How to Outsmart Activist Investors

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By Bill George and Jay W. Lorsch
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In July 2013 the activist investor Nelson Peltz called PepsiCo's chair and CEO, Indra Nooyi, to tell her that his Trian Fund Management had accumulated a more than $1.3 billion stake in her company. He demanded that PepsiCo acquire Mondelēz International, the former Kraft snacks business (in which Peltz owned a $1 billion stake), and then split PepsiCo into two entities, one focused on beverages and the other on food.

Peltz had staged a similar intervention at Kraft, where he pushed CEO Irene Rosenfeld to acquire Cadbury Schweppes and then split the combined company into a global snacks business (Mondelēz) and a U.S. grocery one (Kraft). Mondelēz had struggled, however, to compete with global giants such as Nestlé and Unilever. Hence Peltz's PepsiCo plan.

It was an audacious, even shocking, proposal, but it's the kind of thing that happens often these days. Since the start of the 21st century, a new breed of shareholder—the activist hedge fund—has frequently played a decisive role in interactions between corporations and markets. These activists build on past efforts: Their interest in governance changes such as eliminating staggered boards and poison pills follows similar efforts by public-employee and union pension funds since the 1990s. Their focus on getting companies to take on more debt and pay out more to shareholders recalls the corporate raiders of the 1980s. In fact, a few of the most prominent activists, including Peltz and Carl Icahn, are former corporate raiders.

The new activists have dramatically upped the pressure on corporate executives and boards. Nearly every business day they target another company: More than 200 activist campaigns were launched in 2013, according to the law firm Wachtell, Lipton, Rosen & Katz, and assets under management at activist funds were up more than 50%. Although the value of those funds was estimated at $100 billion—a mere fraction of 1% of the total stock market value of American corporations—the activists' leverage and impact far exceed the dollars they invest.

Their game is simple: They buy stocks they view as undervalued and pressure management to do things they believe will raise the value, such as giving more cash back to shareholders or shedding divisions that they think are driving down the stock price. With increasing frequency they get deeply involved in governance—demanding board seats, replacing CEOs, and advocating specific business strategies. Multiple studies have shown that activism succeeds in raising share prices, at least temporarily. A major recent study by Lucian Bebchuk, Alon Brav, and Wei Jiang of activist investments from 1994 through 2007 also found five-year improvements in the operating performance of targeted companies.

We remain unconvinced, however, that hedge fund activism is a positive trend for U.S. corporations and the economy; in fact, we find that it reinforces short-termism and excessive attention to financial metrics. But because activists—and the institutional investors who often follow their lead—are generating positive returns, there is likely to be more rather than less of it

in the future. In the interest of their corporations, CEOs and boards should be preparing for activist interventions rather than complaining about them.

Indra Nooyi and PepsiCo's board were prepared for Nelson Peltz's onslaught. As we describe below, they had in place a strategic plan that seemed far better attuned to changing market realities than Peltz's simplistic split-snacks-from-drinks proposal. Have a clear strategic focus and stick to it—that is one of six ways we've identified in which top management and boards can fend off activist challenges or sometimes even use them to improve their organizations.

Have a Clear Strategic Focus and Stick to It

When she became PepsiCo's CEO, in 2006, Nooyi recognized that long-term trends, such as the global rise in obesity and Type 2 diabetes, would shift consumer demand toward more healthful foods and beverages and eventually slow the growth of PepsiCo's core business in soft drinks and snacks. In response she devised Performance with Purpose, a strategy targeting three growth areas: (1) "good for you" products, including Quaker Oats and Gatorade; (2) product innovations; and (3) emerging markets. Part of the idea was to fund the substantial investments—including acquisitions—required to build these categories with the cash flow from PepsiCo's core business. PepsiCo did precisely that, acquiring a number of food and beverage companies in emerging economies such as Brazil, India, Russia, and Ukraine.

A major transformation like that can put pressure on management and the board, because results typically take five to 10 years to be realized. As Nooyi's predecessor, Steve Reinemund, has put it, "Major change is never applauded until your numbers prove it." In 2010 PepsiCo hit some bumps when Coke gained share on its soft drinks and Diet Coke overtook Pepsi-Cola as the second-best-selling soft drink in the world. PepsiCo shares declined by 4%, while Coca-Cola's rose by 40%, causing shareholders to criticize Nooyi for failing to invest sufficiently in soft drinks. With her board's support, Nooyi addressed those issues by making some key management changes, but she stayed with her strategic shift. Over the past two years PepsiCo has achieved solid growth in all categories and significantly outperformed Coca-Cola on the stock market. In 2013 PepsiCo's revenue and earnings per share rose by 1% and 10%, respectively, while Coca-Cola's revenue and EPS declined by 2% and 3%.

With a focused strategy that was paying dividends, Nooyi and PepsiCo's board could comfortably reject proposals from Peltz. "PepsiCo as a portfolio is working so well right now," CFO Hugh Johnston said in the summer of 2013. "The complexity of taking on an $80 billion acquisition [Mondelēz]...will distract the business from...creating a lot of value for shareholders." Apparently most of the company's shareholders agreed. Peltz hasn't given up, but when this article went to press, he still hadn't made visible headway.

Analyze Your Business as an Activist Would

CEOs need to ensure that their boards understand the tactics of activist investors and have a game plan for responding. That means analyzing both how the activists might try to increase short-term shareholder value—through spin-offs and divestitures or financial engineering such as stock buybacks and increased debt—and the company's possible vulnerabilities in strategy and capital structure. Specific examples from other companies can help. The changes activists want

generally involve increasing risk in the pursuit of higher returns, but that's not always a bad thing. If a company can do that without jeopardizing corporate strategy, it should move before an activist forces it to.

The Swiss health care company Novartis is in the midst of just such an analysis, initiated by its new chairman, Joerg Reinhardt. CEO Joseph Jimenez said in the company's 2013 third-quarter earnings call that the review is aimed at creating businesses with the scale to compete globally. Three of Novartis's businesses—pharmaceuticals, eye care, and generics—generate revenue of at least $10 billion a year and are ranked first or second in their respective markets. The company's three smaller businesses—vaccines and diagnostics, over-the-counter medicines, and animal health—don't pass that test. Consequently, to reduce the likelihood of an activist intervention, Novartis may consider augmenting them through acquisition or selling some of them.

All multibusiness companies should take this approach to determine whether the corporate strategy adds value to individual business units. The analysis must be rigorous to ensure that management is sufficiently objective about synergies and value added. In 2004 Target Corporation, long one of the nation's best-run retailers, undertook a similar analysis of its three retail arms—Dayton-Hudson, Mervyn's, and Target. Concluding that synergies were limited and that the real growth potential lay with Target, it divested the other two arms.

Have Your External Advisers Lined Up in Advance and Familiar with Your Company

In 2007 and 2008 Bill Ackman's Pershing Square hedge fund loaded up on shares of Target as the company struggled with declining same-store sales during the recession. Initially Ackman focused on persuading the Target board to spin off its credit card operations. The board resisted because of the significant benefits of using its own card to incentivize and reward customers; eventually it agreed to sell 47% of the business to JPMorgan Chase. When Ackman insisted that Target divest the remaining 53%, the board refused.

Next Ackman proposed that Target separate its real estate operations, which own most of its 680 stores, and put them into a real estate investment trust (REIT). Target's board and management concluded that doing so would mean losing control over its store properties, facing escalating operating costs to lease the stores back from the REIT, and taking on too much leverage with the REIT, so they again rejected Ackman's demands.

Ackman then launched a proxy fight to replace long-standing board members with himself and four other directors of his choice. He appeared almost daily on CNBC to take his case directly to investors. Target's board and management fought back, meeting directly with major shareholders. Ultimately, Target's directors won more than 73% of the votes cast at the 2008 annual meeting, and Ackman sold the bulk of his Target shares shortly thereafter.

To be prepared for such challenges, both management and the board must have external advisers whose guidance they can rely on. Target had been working with the same financial adviser, Goldman Sachs, and external legal counsel, Wachtell, Lipton, since a thwarted takeover attempt by J.C. Penney in 1996; those advisers had been engaged when Target spun off Dayton-Hudson and Mervyn's. They were well acquainted with the company and had gained the trust of its board. Thus Target could feel confident that it was on a sound strategic course and justified in

denying Ackman's demands, and that management and the board could prevail in the proxy fight.

Build Board Chemistry

Activist investors are often out to divide a target company's board. To address the issues they raise in an objective and constructive manner, directors need the unity that comes from years of building board chemistry. That chemistry is enhanced through repeated engagement on important issues, weathering crises together, and candid dialogue with the CEO. The latter requires a high degree of transparency from the CEO and a willingness to share even the most sensitive information involved in decision making. To cope with an activist's challenges, directors must be fully committed to the company and its long-term objectives.

Just such board commitment, chemistry, and communication with the CEO enabled Whole Foods Market (WFM) to survive a perfect storm of business troubles, bad publicity, and hedge fund activism in 2008 and 2009. Since its 1978 inception as a single natural foods store in Austin, Texas, Whole Foods had grown rapidly, its same-store sales ever increasing as it evolved into a full-scale supermarket chain concentrating on healthful foods. With little previous business experience, WFM's cofounder John Mackey had established a board composed of retailing veterans and knowledgeable financial investors with stakes in the company. Board chemistry developed as they advised Mackey on how to build the Whole Foods franchise.

After three decades of almost unbroken success, the 2008 recession, coupled with customer perceptions that Whole Foods was high-priced, slowed the company's same-store sales growth by three or four percentage points. WFM had also been criticized in Michael Pollan's best-selling guide to sustainable eating, The Omnivore's Dilemma(2006). Just as Whole Foods was trying to get Federal Trade Commission approval for its acquisition of Wild Oats, a smaller grocery chain, it came to light that Mackey had pseudonymously disparaged Wild Oats in postings on the internet. Between January 2006 and November 2008, WFM stock dropped by 90%. At that time the company brought in a friendly outside investor, Leonard Green & Partners.

Seeing the dramatic fall in stock price, the activist investor Ron Burkle bought 9.8 million shares (7% of the total) and put pressure on the Whole Foods board to increase near-term earnings by slowing growth. But the board did not flinch; it united behind Mackey and WFM's mission and values and rejected Burkle's demands. It did, however, make several changes. Mackey stepped down as chairman but retained the title of CEO, and the following year Walter Robb became his co-CEO.

Whole Foods' directors were able to resist Burkle's challenges in part because of their unity and chemistry and the constructive actions they took. The company appears to be better off as a result: In the past four years, same-store sales have increased annually by high single digits, revenue has grown by 50%, and earnings per share have tripled. WFM stock hit a new all-time high last fall, having risen 750% since these changes were made.

Perform in the Short Run Against Declared Goals

Ultimately, the best defense against an activist investor is consistent performance that realizes the company's stated goals; anything else makes the company vulnerable. J.C. Penney's mediocre performance under CEO Myron "Mike" Ullman—its stock declined by 65% from 2007 to 2010—encouraged Bill Ackman to buy a significant position in the company. Consequently, the board agreed to Ackman's demand for a change in management, which led to an even worse situation. But the company would never have attracted that kind of outside attention had it continued to perform.

The Procter & Gamble board's decision in May 2013 to replace CEO Bob McDonald was also triggered by challenges from Ackman, which included a detailed report on how P&G could accelerate its earnings. P&G was vulnerable because of lackluster performance under McDonald from 2009 through 2012, a period during which the company frequently changed its strategic course in hopes of stimulating revenue growth. Although McDonald boosted P&G stock in 2012 with a $10 billion cost reduction plan, the board decided to replace him with former CEO A.G. Lafley. Had P&G pursued a more aggressive transformation soon after McDonald took over, as Unilever has done under Paul Polman, that change might not have been made.

These examples, and many others like them, demonstrate the importance of solid performance. At the same time, it's crucial to set realistic expectations. Many corporations trip up by publicly announcing overly ambitious goals or giving aggressive guidance to the market. In today's environment, companies and boards would be well advised to consider either skipping earnings guidance altogether or giving it with a range of outcomes that take into account the uncertainties they face.

Don't Dismiss Activist Ideas Out of Hand

Most activist investors are smart, motivated people who often notice things that boards and managers overlook. It is generally worth listening to their recommendations and implementing the ones that make sense. For example, in December 2006 Ralph Whitworth, of Relational Investors, learned about the AFL-CIO's campaign against the big paychecks Home Depot CEO Robert Nardelli was getting despite the company's poor performance. Whitworth asked his staff to examine Home Depot as a possible target. Its analysis uncovered an accounting error in the company's 10-K and a low return on assets at Home Depot's new wholesale division.

Relational Investors then took a small stake in Home Depot and wrote a letter to the board of directors asking for an opportunity to explain its findings. The board met with Whitworth and was stunned to learn that the accounting error had resulted in the company's reporting twice its actual return on invested capital. These events led to Nardelli's departure shortly thereafter, and Whitworth's longtime colleague David Batchelder was named to the board. Home Depot subsequently embraced several changes Whitworth had recommended, including focusing on its core retail business, establishing sounder capital-allocation processes and disciplines, and making its business strategy more transparent to investors.

Under its new CEO, Frank Blake, Home Depot exited the wholesale business in June 2007, revitalized customer service, and initiated a $22.5 billion stock buyback program. Since Blake

took over, the company's stock has doubled. The lesson here is that sometimes activists have good ideas, and boards should take the time to understand what is being proposed.

Doing What's Best for All Your Shareholders

One of a board's most important roles is to ensure that the company stays true to the mission and values that have made it successful. In recent years several activist fund managers with no industry experience have come to corporations with proposals for radical, unproven course changes. Sometimes major changes areneeded, but companies that allow outside activists to implement them without full and careful consideration risk losing the commitment and engagement of their employees and customers.

That is what happened at J.C. Penney when Ackman effectively took it over in 2010. He had no experience in managing retail businesses but elaborate plans for revolutionizing and revitalizing this one. First he replaced Ullman as CEO with Ron Johnson, Apple's senior vice president of retailing operations. Then he and Johnson changed Penney's pricing model, eliminating coupons and large markdowns. The results were disastrous for sales and profits and for Ackman's investment, which declined by almost $500 million. Now Ullman is back in charge of a much-diminished company.

Similarly, the hedge fund manager Edward Lampert took over Sears in 2005 and made major changes. After merging the company with Kmart, Lampert cycled through four CEOs, none of whom had retail experience. He split Sears into more than 30 business units, each with its own president, board, and profit-and-loss statement, on the theory that this would promote accountability. Instead it brought chaos, as units competed against one another for company funds and other resources. In January 2013 Lampert made himself CEO, causing Forbesto label him the third-worst "CEO screw-up" of 2013, just below Ron Johnson. (The Brazilian billionaire turned millionaire Eike Batista, of EBX Group, took first place.) Activist investors are very smart people, but they rarely have the experience and wisdom to run large corporations, as these examples illustrate.

Because the activists usually cash out their holdings shortly after their demands are accepted or rejected, the question remains whether most of them are committed to companies' future success. The risk is significant that their initiatives can weaken a company's competitive position, to the detriment of long-term shareholders, and the high-leverage financing structures they often propose may put companies in jeopardy in the event of an economic downturn.

The new activists are not going away anytime soon. No doubt they will play an integral part in the stock market for years to come. As illustrated by the recent experiences of Procter & Gamble with Ackman and Apple with first David Einhorn's Greenlight Capital and then Carl Icahn, no company should feel immune to their challenges.

Boards and management teams are better able to handle these challenges if they have prepared for them. Recently Warren Buffett offered some sage advice on the subject. "I believe in running the company for shareholders that are going to stay," he said, "rather than the ones that are going to leave." When approached by an activist investor, directors should remember their fiduciary

duty to the company and allits shareholders—not just the most meddlesome ones—and work to ensure the long-term viability of the company's mission and strategy.