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A BATTLE FOR THE SOUL OF TECH

Activist investors are bulking up their stakes in tech companies — and forcing changes in long-held Silicon Valley practices.



BY SUMAN BHATTACHARYYA

Investors are once again battling founders and tight-knit boards for control of tech companies — and scoring some points as they question Silicon Valley's long-held belief in product-led growth.

Recent developments at Twilio may be a sign some companies are ready to put up a fight, but every indication is that these funds that invest in publicly traded firms with the intent of forcing change are going to keep up the pressure.

The San Francisco-based communications software provider, which for months faced an activist push to sell or divest customer-data business Segment, in March decided to keep the unit as part of a series of “operational changes” the company will make on its path to profit. The company saw founder and CEO Jeff Lawson resign early this year to be replaced by Khozema Shipchandler, a longtime Twilio executive and former CFO. The company appointed People.ai executive Thomas Wyatt to lead Segment, after weighing a sale.

Twilio, which declined to comment for this story, is not alone among technology companies targeted by activists in an effort to force lead-

ership changes, leaner operational structures, or the sale of underperforming units. Across industries, activist campaigns reached record highs last year, according to research from S&P Market Intelligence, Lazard and Bloomberg.

Bay Area tech firms that faced activists over the past year include Salesforce, RingCentral, Yelp and Harmonic.

There are indications that activists may be gearing up for more tech battles. According to a report from San Francisco-based investment bank Qatalyst Partners, an uptick in activist fund investments in tech is a leading indicator for more activist maneuvers ahead: Tech stocks now make up 38% of activists' portfolios, up from 30% a year ago.

Qatalyst, which served as the financial adviser to Segment when Twilio acquired the company in 2020, is advising Twilio on shareholder defense, according to CNBC.

Addressing the tech sector more broadly, rebounding valuations and an “anticipation of an uptick in the merger and acquisition market ... seems to be driving more of the activist focus,” said Peter Michelsen,

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a partner and head of shareholder advisory at Qatalyst.

Twilio's activists, a group which includes Legion Partners and Anson Funds, have been pushing either for a sale of the entire company or assets like Segment.

In a healthy equity market like the past year, "laggards are very obvious and that creates a potentially fruitful environment for activists," said Peter Siwinski, a partner at FGS Global, a strategic communications firm that advises companies on activism defense.

Twilio's stock trades at virtually the same price as a year ago.

Low-hanging fruit

Investors typically look for a vulnerability – a falling stock price or an imbalance between growth and profitability at the target firm. Investors might use the "Rule of 40" metric, in which the sum of the company's annual growth rate and profit margin should be at least 40%, according to Derek Zaba, partner and co-chair of the shareholder activism and corporate defense practice at Sidley Austin LLP.

"First off, they have to see something about the company that needs improvement," said Zaba. "They need to have a plan. They need to make money."

Besides engineering a sale of all or part of a company, activists can push for management or organizational changes and staff reductions.

Other activists have pushed for environmental, social and governance changes that they want companies to address.

"There's investors who realized there's a lot of fat in the tech market," said Dion Hinchcliffe, vice president and principal analyst at Constellation Research. "There's this belief that companies can be running much more efficiently."

Near-term versus long-term

What might underlie these disputes are differing perspectives about the time spans to deliver shareholder returns. While that's not unique to tech companies, analysts say, Silicon Valley insiders have often praised a longer-term outlook and decried Wall Street's emphasis on quarterly results.

"There's always a debate about what the right time horizon is – the debate between near-term returns and long-term value," said Michelsen.

Twilio is an example of this tension playing out, argued Michael Fauscette, CEO and founder of Arion Research. Segment, which Twilio bought in 2020, is growing slower than Twilio's core communications offering, but it is nonetheless an important part of the business, he said.

"All of these pieces go together and make a lot of sense long-term," he said. "It takes time to build a customer data platform."

Among the reasons Segment underperformed, according to a report from investment bank Jefferies, which cites Twilio management, is that it had invested ahead of growth; it took customers too long to onboard; and customer churn and contraction were too high.

And Twilio's core business offering – APIs that allow access to communication protocols like voice, messaging and video chat capabilities – can be a difficult sell to some investors, Hinchcliffe said.

Defensive strategies

Ultimately, the best line of defense is performance. Salesforce mostly dealt with its activists with a strong first quarter last year and a subsequent run-up in its stock.

In the absence of that, storytelling is important. Just because a company isn't performing doesn't mean there has to be a board or management change, said Zaba. The real question is whether the company is taking the steps needed to address the underperformance.

"You have to convince people that what you're doing with the company is the right path. The activists will disagree, and you'll have to tell your story, and the story has to be more compelling than the activist story," he said.

In addition to creating value through performance, boards and managers can engage in what Michelsen calls "tactical preparedness," or having a team in place to implement plans.

Why activists might continue to pursue tech targets

In a context where interest rates are high, and consequently, companies aren't growing as quickly, activists see opportunities to effect change, said Hinchcliffe. But while conventional wisdom might suggest they may pull back if interest rates go down, activists' success in being able to force changes in their favor will only embolden them to continue to pursue targets.

It's not clear, for example, if Salesforce's stock rally discouraged or emboldened activists: Those who held onto their shares made money.

"There's this belief now [that] Salesforce was another proof point saying that activist investors can get corporate governance changed in a way that's favorable to them," Hinchcliffe said. "If you buy the stake, you identify the move and you put pressure on the board, then your share prices will go up." For Wall Street, that's an end in itself.

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