Activists at the Gate

CFO Magainze
By Edward Teach
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Your company could be doing better. The stock is in the doldrums, and the price-to-book ratio is low. On a variety of financial measures — shareholder returns, revenue growth, operational costs, and so on — the company is underperforming its peers. Cash flow is reasonably healthy, but one of the divisions is starting to falter. Adding insult to injury, management won the last say-on-pay vote by less than a large margin.

Your company, in short, is a prime target for an activist hedge fund. Such investors make money by taking stakes, and board seats, in public companies and pressuring them to put themselves up for sale, spin off the parts, repurchase stock or increase dividends, or make operational changes. Activist funds have outperformed other types of hedge funds in recent years, attracting capital inflows. They currently boast more than $150 billion in assets under management, says Paula Loop, leader of PwC's Governance Insights Center, "and they are looking for places to invest in."

Last year, activists found a record number of places to invest in. FactSet'ssharkrepellent.net tallied 355 campaigns, with 127 resulting in at least one board seat gained for the activist. Ernst & Young counted 516 activist encounters last year, up 24% from 416 in 2014. And the targets are getting bigger, with megacap companies like DuPont, Procter & Gamble, Apple, and AIG coming into activists' crosshairs.

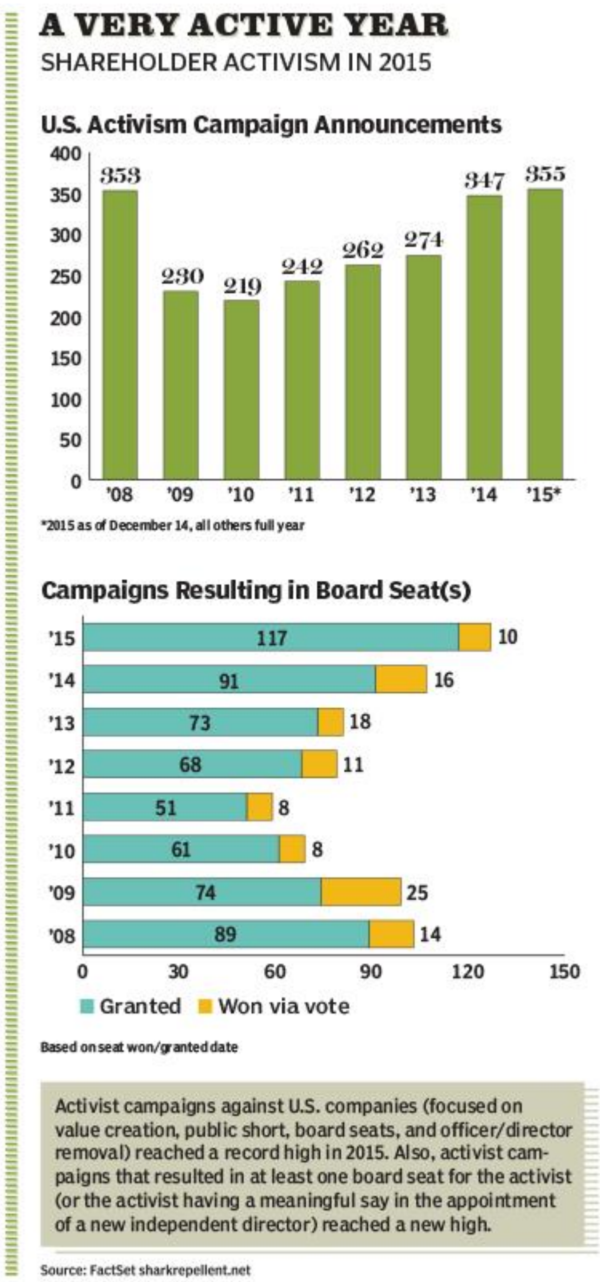
Descendants of (or in some cases, holdovers from) the corporate raiders of the 1980s, today's most prominent activists — investors like Carl Icahn, Nelson Peltz, Bill Ackman, and Daniel Loeb — are rock stars on Wall Street. More collaborative in tone than confrontational, current activists are winning fans among traditional institutional investors.

"The shareholder base is shifting," says Bill Anderson, senior managing director and head of the shareholder advisory practice at Evercore, an investment banking advisory firm. "The big mutual funds that are active holders used to be more supportive of management, but now they are supporting the activists — and that's a giant change."

The *Wall Street Journal* reported that more than half of activist campaigns in 2015 were launched by "reluctavists," normally passive investors who were goaded into activism by poor corporate performance. "We may continue to see 'reluctavists' play a significant role in campaigns," says Richard Grossman, a partner in the M&A practice at Skadden, Arps, Slate, Meagher & Flom who frequently advises firms in response to activist situations.

"It's not just activists, but shareholders as a whole who want a voice — that they are investors, they are owners of a company, and they are not quite as content just to sit back and let management handle things," says David A. Brown, a partner at law firm Alston & Bird who advises companies on shareholder activism. "Even large institutional investors who are not activists, such as BlackRock, are publishing voting policies and their views on how things should be run."

As activism goes mainstream, company size is no protection. A fund that holds a few percent of a target's stock potentially has an unlimited amount of financial clout, "because if I can convince the big, traditional institutional investors to support me, I have all the investment money in the world at my disposal," says Shyam Gidumal, a principal at Ernst & Young who advises clients on shareholder activism.



A Growing Dialogue

In the past, companies could simply circle the wagons and wait for activists to go away. Now they are parleying with them, and often they are settling their differences quickly. In 2015, for example, Icahn Associates, Starboard Value, and Pershing Square Capital Management struck settlements with targets and placed members on their boards soon after they surfaced. At General Motors, activist Harry Wilson dropped his intention to seek a seat on the board when GM, after meeting with Wilson, announced a new capital allocation framework and share repurchase program. (GM says the initiatives had already been in the planning stage.)

The growing dialogue between companies and activists was acknowledged by Securities and Exchange Commission chair Mary Jo White in a 2015 speech at Tulane University. "Increasingly, companies are talking to their shareholders, including so-called activist ones," White said. "That, in my view, is generally a very good thing. Increased engagement is important and a growing necessity for many companies today."

"I think a lot of companies were hoping that the SEC was going to defend companies from the activists," comments Gidumal. "To me, that was another indication of a secular change in the way investors talk with companies." He views activism not as an asset class, but simply as "a core part of the conversation that investors have with companies."

That doesn't mean they're singing "Kumbaya." Activists may be openly adversarial, while CFOs may scoff at proposals to drain the corporate cash coffers or slash research and development spending. Moreover, "there are any number of activists whose ideas don't make sense," points out Gidumal. An activist may be well intentioned but lack crucial information, such as the company's tax basis. "It can be that the company says we've heard that idea before, it's a bad idea, and here's why," says Gidumal.

Sometimes companies wait too long to disclose facts to refute an activist's argument, says Gidumal. He recalls one retailer that sparred with an activist for nearly a year over whether to spin off its real estate holdings, until it finally convinced investors of its case by revealing that the tax costs of the separation would outweigh the deal's benefits.

"Bringing the facts to the table and being crisp in your messaging" enables a company to resolve an activist encounter quickly, and puts the activist in a better position to exit, says Gidumal. He says that for every activist encounter that becomes public, another one is resolved privately, with no change to the board.

Becoming Your Own Activist

To respond to activists effectively, consultants like Gidumal urge companies to, in effect, become their own activists. "Look at yourself the same way an activist would look at you," he says. "Understand and articulate what you think activists might argue, and why you believe that you as a company are doing the right thing."

Brown says companies don't necessarily need to think like activist investors, "but they do need to focus on their long-term strategy for creating shareholder value, as well as opportunities in the short term to return cash to shareholders through dividends or share repurchases."

He recommends that companies form an activist response team, ready to evaluate a hedge fund's approach and history. "Some activists are focused on long-term value creation and have a good track record of being long-term shareholders and helping companies, which benefits the activist through long-term share price appreciation," he says. Other activists "may want to simply force a company to expend cash or lever up for special dividends or share repurchases, which drains the company of resources."

Skadden's Grossman notes that many companies now perform vulnerability self-assessments. "Generally, it's a good thing," he says. The self-assessments "are designed ultimately to enhance shareholder value, which is what boards and management teams should be doing." CFOs, he says, play "a major role, if not the lead role" in vulnerability self-assessments, since such scrutiny typically focuses on financial performance.

Meanwhile, companies need to win the hearts and minds of their shareholders — before activists do. "Companies need to talk to their large shareholders year-round, to understand their concerns," says Brown. "So if an activist does knock on the door, you're already involved with your shareholder base." Brown says companies should also get acquainted with the two main proxy advisory firms, Institutional Shareholder Services and Glass Lewis, whose voting recommendations carry considerable weight with large institutional investors.

Direct discussions between board members and a company's largest shareholders can serve as an early warning system of investor unhappiness, and enable directors to communicate management's strategic vision, says Grossman. Such engagement "is still evolving so that it does not encroach on the traditional role of management communicating with investors," he adds.

"Years ago, it was unusual for directors to meet with shareholders," notes Evercore's Anderson, but today it's common practice among companies in the *Fortune* 200 to have at least one director designated to do so, he says. The board's message to shareholders should be more narrative than data dump, recommends Anderson. Instead of assembling "100-page slide decks," directors should keep it simple, he says, focusing on the five or so yardsticks that are most important to the business and its investors — its margins, cash flow, leverage, and so on — and how the company stacks up against its peers on each.

Grossman downplays concerns that directors risk violating Regulation FD by talking directly to shareholders. "Directors are out meeting with shareholders all the time in contested situations," he says. "They know what the constraints of FD are when it comes to disclosing material nonpublic information."

Of course, a company's board is itself a potential weak point. Increasingly, activists are using top search firms to find candidates who are former executives in the industry, says Anderson. Such new blood "can be attractive to institutional investors," he says. "Boards have to take a tough look at themselves and ask whether their shareholder base would believe that they are the right board for that company."

"The board has to look at itself in the mirror and make sure they understand what their vulnerabilities are," says PwC's Loop. "Sometimes the management team can push back on the board. For example, you could have directors who effectively have 'zombie' status — they didn't receive majority voting in the prior proxy season. Sometimes someone has to say, maybe we need to make some changes here as well."

Some companies have effectively preempted demands for shareholder representation on their boards because they have former fund officials on their boards, Anderson points out. Apple, for example, has a founding partner of BlackRock on its board, and General Electric has a former Vanguard CEO on its board.

A More Invasive Strategy

While most activist campaigns continue to address board seats, balance sheets, and break-ups, a fast-growing theme is core operational change — reducing costs, becoming more efficient, increasing returns on invested capital. In 2010, 7% of activist encounters involved operational change, according to EY; last year 25% did.

While putting a company up for sale and liquefying the balance sheet are discrete processes, operational change is a longer-term, more invasive proposition, says Gidumal. It can take years, for example, for a large, multidivisional company to reduce its supply chain costs by 500 basis points, he points out.

"That's a big change in the nature of an activist engagement with a company," notes Gidumal. "It changes what kind of board members an activist might propose. It changes how the board will talk to management, how the management will talk to the board. Companies are only beginning to recognize how fundamental a shift this kind of activism is."

Are activist hedge funds another investment fad, or will they remain popular? "I don't see the activist funds going away," says Grossman. "But the low-hanging fruit may be gone, and they may have to work harder to find targets."

Like other asset classes, activist funds had a tough 2015; Hedge Fund Research's index of activist funds finished the year up just 1.5%. While HFR's activist index has outpaced other hedge fund indices, it has trailed the S&P 500 in five of the last eight years.

In recent years, many activists have been prodding companies to split up. "That may have made a lot of sense when the market was strengthening and people were focused inwardly post-crisis," says Anderson. "It pushed some spinoffs to happen sooner than they otherwise would have." But lately, such separations haven't performed as well, he says; "a number of SpinCos have traded below expectations."

Once activists cash out, how will their targets perform? "The jury is still out," says Grossman. Despite claims that activist investors are "pumping and dumping," a recent study of activist interventions between 1994 and 2007 by Harvard Law School professor Lucian Bebchuk and others found that Tobin's Q and return on assets were consistently higher three, four, and five years following the interventions. Similarly, a McKinsey study of 400 activist campaigns against large U.S. companies found that the median campaign reversed a downward trajectory in target performance, and created a sustained increase in shareholder returns.

Such evidence suggests that activist investors frequently advocate sound ways to boost corporate performance and create shareholder value. Which points to the best defense of all against activists: Beat them to the punch.

Edward Teach is editor-in-chief of CFO.