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DO-IT-YOURSELF ACTIVISM

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Many corporate executives and board members view activist investors as little more than bullies with calculators: they seem to hunt in packs, force disruptive and risky changes, and use simplistic benchmarks as their call to action.

Yet their ranks have grown rapidly, and activist investors now attack even the largest and most successful companies. Worldwide, the assets managed by activist investors have increased sevenfold over the past decade, from $12 billion to $85 billion. Since 2005, the number of activist campaigns in the U.S. has increased 15 percent per year, reaching a total of 144 in 2012. These investors have pushed for the return of excess cash to shareholders at Apple; urged restructuring through spinoffs and divestitures at PepsiCo, Sony, Timken, and McGraw-Hill; and called for the replacement of senior management or board members at Abercrombie & Fitch, Yahoo, and Sotheby's.

Although some campaigns have backfired, resulting in significant corporate damage (JCPenney is one dramatic example), activists are creating value often enough to continue to attract institutional funds and expand their influence. Indeed, collaboration between activists and traditionally more passive investors is blurring the definition of investor activism. Leading pension funds, such as CalPERS and the Ontario Municipal Employee Retirement System (OMERS), are not only allocating capital to activist hedge funds, they are publicly teaming with activists to campaign for change.

In light of these trends, most large companies can expect to face an activist campaign in the normal course of business. How should they prepare? One common approach is to put an "activist response" team in place, often in collaboration with legal counsel and investment bankers, and to periodically run fire drills with the board in anticipation of future activist interventions. But such reactive procedural moves are like the old "duck and cover" civil-defense drills: They give the illusion of safety without providing it.

There is a more effective response: Senior managers and the board can borrow directly

from the activist's playbook by critically examining their company's portfolio, balance sheet, and governance in much the same way that an activist investor would, and then preemptively making necessary changes. By engaging in what we call *do-it-yourself activism,* senior management can make a company less attractive to activists by making it more attractive to long-term shareholders.

How Activists Unlock Sustainable Value

Executives who think of activists as unwelcome players on the corporate-governance landscape often have in mind those we call *hit-and-run activists.* These hedge funds have short-term horizons—often as brief as six months. They agitate for quick fixes, such as cost-cutting or debt-funded share buybacks, to create short-term value, often at the expense of long-term value. They use intimidation, threats, and litigation to get their way. Certainly, companies should defend themselves against these players.

But there is another type of activist that is increasingly common in today's market for corporate control: We call them *constructive activists* because their goal is to initiate fundamental change that generates shareholder value. Constructive activists have a high research investment per company, relatively long holding periods (at least two to three years), and relatively concentrated portfolios. They recruit industry veterans to provide deep, asset-specific knowledge about key value levers. Functionally, they're a hybrid—somewhere between a full-control model, such as private equity, and a passive model, such as a traditional mutual fund.

The business model of constructive activists is based on influencing a company's agenda without paying for full control. Achieving that goal requires getting smart changes implemented without resorting to costly and acrimonious public battles. Instead, constructive activists rely on a thoughtfully crafted value-creation agenda—often based on diligent and comprehensive study of an enterprise for several months, if not years, before investing—and effective collaboration with management behind the scenes.

Cevian Capital provides one example of a constructive activist in operation. The European firm, founded in 2002, deploys highly capable professionals—many with prior top-tier operational, consulting, or financial experience—to analyze the potential for long-term improvement in corporate strategy, operations, and organizational structure. The firm invests only in companies whose management is open to a constructive dialogue. Its approach has paid off: The firm's Cevian II fund, launched in 2006, had generated returns of 119 percent by the end of 2013, compared with the 4 percent return of the MSCI Europe Index during the same period.

BCG has for some time emphasized the role of the *CEO as investor.* (See "The CEO as Investor," BCG Perspective, March 2012, available at www.bcgperspectives.com.) Yet the unfortunate reality is that many CEOs and senior teams continue to struggle in the investor role.

Strikingly few companies have a coherent analytical process for understanding the sum of their parts and for managing those parts so that each contributes over time to the company's value. More than one-third of the S&P 1500's $8 trillion of invested capital does not earn the cost of capital. BCG research shows that over a five-year period, half of those companies experience a significant write-off, divest a major business, or see a decline of 50 percent or more in company value. And misaligned or misguided capital strategies are one of the primary screens that activists use to find their targets.

The Five Steps of Do-It-Yourself Activism

CEOs can earn their way out of the activist target zone by explicitly exploring the steps that activist investors might take to unlock value at their company. We have partnered with top public companies to do precisely this and have identified five key steps.

Develop an analytically based investment thesis. Senior managers often define financial success in terms of improving

aggregate corporate-accounting measures, such as top-line growth, earnings per share, and profitability. Activists, by contrast, focus on value per share, and they reconstruct a company's value per share as a sum of its parts. They focus more on the balance sheet, dispassionately challenging the logic of owning noncore operations and considering all structural alternatives. Management must do the same. To allocate capital effectively, senior executives must have a clear investment thesis that differentiates priorities by business.

The contrast between the typical managerial view and the typical activist view can be seen in the example of McGraw-Hill. According to an August 2011 company statement, management viewed the business as "a leading global information-services provider serving the financial services, education, and business information markets." But that's not how Jana Partners, an activist hedge fund, and the Ontario Teachers Pension Plan (OTTP) viewed the company. Their joint analysis made a key distinction between McGraw-Hill's education business and its other businesses: "MH Education compares unfavorably with other businesses in McGraw-Hill's portfolio [and] competes with substantially higher-returning businesses for capital, resources, and management attention."

Ultimately, Jana and OTTP persuaded McGraw-Hill to sell its education business to Apollo Global Management for $2.5 billion. As a result, the company, renamed McGraw Hill Financial, has seen its once-stagnant stock price almost double, while also increasing dividends by 10 percent.

Acknowledge and close significant performance gaps. When performance benchmarking raises red flags on key measures, activists are attracted like sharks to blood. Recent BCG research has analyzed the quantitative screens that typically differentiate activist targets from other companies. Using a regression analysis, we identified nine key performance metrics to monitor in the categories of valuation discounts, historical total shareholder return (TSR), cash and operating margins, financial policies, and balance sheet profiles. Industry-specific operating metrics and qualitative screens relating to portfolio shape or governance are often added to these initial quantitative screens.

Screens of this sort were used, for example, in 2011 when Bill Ackman's Pershing Square acquired a 12 percent stake in Canadian Pacific Railway. Ackman insisted that there was considerable value being left on the table at what he termed the "least-efficient major railroad in North America." In just over a year, the company's operating ratio—a key indicator of efficiency that measures costs as a percentage of revenue—improved from 74 percent to roughly 66 percent, well surpassing CP's peer-group average of about 70 percent. Since Pershing acquired CP shares, their value has more than tripled.

Use your balance sheet wisely. Every company must actively manage the tradeoff between reinvesting cash to drive profitable growth and distributing cash (dividends, buybacks, and debt paydown) to provide cash flow yield to shareholders. Recent BCG research has defined ten distinct *value patterns* into which businesses fall, each with different value-creation priorities and implications for capital requirements. (See "Value Patterns: The Concept," BCG Perspective, May 2012, available at www.bcgperspectives.com.)

Some value patterns have more opportunities for profitable organic reinvestment, such as what we call "discovery" businesses, in which considerable investment is required to drive advantaged growth in the core business. In other value patterns, decapitalization is the preferred route to creating value. For example, "deep value" businesses most often create value through turnaround, restructuring, asset liquidation, and refocusing on a profitable core rather than through new growth investments.

More generally, sound capital strategy dictates that each dollar of distributable cash should be either reinvested to generate attractive future returns or returned to owners as a yield-based contribution to

TSR. Failure to do so brings activist attention. For example, even though Apple has had strong historical TSR, the company was targeted by Carl Icahn because of its consistent accumulation of vast quantities of excess cash on its balance sheet.

Engage with your owners openly and candidly. When we first meet with a company's senior executive team, we like to ask, "How many of the company's top 15 investors have you met with in the last six months?" Engaging in candid, ongoing conversations—in which executives listen carefully to their owners' views of the company's key value-creation opportunities—is an excellent preventive measure.

Why? Because investors sometimes have good ideas, but also because activists are less likely to intervene and to succeed if they lack the support of major institutional shareholders. Especially important are the points of view of the more sophisticated institutional players, such as large U.S. asset managers and Canadian pension plans, whose voices hold sway with other shareholders.

In one recent example in Canada, the Canadian Pension Plan and OTPP supported management at Agrium, a Canadian retail supplier of agricultural products and services, against an attempt by Jana Partners to split off the company's wholesale fertilizer-production arm from its farm-products retail business. Managers who seek to understand the ownership styles of their investors—whether they're growth investors seeking top-line growth, income investors seeking dividends, etc.—and adapt the company's plans accordingly can enlist those investors' support at critical junctures.

Build an ownership culture and a value-adding board. A strong, properly compensated management team and governance that adds value are critical to making good on a company's investment thesis. For managers, it's necessary to have effective metrics, transparent performance assessment, and meaningful rewards that are linked to sustained value creation over both the short and long term. At diversified companies, these metrics, assessments, and rewards must be customized for individual business units.

To illustrate the positive role that boards can play, Yahoo's experience is telling. In 2012, Daniel Loeb, who had a 6 percent stake in Yahoo, pressed for the ouster of then-CEO Scott Thompson, helped secure Marissa Mayer as the new CEO, and gained three seats on the board. In her first year on the job, Mayer made 17 acquisitions and brought in top-tier engineering talent and new technologies to improve the company's relevance in key segments. As a result, Yahoo's stock price increased by 160 percent. While the company's story continues to evolve, activist engagement has helped Yahoo re-establish positive momentum.

COMPANIES DON'T NEED activist investors like Loeb to realize such gains. Senior executives can—and should—drive necessary change themselves by examining their portfolio the way a savvy outsider would and then finding and delivering value as do-it-yourself activists.

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