

The pros and cons of activist investors

Management teams that engage positively with attackers may find activist campaigns bring ideas that create value and improve shareholder performance.



In this episode of the *Inside the Strategy Room* podcast, McKinsey partner Joe Cyriac, consultant Sandra Oberhollenzer, and communications director Sean Brown discuss the opportunities and challenges presented by activist investors. Their conversation investigates what activists do to improve the performance of target companies, activist-investor trends globally, and ways companies can respond positively when they are approached by activists. (For more conversations on the strategy issues that matter, subscribe to the series on iTunes.)

Podcast transcript

Sean Brown: From McKinsey's Strategy and Corporate Finance Practice, I'm Sean Brown. Welcome to *Inside the Strategy Room*. Joining us today to discuss the pros and cons of activist investors are Joe Cyriac and Sandra Oberhollenzer. Joe is a partner in our New York office. He leads our work on activist investors globally and assists clients with a wide range of corporate-finance and investment issues. Sandra is also based in New York and is a leader in our activist-investor service line. Sandra, let's start with a question for you. Can you talk us through the different levers that activist investors pull to improve the performance and value of their target companies?

Sandra Oberhollenzer: We typically see four main levers addressed by the activists. The most popular is looking at corporate governance. This is board and governance changes. Ultimately, activists see this as a way to effect change in the organization—by pushing for change of management, adjusting incentive structures—and through that being able to influence changes that they want to see in the organization more broadly. The second is M&A activity. In this case, we're talking about pushing for or against transactions that are being proposed. It could be looking at spinning off certain sections of the assets that the activists see as noncore or lower margin. They are seeing that companies with smart M&A activities will outperform. Whether they're selling larger or smaller assets, both spin company and parent company will typically

outperform in the longer term, and that's what the activists are pushing for here. The third lever would be looking at the strategy and operations. This involves pushing on getting margin performance above their peer sets, focusing on cost cutting where required, and shifting a strategic lens to focus on the core business. The fourth and final lever is looking at the different capital structures that they are trying to employ. This means trying to understand whether there is a share buyback required. Or perhaps there's an increase in dividends if the activists feel there's too much cash on the books. And then anything that is debt restructuring or recapitalization.

Sean Brown: We're seeing a lot of press about activist investors. Can you comment briefly on how much activist-investor activity has grown, and where you see it going? Is the hype in line with the reality?

Sandra Oberhollenzer: We have seen activism grow globally over the last five years. Globally, we've seen the number of companies under attack increasing by about 8 percent per annum. That includes small- and larger-cap companies, and we do see that growth continuing going forward. If we look at the assets that they have under management as well globally, activists are increasing at about 9 percent per annum; we do see growth in terms of the amount of assets that they have to work with. In the United States in particular, we do see continued strong growth. There has been an uptick in activist activity in Europe, but in the United States, which is our largest base and where we have in the past seen most activity, that growth does continue, and we do see it continuing going forward.

Sean Brown: Thanks, Sandra. Joe, are there any sectors that are safe, or is this growth across the board?

Joe Cyriac: We believe that no sector is safe and that there is a fundamental question that activists ask: What is the value-creation opportunity? Our belief is, and the track record of the activists shows, that their willingness to find that opportunity, no matter

what the sector, and increasingly no matter what the geography, will continue into the near future.

Sean Brown: Does a company figure out whether or not they're in an activist's crosshairs?

Sandra Oberhollenzer: What we see is that typically the activist will go after a good company that has gone down to the mean, or that is now performing more like their peer sets. Then after the activist activity, in the post-campaign, they will go up again. What we see is not so much geography or industry affecting whether a company could be under attack, but rather a good company that has been performing less well recently.

Sean Brown: What are some of the key steps that you would have a company take to prepare for the eventuality of one day being in the crosshairs of an activist investor? Are there any steps that CEOs should be looking at starting today, even if they're not currently an activist target?

Joe Cyriac: We think that there are two elements to this: understanding where one is vulnerable, based on the analysis and performance of the business; and also understanding how, as a management team, you would react to an attack. We think that those are two pieces of the puzzle that need to go together in a concise way to prepare for an activist attack.

Sean Brown: Many listeners might be wondering whether they may be an activist's next target. Joe, could you give us an example of where a company and their executive team did a good job of responding to an activist investment and demands?

Joe Cyriac: In early 2017 Elliott Management, an aggressive activist, made an investment in Cognizant. Cognizant was the IT-outsourcing company led by Frank D'Souza that had been spun out from Dun & Bradstreet about 15 years prior. Elliott came to management with a set of demands, and Cognizant, if you look at the public record, ended up in a successful place. The Elliott demands included better operating

performance as well as a return of capital to shareholders. The Cognizant management team looked at the demands, made an assessment, and agreed with Elliott on their point about the capital structure. Cognizant had been a growth company. It had ridden the wave of outsourcing to low-cost countries for 15 years and had been incredibly successful. But it was now a company that had never done a share buyback or actually paid a dividend, because it believed investing in its business was the best answer for shareholders. The board and management quickly realized that as a mature business they should be returning capital to shareholders and came up with a dividend and share-buyback program.

They also made an argument to Elliott, which was that their margins were lower because they were investing for the future. And unlike a number of situations where the activist does not believe it, Cognizant was able to point out why these investments would help the company grow in the future, as the simple labor arbitrage of moving work offshore was going away, and companies, to be successful, would have to make investments in areas such as artificial intelligence and natural-language processing. Those investments affect today's margins, but they drive tomorrow's growth. Contrary to the established view that activists are only looking for the short term, Elliott put out a press release supporting management. They were happy to see that the capital-restructuring, share-buyback, and dividend policies had been enacted, but they also supported the fact that Cognizant would have lower margins in the short term as they made these investments to drive growth in the future.

Sean Brown: At what point does an investor in a public company become an activist? How does the CEO and management team realize once they're dealing with an activist? Is there a formal announcement? Do they typically send a private note to management when they take the position and before they go public with their demands? Could you just take us through how this all works?

Sandra Oberhollenzer: What we typically see is that there will be some private conversations that are happening before any public proxy will occur. The private conversations are often quite transparent in terms of what the activist is interested in understanding about the business or what they're interested in changing about the business. And only with a reluctance for the

management to meet with the activists, or a reluctance to react and discuss the thoughts that the activist has, will this typically turn into a proxy fight or become more of a hostile situation for the management team.

Sean Brown: Joe, Sandra, thanks for joining us today.

Sean Brown is McKinsey's global director of communications for strategy and corporate finance and is based in the Boston office, and **Joe Cyriac** is a partner in the New York office, where **Sandra Oberhollenzer** is a consultant.

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