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How to Think Like an Activist Investor

Too often, boards realize too late that the battle for their company has already begun—and they are ill-prepared and outflanked.

By Darren Novak, Joel M. Koblentz, and Patrick R. Dailey

Those who skillfully leverage pools of capital and shareholder influence are redefining the dynamics of board governance. Chief among these groups are activist investors, adroit disruptors that pursue short- to medium-term returns—and they are screening companies like yours.

Boards oftentimes realize too late that the battle for their company has already begun, and not only are they outflanked, but they are not prepared to respond. Boards frequently fail to scrutinize their company the same way an activist does.

So, how do you as a director think more like an activist investor? Our recommendations will enhance your readiness, help protect your reputation, and better represent the interests of your shareholders.

What Attracts an Activist?

Activists focus on three primary factors: value, variety, and vote. When these three factors align, an activist has identified a target.

■ **Value.** Valuation is the most fundamental component for identifying a target. Is a company trading at a price less than the company's intrinsic value? Activists look at tried-and-true valuation metrics to identify companies that appear to be undervalued. In particular, they screen for:

Trading multiples. Companies whose trading multiples are outliers on an absolute and relative basis.

Share price performance. If a company's total shareholder return (TSR) is below applicable market indices or that of its industry peers, this is a clear sign of vulnerability to an activist. Furthermore, TSR is fundamental to Institutional Shareholder Services' (ISS) analysis in determining whether change is warranted in contested director elections.

Liquidity. Activists target companies not only with large balances of unrestricted cash but also with debt capacity. A company with limited cash may still be an attractive target if that company can support additional debt.

Operating metrics. Cash flow profile is perhaps the most popular operating metric that activists analyze. Companies that generate strong cash flows but are undervalued by the market represent attractive opportunities, as they provide downside protection for activists. Operating metrics that indicate a company is lagging behind its peers are important factors. Selling, general, and administrative expense levels that exceed that of peers can also be red flags for activists.

Hidden assets. The market often does not value certain company assets unless the asset is specifically highlighted. These "hidden assets" include material levels of owned real estate and non-core investments.

Sum of the parts. If a company has a number of business divisions, a sum-of-the-parts analysis may show greater value if these businesses are valued separately by the public markets (through a spin-off) or private markets (through a sale). The public markets may not appreciate the revenue and cost synergies associated with different business units, and the sum-of-the-parts analysis may lead to a significant unlocking of value for shareholders.

Board and management. Activists spend a great deal of time reviewing the composition and competency of boards and management teams. Activists will use any perceived weaknesses in boards and management teams to increase pressure on companies for change. While perceived weaknesses alone will not make a company a target, such factors will make a company more appealing if the financial factors are also in place.

Governance. Activists focus on reviewing the governance structures of companies; however, governance alone rarely makes a company a target.

- **Variety.** Activists generally seek potential targets where a number of levers can be pulled to potentially enhance shareholder value. A target is a higher-risk investment for an activist if there is only one path to unlock value, such as selling the company. This, however, is not always the case for activists targeting mid- or small-cap companies. In many of these situations, the activist is purely seeking a sale of the company, and historically, this platform has been highly successful.

- **Vote.** It don't mean a thing if you ain't got that vote. A company may have all the attributes an activist finds attractive from a value and variety perspective, but if the shareholder base appears difficult to persuade, an activist will pass. Activists need to feel confident that if they proceed to a shareholder vote to effect change, they will be able to win. Activists analyze the voting records of shareholders to gauge receptivity to a campaign. They frequently take the temperature of key shareholders prior to making an investment in a company, as well, and these early conversations can give them a distinct advantage over a company.

Not surprisingly, activists rarely pursue campaigns where insiders control a material stake. But the playing field is changing, with an increasing number of campaigns against companies with insiders controlling 20 percent to 35 percent of outstanding shares.

Activists will aggressively push for their change agenda from the outset.

The Activist Attack Plan

While each campaign has its own attributes, activists traditionally employ the following tactics:

Quietly build ownership in a target company. Activists generally use relatively small ownership positions—say, 2 percent to less than 10 percent—as their bully pulpit to gain attention and promote their change agenda. In contrast, private equity investors typically seek major controlling ownership positions to initiate change. From this small ownership position, the activist intent is to make a compelling case for change to drive up the share price.

Reach out privately and with a soft touch. Activists initially reach out to the company typically through an existing contact, the CEO, the chair, or the investor relations department. That initial contact sets up a meeting to discuss their concerns and how they think management should approach the company's issues. During this stage, the activist is assessing whether the company's leadership is listening or avoiding dialogue. Resistance to having an initial conversation will be noted and used to the activist's advantage in the future, and will be expressed publicly. It is critical that companies are in listening mode during these discussions.

Any defensiveness will be noted and used against the company. These initial meetings are not the platform for the company to provide plans, but to hear the activist and offer information in terms of their own diligence. It is, however, legitimate for your company's leadership to probe specific changes the activist recommends. This is not the time to be bashful.

It is important that management fully appreciate what the activist is demanding. This is where experienced external advisors can assist companies in clarifying the risks and opportunities from both a tactical and a financial perspective. If the activist does not elaborate on their demands, companies must take particular caution.

At this stage, your largest shareholders have already been contacted and vetted. Activists have tallied an anticipatory vote count, if it comes down to a proxy battle.

Push for agreement of their change agenda at any time. Activists will aggressively push for their change agenda from the outset. Their analytic and investigative homework on your company will be completed well in advance of their initial call. The activist team may have invested six months or more in research, "stealth" site or customer visits, investor consultation, and financial analysis to learn your company. They arrive with a solid change plan and want you to adopt it.

Go public, but stop short of a proxy fight. If private negotiations hit a wall, activists, thinking that the target company is not listening, is responding too slowly, or is not responding at all, will go public with their demands.

Activist investors are not compensated by their own investors for proxy contest wins, only for pure investment return. Prior to a true solicitation for proxies, activists will work to convince the target company to accept its change plan.

Increase pressure as major company deadlines approach. Remember that an activist's investment timeline, while not necessarily short term, is not infinite. As the deadline for nominating directors looms, an activist is likely to increase pressure on the company. Companies can respond by doing some serious homework on the activist's plans. The board, together with its financial, communication, and other advisors, can review the activist's plans in detail, with a promise that they will respond to the activist once they've had an opportunity to review. The activist is forced to abide, assuming that the review is not simply window dressing.

Ramp up the pressure on the company and launch a proxy fight. Activists become hostile when negotiations don't go their way. They make their criticisms known to all of the company's stakeholders: shareholders, directors, management, employees, customers, vendors, prospective acquisition targets, and the broader investment community. At this point, the company is on the defensive and must regain shareholder confidence.

Release detailed white papers. In these reports, activists enumerate what they see as the failures of the company, their plans to create shareholder value, and their proposed slate of directors to effect their plan. They have the upper hand in this stage. They typically come out first, as most companies are not prepared. Activists are not beholden to Regulation Fair Disclosure, nor are they saddled by the need to ensure that customers, suppliers, and employees remain committed to the company's plan. Activist investors also typically have a view of valuation and how that value can be extracted. At this point, it all comes down to votes or a settlement.

Win or go home. In the majority of situations where an activist goes public, they win something, such as representation on the board. But if the campaign fails, the activist will quietly sell down their position and generally move on.

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The Battle to Govern Value

Activists and institutional investors are battling to govern boardrooms. Based on interviews with investors, there is a general concern that boards aren't as sensitive to shareholder concerns as investors expect them to be. Accordingly, the heat is on boards to be less insular and more respectful of investor concerns.

However, an activist's area of influence extends well beyond balance sheets and operating structures. Activists are playing increasingly important roles in selecting company leadership. In 2013, activists were elected to 39 boards, and nearly half of those companies changed their CEOs within the next year or so, exceeding the average time turnover of CEOs. This trend is expected to accelerate.

With that in mind, here are six recommendations for directors to better prepare for an activist engagement.

1. Monitor financial metrics differently. Discipline your board to think like outsiders. Build a new analytic dashboard using the metrics within the three assessment categories: value, variety, and vote. Fully understand which metrics are significant influencers to value accretion. Consider the insights of outsiders that analyze and evaluate your company. Ferret out the potential disruptors, scan the environment for opportunities, and continually assess strategic options. Expect sitting directors to offer an articulate outsider's perspective during board discussion.

In sum, fully comprehend value drivers from your company's detailed strategy, structure, and whether the board possesses talent to deliver sustainable, superior results. In a 2013 study of global directors by McKinsey, only 33 percent of directors self-reported that they understood the strategy of the company they govern. While this may be shocking to some, it suggests an opportunity for directors to deeply engage in knowing more about how value is, and will be, created while observing the old axiom: "Nose in. Fingers out."

2. Identify talent gaps. Your board may need refreshment. Closing director talent gaps is never easy, but it is necessary as your board faces a future with differing value dynamics. It is important to know the qualities and contributory requirements that directors must possess to close the gap between today and the pursuit of future value. Know what elements must be considered strategically and governed (more than compliance and risk).

Simply stated, govern the change agenda effectively or be replaced. Given the dynamics of boards, a change in directors can bring new thoughts, experiences, and insights to deal with the unchartered and uncertainties of evolving global challenges.

Develop a board-managed process to evaluate board leadership, board composition, and individual director competency so that board succession is a continuous event rather a periodic episode. Inform every director that board refreshment is in the best interest of effective governance and less about old relationship ties and personal feelings.

3. Prepare your leadership team for the future. Install a rigorous approach for monitoring CEO effectiveness as well as scenario planning for long-term CEO succession. Reporting, updating, and discussing effectiveness and succession should be a regular part of your board meeting agenda.

4. Engage with major shareholders differently. Develop a coherent shareholder communication strategy and a rigorous process to monitor its effectiveness. Designate a director as the lead facilitator (not necessarily the spokesperson) who is responsible for the quality and frequency of shareholder interfaces, including huddles with institutional holders, conferences, and specialized investor relations.

Given the increasing impact of activism on moving share price, consider engaging professional advice for presenting your case without breaching director fiduciary responsibilities. For some, a separate shareholder communications committee may be necessary.

5. Have your external advisors already lined up. Preparation is an essential element of board governance. It's too late to "shop" for advisors when an activist calls or a crisis hits. Have an inner circle of legal, investment banking, communication, and board advisors lined up and kept current on governance challenges and integrate their advice into board decisions. To enhance effectiveness, assure that "all" of your advisors know one another and their roles to avoid confusion when they are called into action and must collaborate.

6. Be prepared to respond quickly. Your board should never be surprised by a 13D filing. Too many signs and signals are easily detectable. But it takes vigilance and a proactive board culture to think like an activist investor.

Shareholders are demanding more from boards. Directors are expected to be out front on strategic matters, reading the faint signals of the "unknowns," and the approaching disruptors. They expect you to constantly re-earn their trust.

Engage differently. Move quickly. Act prudently. Think like an activist. D

Darren Novak is a senior member of Houlihan Lokey's activist situations team. Joel M. Koblentz is the founder of The Koblentz Group. Patrick R. Dailey is a member of RHR International's Board Services Practice.

Activist Attack Tactics

- Releasing aggressive public statements on company operations
- Fixing blame for shortfall in company performance
- "White paper" critical of company strategy and performance supported by the activists recommendations for unlocking hidden value
- Precatory proxy resolution for undertaking a strategic review of the business
- Launching public relations and social media campaigns for change
- Highlighting perceived corporate social responsibility (CSR) shortfalls
- Criticizing the company's capital return practices
- Criticizing corporate governance practices
- Highlighting perceived excesses in executive compensation
- Disapproval of director competency, tenure, and independence
- Triggering a proxy fight
- Seeking board representation aligned with the activist's motives and interests
- Orchestrating a "withhold the vote" campaign against current directors
- Forcing a sale
- Leaking rumors of an unsolicited approach to trigger a "deal climate"
- Forming a wolf pack to increase funding and ownership levels
- Inventing a "stalking horse"
- Building substantial stock ownership positions to facilitate an outright takeover
- Using stock loans, options, and derivatives to increase voting power
- Leveraging "friendly" institutional investors to the activist's cause
- Conducting aggressive diligence on officers and directors
- Publicly discrediting company leadership with public records and hearsay
- Commissioning a private investigator to examine officers' and directors' behavior
- Highlighting potential relationship issues and conflicts of interest
- Engaging in "nuisance" litigation
- Litigating for board records
- Blocking company transactions