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Dealing With Investor Activism

Investors seek high returns from pushing your buttons. There are things you can do to prepare for an attack.

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The activist investor is this year's—and probably this decade's—boardroom bogeyman. Using little more than threats, press releases, and the odd lawsuit, this new breed of invulnerable investor seizes board seats, humiliates managements, disrupts business strategies, forces huge unplanned payments to shareholders, and even opens the gates to uninvited takeovers.

Or so it seems. Here's a contrary view: An activist investor is like a guy standing at an ATM. What he wants is fast cash, and he'll push as many buttons—in this case, your buttons—as necessary to get that cash. That's what he's all about.

Somewhere between these two extremes can be found some basic principles: Activist investors, good and bad alike, follow predictable patterns. Corporations, good and bad alike, can predict their vulnerability to activism; they can prepare for, and sometimes deter, possible attack, and when attacked, they can defend themselves, and sometimes prevail. This note contains some of our observations from recent seasons of investor activism.

Let's size the epidemic. A proxy solicitation firm identified 75 incidents of investor activism in 2006. That's one percent of publicly traded U.S. corporations. There were 20 incidents in 2005. Neither number includes activist initiatives that got no results and no public notice. Some of those activists were constructive influences; some weren't. Some of their targets probably benefited from their activism; some were harmed, even devastated.

Most everyone expects a higher level of activism into the future. Two reasons: First, hedge funds have so crowded the investment management space that above-average returns are getting hard to find without taking matters into one's own hands. Second, investor activism works—not all the time, but often enough to be a legitimate return-enhancement stratagem.

It's the cash, stupid. Activists are professional investors. They are often, but not always, hedge funds. What activists want is a cash return on their investment that's larger and quicker than they'd get if you kept doing whatever investors thought you were going to do at the time they bought their shares.

How are you going to give them that cash return? Buy back a lot of shares. Pay a whopping special dividend. Or, best of all, sell the company for a tidy premium. If you don't sell out, where does the cash come from? You can sell assets, especially big ones, even whole businesses. You can reduce expenses. Defer capital programs. Raid working capital. Leverage yourself (borrow what you're going to pay out). Are these good ideas? Maybe. Maybe not. But by the time it's clear they were bad ideas, your activist will be long gone.

> So, there are two quick tests to see how juicy a target you are for an activist. Number one: Is your share price a laggard? Compared to what? Compared to whatever your major investors normally compare you to. If you're a star performer, few activists are going to mess with you. Number two: Can you, in fact, generate a pile of cash to give to shareholders? If not, you're probably immune to activism. Unless, of course, there's an obvious buyer out there who'll pay up for your shares.

Then what about governance? Corporate managements and their boards of directors aren't generally enthusiastic about activists' proposals. If handing out lots of cash were part of their strategy, they'd already be doing it. So how, short of winning a shareholder vote of some kind, can the activist bring balky directors around? Here's how: Embarrass them. Embarrass you.

For starters, activists can accuse you of inattention to the business, of rubberstamping anything management proposes, of ignoring the best interests of shareholders. All okay as accusations, but boring.

To really get your attention, they accuse you of lax governance practices, conflicts of interest, overpaying management, overpaying yourselves. In today's climate of post-Enron vigilantism, the media report most such accusations uncritically, most managements can only splutter a Nixonian "I am not a crook" in response, and many—too many—outside directors cave in to proposals they don't really believe in. Caving in gets them what they want: Once the cash-generating event is launched, the governance accusations fade away.

> So, two more steps to take in advance: Have a tough-minded outsider check out your vulnerability to accusations of sloppy or venal governance. And give your outside directors a gut-check. Are they ready to see prison-style mug shots of themselves in their hometown newspapers, under the headline, "Long-Term Liabilities" (this has happened)?

Take the first meeting. This doesn't happen all at once. The normal progression goes like this: The activist accumulates a substantial stake in your shares (typically 5 to 10 percent, sometimes a good deal more). The activist asks for a meeting with management in order to present his analysis of the company's underperformance and his ideas for creating shareholder value through cash generation and distribution. Governance questions may or may not be on the agenda.

Should you take this meeting? Usually, yes. Four reasons: One, this is a courtesy you would probably accord to any shareholder who owned a tenth of your shares. Two, activists are smart people, and might have a useful idea or perspective to offer. Three, occasionally, you can persuade activists that their proposals would be harmful. Four, if there's a possibility that you're going to war, knowing your enemy is a good thing. (If you're media-shy, here's reason five: When you say no, the activists will make it a headline).

Rejection starts the fight. "We'll think about this and get back to you," generally ends that first meeting. When you get back with a rejection (or earlier, if you declined to meet at all), the activism begins. Typical activist actions:

- Demand a meeting with the full board of directors
- Go public, via the news media, with accusations of lousy governance and lousy performance
- Reach out to other shareholders for expressions of support
- Demand seats on the board of directors
- Threaten legal action
- Threaten a proxy fight

An activist may do some or all of these, in any order and over most any period of time (but with the filing date for a proxy contest clearly in mind). Keep in mind: Threats, demands, announcements, and other communications aren't very expensive. Few activists like spending money. Keep in mind also: The goal is still the value-creating, cash-distributing event. A board seat is ultimately a preferred position for activist agitation (and a face-saver when activism is rebuffed).

Here's when you find out who your friends are. In the hierarchy of investor activism, there are no more than a couple of dozen full-timers—institutions that make activism a central strategy. There are a larger number of reluctant activists—institutions that become one-time activists because they're fed up with the performance of an investment (or its management). Then come the wolf pack activists, a hundred or more of them—institutions that buy shares and voice support once another activist has taken the first steps. And, lastly, there are the sanctimonious sympathizers, conventional investors whose recurring choruses are "we just want you to make this go away" (Translation: Do what the activist wants) and "what harm could it do to give them a seat on the board?" (Translation: We know what harm it could do, and that's what we want). When an activist goes public, he has two goals in mind: Embarrass the board (so directors feel they have something to lose personally) and mobilize the wolf pack and the sympathizers (so the something-to-lose is real and imminent).

This is a popularity contest. A very-high-stakes popularity contest. No rules. No official scorekeeper. At one extreme, wolf pack investors and sympathizers can create the appearance of substantial support for an activist (20 percent to 30 percent is not uncommon, but majorities are rare). At the other extreme, large-investor endorsement of a corporation's stance can leave an activist alone in an increasingly uncomfortable spotlight. In between, the degree of apparent support or non-support for an activist is crucial to

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management decision-making. Note the word "apparent." A phone call to management isn't at all the same as a vote cast in a proxy contest.

> So, one more step to take when there's no activist in sight: Consider your largest shareholders. What are they telling you about yourself? Do they like your business strategy and your approach to shareholder value creation? Do they show confidence in your ability to execute the strategy and create the value? Dismal fact: Most corporations think they've stated a strategy to investors, but most investors think they haven't. Sometimes, you can ask investors these things directly. Other times, you have to read body language as best you can. But once an activist fires a public broadside, it's too late to take your investors' temperature.

Should you let an activist meet with your board? Usually, no. You wouldn't give another investor this privilege. If management has reported accurately on its meeting, there's no new information to be conveyed. And the activist's motivation, all too often, is to intimidate or divide the board or to gather grist for subsequent legal action. Boards need robust debate in private, but they also need a unified face in public.

Should you mix it up with an activist in the news media? Within limits. When an activist opens fire, the urge to shoot back can be overwhelming. Public name-calling makes great copy, but it's also a sure-fire wolf pack attractant. Better to encourage calm and perspective in media coverage. You do need to be sure your major shareholders understand your views (and your strategy). But that audience really boils down to somewhere between 10 and 100 people, and while media can be helpful, there are usually better ways to talk to them.

Should you give an activist a seat on the board? You won't want to, but sometimes it's worth considering. The activist himself has a conflict-of-interest hurdle to clear: reconciling his fiduciary duty to his own investors with his prospective fiduciary duty to your shareholders. That said, some activist-sponsored directors are hugely valuable to the boards they join, while others make the boardroom a legalistic chamber of horrors. Suggestion: If you reach the point where you're seriously considering an activist director, interview the candidate just as you would any other—and get references from other boards he's served on.

How does an activist win? Victory comes in two ways. One, the activist convinces your board that he has enough support that he would win a proxy fight if he waged one. Or, two, the activist convinces your board that the fight is not worth the pain that would be suffered by the company, its shareholders, its business, or its board members. In either case, the board agrees to give the activist his value-creating event, his board seat, or whatever else will restore peace. The activist's final card, of course, is to actually launch a proxy contest, but that's quite expensive, and is rarely undertaken without a virtual certainty of winning. The board's final ploy in a losing battle is to actually sell the company: A new kind of white knight today will step in to "stop the pain"—usually offering only a modest premium. An irony: If your board would have considered selling for a large premium, the activist actually destroys shareholder value when he creates a climate in which a small-premium offer is welcomed.

How does a company win? Victory comes when the activist withdraws. Perhaps the activist concludes that the company cannot create the cash-generating events he seeks—or has already performed all the events of which it is capable. Perhaps other shareholders fail to rally to the activist's side, either in the popularity contest phase or in the rare proxy fight. Some boards have seen self-mutilation as a winning ploy. They effect an otherwise unattractive transaction that eliminates the possibility of the activist's desired event. Others have said, in effect, "if you activists win, we're leaving, do what you want." Few activists want to run your company; they want you to do their bidding—and take the rap if it doesn't work out.

Reportedly, activists won about 60 percent of the attacks that went public last year (and, probably, next to none of the ones that did not go public). If you wind up in an activist's sights, you've got a 50-50 chance of emerging without damage. How to make the most of that chance? Scout your vulnerabilities well in advance. Articulate a credible value creation strategy. Make sure your investors know and understand that strategy. Play straight with activists. Avoid mud-slinging contests. Execute. Perform. Don't panic.

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