

THE ACTIVIST REPORT

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10 Questions with Stephen Gill



Steve Gill is a Partner at Vinson & Elkins LLP in Houston. He concentrates his practice on mergers and acquisitions for public and private companies and

private equity firms, including takeovers and takeover defense. He also represents a number of public companies with respect to shareholder activism defense, securities law compliance, securities offerings and corporate governance. Steve recently sat down with us to discuss activism in the Energy sector for this month's edition of 10 Questions.

13DM: Shareholder activism has been on the rise in the energy sector, with eleven 13D filings in the last year and DE Shaw's under the threshold position in EQT. What factors do you think have contributed to this level of engagement?

SG: Activists may be many things, but one thing they certainly are not is bad at math. It isn't that they have ignored the energy space in the past, so much as the sector generally wasn't in the point in its business cycle where most activists might think it would be profitable to dive into the sector. The recent rise in oil prices has refocused activists on the energy space. Also, there were a significant number of energy industry bankruptcies following the oil crash of late 2014 and early 2015. Those companies emerged from

bankruptcy with strong balance sheets but a very different shareholder base: one dominated by traditional debt investors who are very different than the equity investors energy companies and their boards were used to working with. This has created some interesting dynamics and led to increased activism.

13DM: You have led significant corporate control transactions in recent years, including Rice Energy's sale to EQT, a move that DE Shaw advocated but JANA had previously opposed. What was it like to advise a company that was targeted by two separate activist investors, each operating independently?

SG: Best analogy: three-dimensional chess on the back of a moving flatbed truck. It's invigorating, but there is a sense of accomplishment and relief when the game is over and the truck stops.

13DM: The spotlight and emphasis on ESG-responsible investing has become more pronounced. How does the increased level of awareness and interest around environmental sustainability impact engagement in this sector?

SG: The addition of any driver of engagement is generally a good thing. Engaging with shareholders about ESG related issues provides an opportunity to engage with them about other concerns they may have and build a track record of engagement that will be invaluable if an activist ever appears.

13DM: When we last spoke in 2013, you noted that in addition to other

characteristics, almost all target companies in the energy sector came under attack for insufficient corporate governance practices. Is this still the case? What have been the other characteristics of the energy companies that have been targeted and what steps can an energy company take to reduce its vulnerability to shareholder activism?

SG: The best "moat" for any company in any sector, energy or otherwise, is great performance. Companies with best in class TSR performance tend not to encounter a lot of activism. Corporate governance becomes more of an issue when a company has disappointed on performance and an activist is looking for mechanisms to change management that oversaw the performance problems. In terms of steps that could be taken to reduce vulnerability, step-one is be thoughtful and continue engagement with your shareholder base so they understand why any disappointing results happened, and step-two is "please, refer back to step-one." A board can't have a mindset of "Well, we'll fix the operational hiccups first, and then we'll engage with our base." It's a "means are the ends" type problem.

13DM: Back in 2013, you noted that activists had been successful in demanding stronger boards that were capable of controlling powerful executives and founding families of energy companies, and that variations of this theme had been used successfully by activist campaigns engaging energy companies in part because of the

Investor Communications Network

152 West 57th Street, 41st Floor
New York, NY 10019
www.13DMonitor.com
(212) 223-2282

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energy industry's 'Good ol' Boys Club' reputation. As someone who represents and advises Boards, has there been a shift towards more diversity in energy sector boardrooms?

SG: There has definitely been a shift, but the pace car doesn't have to be moving that quickly on this topic for the change to be significant. If you start with a small enough base, any change seems enormous. That being said, the sector is certainly continuing to move in the right direction. For example, we are seeing a number of companies actively seeking diversity on boards.

13DM: Two of the most successful activist campaigns in the energy sector were Icahn/Chesapeake and Corvex/Williams. In the former, Icahn got his board seats and replaced the CEO and in the latter Corvex got Board seats and orchestrated a merger. However, both of these situations were extremely disappointing from a returns perspective because the price of oil imploded. Is activism practicable in an industry where the price of the commodity could trump any benefit from the activist catalyst?

SG: The best answer is a rhetorical question. Does good management matter in an industry highly sensitive to commodity price changes? I think most would answer "certainly, yes." So, if good management matters, then bad management matters, and if bad management matters, then activists will likely believe they could catalyze improvement.

That being said, I think a number of activists do not have a firm understanding

of the energy space. Ones that do can be very successful. Ones that don't might often effect change but at best create a whole new set of problems and at worst, really make things worse. Institutional investors asked to choose between management and activists should focus not only on managements' performances, but also on the activists' track records in

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the space.

13DM: How do you think the 2017 tax reform legislation will affect activism?

SG: Moderate effects, but probably not transformational. Boards of even the most successful companies realize they can't sit on a bunch of cash for long, Icahn/Apple showed us that. Also, a single-issue "management hasn't allocated cash from 2017 tax reform properly" campaign wouldn't have much teeth in it from activists.

13DM: Which themes from energy targets defending against activists resonated well with shareholders? Which did not?

SG: Managements that can plainly and credibly explain their business plans are the most successful. If the company has struggled, most institutional investors will need a credible explanation as to why,

but that is manageable if you have a plan that investors understand. Companies that have struggled have had a difficult time articulating their business plan. Companies with perceived excessive executive compensation programs have also been vulnerable.

13DM: What is the most important thing an activist could do to be well received by management?

SG: Be authentic and genuinely open to working constructively with management. A board is still composed of human beings, and it is difficult for any human being to work constructively with someone they feel is being disingenuous or hiding the ball with respect to their goals.

13DM: What trends do you see in shareholder activism and in the

energy industry?

SG: I think one key trend will be producing companies continuing to be encouraged to spend within cash flow. I think investors are going to continue to demand capital discipline with memories of 2014/2015 still fresh. Of course, there will be consequences of this, as I do think capital discipline will lower production and create opportunities for PE sponsored companies to gain market share. It will be interesting to see how that plays out over the next few years.

I also think in certain areas, you'll see activists continue to advocate for M&A. Investors have rewarded companies who have focused on a few or even a single basin, and I think that trend will continue. And, as the industry gets its sea-legs back from the downturn, I do believe you'll continue to see consolidation, particularly in certain basins.

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