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Winning Moves in the Age of Shareholder Activism



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Winning Moves in the Age of Shareholder Activism

Jody Foldes, Gerry Hansell, Daniel Friedman, Joel Janda, Jeff Kotzen, and Tawfik Hammoud

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AT A GLANCE

Shareholder activists are growing in size and influence, and their targets have also grown increasingly bigger. Although their methods may be aggressive, activists' goals are generally legitimate. Instead of recoiling from the activist threat, management and boards must remember that a company's owners may have different views on how—and how quickly—to maximize value.

PREPAREDNESS AND RESPONSE

The best response to the activist challenge is do-it-yourself activism: assessing the company from the activist's perspective to make needed changes preemptively. If an activist campaign becomes imminent or actually occurs, the company must devise a "strategic response"—mapping alternative future states that could create as much or even more value than the activist's proposal. In either case, the company's response must be firmly grounded in data, facts, and logic.

FIVE GUIDING PRINCIPLES

When an activist strikes, companies can fortify their position and reassure shareholders by deploying senior management wisely, buying time, analyzing the activist's value-creation plan, seeking complete transparency, and being on high alert.

SHAREHOLDER ACTIVISM HAS COME of age. We know it when leading CFOs routinely confess that an activist threat is now what most keeps them awake at night. We know it when the list of companies under attack reads like a subset of the Dow Jones. We know it when the number of activist events at companies with a market capitalization of more than \$100 million grows nearly fourfold in three years. And we know it when nearly 400 hedge-fund managers, corporate attorneys, investment bankers, proxy advisors, and public relations representatives—along with CNBC—pack the ballroom of the Crowne Plaza Times Square Hotel to attend a conference on activist investing. (In 2013, just two years earlier, that same event—13D Monitor’s Active-Passive Investor Summit—was held in the gentlemanly atmosphere of New York’s University Club, with a much smaller audience.)

Activism used to be a dirty word, but not anymore. Today, activists regularly grace the covers and homepages of the major business press. Whereas once an institutional investor had to sneak out of the office to share an investment tip with an activist, today investors talk openly about potential targets in their investment portfolios—companies that might be prodded into a different business or financial strategy to get their stock moving again.

Activists are large—and, like their targets, are getting larger. Their influence is continuing to grow. Their critics (and targets) see only ruthlessness or rapaciousness; but it’s facile to view activists as hit-and-run artists out for their own gain. Their methods may be aggressive, but the ends they agitate for—more disciplined management, a sharper strategy, and a more rational portfolio—are generally legitimate. Regardless of their ownership stake, activists deserve to be taken seriously.

So how should companies navigate today’s more unforgiving capital-market landscape? By thinking like their challengers: scrutinizing every dollar to be spent, questioning each business’s fundamental role in the portfolio, and maximizing every dollar of cash they hold.

If an activist strikes, management and the board must give its proposal fair consideration: honestly evaluating the activist’s demands against the lens of maximizing total shareholder return (TSR), and determining which ones stand the best chance of maximizing value. It is, after all, their fiduciary duty to define the path that generates the most value for shareholders. Then they must calmly execute the plan that best integrates the goals of shareholder value and long-term business success.

Activists’ methods may be aggressive, but the ends they agitate for are generally legitimate.

The Activist Landscape: A Quick Scan

Since 2009, 15 percent of S&P 500 companies have faced an activist campaign, according to FactSet. Assets under management by activist fund managers soared from \$58 billion in 2007 to \$120 billion by 2014—an 11 percent annual growth rate.¹ Other sources put the current total closer to \$200 billion.²

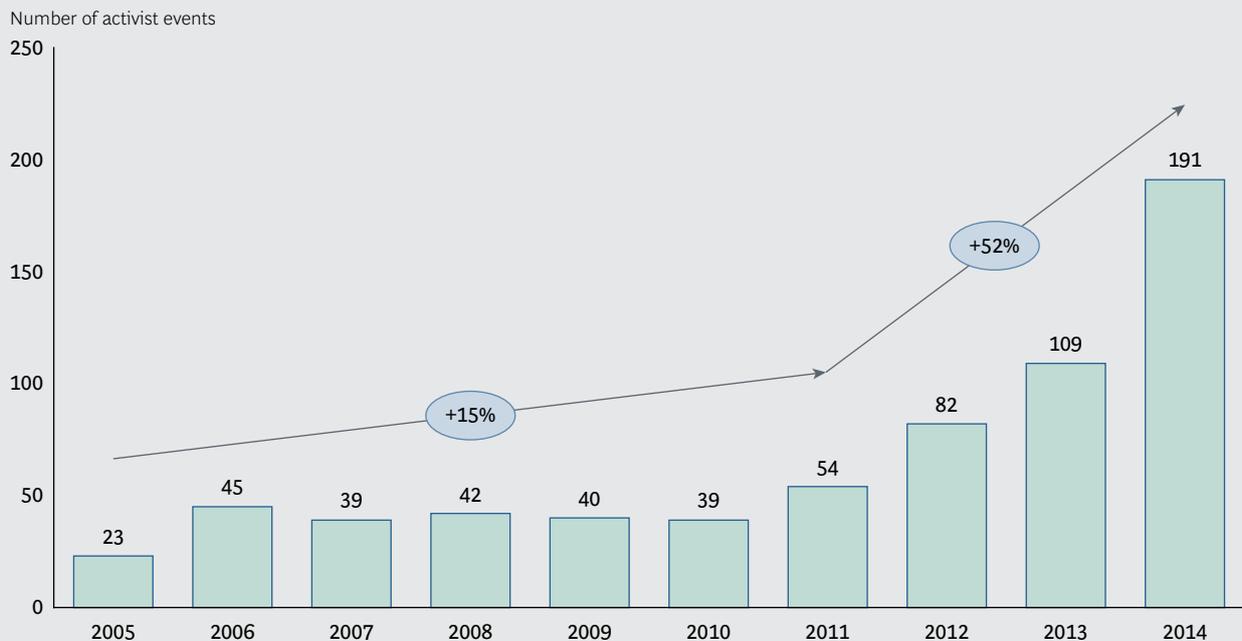
Even more striking is the recent surge in activist events involving companies with a market capitalization of more than \$100 million.³ Although activist events at such companies increased at a 15 percent annual rate from 2005 through 2011, they nearly quadrupled from 2011 through 2014, growing at a 52 percent CAGR. (See Exhibit 1.)

BIGGER TARGETS, SMALLER STAKES

The size of takeover targets has also spiked dramatically in recent years. The median market capitalization of target companies surged past the \$1 billion mark in 2012 and 2013, and since 2011 the top quartile has consistently comprised companies with more than \$2.5 billion in market capitalization—the highest value ever. (See Exhibit 2.)

At various points in recent years, the average target size in telecom services, energy, and consumer staples has exceeded \$50 billion; in technology and financial services, it has been between \$20 billion and \$30 billion. In the aggregate, the size of target companies contracted slightly in 2014, likely owing to the substantial uptick in overall activist events (as new funds pursue the classic smaller target set).

EXHIBIT 1 | Activist Events Have Been Increasing Rapidly

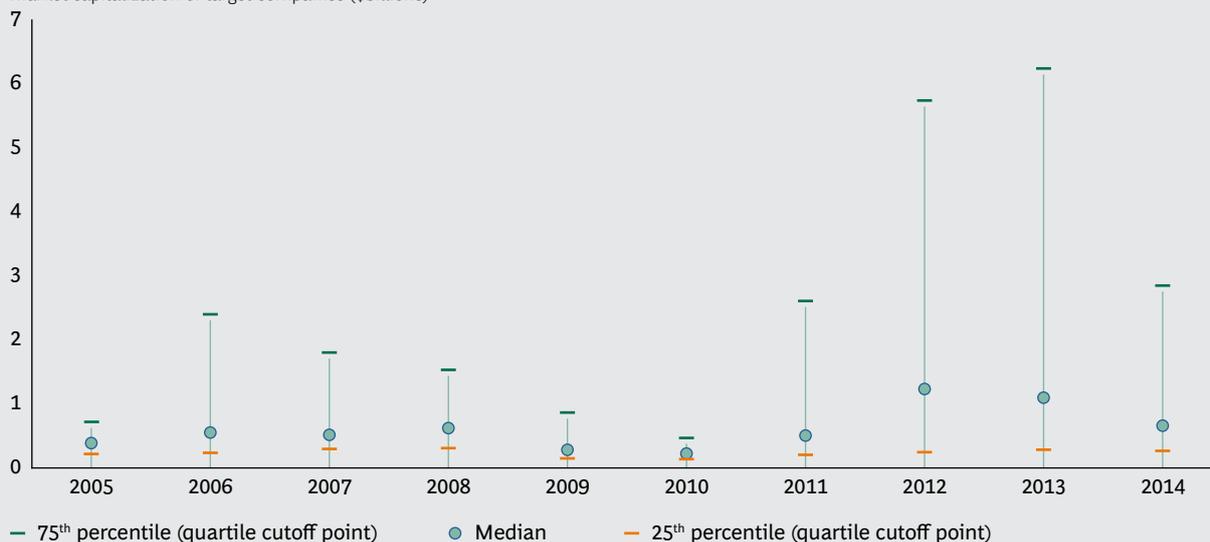


Sources: S&P Capital IQ; BCG ValueScience Center.

Note: The sample was limited to companies with \$100 million or more in market capitalization at the time of the activist event.

EXHIBIT 2 | The Size of Target Companies Has Increased Substantially in Recent Years

Market capitalization of target companies (\$billions)



Sources: S&P Capital IQ; BCG ValueScience Center.

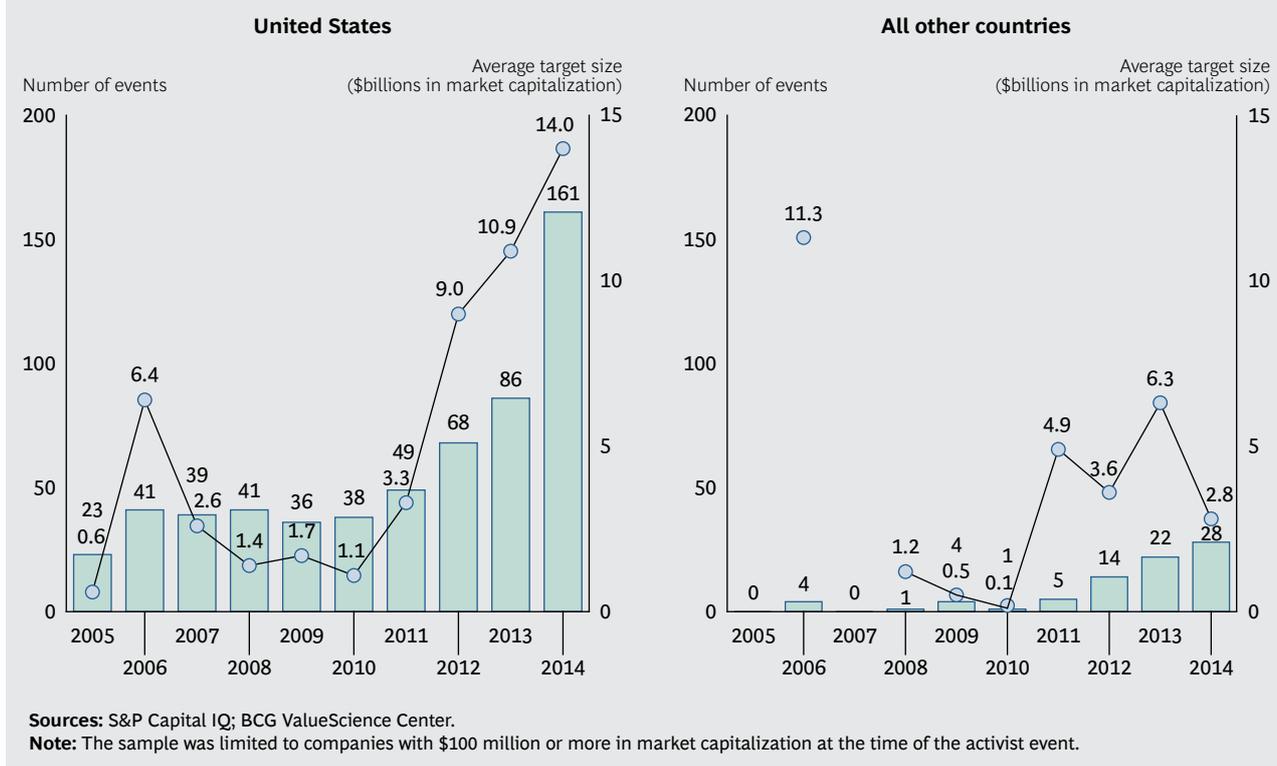
Note: The sample was limited to companies with \$100 million or more in market capitalization at the time of the activist event. The decline in the size of target companies in 2014 was likely due to the increased number of activist events; new funds typically pursue smaller targets.

Historically, most targets have been small. An activist could rapidly amass a 10 percent or greater stake in a target and credibly threaten to acquire a majority share. Today, in contrast, targets are the likes of Apple, Procter & Gamble, Sony, and PepsiCo. Even relatively healthy giants like DuPont are fair game. (Valued at \$68 billion, the 212-year-old industrial icon just narrowly won one of the biggest proxy battles in U.S. history.) Securities and Exchange Commission rules require a 13D filing when an investor acquires a 5 percent stake in order to publicly announce the investor's ownership and designs. But more and more investors are skirting that requirement by acquiring a smaller stake—sometimes just 1 or 2 percent. That's enough to have a voice, especially in this era of high-profile activists and ubiquitous investor-oriented media channels.

Interestingly, shareholder activism remains largely a U.S. game. Although activity has picked up in Canada and Europe, it started from a very small base. In 2014, there were only 28 events outside the U.S.—less than 20 percent of the number that occurred inside the U.S. (See Exhibit 3.) Pershing Square Capital Management's Bill Ackman noted that Europe's unique regulatory environment, with its minimum thresholds and worker protections—together with the burden of travel for U.S.-based activists—deter EU-directed activism.⁴

In addition, activists' success rates are at an all-time high. BCG analysis shows that in 2014 activists won or settled 84 percent of their campaigns—a rate not seen since 2005, when there were only one-eighth the number of events as there are today. Further, the average campaign lasted 92 days—by far the lowest on record. In previous years, campaigns ran from 148 to 239 days. (See Exhibit 4.) Shorter campaigns, we believe, are the result of increasingly sophisticated moves by activists, deliberate ef-

EXHIBIT 3 | Activism Remains Largely a U.S. Phenomenon



forts to resort to hostility only when necessary, and a trend among management (and advisors) to respect activists’ demands and engage with them earlier.

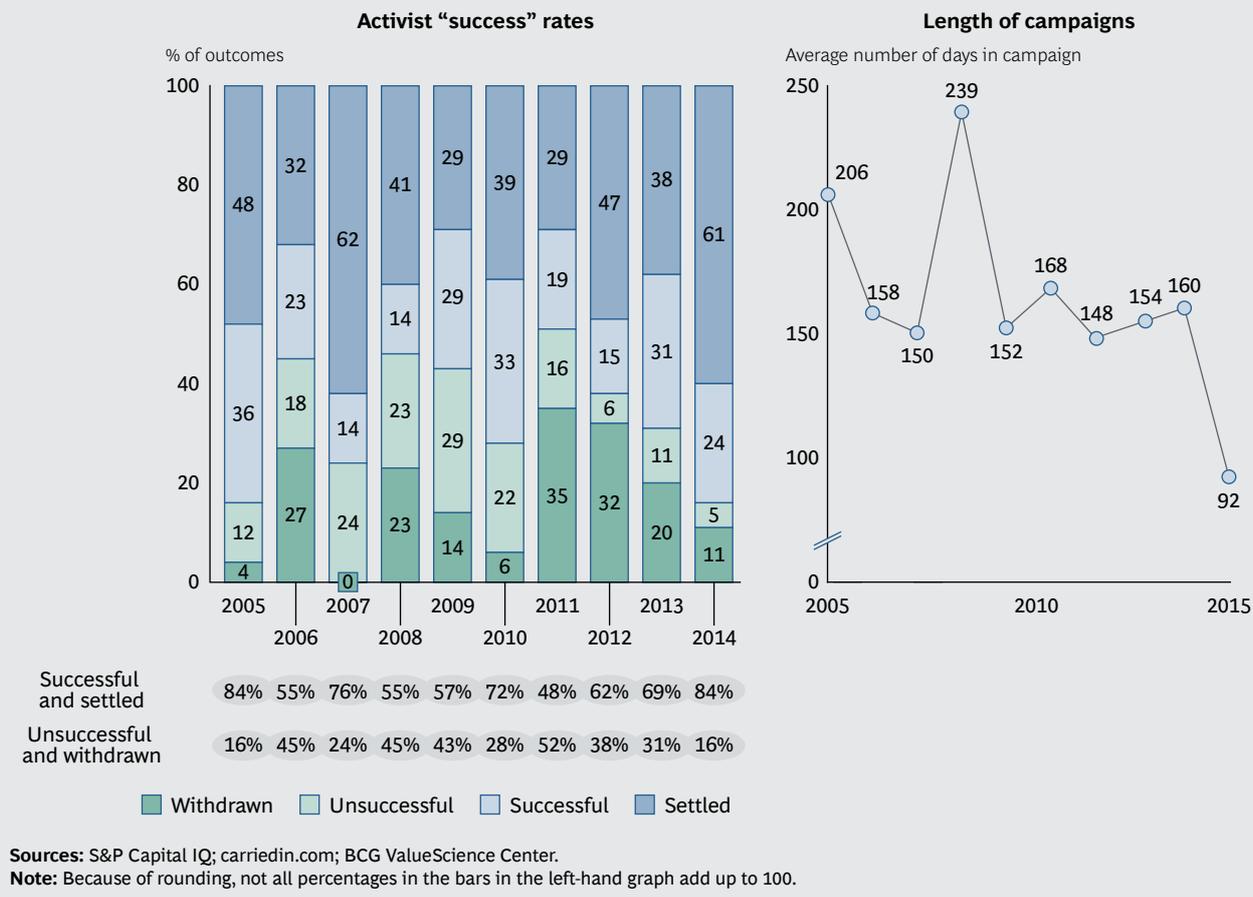
PASSING FAD OR PERMANENT FIXTURE?

Critics wonder whether the massive growth in activism will weaken the quality of campaigns. We believe otherwise. For one thing, institutional investors are backing some activists openly, and with greater frequency. For another, activists are getting better at targeting larger companies and are learning lessons from their high-stakes gambles. (Ackman’s failed attempt to take over Allergan, for example, has been studied exhaustively by other activists as they look for more creative ways to pursue targets.) Also, activists are increasingly developing simple but effective “industry playbooks” that enable them to roll through biotech, consumer and retail, and, most recently, mature technology.

The activist thesis typically revolves around one or more of six levers:

- *An M&A or a Breakup Move.* Some academic research suggests that transactions are the surest, and possibly the only reliable, means of fortifying shareholder returns in activist situations.
- *Financial Policies.* Activists look for companies with strong cash flows and excess cash, and urge them to return more of that cash to shareholders, through either share buybacks or dividends.

EXHIBIT 4 | Activists Are Winning More Contests—and Winning Them More Quickly



- **Capital Structure.** Activists often urge companies with little existing debt to take on more debt to fund alternative financial policies (such as a “levered repo”).
- **Capital Allocation.** Activists commonly seek to limit a company’s investment in mature businesses and, in some instances, to redirect spending in order to grow competitively advantaged businesses.
- **Governance.** Almost every activist campaign involves some element of governance, such as changing the board’s composition or reelection cycle, or modifying compensation and incentive systems.
- **Cost Cuts or Efficiency Measures.** Increasingly, activists are benchmarking companies against their competitors and using the comparisons to find apparent opportunities to reduce operational spending.

Preparedness and Response

The more that activism becomes a fixture on the corporate landscape, the more acutely companies need to be proactive about its imminence. When activists strike,

they have already formulated a plan they believe will generate the most value. But management is usually in reactive mode—unprepared to set the terms of the debate and without a plan that might generate as much value as, or more value than, the activists’.

BCG’s view of a proactive defense is “do it yourself activism”—an approach in which company leaders borrow from the activists’ playbook.

BCG’s view of a proactive defense can be summed up as “do it yourself activism”—an approach in which company leaders borrow from the activists’ playbook and scrutinize the company’s balance sheet, portfolio, and governance, and make needed changes preemptively. (See “Do It Yourself Activism,” BCG article, February 2014.) Arguably, this is the most critical stage. As one C-level executive who was victimized by an activist told us, “Once the activist is in, it’s already over.” In other words, an aggressive activist’s move can change the company irreparably.

Our experience advising companies through some of the most high-profile contests of the past five years has shown us that when an activist’s campaign becomes imminent or actually occurs, the company’s response must be firmly grounded in data, facts, and logic. It’s not easy for executives and boards to remain coolheaded as the headlines emerge on the front pages of the *New York Times* and the *Wall Street Journal*. But ignoring the activist’s demands, failing to evaluate them objectively, or simply being defensive does companies no good. Having inside information constitutes a big advantage.

For boards, which have a fiduciary duty to represent the company’s owners, these analytics can be indispensable. Board members can evaluate the various scenarios with the assumptions laid bare and decide for themselves which set of facts best predict company performance. With such analysis and scenarios in hand, boards can make more objective, informed decisions about the best course of action.

THE ELEMENTS OF A STRATEGIC RESPONSE

Traditionally in activist response situations, the advice that senior managers and board members get amounts to what we call a *tactical defense*: obtaining a fairness opinion of the company’s fundamental value, assessing legal and governance options, and working the public relations machine. But that’s not enough. We advise companies to engage further, in what we call a *strategic response*: mapping alternative future states of the company that could generate even more value than what the activist thesis proposes. To create a strategic response, companies should carry out one or more of the following actions.

Build a pressure-tested “momentum case.” Define how the company would perform if it grew with the market (that is, maintained its market share) and sustained existing margins in each of its businesses, regions, and channels. With no other moves, would the company be a top-quartile TSR performer? A bottom-quartile performer? Or something in between?²⁵ We believe this exercise is a critical step to establishing a logical foundation for the shareholder value outlook.

Rapidly evaluate strategic alternatives. Management should fully explore its corporate strategic options and then assess the future value of each one. These options might include M&A or divestitures, significant organic investments, cost cuts, alternative capital strategies, or transformational programs such as a pric-

ing-strategy or site-network redesign. By rapidly assessing each option and understanding the value it creates and the risk it entails over a given time period, management can effectively respond to the activist through a value-maximizing strategy, along with the appropriate facts to convey to investors.

Devise an appropriate “war plan.” Every management team comes to the investor community with a different level of credibility. Reputations should be taken into account in formulating the response to the activist. A management team with strong support from its top institutional investors (or, outside the U.S., from its local governing regime or regulators) can afford to issue a stronger response. One with a weak reputation or mediocre track record of delivering shareholder value may be forced to concede a good deal to the activist, regardless of how compelling its alternatives are.

Which response strategy a company adopts will depend on the imminence of the activist’s moves and the capabilities of the specific activist. (See the sidebar below.)

DEFENSE STRATEGIES

Contrasting Examples

Circumstances should dictate the approach and tenor of the response to an activist. The examples below illustrate how different successful defense strategies to two different types of challenges can be.

Constructive and Amenable. In early 2012, in response to an activist challenge, a large software company evaluated a variety of strategic options (including a margin program, large-scale M&A, aggressive investment in innovation, and a capital return play) to determine the optimal path to shareholder value creation. Although time-sensitive, the discussions with the activist didn’t threaten an immediate proxy battle. BCG assessed the company’s theoretical optimum as well as its risk-return trade-offs. Discussions with the activist were largely constructive; the path forward, which included a mix of the strategic options, was welcomed by the market; and by late 2012, the stock was outperforming its peers

and the activist had sold off more than 50 percent of its stake. Today, the activist has fully exited its position.

Sudden and Hostile. In 2014, a biopharma company faced a hostile threat. BCG helped management rapidly define a strategic alternative to the activist’s proposal, including a cost-out program that would have reduced selling, general, and administrative expenses by about 15 percent. Typically, activist proposals feature similar promises based on outside-in estimates and benchmarking. In this case, the plan specified exactly which expense categories would be reduced. It was also backed by a comprehensive change-management program designed to earn buy-in from leaders throughout the organization. Supported by smart legal and other tactical defensive measures, the plan helped management buy time with investors and ultimately helped the company fend off the attack.

FIVE GUIDING PRINCIPLES

From our experience counseling companies in a variety of activist situations and our deep knowledge of most major activists, we have identified five guiding principles that companies can follow to fortify their position and reassure shareholders.

- *Deploy senior management wisely.* The roles of the senior management team are critical during the activist response. Companies need to maintain focus on their core operations. But they also must engage in tactical defense and have frequent, effective communication with their board and shareholders.
- *Buy time.* At a minimum, management should send a clear (and immediate) signal that it is listening to the activist and trying to act in the best interest of all shareholders. In some situations, management might need to go further and implement legal tactics to stave off a shareholder vote until the right strategic alternative can be found. Either way, it must create enough breathing room to evaluate the options and pursue the best one.
- *Analyze the activist's value-creation plan, item by item.* Management needs to fully digest the activist's proposal—and be prepared to respond with the same, if not a greater, level of detail and analysis.
- *Push for complete transparency.* Investors must be able to trust management in order to support management. While it is tempting to present a rosy story to investors and ignore the challenges the business faces, it is far better to opt for candor. For example, management should acknowledge performance gaps and articulate the specific initiatives or investments that will help address them.
- *Be on high alert.* Increasingly, activists seem willing to negotiate behind the scenes and maintain a public posture of respect for management. Still, management needs to remember that things can quickly turn ugly. Triun Partners publicly criticized DuPont CEO Ellen Kullman for selling stock. Third Point revealed that Yahoo! CEO Scott Thompson falsified part of his résumé, which led to his dismissal. Every move should be made with the understanding that it will be examined under the public microscope.

Companies need to assess their businesses from the activist's point of view and engage in strategic defense if an activist comes knocking.

Companies must remember that every activist campaign begins with the end point in mind. Activists plan out the time and capital investment required for a full proxy fight in order to achieve their aims. As JANA Partners' Barry Rosenstein once warned, "You're stuck with us. If we don't succeed this year, we'll be back next year." In a contest, both sides are negotiating on the basis of would-be shareholder votes: which argument would sway shareholder support in the event the fight played out to its natural conclusion? Although in reality only a small proportion of the contests get that far, management teams must be prepared for the possibility.

Activist investors will no doubt wield even more muscle in the years to come: directly, in their campaigns, and indirectly, in the preemptive actions they force out of potential targets. Companies would be well advised to be on guard in the new era of shareholder activism. They need to assess their businesses from the activist's point of view—with the same level of stringency—and to engage in strategic de-

fense if an activist comes knocking. Ultimately, this is the best way to fulfill their responsibility of delivering maximum value to shareholders.

NOTES

1. "An Investor Calls," *Economist*, February 7, 2015.
2. The precise total depends to some extent on how *activism* is defined; the higher estimates include many traditionally passive investors who have become much bolder and more vocal in their demands.
3. While many sources include in their data any instances of activism, regardless of target size, we have eliminated from our sample both nano-caps and microcaps with \$100 million or less in capitalization.
4. From comments delivered in a presentation at 13D Monitor's Active-Passive Investor Summit at the Crowne Plaza Times Square Hotel, New York, April 13, 2015.
5. We believe that this approach should be part of any effort to develop corporate strategy and boost shareholder value. In most activist situations, the time frame is compressed substantially and the stakes are obviously much higher.

About the Authors

Jody Foldesy is a partner and managing director in the Los Angeles office of The Boston Consulting Group and the global leader of the firm's shareholder activism topic area. You may contact him by e-mail at foldesy.jody@bcg.com.

Gerry Hansell is a senior partner and managing director in BCG's Chicago office. You may contact him by e-mail at hansell.gerry@bcg.com.

Daniel Friedman is a senior partner and managing director in the firm's Los Angeles office. You may contact him by e-mail at friedman.daniel@bcg.com.

Joel Janda is a partner and managing director in BCG's Seattle office. You may contact him by e-mail at janda.joel@bcg.com.

Jeff Kotzen is a senior partner and managing director in the firm's New Jersey office. You may contact him by e-mail at kotzen.jeff@bcg.com.

Tawfik Hammoud is a senior partner and managing director in BCG's Toronto office. You may contact him by e-mail at hammoud.tawfik@bcg.com.

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For Further Contact

For more information about this report, please contact one of the authors.

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