related to the principal-agency dilemma. The authors Adolf Berle and Gardiner Means identified a difficulty of one party (principal) to motivate another (the agent) to put the interests of the principal ahead of the agent's own interests in their work *The Modern Corporation and Private Property (1932)*. Additionally, they suggest the way corporations are run implies a protection of the agents (the boards of directors) from the supervision of the principals (shareholders) as they are motivated to pursue their own interests and not take into account the shareholders' visions, which are often small or dispersed to be noticeable. As a result, the separation between ownership and control creates a potential distortion of power in which the interests of the owners of an organization may not be one of the primary focuses of its operation (Carlisle, 2014). Since public companies are run by complex boards of directors and different layers of management, this approach often carries some synergy concerns which impacts the success of activist campaigns. As a starting point, while it may seem intuitive that an activist investor acquires a qualified participation in a company in order to implement a set of ideas and strategy with the purpose of creating value, more often than not, the vision clashes with the one of the management board, leading to a tension between both parties and a potential undermining of the company's prospects. It is in this context that activist campaigns gained a bad reputation some decades ago: on one side there is a reluctance to takeovers by management and a natural avoidance of attempts to guide the strategy of the company by an investor as a consequence of such behavior; on the other, a conception of myopic activity driven by short-term gains

and lack of long-term commitment to the company (Coffee Jr. and Palia, 2015). When both aspects aligned, it was not uncommon for events of 'Greenmail' to occur due to divergences regarding the company strategy: the management sought a way to remove the investors influence by offering to rebuy, at a premium, the shares bought by the former shareholder, eliminating the activist influence in the course of the company. This process, however, was considered to be a minority in the activism landscape and not a reflection of the overall motivation of activism (Bebchuk, Brav & Jiang, 2015). In fact, the concept is no longer viable as several regulatory bodies in the U.S. have made this practice unlawful, yet activism continued to grow for many years after. That was only possible due to a change in the activist agenda to a more diverse approach that focuses on topics of business strategy, operations and management compensation, sale of assets, or even return of capital through dividends or stock purchases which, in some topics, contrasts with the short-term and event-driven motivation of previous years (Arcano & Grossman, 2014).

In that sense activism has evolved from decades ago to a scenario in which is embraced as a reality of corporate landscape. That is reflected in governance trends such as the dismantlement of classified boards and shareholder rights plans, or the increasing prevalence of shareholders' ability to call special meetings, which balance the onus of decision between management and investors in the action of a company (Arcano & Grossman, 2014). As the growth of activism could not be sustained if there were no upsides to it, since investors and companies would prevent from undergoing into campaigns, it is relevant to examine the effects of such campaigns in the targeted companies.

1.5 Effects of Activism in Targeted Companies

When it comes to the effects, there is a wide literature on the topic of consequences for corporations after the arrival of an activist investor. Starting from the announcement of an activist campaign, research has shown a positive market reaction

around the activist's intervention date, supported by positive short and long-term cumulative abnormal returns and an increase in stock price (Boyson & Mooradian, 2011; Krishnan et al., 2015). The market generally regards such participation as a positive event in the course of the company and a potential explanation for that arises from the perception about activists and their measures aimed at improving efficiency. This effect may be empowered depending on the fund involved, as the market rewards a reputation of financial clout and experience demonstrated through past performances (Dasgupta & Piacentino, 2014).

On the other hand, consequences of activism are not clear and while there have been many studies on topic, there is a lack of consensus in the literature on the effects that arise from it for the companies and what results can be attributed to the intervention of the activist. In part, this is due to the difficulty in establishing a causal relationship between the behavior of an activist in a campaign and the outcomes generated in a targeted company which leads to a theory that management of an underperforming company will implement changes, regardless of the activist's campaign, and therefore a potential positive outcome is not necessarily reflected by the intervention itself. In order to test this hypothesis, Brav et al. (2015) researched on the possibility that activists use stock-picking to target companies prone for improvement, rather than the outcome of an intervention, and through the analysis of a subsample of firms with investors who changed their position from passive to active investors, found that performance of plants increased after a passive investor becomes active. In that sense, the combined results from this empirical research suggest hedge fund activism is the type which is more able to improve performance at target companies. A potential explanation for this lies in how hedge funds are resourceful investors who rely not only on stock-picking, but effort exertion to implement their investments, which means funds choose their targets based on the likelihood of influencing the company and implementing a successful activist campaign or, in case that is not possible, can potentially profit with improving prospects even if they remain passive shareholders (Bebchuk et al., 2015). This motivation seems to be the most

reasonable description as it is unlikely that hedge fund activism can be justified as pure stock picking, given that the median campaign is a lengthy process and the ones who end in a proxy fight are estimated to cost an average of \$10.71 million (Gantchev, 2013). These include the research required to identify an opportunity to improve a target's business strategy, the financing and opportunity costs of its equity position, the idiosyncratic risk resulting from holding an undiversified position, to the engagement with the target and costs associated with a potential proxy fight (Coffee, 2017).

Other studies suggest that activists are able to improve profitability and corporate governance of the target firm by using unique and aggressive tactics (Flugum & Howe, 2017). While some measures may be labeled aggressive, research has also shown how the reputation of an activist determines the success of a campaign, even though the market doesn't reward activists with a reputation for being simply aggressive (Zur, 2008). A deemed successful aggressive stance is rather a reflection of other indicators such as the size of the activist fund, since it is often the case that experienced hedge fund activists have existed for longer and have greater assets under management (Boyson et al., 2016). The perception is that, through financial clout and past performance, activists are able to increase factors such as the return on assets to approximate comparable firms of the industry, sales revenue growth, R&D spending and overall operating performance, particularly in comparison with other type of investors who are unable to gather the resources to perform such changes (Krishnan, Partnoy & Thomas, 2016). On those terms, the success of an activist campaign regarding company performance is correlated to the outcome of the measures proposed by the activists themselves. As the average share stake held by activists across countries is 11%, there is a need to engage with other investors in order for a campaign to be successful (Becht et al., 2017). Among those, institutional investors play a central role in the sense that activists are unable to implement measures without their support. This complementary link is created due to the risk of inadequate diversification which prohibits many fund managers from selling shares in

underperforming firms (Monks & Minow, 1991), and institutional investors' profile characterized by a form of passivity yet responsiveness to other investors' proposals (Coffee, 2017). On the side of activists, these specialize in monitoring the company's strategy and develop alternatives to present to institutional investors who focus on evaluating them and in portfolio management overall, which creates a codependence mechanism between both parties, increasing the value of governance rights for the activist by allowing the choice to be dependent on institutional investors to go forward on the proposal (Bebchuk et al., 2015). This happens due to the nature of activism in the present which intends to create value or maximize potential by leveraging a small ownership percentage (Ruggeri, 2019). However, in order for that to happen there must be a common alignment of incentives between both parts. It is often the case that institutional investors lack the incentive to elaborate complex business plans, though are able to sense issues related to underperformance of companies and evaluate restructuring proposals (Brav et al., 2010). On the other hand, when an activist is highly regarded it is often due a successful history in difficult interventions, namely by having the ability to pressure managers in credible ways and gathering the support of other investors, including pension funds and other activists (Krishan, Partnoy & Thomas, 2016). Activists are aware of this dynamic and optimize it in the selection of the target, as the majority of companies targeted have a higher institutional ownership in comparison with their peers (Brav et al., 2010). This potential cooperation is determinant on how the campaign develops, namely in the avoidance or support of proxy fights – which often happen in the form of lawsuits -, pressure of target boards with the use of media, overcoming strong anti-takeover defenses or even replacement of board members (Krishan et al., 2016). When a proxy fight takes place between activists and management, institutional investors are incumbent of analyzing the proposals offered by both sides in order to support one view. This mutual dependence and a potential agreement between activists and money managers has shaped a new channel of communication in the corporate world, by creating an incentive for management to establish a closer engagement with these parts in the discussion of

governance, performance and strategic concerns of the company (Cheffins, 2015). Since size and reputation of the activist imply a credible threat to win board seats, it is often the case for a settlement to happen between the activist and the target board which results in changes in the board composition and the nomination of activist directors (Hamdani & Hannes, 2019). With this, the activist intends to create a form of monitorization which supports the implementation of his vision for the company, as well as an active participation in the strategic business plan (Becht et al., 2017). Since the directors have access to nonpublic information of the company, they are able to share this information with the activist in order to perform a deeper analysis and adapt the overall vision, which institutional investors (money managers?) often don't have the resources to execute. Once this form of settlement takes place is when the activist can apply the operational changes which he seeks, such as increases in CEO turnover, increased payout to shareholders or improvements in valuation (Bebchuk et al., 2019). Additionally, the literature reveals a positive outlook on the ability of activists to improve the target firm's fundamentals, not only by reallocating resources to mitigate agency costs but by improving the productivity of assets-in-place (Clifford, 2008; Brav et al., 2008; Klein and Zur, 2009; Boyson and Mooradian, 2011; Brav, Jiang, and Kim, 2015a; Krishnan, Partnoy, and Thomas, 2015). When it comes to activists' changes from an operational view, Brav et al. (2015) carried a research on a set of manufacturing companies in the USA targeted by activists (about one third of the total targeted companies) in the time period between 1994 and 2007. With the use of data from sources such as U.S. Census Bureau's Annual Surveys of Manufacturers (ASM) and the Census of Manufacturers (CMF) - which aggregate official data on variables such as plant assets, number of employees and capital and materials used -, Brav et. al (2015) found that productivity of a company increased following the intervention of the activist, while keeping the same level of wages and a decreased number of working hours by employees. Additionally, an important factor to consider following the intervention regards the CEO compensation which is shown to be more related to performance after the intervention (Fos, 2014). While in general this may seem as a

threatening action towards the different tiers of workers in a company and, therefore, a potential decrease in the number of working hours, the research revealed it happens due to a focus on efficiency and total productivity which resulted in an increase in the output per hour and an evidence of previous studies which suggest monitorization of the target management results in improved labor efficiency (Pagano & Volpin, 2005). In comparison with similar companies who were not associated with an activist intervention, the increase in productivity amounted to six times greater and, after a deeper analysis, the authors suggest this is achieved by the activists' expertise on two main channels of productivity, namely the improvement of the efficiency of assets in place and the reallocation of capital (Brav et al., 2015). This description is coherent with findings of other researches in which is stated that activists target strong and established companies but with occasional cases of mismanagement or other governance issues which can be solved through such channels of improvement (Brav et al., 2008).

1.6 Criticism

When it comes to criticism of hedge fund activism, the central point of the matter is related to the investment horizon. In that sense, the conception is that activist funds aim for short-term gains at the expense of long-term prospects, namely in terms of agency costs and performance, and a particular focus on financial metrics. Not solely in the form of the previously mentioned case of greenmail, but also by taking advantage of the subsequent positive abnormal returns in the period following the arrival of the activist. In that sense, while research reveals a positive short-term gain in terms of operating performance and stock return, the underlying issue is at what cost for the company. A portion of the critics suggests the use of financial engineering to obtain these achievements which translates into non-sustainable changes that compromise the long-term improvement of the company, such as shareholder distributions or increased leverage, measures considered to be transfers of wealth rather than long-term value creation (Fox & Lorch, 2012). This behavior comprehends

several strategies identified by the critics of activism which have been addressed and examined in a research by Bebchuk et al. (2015). The first is a “pump and dump” argument which suggests investors engage in a campaign to perform financial engineering measures, such as leveraged recapitalizations, in order to sell the stock in the future and profit from positive abnormal returns. Even though this method implies an undermining of the company’s prospects and compromise of the future through devaluation of total assets, the authors were unable to find a correlation between an activist departure and an underperformance of companies in the three-years following the departure of the investor. The second strategy, “asset stripping”, consists in a reduction of a company’s assets, through cash payouts and asset sales, which critics claim it is harmful to the company in terms of increased risk and decreased flexibility (Lipton, 2013). In order to test the previous theory, Bebchuck et al. (2015) analyzed a sub sample of companies with factors which can be regarded as “asset stripping”, specifically considerable reductions in capital investments, increases in leverage, or increases in payouts to shareholders. The analysis of long-term performance found no difference between the development of performance between the companies in the sub sample and the remaining, as in both types of companies revealed a sustained increase in operating performance in each of the five years following the activist’s intervention. As for the final strategy, “adversarial interventions” describe an intervention with a clash between activists and the management, in which critics argue there is an incapability of running the firm due to a distraction imposed by the activist. With a similar method as of the one used for “asset stripping”, Bebchuk et al. (2015) found no evidence of a negative long-term performance for this parameter either.

Another criticism pointed at activists is related to how they deal with the R&D division of a company. It suggests that, as a consequence of a short-term motivation, activists will decrease significantly the spending on R&D as a way to redirect funds to share buybacks or shareholder payouts which ultimately will increase share price (Coffee & Palia, 2015). This fits the agenda of a short-term investor who, within a

period of one year, will have left the company and obtained a sizeable profit, yet this creates an agency cost between activists and the remaining investors since the increase in share price is obtained at the expense of the long-term growth of the company and consequently, long-term indexed investors (Coffee, 2017). On one side there has been evidence of a considerable decrease in total spending on R&D, pointing to a decrease from 18% to 8.12% of sales over a four-year period following an activist intervention, in contrast with firms not targeted by activist in which R&D spending grew relatively as a percentage of sales over the same period (Allaire & Dauphin, 2015). Yet there have been contradicting research which also points to a more efficient outcome of research spending, namely in terms of "innovation output" measured by an 15.3% increase in number of patent applications and citations (Brav, Jiang & Tian, 2018). The controversy in the interpretation of these studies places the debate back onto the initial motivation of the activist as different strategies will fit different investment horizons. It is reasonable for management to be reluctant to the arrival of an activist, yet the reality of its growth in the corporate scenario creates a new dynamic in how the relation between both agents develops and ultimately the success of a campaign.

2. REVIEW OF PRACTICAL CASES

2.1 Sequoia Fund Inc./ValueAct on Rolls-Royce

Activism has expanded in Europe and targeted large firms of various industries. An example of that are the campaigns carried by funds towards the automobile sector targeting companies such as Rolls-Royce Holdings Plc and Volvo AB. When it comes to Rolls-Royce case the activist, an American fund named Sequoia Fund Inc., acquired shares of the company in 2007 which reflected a participation of 0,67% in 2015⁸. It was only until that year, after a period of consecutive profit decreases and underperformance which resulted in the first sales drop for the company in a decade, that the fund manifested dislike regarding the strategic plan of the company in a letter stating several points of disagreement. The most relevant concerned a matter of diversification in the sense that the company's main business line at the time involved the production of jet engines which were sold at a loss and, because of that, sustained in maintenance service contracts the main source of profit. Despite this, management was embracing a diversification plan which included an expansion to sea and land operations through the sectors of marine-engine and power-generation. In an escalation of hostility and a demonstration of incompatibility in the discussion of these matters, the letter written by Sequoia labelled the management and board "stubborn and entrenched" describing the strategy as detrimental for shareholder value and manifested an urge for change to focus on the main line of operation, benefiting from an almost duopoly in air-engine production instead of expanding to sectors with numerous competitors⁹. This diversion ultimately led to the CEO replacement about one month after and a share price increase of 5,4% in the announcement date¹⁰. Later

⁸ <https://www.bloomberg.com/news/articles/2015-03-16/rolls-royce-may-need-tough-activist-to-push-change-fund-says>

⁹ <https://www.valuwalk.com/2015/03/sequoia-fund-2014-letter/>

¹⁰ <https://www.bloomberg.com/news/articles/2015-04-22/rolls-royce-volvo-replace-ceos-as-activist-investors-gain-clout>

that year, an acquisition of 5,44% shares made ValueAct, an American fund connected with past activist interventions, the largest shareholder of Rolls-Royce¹¹.

There are some relevant takeaways from this case. The first considers the investment horizon in question as the campaign by Sequoia was likely not prepared in the moment of investment, since between both events there is a time frame of eight years. Even though ValueAct, a large American fund with clout and reputation in past activist interventions, became the biggest shareholder of a company with demonstrated recent underperformance, the case of Sequoia describes a different form of activism and less common in the literature. The mostly 'pacific' first years of the intervention suggest a less active form of campaign, in contrast with a more planned and calculous intervention which is a more common form of activism. Yet it was manifested nonetheless once there was a form of disagreement regarding the direction of the company and the existence of this form of activism defies the critics' concept of short-termism or at least questions the argument in terms of time length, as it had been researched by Bebchuk et al. (2014).

On a deeper level, this also questions the conception of the activist investor profile. While the most common form involves a specific investor with a plan towards a particular firm in a given time, there is a contextual factor which reveals the different forms which activism can take. This means a longer-term investor, such as pension or mutual funds, might adopt a more activist approach in a given time if the company embraces in negative action, from the perspective of the investor, either through proposals and engagement with the management or by supporting the campaign of a different investor¹². Among other forms, there is a frequent hedge fund approach which targets specific companies and elaborates a plan to deal with problems affecting the performance of a given company. This contrast shows activists are usually seen as shareholders who want to improve the value of companies through engagement with

¹¹ <https://www.ft.com/content/58212f4c-3792-11e5-b05b-b01debd57852>

¹² <https://www.wsj.com/articles/mutual-fund-managers-try-a-new-role-activist-investor-11546174800>

managers, despite investment horizon or portfolio composition, and the level of activism is subject to change across different investors as well as within different investment avenues of the same investor as it was researched by Millo & Wearing (2011).

Secondly, the increase in short term returns following the CEO substitution suggests a practical indicator of the literature on market's reaction to activism. If this can be explained by a CEO change in a company with recent underperformance, which is in essence a positive action in the course of the company from a market perspective, a reasonable speculation can be attributed as well to the market perception of the activist's role in the process, since the confrontation of ideals was public and ultimately the activist's vision prevailed. Given this, Sequoia was one of the first investors to demonstrate public dislike regarding the course of the company and, if under normal circumstances the task would have a higher degree of difficulty, the ability to gather other investors to support a certain vision is an aspect which should not be underestimated. Following the publication of the letter, an Australian fund and shareholder of Rolls-Royce demonstrated support for Sequoia's vision and claimed that John Rishton, CEO of Rolls-Royce at the time, had some "explaining to do"¹³. At the same time, Sequoia's position at 0,67% was not enough to enforce changes in the company without the support of other investors and the fund was aware of its incapacity to further influence the destiny of the company when states that it may take a "tough-minded activist to force strategic change". However, Sequoia made its contribution by taking a public action against the management of the firm, gathering the support of other investors in the clash of different visions and ultimately forcing a CEO replacement which occurred shortly after.

As for ValueAct, the fund prepared a campaign on Rolls Royce after five profit warnings in two years of underperformance which resulted in an acquisition of 5.44% stake in 2015, becoming the largest shareholder of the company. Considering the circumstances of Rolls Royce at the time, the campaign was planned with the goal to

¹³ <http://brontecapital.blogspot.com/2015/03/rolls-royce-and-sequoia-letter.html>

implement changes in business restructuring and operational efficiency reviews for cost savings¹⁴ (Barker & Chiu, 2017). This was in line with the plan of the new CEO, Warren East, who had a vision for the company which included a change in slow and bureaucratic decision-making, clarifying executive accountabilities and intensifying leadership focus on operational performance, as well as a reorganization of executive management responsibilities. As of before, the structure was divided in two broad areas – aerospace, and land & sea – and the new management restructured it to civil engines, defense, marine, power systems and nuclear with the heads of these operating units reporting directly to the chief executive¹⁵. These measures were mostly aimed at improving efficiency and showed an alignment of visions between the new management and what Sequoia had defended months before and which ValueAct was trying to implement at the time. This form of agreement between these three parties evidences the role which activism can have in corporate restructuring. In this case, previous management demonstrated an inflexible form of governance by not engaging with investors in order to understand and adapt their proposals. Considering the recent underperformance of the company at the time and the dislike manifested by certain shareholders, it was a matter of time until a breach between management and investors occurred if the circumstances had remained unchanged. Since the incentive structure and set of resources of both sides is different, the value which activist campaigns can add to a company is in the discussion and direct engagement in order to find a balance which fits both, as opposed to a scenario of increased hostility and lack of engagement from both sides. This was apparently what happened with ValueAct and the new management. While there was a type of consensus among them in terms of efficiency measures and turning the company leaner, the same cannot be applied to the matter of diversification, as ValueAct wanted to sell marine division, and management wanted to expand it¹⁶. Additionally, ValueAct had been looking to

¹⁴ <https://www.ft.com/content/9c8b8148-cf9d-11e5-831d-09f7778e7377>

¹⁵ <https://www.ft.com/content/fafa429e-a349-11e5-8d70-42b68cfae6e4>

¹⁶ <https://www.ft.com/content/58212f4c-3792-11e5-b05b-b01debd57852>

put one of its nominee directors on Rolls Royce Board but was only able to do it after management announced a dividend cut which made institutional investors support ValueAct's proposal¹⁷. In order to obtain board representation, ValueAct signed a settlement with the management which prevented the former from unduly disrupting the business with activist and business restructuring demands, as well as openly criticizing the company for a period of two years (Barker & Chiu, 2017), which meant Rolls-Royce nominee for board would not be considered independent and would have to vote in favor of management. These clauses protected management in two ways: by giving time to implement its business strategy plan and convincing other investors of the capability to successfully manage the company; by preventing an escalation of potential conflict through avoidance of public accusations.

At the same time, the settlement also revealed a degree of skepticism relative to the motivation of activists and the influence on remaining investors, as the management was aware of the divergence regarding the diversification plan and intentions of the investor. In that sense, ValueAct pushed for a sale of the maritime division and a focus on the main operation line which from the management's perspective could be interpreted as a potential sale or even spin-off to execute a pump and dump strategy, by an activist who seeks short-term price performance instead of long-term value creation. That is a reasonable fear considering a number of campaigns often leads to the company being sold (Greenwood & Schor, 2009), yet there are contradicting studies which indicate there is little change in a company's stock price or financial results in the 18 months period following the intervention (Stowell, 2018), apart from the announcement date, which suggests that a short-term motivation of investors can be an inaccurate perception of some activist campaigns. As of this case, by entering the settlement, ValueAct was willing to resign a 2-year period activity to obtain a board seat which fits more into a long-term commitment. In overall, this intervention was an example of how a formal arrangement is a trade-off for both sides and the increasing number of settlements from activism outcomes can exemplify an

¹⁷ <https://www.ft.com/content/2806e91c-8ec4-11e5-a549-b89a1dfede9b>

answer to the differences regardless of more director or shareholder centric forms of governance.

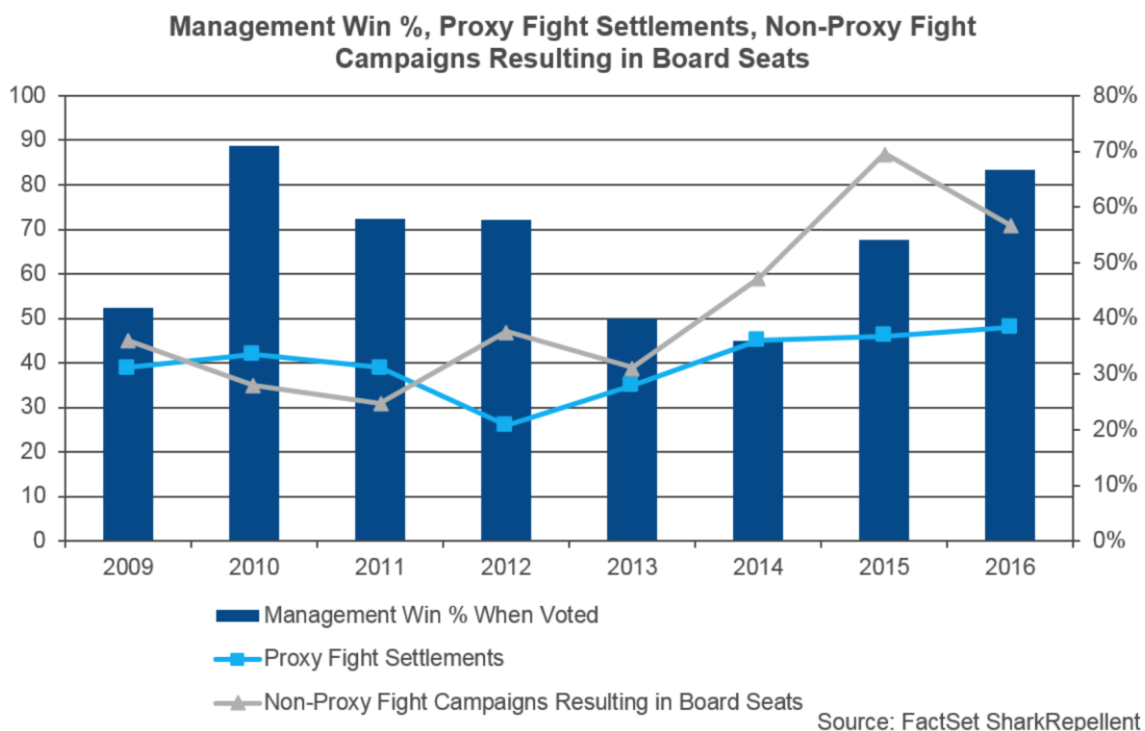


FIGURE 3

Increasing number of settlement outcome from activist campaigns¹⁸

But the reasons behind this growth are no less important. Often activists are resourceful investors who are able to put in practice what they believe is the best course of action for a company and that is reflected on how they have achieved over 75% success in proxy contests, electing at least one director (Alaire & Dauphin, 2015). Considering the number of shares acquired, in order for a campaign to be successful the activists will have to gather support of other investors as mentioned in Brav et al. (2010), namely pension funds or mutual funds who are often not interested in pursuing short-term goals but rather long-term performance. Given the different incentive structure and considering the criticism of investment horizon, the fact these two types

¹⁸ Source: Factset, available at: <https://insight.factset.com/2016-shareholder-activism-trends>

of investors are able to support a common strategy for a company indicates there is more to activism than pure short-term performance gains, as suggested in a segment of the literature (Fox & Lorch, 2012; Coffee, 2017). It reveals in some cases there might be a dismissal of shareholder's concerns and an alienation of its role as important stakeholder in a company to be replaced by an increased type of management governance, who in some cases pursue their own financial well-being than that of the shareholders (Jensen & Meckling, 1976). This can be seen in Germany, where activism has seen a growth, in part, due to the fact many directors have been managing companies for long periods of time without significant improvement of the company's performance, lack of transparency regarding the process of decision-making or in controversies regarding the compensation of executives¹⁹.

On the other hand, activists are not necessarily right in their judgement of a given company. Whether for reasons related to the original motivation to enter a campaign in particular or due to wrongly formulated plans, a company may suffer from the arrival of an activist. This result seems to be more when it is not taken into consideration the complementary factor between managers, who are knowledgeable of the business in which they work, and activists, who are financially resourceful and able to identify problems in a company. When it comes to the latter party, as the critics often argue, an activist who arrives at company with an intention to solely obtain short performance may lead to detrimental measures such as asset-stripping or dismantlement of divisions that may increase short-term performance but weaken the company as a whole.

2.2 Pershing Square on J.C. Penney

In 2010, Pershing Square, the fund of Bill Ackman, a famous activist investor, acquired a 16,25%²⁰ stake in the retail company, J.C. Penney (JCP). As another of its

¹⁹ <https://corpgov.law.harvard.edu/2019/01/29/shareholder-activism-in-germany-2/>

²⁰ <https://www.ft.com/content/7e443b12-d2e6-11df-9166-00144feabdc0>

activist investments, the fund soon tried to establish its vision for the future of the company, which resulted in securing a board seat²¹ for Ackman, swapping the CEO of the company²² and pressuring for a radical strategy plan change²³ based in a change of the pricing model, among others. The results were far from great, leading to the substitution of Ackman's appointed CEO for Mike Ullman²⁴, the CEO of the company prior to the arrival of the investor, due to a sales drop of 25% as well as consecutive decreases in revenue in 2013 and a 60% stock price reduction since the start of 2012²⁵, resulting in a \$500 million²⁶ devaluation of Ackman's investment.

Overall, the campaign was marked by hostility and a constant tension between management and the activist which, as the study by Boyson & Mooradian (2010) suggests, are indicators that generate a shorter investment horizon. Despite the new CEO having been hired by Ackman with the intention to implement the new strategy, the underwhelming performance of the company resulted in a 97% pay cut in Ron Johnson's compensation and in the case of the subsequent CEO, Mike Ullman, being pressured only four months after taking the position²⁷. The last part, along with additional pressure to replace the chairman of the board²⁸, were the last activist attempts before the exit of Ackman as shareholder of the company. This campaign was an example of how hostility and the inexistence of a complementary link between management and the activist can undermine the performance of a company to a worse scenario prior to the arrival of the investor. In the analysis of this case, several critics claim a relentless position of Ackman along with an inexperience in the retail sector to be the causes for this campaign failure²⁹. It is in this context the knowledge of both

²¹ <https://www.ft.com/content/b783d400-27c8-11e0-a327-00144feab49a>

²² <https://www.wsj.com/articles/SB10001424052702304070104576397371755324358>

²³ <https://investorplace.com/2017/11/ackman-jcp-stock-short> Full presentation:
<http://online.wsj.com/public/resources/documents/AckmanJCP.PDF>

²⁴ <https://www.forbes.com/sites/steveschaefer/2013/04/08/ron-johnson-out-at-j-c-penney-replaced-by-former-chief-mike-ullman/>

²⁵ <https://money.cnn.com/2013/08/26/investing/bill-ackman-sells-jcpenney/>

²⁶ <https://money.cnn.com/2013/08/26/investing/bill-ackman-sells-jcpenney/>

²⁷ <https://www.businessinsider.com/jc-penney-opposed-to-ackman-ceo-change-2013-8>

²⁸ <https://www.businessinsider.com/bill-ackman-letter-to-jcpenney-2013-8>

²⁹ <https://www.newyorker.com/business/currency/when-shareholder-activism-goes-too-far>

parties can act, as notable activists have the financial expertise and resources to create solutions, yet management has specific knowledge on the sector which is usually backed by years of experience. This engagement is necessary to have a positive outcome from a campaign, meaning that also management should proactively engage with investors and be prepared for activists with strong position and different visions³⁰.

2.3 Relational Investors on Home Depot

A contrasting case with Ackman's campaign on J.C. Penney, was the campaign run by Ralph Whitworth, head of the fund Relational Investors, on the retail company Home Depot. Shortly after the arrival, Whitworth wrote a letter to the then CEO, Bob Nardelli, requesting a reunion to review the situation of the company which the fund considered to be suffering from a "chronic underperformance and deficient strategy", in particular regarding an inferior evolution in stock price and the compensation of CEO which did not go in line with the results of the company³¹. To back up this criticism, the fund claimed that it was preparing a strategy plan to enhance the company, as according to Whitworth, since the arrival of Nardelli in 2000, the stock price had only increased 3% while in the case of the direct rival, Lowe's Companies, it grew 177%³². One month after, Nardelli resigned to CEO of Home Depot³³ and two months later, in February, after meetings involving both parties, the company issued a statement granting the fund a board seat³⁴ and endorsing the strategy by the fund. This strategy was not compatible with the previous CEO, as Nardelli had invested \$7 billion in acquisitions to create a whole-sale supply business in the two years prior to the exit, and the fund believed this division was operating on low margins and not adding value, while at the same time removing focus from the core retail business of

<https://hbr.org/2014/05/how-to-outsmart-activist-investors>

³⁰ <https://corpgov.law.harvard.edu/2019/02/19/investor-engagement-and-activist-shareholder-strategies/>

³¹ <https://www.ft.com/content/56b73418-8ee9-11db-a7b2-0000779e2340>

³² <https://www.nytimes.com/2006/12/19/business/19home.html>

³³ https://money.cnn.com/2007/01/03/news/companies/home_depot/

³⁴ <https://www.nytimes.com/2007/02/06/business/06depot.html>

the company. In one of the meetings between the fund and the management, the activist was able to demonstrate how a faulty assumption regarding the return of capital in the new whole-sale supply division was actually double of its true value³⁵. This approach had similarities with other campaigns³⁶ in which the fund was involved, as the activist gained a positive reputation for reverting a downward trajectory of a company and doing so by avoiding hostile public battles³⁷. By having a public position on specific topics which were based on a prior analysis and having non-public meetings with the management, the fund was able to demonstrate its rational and establish the complementary link with the management which is necessary in order to have a successful campaign and ultimately benefit the company. Shortly after, the proposal of the fund was implemented in the plan by selling the whole-sale supply division³⁸ and implementing a \$22.5 billion share buyback plan³⁹, which led the stock price on an increasing trajectory for years after.

The cases described in this chapter support a portion of the literature, namely the theory of positive market reaction described by Boyson & Mooradian (2011) evidenced in the case of Rolls-Royce after the arrival of ValueAct and the negative impact of adversarial interventions on companies targeted by activists in the short-term (Lipton, 2013), among others. Yet, the more interesting outcome is related to the case of Relational Investors on Home Depot which embraces the concept of value-creation driven by activism through the identification of a problem, submission of proposals and implementation of an alternative strategic plan which resulted in a positive outcome for the operation. The conclusion of this case defies the main argument concerning activism criticism in the literature, in particular the conception of myopic

³⁵ <https://www.wsj.com/articles/SB117128796358705782>

³⁶ <https://www.forbes.com/sites/forbesleadershipforum/2014/01/29/why-ralph-whitworth-may-be-americas-best-board-member/#10f70c8b1a05>

³⁷ <https://www.breakingviews.com/considered-view/ralph-whitworth-the-gentleman-activist-investo/>

³⁸ <https://www.supplyht.com/articles/91086-aug-31-2007-the-home-depot-completes-sale-of-hd-supply>

³⁹ <https://www.wsj.com/articles/SB118226545165740543>

activity driven by short-term gains through asset-stripping and lack of long-term commitment to the company suggested by Coffee Jr. and Palia (2015). While the latter research brings relevant points to the discussion of the topic, a positive outcome from an activist campaign is dependent on several variables already mentioned and the case of Relational Investors is an example which suggests activism may, indeed, create value under certain circumstances.

3. THE CASE: LETTER AND ACTIVIST CAMPAIGN

This research focuses on the case-study of an ongoing activist intervention between a Portugal based multinational company in the utilities energy sector, EDP - Energias de Portugal, S.A (“EDP”) and an American hedge fund, Elliott – Elliott Management Corporation (“Elliott”). EDP is the leading company in the energy sector of Portugal and one of the largest in total market value. As a multinational company, it embraces a focus on renewable sources and is present in Brazil and Spain, among other countries, as part of an international expansion plan of its operation which includes production, distribution and supply of electricity powered by wind, solar, hydro, gas and other sources of energy. On the other hand, Elliott fund has created clout in the activist investment sector, by entering a number of activist interventions involving companies, but also in risky investments and the use of confrontational and controversial methods. According to 2019 Lazard’s report on activism, it is the oldest fund in active with approximately \$40.2 billion assets under management and the leading activist worldwide with reported \$3.4 billion of new capital deployed in the first half of 2019 and a total of \$17.4 billion in new and existing activist positions⁴⁰.

In most recent years, the fund has been responsible for part of the activist investment growth in Europe by targeting large European based companies such as Bayer and ThyssenKrupp. In October of 2018, in one of the 22 activist campaigns launched by the investor that year, Elliott acquired a qualified participation of 2,2925%⁴¹ of EDP in the sequence of the withdrawal of the former second largest shareholder, Capital Group, who owned over 10% of the company⁴².

According to Ricardo Mexia, CEO of EDP, this exit was a reaction of the shareholder to an uncertainty based on a legal dispute between EDP and the Portuguese

⁴⁰ According to Lazard 2019, available at: <https://www.lazard.com/media/451008/lazards-h1-2019-review-of-shareholder-activism.pdf>

⁴¹ https://www.jornaldenegocios.pt/empresas/energia/detalhe/abutre-da-argentina-entra-no-capital-da-edp?ref=DET_relacionadas

⁴² <https://web3.cmvm.pt/sdi/emitentes/docs/PQ69928.pdf>

government who claimed the return of an overcompensation of 285 million euros⁴³ regarding CMEC⁴⁴ payments. These are contracts signed by both parties which covered an additional payment to EDP for a number of power plants in an attempt to balance the forecasted gains for EDP of the previous contract which was terminated⁴⁵. In that sense, according to a study of the Portuguese competition authority, these represented about 34% of earnings before taxation in 2012 for EDP as a result of a supposedly contract violation by EDP which limited the capacity of the plants included in the CMEC regime and offered the service through the remaining plants, under a market regime that increased the final price for consumers⁴⁶. Even though this litigation threatened to reduce the forecasted profit of 2018 in 30%⁴⁷, EDP had a positive review from Macquarie⁴⁸ who issued an 'outperform' classification with a target-price of €3,60, an increase of €0,20 from the previous 'neutral' status. At the same time, EDP was subject to an ongoing takeover bid from one of the largest shareholders of the company, China Three Gorges (CTG), who had 23% and offered a price of €3,26, valuing the company 10% lower than Macquarie and at a 3,5% discount compared to what the share-price was trading in the market as of 7th June 2018⁴⁹. Besides the bid price, CTG included the reallocation of its own wind and hydraulic energy assets to be managed by EDP for the purpose of expanding the operation in Asia and South America and claimed there was a potential yearly increase of one billion euros in EDP's EBITDA derived from an increased operation in Brazil⁵⁰.

⁴³ <https://www.jornaldenegocios.pt/empresas/energia/detalhe/mexia-reage-a-reducao-do-capital-group--as-pessoas-gostam-de-estabilidade>

⁴⁴ Custos de Manutenção do Equilíbrio Contratual

⁴⁵ https://www.jornaldenegocios.pt/empresas/energia/detalhe/dez_perguntas_e_respostas_sobre_um_palavrao_chamado_cmec

⁴⁶ http://www.concorrencia.pt/vPT/Noticias_Eventos/Comunicados/Paginas/Comunicado_AdC_2018_12.aspx

⁴⁷ https://www.jornaldenegocios.pt/empresas/energia/detalhe/accionistas-da-edp-vaio-processar-o-estado?ref=HP_Destaques3not%C3%ADciascompatro

⁴⁸ https://www.jornaldenegocios.pt/empresas/energia/detalhe/edp-promovida-a-outperform-pela-macquarie-que-ve-potencial-de-15?ref=DET_relacionadas

⁴⁹ <https://web3.cmvm.pt/sdi/emitentes/docs/fsd492459.pdf>

⁵⁰ <https://www.jornaldenegocios.pt/empresas/energia/detalhe/ctg-pode-aumentar-ebitda-da-edp-em-mil-milhoes-por-ano>

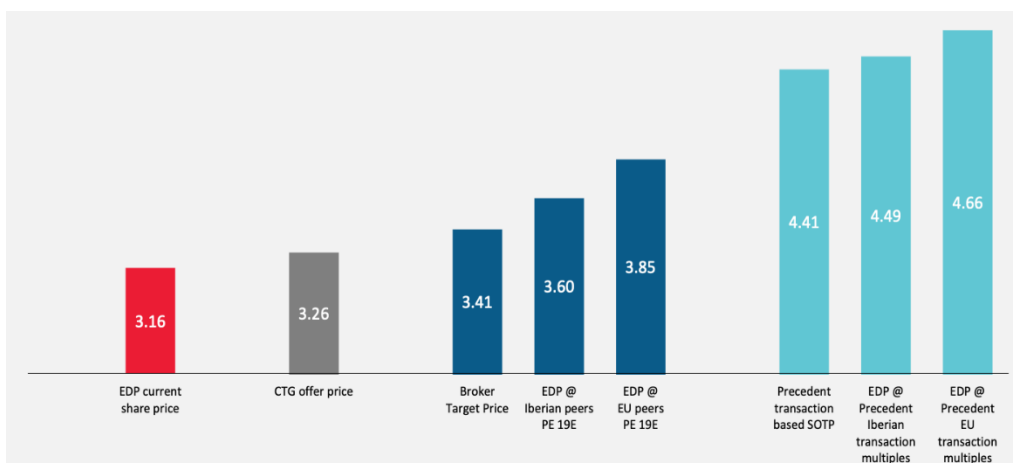


FIGURE 4

51

Elliott’s analysis on share price comparison

It is under this ongoing process that Elliott acquired a qualified participation in EDP in October of 2018, as the takeover bid was announced in May of the same year yet was still awaiting to gather the approval of eight countries and eighteen regulators⁵². Considering the relevance of Elliott, this acquisition of capital in EDP did not remain unnoticed and, even though the first months of the participation did not see any public activity of the fund regarding the company, in February of 2019 there was the first expression of activism by Elliott. After several meetings with EDP and CTG, the fund wrote a letter to EDP’s management in which proposed a strategic plan to address the overall situation of the company at the time, in particular regarding the takeover bid by CTG and international expansion plan.

3.1 China Three Gorges (CTG)

Elliott believed the offer from CTG undervalued the potential of EDP by paying a small premium of 4.8% at €3.26 per share, while at the date of the preliminary

⁵¹ Page 12 of Elliott’s presentation, taken from the no longer available website: empower-edp.pt

⁵² https://www.jornaldenegocios.pt/empresas/energia/detalhe/turbilhao-de-obstaculos-afecta-opa-chinesa-sobre-edp-e-grupo-cede-em-bolsa?ref=DET_relacionadas

announcement of the takeover by CTG, made after the closing of the market, the company had a share price of €3.16. This reticence towards the price was shared with the executive board of EDP, who initially considered to be a low premium once the offer was issued⁵³. Not only did Elliott consider the price to be a significant undervaluation of EDP, the fund claimed there was no justification for such an undervaluing offer in terms of how CTG plans to handle EDP's US assets - which were going through several regulatory issues at the time due to a commercial war between US and China -, as well as the actual contribution of CTG regarding assets and terms for the company. At the same time, the process had been going for nine months which made the operation, according to Elliott, one of the longest M&A processes in the utilities sector, arguing that utilities deals notified to the European in the past five years took on average 162 days and that, at the time, there had been 278 days elapsed since the announcement of the takeover by CTG. The fund also argued this lag in the operation was harming EDP, claiming there was a significant underperformance of 9% in total shareholder returns since CTG made its bid on 11 May 2018 compared to peer industry and a postponed update on its business plan by the management until it has a clearer view on the overall transaction.

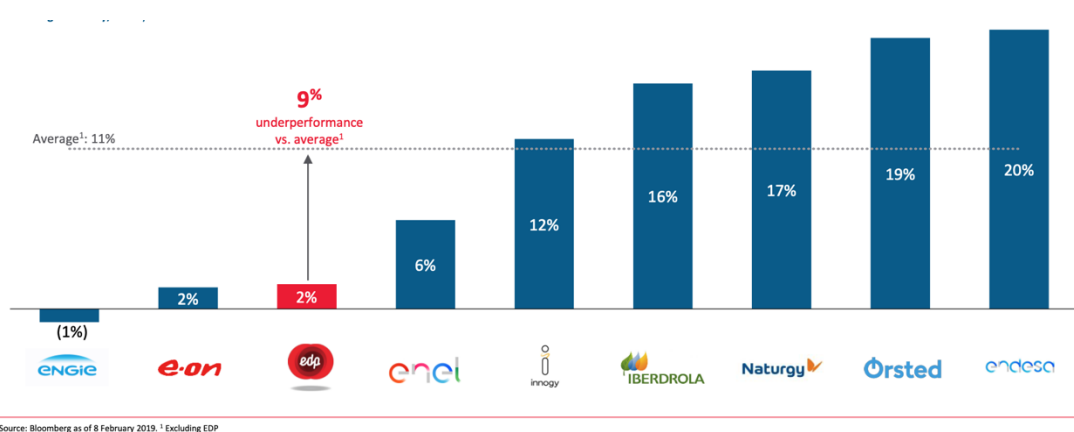


FIGURE 5

54

Shareholder return comparison since the start of CTG's takeover bid

⁵³ Page 6 of the Report of the Executive Board, available at: https://www.edp.com/sites/default/files/08-jun-2018_bod_report_-_edp_final_en.pdf

⁵⁴ Page 15 of Elliott's presentation letter

The operation had an additional element of considerable uncertainty regarding the required authorizations to proceed with the operation as, despite the delay, there were still 16 of the 17 anti-trust conditions waiting on approval. The fund claimed CTG was unable to answer how it expects to deal with the different anti-trust, foreign investment and energy regulatory concerns, as well as the handling of US assets, unbundling issues, or even the justification for a price which undervalues EDP. Among these regulation issues, the most significant were related to the operation of EDP in USA and North America, in particular the division of renewable energy platforms which represented 17% of EDP's EBITDA⁵⁵. In that sense, the takeover compromised the rule of unbundling which states the separation of the production and commercialization activities from the distribution part in the USA market⁵⁶. Until this point the distribution division was carried by a company named REN, who had in its shareholder structure a company named State Grid with 25% of the capital. This firm, just like CTG, were Chinese-state owned companies and considering that, at the time, there was an ongoing trade-war between USA and China and one of the regulations waiting on approval had to be accepted by the Committee on Foreign Investment in the United States (CFIUS), Elliott considered to be very unlikely the possibility of a positive outcome regarding this operation⁵⁷. As a consequence, this would lead to the disintegration of one of the core operations of EDP Renewables, as CTG would have no choice but to divest in the renewables' portfolio of USA and was, according to a news editor, sounding potential buyers of the assets among European peers⁵⁸.

⁵⁵ Page 6 - Note 11 of Elliott's letter presentation

⁵⁶ Unbundling Regime in Directive 2009/72/EC (Électricity Directive') and Directive 2009/73/EC ('Gas Directive')

⁵⁷ https://www.jornaldenegocios.pt/empresas/energia/detalhe/elliott-arrasa-oferta-da-ctg-e-passa-a-bola-a-mexia?ref=Premium_1BucketDestaques

⁵⁸ <https://www.reuters.com/article/us-edp-m-a-china-usa/china-three-gorges-sounds-out-interest-in-edps-u-s-assets-sources-idUSKBN1JM2BM>

3.2 Strategic Plan

From the perspective of the fund, in order to maximize the value of EDP there were three core areas in need of change from both operational and financial perspectives which, at the time, created a suboptimal value for the company: firstly, an excessive leverage of 4,0x Net Debt/EBITDA which resulted in one of the highest levels of leverage in the industry and excessive interest costs of which EDP Brasil's high cost of debt was one of the main sources of the issue; as a consequence, this compromised the shareholder remuneration through dividends and created a problem of underinvestment in growth due to various business units competing for capital resources of the EDP group which did not fulfill the growth potential of the renewables unit. Additionally, the fund considered this factor was boosted due to the fact there were four main business unities which operated as standalone entities and benefited from few synergies from being part of a single group. This dispersion removed the focus from areas where EDP has core know-how and inhibited more attractive return opportunities. One of them being the renewables sector which did not realize the potential which it had until then, considering the annual capacity growth of the renewables was growing at a lower rate compared to the EMEA & American peers and the previously set target in 2009 of reaching 10,5 GW of installed capacity by 2012, was only realized by 2017⁵⁹. Elliott considered this constraint was due to a lack of capital deployed into the renewables sector and believed EDP was capable of adding 2 GW of annual renewable capacity at attractive rates of return by suggesting an increased financial flexibility and focused resource dedication through the investment in existing pipeline in North America which was in pre-development stage and by focusing on further selected projects scheduled for 2022-2024. As it was, the renewable sector was not able to fulfill the market prospects of growth in 2019/2020 of 11%-15% in the sector which resulted in an increase of 1,7 GW of capacity to be in line with the market, in contrast with the projected decreasing capacity growth for

⁵⁹ Page 18 of Elliott's letter presentation

2019 and subsequent years at less than 1 GW⁶⁰. This plan was labeled by Elliott as investment in growth based on the premise that historical returns demonstrate investment in renewables had been the most positive sector for stakeholders and most profitable for shareholders in particular.

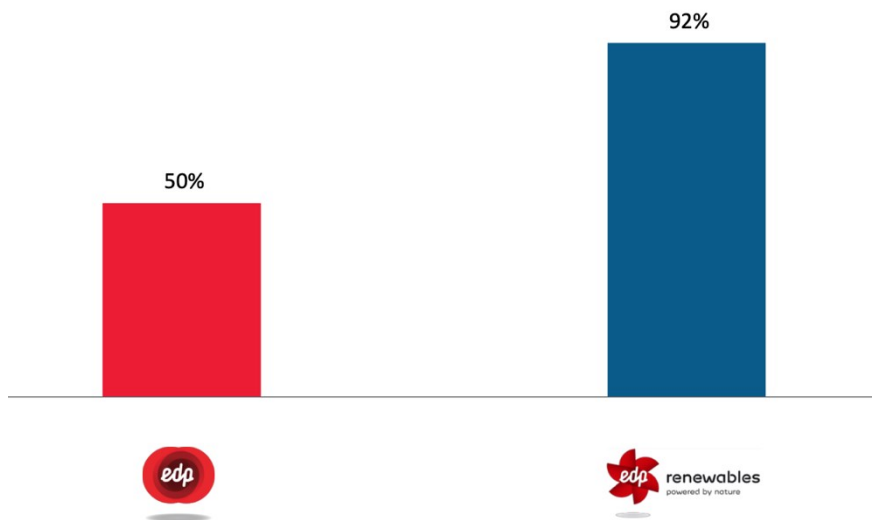


FIGURE 6

61

Total shareholder return over last five years

In order to fulfil this, part of the plan included the previously mentioned optimization of portfolio which, from the perspective of the fund, included the self of the 51% participation of the company in EDP Brasil, 49% in EDP’s Iberian Electricity Distribution and the legacy thermal assets in Iberia. What concerns the first, Elliott believed the existing capital constraints blocked the progress of EDP’s Brasil, as the company was unable to imprint itself as a leader or “credible challenger” in the South American market, being placed as the 7th largest player in terms of installed capacity and 9th in total distribution⁶². This lag compared to peers allied to a lack of the required investment lead the fund to consider that the situation of the company and additional exposure to the volatility of the Brazilian Real had a negative impact in the total value

⁶⁰ Page 19 of Elliott’s letter presentation

⁶¹ Page 20 of Elliott’s presentation letter, through Bloomberg as of 8 February 2019

⁶² Page 21 of Elliott’s presentation letter

of EDP, as the overall Brazilian exposure attracted a higher WACC through an average cost of debt of 11,1% compared with a 4,1% for EDP as a whole, resulting in a lower trading multiple for EDP. As a result, Elliott considered that EDP Brasil would gather demand by referencing a number of article news⁶³ reporting an increase of investment in the sector in the past years, as well as the strategic plans of some major players of the market in Brazil (Emel and Engle). In this context, the fund considered EDP could be an attractive asset for an established player in the market who could capitalize on the existing resources to grow further, though not appropriate for EDP's situation at the time. Additionally, the fund considered the company could be sold at a substantial premium based on the past acquisitions of CPFL Energia by State Grid and Eletropaulo Metropolitana by ENEL, which would allow significant gains in available capital to allocate to other investment opportunities⁶⁴.

3.3 Iberian Electricity Distribution

It is in this context that Elliott believes in the sale of the stake in EDP's Iberian Electricity Distribution as, despite not going into a deep analysis as in the case of EDP Brasil, the fund considers the company in question to be a fully regulated asset with long-duration cash flows. As such, the fund does not include it in the proposed strategic plan and believes EDP could take advantage of a substantial premium based on several brokers evaluation of EDP's Iberian Networks at 7-10x last twelve months EBITDA⁶⁵, and the fact Portugal's sovereign rating at the time had been upgraded to investment grade, making the assets more attractive and increasing the price of a potential sale as a consequence.

⁶³ <https://m.folha.uol.com.br/mercado/2016/03/1747452-companhias-chinas-miram-distribuicao-de-energia-no-brasil.shtml>

<https://valor.globo.com/empresas/noticia/2020/01/23/iberdrola-diz-nao-ter-interesse-por-venda-da-eletobras.ghtml>

⁶⁴ Page 24 of Elliott's presentation letter

⁶⁵ Page 24 of Elliott's presentation letter

3.4 Legacy Thermal Assets in Iberia

Additionally, in a similar argument, Elliot proposes the sale of the thermal assets in Iberia, considering they are non-core of EDP's activity and removes the focus from renewables and green power generators. Not only from a strategic perspective, as the fund argues the installed capacity of these assets is marginal and that a potential sale will not remove EDP as the leading power producer in Portugal⁶⁶ while unlocking additional investment in high return renewables capacity.

In summary, the measures proposed in the letter aimed at: reducing financial leverage and cost of debt as a consequence, in order to benefit from a rating improvement⁶⁷; Optimize portfolio by selling a 51,2% stake in EDP Brasil to unlock €2.3 billion, sell the 49% stake in Iberian networks to unlock €3.6 billion, as well as the Iberian thermal assets to unlock a further €1.7 billion and a total of €7.6 billion to re-deploy in EDP; Invest in growth and leverage reduction through a de-lever to 3,0x net debt in order to unlock €2.8 billion in the future, invest €3.5 billion in "high return" renewables pipeline in North America and a final share buyback plan of €1.2 billion. The final remarks in the letter comprehend a list of steps to achieve the desired outcome of the fund: firstly, an assessment of the CTG bid and its flaws, namely the regulatory and anti-trust issues, the intentions regarding the solving of unbundling issues, a detailed plan regarding the contribution to the strategy of EDP and its assets, as well as a revision of the offer price which did not reflect the fair value of EDP according to Elliott. Second step involves an invitation to all stakeholders to urgently decide on the future track of the company, which in the case of CTG meant to either form a coherent plan and improve the takeover offer or adopt the strategic plan proposed by the fund in the letter, which Elliott described as "fresh approach". The final step concerns the implementation of Elliott's plan of which the fund emphasizes once more the re-focus on growth through investment in renewables, portfolio

⁶⁶ Page 26 of Elliott's presentation letter

⁶⁷ Page 28 of Elliott's presentation letter

optimization through the sale of selected assets and additional financial metrics such as reduction of debt and improved shareholder returns.

4. THE CASE - ANALYSIS

This chapter intends to analyze the case in itself and the overall outcome of the activist campaign. As a starting point, it considers the overall position of EDP regarding the strategy of the company and other several topics of interest before the arrival of Elliott as a shareholder. Considering this, there can be divided two periods in time: one prior to the activist campaign period, in particular the date which the letter written by the fund addressing EDP's management was issued, and another period after which comprehends potential adjustments to the strategic plan and outcomes of the campaign process. Considering this, the ultimate goal aims at establishing a comparison between these two timelines, before and after the activist letter, as it marks the first public manifestation of activism by Elliot in the company.

4.1 Market Reaction

The issuance of the letter, in 14th February 2019, was marked by a share price increase of 2,64%⁶⁸ to €3,266 per share, above CTG's offer of €3,26, and a maximum in a period of about four months, date which also coincided with the announcement of Elliott's stake in EDP and a subsequent positive market reaction.

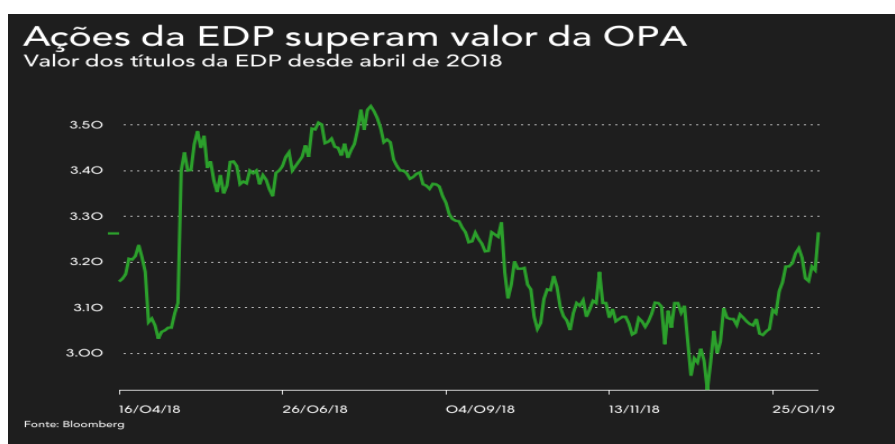


FIGURE 7

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Market reaction to the issuance of the letter

⁶⁹ <https://www.jornaldenegocios.pt/empresas/energia/detalhe/elliott-poe-edp-a-cotar-acima-do-preco-da-opa-pela-primeira-vez-desde-outubro>

If the latter result is coherent with the literature's research on the positive market reaction to activist stakes' announcements, the former outcome is a reaction to a polarizing form of activism which challenged the management of EDP by revealing an alternative plan for the future of the company. Given this, the price increase can be interpreted as an indicator of an underlying condition which the company was going through, yet not voiced or challenged until this point in time. As a result, two possibilities emerge from this: an uncertainty regarding the lengthy takeover bid operation and the position of the management which, despite having criticized the low premium on the bid⁷⁰, did not take a firm position on the topic; an appeal of the remaining shareholders to an alternative strategy plan for EDP proposed by the activist, in contrast with the one of the management on certain points.

4.2 Activist Stance on CTG's Takeover Bid

When it comes to the first, Elliott served as a catalyst in the development of the takeover operation by manifesting a firm opposition in the letter regarding the offer price, lack of strategical plan regarding EDP's assets and the handling of several regulatory issues crucial for EDP's operation in North America and Europe. As seen in the previous chapter, the takeover operation carried some regulatory concerns in EDP's operation in USA as there is an unbundling law that forbids the possession of the production and commercialization activities with the distribution by the same entity or shareholder in the USA market⁷¹. In this context, Elliott did not believe the offer would get the approval of the Committee on Foreign Investment in the United States (CFIUS) which, due to the fact both CTG and State Grid were owned by the Chinese government, with the latter having a 25% stake in REN, a company responsible for the handling of the transportation activity of EDP's operation in USA. This concern was later endorsed by the ambassador of USA in Portugal, George Glass, by stating

⁷⁰ <https://www.jornaldenegocios.pt/empresas/detalhe/edp-considera-que-preco-oferecido-pela-ctg-nao-reflecte-adequadamente-o-seu-valor>

⁷¹ Unbundling Regime in Directive 2009/72/EC (Electricity Directive) and Directive 2009/73/EC ('Gas Directive')

the takeover would be rejected by CFIUS and the portfolio in the country dismantled due to a national security conflict as EDP, the third largest producer of renewable energy in USA, would be under control of the Chinese government in the event of a successful takeover by CTG⁷². After the initial manifest of opposition towards the takeover in the letter, Elliott proceeded the campaign against it by submitting, in 26th March 2019, the inclusion of a voting proposal, in EDP's annual general meeting of 24th April 2019, to keep the 25% voting rights limit regardless of shareholders' stake and incentivize the remaining shareholders to vote like the fund for the maintenance of this statute, as this clause was one of the demands in CTG's takeover bid⁷³. In doing so, Elliott claimed to be motivated by the positive feedback from different groups of stakeholders to his previous letter which led the fund to create this "make or break" situation in the takeover process which had the potential to end it, contingent on the outcome of the shareholders' voting, as the fund believed CMVM, the Portuguese authority, would have foundation to eliminate the offer if CTG did not resign promptly to this demand⁷⁴. This addition was approved days after, in 1st April 2019, by Rui Medeiros, Vice-Chairman of the General Shareholders' Meeting⁷⁵, and resulted in an intervention by CMVM⁷⁶, in 12th April 2019, to confirm that if the lifting of the 25% voting rights limit did not gather the voting majority of the shareholders, the takeover would end unless CTG resigned to that condition before the annual meeting, as the supervisor justified this decision with demands for efficiency and speed to prevent the disturbance of the societies' activity beyond a reasonable period and in accordance with previous takeover operations. CTG's position was known ten days later, and two before the general meeting, in a letter to Rui Medeiros and communicated to CMVM⁷⁷, stating

⁷² <https://jornaleconomico.sapo.pt/noticias/embaixador-dos-estados-unidos-revela-que-trump-vai-chumbar-a-opa-chinesa-sobre-a-edp-422394>

⁷³ <https://www.jornaldenegocios.pt/empresas/energia/detalhe/elliott-quer-votacao-na-ag-da-edp-que-pode-matar-opa-dos-chineses->

<https://web3.cmvm.pt/SDI/emitentes/docs/CONV71488.pdf>

⁷⁴ <https://eco.sapo.pt/2019/03/28/fundo-elliott-quer-manter-limites-aos-direitos-de-voto-na-edp-e-travar-opa-dos-chineses/>

⁷⁵ <https://web3.cmvm.pt/SDI/emitentes/docs/CONV71486.pdf>

⁷⁶ <https://www.cmvm.pt/pt/Comunicados/Comunicados/Pages/20190412a.aspx?v>

⁷⁷ <https://web3.cmvm.pt/sdi/emitentes/docs/FR71758.pdf>

it would not resign to the condition and therefore the takeover was contingent on a favorable voting outcome to change the statute of voting rights cap. The process ended in the general meeting as the majority of the shareholders voted against the lifting of voting rights cap and the takeover was eliminated⁷⁸.

4.3 Activist Influence and Stakeholders' Perception

This outcome shows how the entrance and manifestation of an activist investor, in particular the largest in the world in total capital deployed⁷⁹ at the time, can impact the operation of a company by creating polarizing views and shaping the decision making through the application of financial and legal tools. This influence has been described earlier as a powerful factor in an activist campaign, as the research by Krishan et al. (2015) suggests the relevance of clout and reputation of the activist in the outcome of a campaign. These elements are often associated with size and technical resources which enable the exercise of influence and, in the case of Elliott, being one of the world's largest activists, also carries a fearsome reputation based on past campaigns which makes the fund one of the most feared worldwide⁸⁰. In the case of EDP, this influence starts from the moment of Elliott's arrival as shareholder with the positive market reaction as an indicator of a positive perception of the stakeholders of change in the near future of the company. In that sense, Elliott invested in a particularly uncertain moment of the company, as the takeover bid had already been in process for several months and was undergoing the CMEC which could compromise a considerable percentage of EDP's EBITDA, confirming reports which suggest activists target established companies with a profile of recent underperformance or

⁷⁸ <https://www.jornaldenegocios.pt/empresas/energia/detalhe/acionistas-da-edp-decretam-fim-da-opa-dos-chineses>

⁷⁹ According to Lazard report on activism for the first half of 2019, Elliott had \$17.4bn in new and existing activist positions, available at: <https://www.lazard.com/media/451008/lazards-h1-2019-review-of-shareholder-activism.pdf>

⁸⁰ <https://www.bloomberg.com/graphics/2017-elliott-management/>

uncertainty⁸¹, and just like Elliott executed later with an investment in Bayer⁸². As such, despite the issuance of the letter four months after the arrival, it is possible to infer there was a clearly planned activist approach by Elliott in this investment since the beginning, based on the reality of EDP at the time and the awareness of the fund regarding the feasibility of the measures proposed to influence the outcome in its favor. By reading the conjecture of the situation, namely the lag and conditions offered in the takeover process, the fund understood it could capitalize on its resources to serve as the guide to a passive resistance among other shareholders to the takeover bid.

This carries other concerns, as critics of activism may argue if activists can take advantage of the size or reputation of their funds to pursue their own interests, nothing guarantees they coincide with the best interest of the company and are not capitalizing on the fear of the remaining stakeholders for personal gain. While this is a reasonable argument, the development of this case regarding the takeover bid suggests it is more of a circumstantial matter. Even though the fund acted as a polarizing agent in the process by campaigning to gather the support of other shareholders in the voting to block the takeover, the reality is Elliott would not have the power to unilaterally decide the outcome of the process and, as a consequence, could not force its will onto the remaining stakeholders. The fact an activist needs to gather the support of the remaining shareholders to move forward with an alternative plan is a condition which allows the possibility of its rejection and therefore the activist campaign in itself. It is in this context that activism can work as a balance on topics which may be subject to a more managerial centric form of governance, as the nature of activist minority stakes allows the decision to be dependent on the approval and support of other investors. In part one can speculate this to be one of the factors

⁸¹ <https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/preparing-for-bigger-bolder-shareholder-activists>

⁸² <https://www.jornaldenegocios.pt/trading/detalhe/fundo-abutre-da-edp-revela-deter-11-mil-milhoes-na-bayer-e-aco-es-sobem-mais-de-3>

behind the increase in number of settlements, as a compromise between management and shareholders is often the key to solve disagreements in activist campaigns. In the case of EDP, while Elliott was able to obtain what can be considered as a win in the takeover process, the same cannot be applied to other proposals in the letter. That is the case with EDP Brasil, as Elliott strongly believed in the sale of the division, claiming the company was behind other competitors and lacked the necessary investment to capitalize on the growth potential of the market. Yet this vision was not shared by the management of the company, as the strategic update⁸³ of 12th March 2019, about one month after the issuance of Elliott's letter, confirms. In this, the management reassures the investment in this division, by pursuing a growth strategy focused on networks⁸⁴. It sustains this vision on the potential of the market and the positive results of 14% growth in EBITDA in local currency⁸⁵, an increase of 29% in the consolidated net profit of EDP, as well as an anticipated interest to invest around 800 million in the transmission market of the country⁸⁶ and open approach to opportunities which create value⁸⁷. In sum, the management of EDP intended to transmit a positive outlook of EDP Brasil's operation based on recent results and an investment plan to grow further, in contrast with the vision proposed by the fund in the letter. Additionally, the CEO of EDP, António Mexia, emphasized the importance of CTG as a strategic long term partner⁸⁸ after the failed takeover and acknowledged a special interest of CTG in EDP Brasil⁸⁹ while other news, before⁹⁰ and after⁹¹ the rejection of the takeover, reported

⁸³https://www.edp.com/sites/default/files/transcript_2018_results_and_strategic_update-_edp_0.pdf

⁸⁴ Pag. 2 of the Strategic Update

⁸⁵ Pag.4 of the Strategic Update

⁸⁶ Pag.9 of the Strategic Update

⁸⁷ Pag.21 of the Strategic Update

⁸⁸ <https://www.jornaldenegocios.pt/empresas/energia/detalhe/mexia-a-parceria-com-a-ctg-e-importante-e-e-para-manter>

⁸⁹ <https://www.jornaldenegocios.pt/empresas/energia/detalhe/joint-venture-entre-ctg-e-edp-para-america-latina-e-plano-b>

⁹⁰ <https://www.bloomberg.com/news/articles/2019-04-12/china-three-gorges-is-said-to-plan-scaling-back-offer-for-edp>

<https://www.reuters.com/article/us-edp-ctgpc-latam-exclusive/exclusive-portugals-edp-could-create-latam-jv-with-china-three-gorges-if-takeover-bid-fails-sources-idUSKBN1QU1UF>

⁹¹ <https://www.bloomberg.com/news/articles/2019-06-04/china-three-gorges-is-said-to-mull-deal-for-edp-s-brazil-assets>

the possibility of a merger or joint venture between EDP and CTG in Brazil. This position by the management was a clear dismissal of Elliott's proposal for EDP Brasil - arguably one of the most important in the letter for the fund -, and revealed a willingness to go against its vision.

4.4 Management Reaction to Activist Proposals

Considering the management is motivated to pursue its own interests, it is unlikely to change its vision unless it is under external pressure or a stakeholder provides a valuable take on a given topic. This was the case with the takeover, as despite the management taking a neutral position towards the takeover until its end, the fund took action in order to have an outcome rather soon, leaving the management no choice but to take the voting to the general shareholders' meeting. However, one can speculate this was a premediated move with the collaboration of the management, who was not interested in having a majority shareholder to reduce its decision power and was aware of a relevant portion of the shareholders against the takeover, leading it to an end without "burning bridges" with the biggest shareholder of the company at the time, CTG. This suggests activism can, indeed, create value contingent on the support of an activist's vision by the management and consequent positive results, as the fact management is willing to dismiss an activist's plan means it won't cater to any proposal presented by the latter agent. It is a limitation of the clout and reputation of a given activist which, despite being an important factor in the development of a campaign, does not mean there will be a concession by the management to any demand. As a consequence, regarding certain topics in which there is no evident external pressure, one can infer a portion of the proposals which are taken further are done so based on a positive review by the management and in pursuit of value creation. This is reflected in other positions communicated by the management in the strategic update which are aligned with what was proposed in the letter by Elliott, in particular the focus on optimization of portfolio, investment in renewables and deleveraging the company. When it comes to the first, the strategic update included

the sale of power generation assets in Iberia, such as thermal plants and dams valued at 2 billion euros, in order to reinvest in renewables to create value and to strengthen the balance sheet by deleveraging⁹². This is coherent with the proposal by Elliott on several points: first, it identifies the path of renewables as the long-term solution to value creation for the company which, despite being a point in common, EDP had been pursuing for the past years and therefore cannot be considered as a result of the campaign. On the other hand, the assets deemed for sale are the ones proposed by Elliott in the presentation described as legacy thermal assets in Iberia with a potential to unlock €1.7 billion⁹³ - close to the number indicated by the management -, in order to pursue growth opportunities in renewables and deleverage the group. Not only that, the sale of these thermal assets was firstly introduced by Elliott in the letter and only addressed by the management for the first time in the strategic update with the inclusion of the proposal and a plan to reduce thermal exposure⁹⁴, considering that the more noticeable thermal sale until then had been mini-plants for a total of €164 million in December 2018⁹⁵. The deleverage part is also relevant, as Elliott believed EDP's leverage was one of the highest in the industry at 4,0x Net debt/EBITDA for the year 2018⁹⁶, an increase from 3,3x in 2017, even though the management established the target of 3,0x in 2020⁹⁷. This was apparently the same goal for both parts, but the increase of the previous year made Elliott include this point in the letter to emphasize its importance and inform that, according to its analysis and if the proposals were to be accepted, the expected Net debt/EBITDA of the 'new EDP' would remain in x4,0 for 2019 and x2,9 in 2022. Later in September that year, EDP effectively put four thermal plants for sale⁹⁸ - which were sold in December, even though the operation would only

⁹² Pag. 14 of the Strategic Update

⁹³ Pag. 27 of Elliot's presentation letter

⁹⁴ Pag. 15 of the Strategic Update

⁹⁵ <https://www.jornaldenegocios.pt/empresas/energia/detalhe/edp-conclui-venda-das-mini-hidricas>

⁹⁶ Pag. 12 of EDP's annual report of 2018, available at:
https://www.edp.com/sites/default/files/rc_2018_en_compress.pdf

⁹⁷ Pag. 42 of EDP's annual report of 2018

⁹⁸ <https://eco.sapo.pt/2019/09/05/edp-poe-quatro-barragens-a-venda-e-ja-selecionou-cinco-candidatos/>

have the approval to go forward in March 2020⁹⁹ for a total value of €2.2 billion. In addition, still in 2019, the company put other assets for sale as part of the portfolio optimization plan which included the sale of wind power parks in a total amount of €800 million¹⁰⁰. These measures revealed a compromise with the deleverage target which had not been shown until then and eventually lead to a decrease of the Net debt/EBITDA to x3,6 in the year 2019¹⁰¹, even surpassing Elliott's expectations which resulted in a rating increase by agency Fitch¹⁰². In one way, this same compromise can be applied to the policy review on shareholder remuneration in the strategic update. One of the proposals in Elliot's letter concerned a €1.2 billion share buyback plan as a reinvestment in EDP to reflect its 'true' value. This point was not included in the strategic update, likely due to diverging interpretations of the measure. If on one side the fund labels this measure as a reinvestment in EDP, a better description is the pursuit of the benefit for the shareholder which a potential buyback would bring by increasing the share price and subsequently the value of Elliot's stake. On the other hand, management did not follow on this measure possibly due to an unwillingness to allocate such amount from the proposed €12 billion investment in renewables. Instead, the strategic update reviewed the dividend policy in positive light, by setting a dividend minimum of €0,19/share and a payout ratio between 75% and 85%, an increase from the interval of 65% and 75% established for the previous years. In doing so, it guaranteed an attractive dividend – considering the recent past of the company –, independent of a potential negative year for EDP, and assures a growth margin if the prediction of the management for net income to grow at 7% per year until 2022 confirms. An example of this commitment can be seen recently, as despite the foreseen

⁹⁹ <https://www.publico.pt/2020/03/09/economia/noticia/bruxelas-autoriza-venda-seis-barragens-edp-consorcio-frances-1906949>

¹⁰⁰ <https://www.jornaldenegocios.pt/empresas/energia/detalhe/edp-arranca-plano-de-vendas-de-ativos-e-encaixa-800-milhoes>

¹⁰¹ Pag. 13 of EDP's annual report of 2019, available at: https://www.edp.com/sites/default/files/2020-03/RC_2019_EN.pdf

¹⁰² <https://www.jornaldenegocios.pt/mercados/detalhe/fitch-sobe-perspetiva-do-rating-da-edp-apos-cumprimento-solido-do-plano-estrategico>

impact which the covid-19 pandemic will create in the results, EDP has assured it will maintain the payout ratio to its shareholders¹⁰³.

This is an example of how, despite not having a concrete settlement, there can be achieved an apparent form of agreement based on compromises of both agents and how cooperation between them can be a key element in the success of the campaign. In activist campaigns, even though both sides often have different goals, the access to different information and tools can complement each other to optimize decision making, please both parties and benefit the company, as the nature of settlements exemplifies. In the case of EDP, that is evidenced on the outcome of the implementation of specific plans, during 2019 and 2020, which were either proposed by the fund or the management. The sale of the thermal assets in Iberia, firstly proposed by Elliott and later endorsed by the management, is an example of a complete alignment in the proposals. Coincidentally, still in the year 2019, EDP saw a 47%¹⁰⁴ reduction in the thermal production – and 39% below historical average - in the first nine months due to lack of rain, reflecting a negative impact on the EBITDA of €200 million¹⁰⁵. This shows the volatility of this type of power source and is likely to be behind the plan to reduce thermal exposure expressed in the strategic update, shortly after it was first proposed by Elliott in the letter, and carried further by the management with subsequent thermal sales¹⁰⁶ in the year 2020. A similar interpretation can be taken from the previously seen deleverage plan, pressured by the fund, which resulted in a rating improvement, reducing the leverage ratio and achieving, in 2020, the lowest net debt in 13 years¹⁰⁷.

¹⁰³ <https://www.reuters.com/article/us-edp-forecast/portugals-edp-keeps-net-income-goal-and-dividend-despite-pandemic-idUSKCN24118I>

¹⁰⁴ Pag. 4 of EDP's 9M 2019 Results Presentation

¹⁰⁵ Pag. 5 of EDP's 9M 2019 Results Presentation

¹⁰⁶ <https://www.jornaldenegocios.pt/empresas/energia/detalhe/edp-encaixa-515-milhoes-com-venda-a-total-de-ativos-em-espanha>

¹⁰⁷ <https://eco.sapo.pt/2020/05/07/lucro-da-edp-dispara-45-para-146-milhoes-no-primeiro-trimestre/>

Another positive development concerns the plan for increasing installed capacity, as Elliott considered EDP could add 2 GW on an annual basis, in contrast with a previous period of less capacity growth, given that in 2009 management set the goal to reach 10.5 GW of installed capacity by 2012, yet it was only completed in 2017. The strategic update also focused on this aspect with a plan to add 7 GW until 2022, closer to the number proposed by the fund. The reality exceeded expectations seeing that around seven months later after the update, by October 2019, the company had already achieved half of the 7 GW goal¹⁰⁸ with contracts mostly in USA, Mexico¹⁰⁹ and Brasil. If on one hand, it follows on the proposal of the fund to focus on USA to add installed capacity, the management also reinforces the investment in Brasil. Even though being a strong point of diversion between the two parties, EDP Brasil saw positive results in the course of 2019 based in an increase in net income of 5,1%¹¹⁰ and a record investment of 149% compared to 2018, while the total net income of EDP reduced 1%¹¹¹. This leveraged the position of the management to keep investing in renewable capacity and transmission lines in the country¹¹², at the same time weakening the sale proposal by the fund.

4.5 Final Period of Activist Intervention

In May of 2020 Elliot reduced its stake in EDP¹¹³ to 1,91% from 2,45%, just one day after receiving the dividend payment¹¹⁴, and removing the status of qualified

¹⁰⁸ <https://www.jornaldenegocios.pt/empresas/energia/detalhe/edp-ja-instalou-mais-de-50-da-capacidade-prevista-ate-2022>

¹⁰⁹ <https://www.jornaldenegocios.pt/empresas/energia/detalhe/edp-renovaveis-fecha-contrato-de-100-mw-no-mexico>

¹¹⁰ <https://brasil.edp.com/pt-br/edp-registra-lucro-liquido-de-r-13-bilhao-em-2019>

¹¹¹ <https://web3.cmvm.pt/sdi/emitentes/docs/FR74580.pdf>

¹¹² Pag. 61 of EDP's annual report of 2019

¹¹³ <https://eco.sapo.pt/2020/05/19/paul-singer-ja-nao-e-acionista-qualificado-da-edp-controla-agora-191/>

<https://web3.cmvm.pt/sdi/emitentes/docs/PQ75732.pdf>

¹¹⁴ <https://www.jornaldenegocios.pt/mercados/bolsa/dividendos/detalhe/edp-paga-dividendo-de-19-centimos-por-acao-a-partir-de-14-de-maio>

participation after an increase in share price to 3,87€ compared to 3,07€ at the time of the arrival.

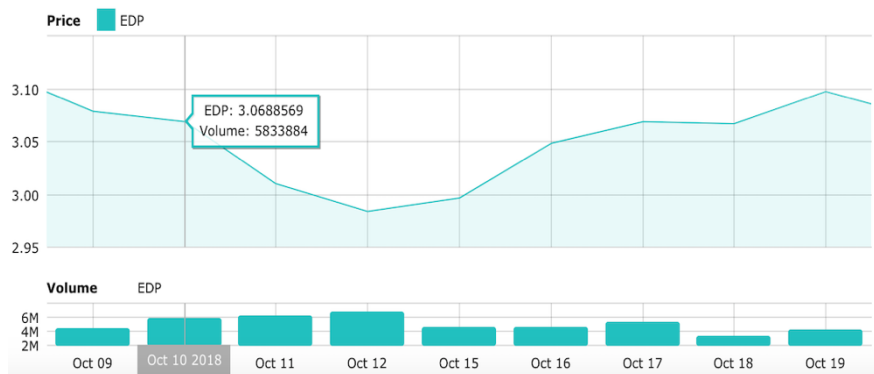


FIGURE 8

115

EDP stock price on the arrival date of Elliott

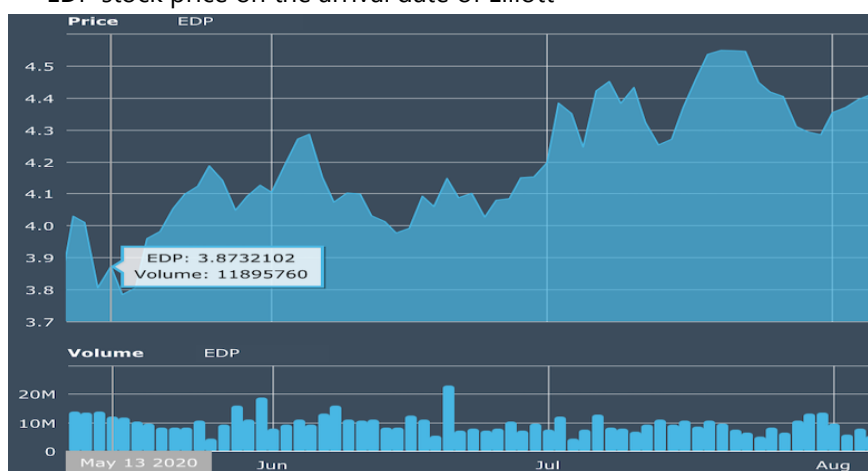


FIGURE 9

EDP stock price on the sell date of Elliott

116

This event changes the nature of the interaction between both sides, as activism is harder to execute without a qualified participation and the inherent voting rights¹¹⁷. If on one side critics of activism might have something to say regarding the timing of the withdrawal, shortly after the dividend payment, the recent results of EDP seem to

¹¹⁵ Source: Euronext

¹¹⁶ Source: Euronext

¹¹⁷ <https://www.asf.com.pt/NR/exeres/4B0482B8-4C47-43FB-99DC-FA2C9E2CBB97.htm>

show a positive path built on the new strategy to which the fund was an important contributor for several topics: in the pressure to obtain an outcome on the CTG takeover bid and shape it in its favor; in the sale of thermal assets in Iberia and on the strategy update to reduce thermal exposure; in setting a deleverage target more suitable to EDP and in accordance with industry peers; in promoting the enhancement of shareholder remuneration; and in the elaboration of a plan to grow installed capacity based in renewables and in the USA in particular. In overall, the reduction of the stake suggests a stepping down on an activist approach by the fund yet, by keeping a 1,91% participation, also indicates a belief in the new plan for EDP even if it means embracing measures which Elliott did not agree initially. As of the date this case study is written Elliott had not taken additional public activist stances, since the date of issuance of the Strategic Update in March 2019, and after the dispute on the takeover bid by CTG and proposals on the strategic plan of the company included in the letter.

5. CONCLUSION

The main suggestion from this research is that indeed activism can create value, yet its successfulness is contingent on a set of variables. Among these the most prominent lie in the agents involved and its dynamic, with the closeness to engagement from the side of the management and an irreducible vision by the activist being the main obstacles to a positive outcome in a given company. Excluding extreme cases of significant mismanagement and consequent external pressure to pursue a different path, more often than not the key to a successful campaign lies in the cooperation between both agents to capitalize on its individual resources and obtain a compromise between both visions. In that sense, it is unlikely for a party to be sure of the best path to take in every situation, so the reality lies "somewhere in the middle". This can be observed in EDP's campaign as, despite several proposals by Elliott being embraced, the plan for EDP Brasil was not, yet its results until the moment of this research reveal to be successful. The conditions which lead to activism are often linked to an inner characteristic or contextual aspect of the targeted company which might make it an attractive investment for a resourceful investor. This brings to an additional outcome from this research on activism and is that it acts as an equilibrium in the governance style of a company to balance more management centric forms of governance. This is seen in the case of Home Depot – Relational Investors and further illustrated in EDP by having in Elliott a catalyst agent to lead a shareholder disagreement regarding the takeover bid by CTG. In that sense, activism can work to polarize considerations on a given topic and voice disagreements which other shareholders might have towards a deemed prejudicial path a given company takes, whether by initiative of management or not. This effect is further enhanced with the size of the activist, resources and perceived credibility among other stakeholders: on one side, management is concerned about its own interests and the consequences of potential proxy-fights with activist funds which leads to a careful consideration of proposals from the latter agent. On the other hand, remaining shareholders are interested in the future of their company and, in the event of a disagreement with its current path, open to new

approaches who might serve their own interests. As seen in the research, the dynamic among these agents is central to the success of an activist campaign given that an activist, regardless of its size, is only able to implement a different strategy plan through the support of remaining shareholders and, often as a consequence, management. Even though this aspect makes the nature of activist campaigns inherently contextual and, therefore, difficult to generalize, this research suggests that activism, indeed, can create value. In EDP this was reflected in the form of shareholder value through an increase in the share price of EDP during the period of the campaign, the deleverage plan implemented and the pursuit of portfolio optimization which allowed the company to focus on its renewables core and, consequently, improving operational efficiency with greater results.

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