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Corporate Finance

How activist investors are transforming the role of public-company boards

Collaboration between activists and traditional asset managers is changing the boardroom. Here's how.

David R. Beatty

Like it or not, hedge-fund activism has become a characteristic of the corporate landscape. In 2015 alone, activists made public demands of some 637 companies worldwide.[1] In 2016, they'd already made demands of 625 companies by the end of October.[2] And these are just the campaigns that are made public: there are probably at least as many that are never covered by the press because of a quiet settlement between the activist and the target company's board.

What constitutes an activist and the definition of embedded funds does vary. But combined, there appear to be around 550 "active activists" around the globe,[3] controlling more than $180 billion in embedded capital—up from $51 billion in 2011.[4] Most are centered in the United States, but new firms have also sprouted up in Australia, Canada, Europe, and Hong Kong. And to magnify their clout, they are increasingly attracting the interest of asset and pension-fund managers and collaborating in transformative campaigns.[5] Working together, they could mobilize trillions of dollars to challenge the strategies and performance of publicly traded companies.

Whether you see hedge-fund activists as a catalyst for beneficial changes in governance and strategy or

short-term opportunists detrimental to long-term value creation, this much is clear: the growing influence of activists on global capital markets will fundamentally transform how public-company boards interact with investors. This includes the role of the board in investor relations, the importance of outside voices, and more transparent relationships between directors and company managers.

Boards must now be directly involved in investor relations

All medium and large public companies have investor-relations (IR) departments that report regularly to the board about shareholding levels and shareholder concerns. But traditionally, few, if any, directors would actually visit a shareholder to discern his or her view. Most boards would meet with their largest and most interested shareholders at the annual general meeting. But beyond that, reports from IR were more than likely deemed sufficient to understand the views of investors. Even now, some companies still have explicit policies that preclude directors from communicating with investors.

Today, as a direct consequence of shareholder activism, boards and executives frequently review lists of the largest shareholders in order of percentage of holdings. They then decide on a consultation strategy that may well include a visit from an independent director without any management being present. Mary Jo White, the current chair of the US Securities and Exchange Commission, has even publicly stated that shareholder relations are now a board duty: "The board of directors is—or ought to be—a central player in shareholder engagement."[6]

Public examples abound. Among companies, Andy Bryant, the independent chair of the board at Intel, meets with four of the company's largest shareholders each quarter. Sometimes CEO Brian Krzanich or other senior managers are present, and sometimes other independent directors join in. Among asset managers, Larry Fink, CEO of BlackRock (with an estimated $5.1 trillion in assets under management), wrote an April 2015 letter to all S&P 500 CEOs, urging them to have "consistent and sustained engagement" with their shareholders.[7] And Bill McNabb, CEO of Vanguard Group (with an estimated $3.5 trillion in assets under management), has encouraged boards to promote communication with shareholders through, for example, a new "shareholder liason committee" or other structures.[8] The board of Tempur Sealy International has now created a Stockholder Liaison Committee.[9] A new industry of advisory organizations has already sprung up to help boards cope with these new shareholder-relations responsibilities.

Corporate strategy must consider alternate perspectives

In most, if not all, corporations, senior managers lead an annual strategy meeting to examine where the company is headed with respect to its competitive context. Typically, these are two- or three-day occasions, held off-site, with the agendas carefully planned to maximize the likelihood of developing a coherent and insightful strategic plan.

In fact, according to a recent McKinsey survey,[10] boards have significantly increased the time they spend on strategy. This is not surprising given the ever-increasing complexity of the global and digital world we live in. Corporate strategy is tougher to hone and of shorter duration than ever before. An increasing number of companies now insist that strategy be on the agenda of each and every board meeting, so that the directors can be assured that they are investing their time in the most important function: helping to figure out and navigate the way ahead.

When it comes to the traditional off-site, there is a real chance to go back to the basic roots of company competitiveness and to reexamine assumptions and past approaches. This is almost always led by the C-suite team, but it can include external speakers with specific company knowledge. If you, as a director thinking about the next strategic review, were reasonably certain that activists were closely examining your company, why not actively invite their insights?

Given current norms and expectations, asking activists to report their view of alternate corporate strategies to the board may be awkward, or even threatening. But failure to understand alternate strategies to maximize corporate performance might well lead to an open proxy fight. To look at the matter in a less threatening way, instead of having to spend millions on a consulting review, you could get one for free from would-be activist investors.

Board relationships with management must become more transparent

Relationships between a company's directors and its CEO and C-suite executives depend upon many things, especially the trust between the chair (or lead director) and the CEO. These relationships have always evolved over time, as companies progressed or failed to progress and as CEOs grew into their positions. But the basic operating norm in the past would be to let the managers get on with running the business and fundamentally trust in their strategy for doing so.

Today, the presence of activists in the market have further transformed these relationships. Questions about performance and strategy have never been absent from board meetings, but with the level of activist interest, they are now always front and center. Directors—who are fundamentally dependent on management for information and data—must constantly be aware that activists and institutional investors are also closely examining their performance. And boards that don't understand alternative points of view on corporate strategy or bring them to the top management team for consideration can never be fully confident that the management's view of the world is the right one. The outcome can be bitter. Failure to find out who is interested in your company and who might have a different twist on the strategy can quickly lead to damaging hostilities that could be lethal to the company, its employees, and its customers.

One meaningful step toward greater transparency internally would be to appoint CFOs to companies' boards of directors. As directors, they could be charged with discerning where activist investors are proposing different approaches—and with purposefully representing any alternate asset-deployment strategies. Since CFOs don't "own" capital investments the way operating executives and the CEO might, they can afford to be dispassionate third-party evaluators of investment flows and alternate investment strategies. This is a long-standing practice in the United Kingdom, recognizing the CFO's knowledge of a company's assets, the returns on those assets, and often

Questions about performance and strategy have never been absent from board meetings, but with the level of activist interest, they are now always front and center.

a profound viewpoint on the likelihood of a performance improvement.

Activist funds allied with asset and pension-fund managers have transformed the landscape of shareholder involvement. By embracing the three principles outlined above, directors will be better prepared for what's ahead. ■

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[1] *Activist Insight Monthly: Half-year review*, a joint report from Activist Insight and Olshan Frome Wolosky, July 2016, Volume 5, Issue 6, activistinsight.com.
[2] "Big is over," *Activist Insight Monthly*, November 2016, Volume 5, Issue 10.
[3] Ibid.
[4] *The activist revolution*, JPMorgan Chase, January 2015, jpmorgan.com.
[5] David Benoit and Kirsten Grind, "Activist investors' secret ally: Big mutual funds," *Wall Street Journal*, August 9, 2015, wsj.com.
[6] Remarks at the 10th annual Transatlantic Corporate Governance Dialogue, speech by chair Mary Jo White, US Securities and Exchange Commission, December 3, 2013, sec.gov.
[7] *BlackRock Blog* and *Business Insider*, "BlackRock CEO Larry Fink tells the world's biggest business leaders to stop worrying about short-term results," blog entry by Larry Fink, April 14, 2015, businessinsider.com.
[8] F. William McNabb III, Vanguard proxy voting CEO letter, February 27, 2015, about.vanguard.com.
[9] "Tempur Sealy announces leadership and board changes," Tempur Sealy press release, May 11, 2015, tempursealy.com.
[10] "Toward a value-creating board," February 2016, McKinsey.com.

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What CEOs can learn from activist investors

December 2015

Leaders don't have to think of activist investors as the enemy. In this exclusive look at McKinsey's internal video series, global managing director Dominic Barton and principal Tim Koller discuss what activism means for CEOs.

The appearance of an activist investor on a company's share registry is often viewed warily by executives. Yet one of the biggest lessons from the rise of activist investing is that it often prompts positive action—both strategically and with regard to generating long-term value. In this interview, McKinsey's global managing director, Dominic Barton, talks with principal Tim Koller about what CEOs can learn from activist investors and whether their growing presence may help rather than hurt. This discussion is from the video series "What happens next"—usually available only to McKinsey consultants—in which Barton has in-depth conversations with colleagues and outside experts on topics relevant to our clients. An edited transcript of his conversation with Koller follows.

CEOs, corporate finance, and the rise of activism

Dominic Barton: What should CEOs be concerned about with respect to the rise of activist investors?

Tim Koller: The question that people typically ask is, "Are activists good or bad for the long term?" And some of the academic evidence suggests that activists are in fact good for long-term shareholders. I think that's the wrong question, though. There are activists who are long-term oriented. They may hold onto an investment for five to seven years, work with management. And then there are investors who are perhaps a little bit more short-term oriented and are figuring out a way to make a quick buck. So it's not necessarily helpful to lump them all together.

Dominic Barton: There are good activists and bad activists.

Tim Koller: Exactly. And we've talked to CEOs who have activists on their board, and in some cases they say that they're great board members—they add a lot of value, they're well prepared, they ask good questions, they do research. And they have a longer horizon perspective, so it's not just about cutting costs, for example.

So some activists are very good for companies. Often, in cases when management has been a bit sleepy, or when they have not aggressively been looking at their portfolio of businesses and asking questions like, "Am I still the best owner of these businesses? Should this business be shrinking? Should I be cutting cost there? Should I be growing somewhere else?," management gets into a rhythm where everything is incremental from year to year. And activists will come in and shake that up—not necessarily in a bad way.

How can CEOs think like activists?

Dominic Barton: What are the two or three things that a board or CEO should be thinking about to be able to make sure that they're activist proof from a negative side?

Tim Koller: There's not much you can do to be activist proof. But what we think companies could do is to look at themselves as an activist would and to say, "If I was an outside activist investor analyzing your company, what would I do differently? Do I think that would create a lot of value?"

How would you answer that question? So why *aren't* you doing that? If an activist would say, "I'm going to do *X*, *Y*, and *Z*," it's usually not too hard to figure that out. Why am I not doing that, and am I comfortable not responding to what even a hypothetical activist would do? Am I the best owner of the businesses? Am I growing the businesses adequately? Am I cutting costs where they need to be cut? Am I returning cash to shareholders when I don't need it? So it's much more a matter of doing it yourself.

What valuation really means

Dominic Barton: The sixth edition of the *Valuation*[1] book is out. What's new in corporate finance? What prompted you and your coauthors to write the sixth edition?

Tim Koller: I'm also happy to say that it's not just the sixth edition but the 25th anniversary of the book, which is pretty exciting.

Dominic Barton: Congratulations.

Tim Koller: Thank you. So let me step back for a second. The fundamental principles of value creation and the fundamental principles of economics and how companies create value—those are universal. Those haven't changed. So a lot of the core ideas are still the same ones that we talked about 25 years ago. Hopefully, we've gotten better at talking about it, but we always try to emphasize those things.

[1] Marc Goedhart, Tim Koller, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, sixth edition, Hoboken, NJ: John Wiley & Sons, August 2015.

Dominic Barton: And which are those?

Tim Koller: The emphasis is on understanding what creates value. Companies create value by earning an adequate return on capital and growing their business. Getting the right combinations of growth and return on capital is what ultimately is going to drive the cash flows of a company and drive value.

The other point that we're trying to make now that probably has less emphasis on the past is that oftentimes when you look inside of a company, there are big differences in the performance and the potential of different business units. Not just at the level of, say, four or five divisions, but several layers down. And we think companies also need to be much more granular about how they're managing those businesses so that they can truly invest in those where there's growth opportunities and not invest or cut back on other businesses. So in a lot of ways, what's happened is not that the principles changed but the context changed. The economic environment, the competition changes.

Dominic Barton: In what ways? It's more intense competition?

Tim Koller: Yeah, and we find it depends a lot on the sector, on the industry. Clearly, things move very quickly in the tech sector, for example. In other sectors, it may be other forces that are driving it. There may be sectors that are simply declining because consumers don't need as much of those products.

Department stores have been declining as more focused stores and big-box stores have come up. And so it varies a lot from sector to sector. As a result, you'll see the returns on capital and the growth rates across sectors very enormously. What companies need to do is figure out what's right for them.

And that's what we try to emphasize. It's not that there's a "one size fits all" answer. It's what's right for you given your return on capital, given your competitive environment, given the growth opportunities? That's what's important. □

Dominic Barton is McKinsey's global managing director; **Tim Koller** is a principal in McKinsey's New York office.

MARCH 2014

Dealing with activist investors: A conversation with Larry Kanarek

Shareholder activists are having a profound impact on the behavior of companies. McKinsey director Larry Kanarek says executives must work with—rather than against—activists to improve performance.

Shareholder activists—who grab stakes in companies and agitate for significant change—can be a force for creating long-term value, says McKinsey director Larry Kanarek. In this video interview, he argues that activists often have valid reasons for pressing companies for change and urges executives to react more collaboratively when confronted. Working with activists, rather than gainst them, says Kanarek, actually can create value for all parties. An edited transcript of his remarks follows.

A profound effect

Are activists having a profound effect across American boardrooms? I think the answer is absolutely yes. I think what's given rise to activists is there's an awful lot of capital out there. And there's an awful lot of effort underway to see if that capital can earn above-average rates of return. And people are turning to lots of different types of investors in pursuit of above-average returns. There's private-equity companies, for example, and there are hedge funds. Activists are one other method by which you can put your capital to work, attempting to outperform the market.

That's what activists have actually done. With relatively few situations, they have gotten management in boardrooms, at least across America, on edge, talking about them, worrying about them. And by the way, I'm not so sure that's a bad thing, because it means they're asking themselves hard questions about whether they're doing the kinds of things that drive shareholder value, which is what activists are all about anyhow.

Creating value

Quite often, activists do have at least the kernel of a good idea, and the fact that our research shows that, on average, they are creating long-term value suggests that they're right more often than they're not. The activists I've worked with are extremely analytical, they're very sharp, very rational people. And often, they have a pretty positive story to be told that should be at least paid attention to. They're not always right, but their batting average isn't bad.

I think management often overreacts when an activist gets involved. And, by the way, I have sympathy for that. It's not a criticism; it is startling to discover that somebody now owns a chunk of your company and is going to have some direct discussions with you, and maybe your board, about what you should be doing. It's a pretty threatening feeling, so I have some sympathy, but I do think they are overreacting.

When an activist feels like your first and second response is defensive—simply refuting everything they've said—then they get defensive and go into a different posture as well. You've given them no reason to think they're not right. They still have strong convictions, so they're going to double down in intensity. And they're going to hunker down for a fight. It's a fight they're pretty good at, a fight that they know how to fight—and one that management often does not.

Sometimes the disconnect is a coldly rational point of view versus an emotional one. I also think the disconnect sometimes takes place because management really does understand something about their business, their strategy, their direction—but they're not that good at articulating it. Two of the most common things activists come in believing is that either "Your costs are too high" or "You shouldn't be in all these businesses that you're in"—that the portfolio needs a shake-up. Management teams often see more synergies among the businesses within their portfolio than the activist would.

Sometimes management's right about that, and those synergies either haven't been well communicated or they haven't been fully exploited. But their view is, "If you take out this piece of me, the rest of me is not as good." They may have a point, but sometimes they don't—it's just they've gotten comfortable with that. When they do have a point, it also may be true they haven't really exploited the synergies as effectively as they could, and that's a good conversation to have with an activist as well.

When activists knock

I think the phenomenon of activists is just going to get more common. It's a growth industry, basically. And the best thing you can do is think like an activist.

Every year, a company usually goes about rethinking its strategy. One very useful practice is to take an outside perspective, and say, "If I were an activist, how would I view us?" And particularly, "How would I look at our share price today? How has it performed compared to peers? How are my other performance metrics? My cost structure, my revenues, my growth, my expansion—how does that stack up compared to my peers?" And if it's not stacking up favorably, why not? And how would an investor think about it? "Am I underperforming in some important way, particularly my share price? And for how long has that been? And, if I have been underperforming, what am I really doing to address it? And am I doing it fast enough? Am I doing it aggressively enough? Am I pulling all the levers that I have? Or am I doing it a bit more incrementally, thinking that we're doing the right things and over the next couple of years things will change?" That may not be fast enough, and may not even be effective enough.

When an activist knocks on the door, I think the right response is, "Come in and let's have a chat," and a pretty open chat. The first thing is not to panic, it's to hear them out and to understand the analysis they've done. Activists will usually give you some time. I would take their hypothesis. I'd analyze it. I'd be completely neutral, I'd be completely open-minded. And if you prove part of it right, you go back to the activist and say, "There's parts of what you said that we agree with, and we're prepared to do some things differently, and we'll share that with you. There are some things we don't agree with, and we'd like to share that with you, too." I think you'll get a hearing; it doesn't mean you'll always agree. But if you approach them like that—and I think more and more management teams are beginning to approach them in that spirit—I think you have a fighting chance to actually create value for everybody. ▢

Larry Kanarek is a director in McKinsey's Washington, DC, office.

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MARCH 2014

CORPORATE FINANCE PRACTICE

Preparing for bigger, bolder shareholder activists

Activists are targeting more and bigger companies. Here's what attracts them—and some tips on how to respond when they show up.

Joseph Cyriac, Ruth De Backer, and Justin Sanders

Activist investors[1] are getting ever more adventurous. Last year, according to our analysis, the US-listed companies that activists targeted had an average market capitalization of $10 billion—up from $8 billion just a year earlier and less than $2 billion at the end of the last decade. They've also been busier, launching an average of 240 campaigns in each of the past three years—more than double the number a decade ago. And even though activists are a relatively small group, with only $75 billion in combined assets under management compared with the $2.5 trillion hedge-fund industry overall, they've enjoyed a higher rate of asset growth than hedge funds and attracted new partnerships with traditional investors. As a result, they have both the capital and the leverage to continue engaging large-cap companies.

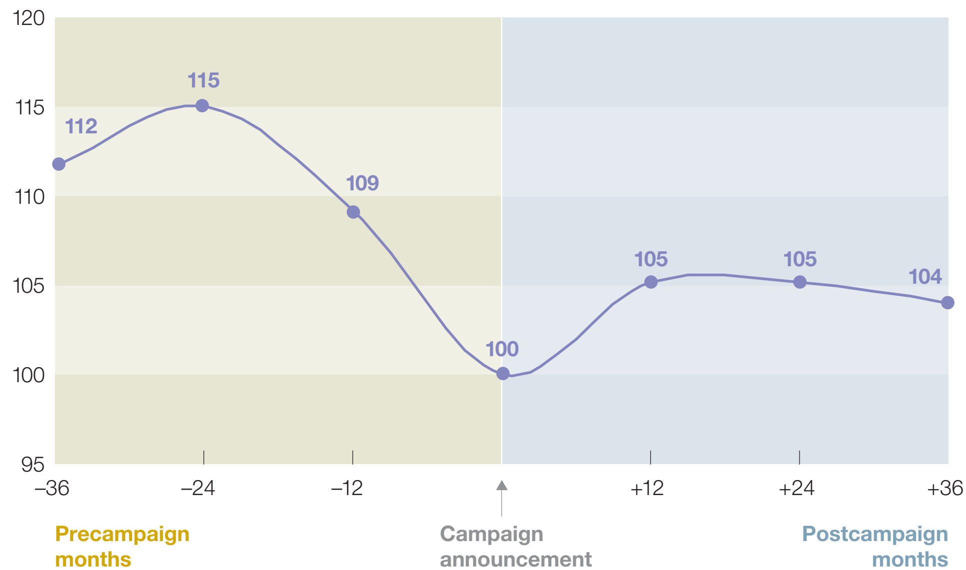
Shareholders generally benefit. Our analysis of 400 activist campaigns (out of 1,400 launched against US companies over the past decade) finds that, among large companies for which data are available, the median activist campaign reverses a downward trajectory in target-company performance and generates excess shareholder returns that persist for at least 36 months (Exhibit 1).[2]

Internationally, others have reached similar conclusions.[3] That's consistent with a general shift in the tone of the debate around activist

Exhibit 1

Activist campaigns, on average, generate a sustained increase in shareholder returns.

Excess TRS[1] performance of activist campaigns, at companies with annual revenues of >$1 billion, 2001–present[2]; index: 100 = day of campaign announcement



[1] Total returns to shareholders relative to industry average.
[2] n = 67. For purposes of this chart, we chose a more conservative sample that includes campaigns at companies with annual revenues of >$1 billion for which historical 6-year TRS data are available. The trend is similar for a broader set of 112 companies of all sizes.

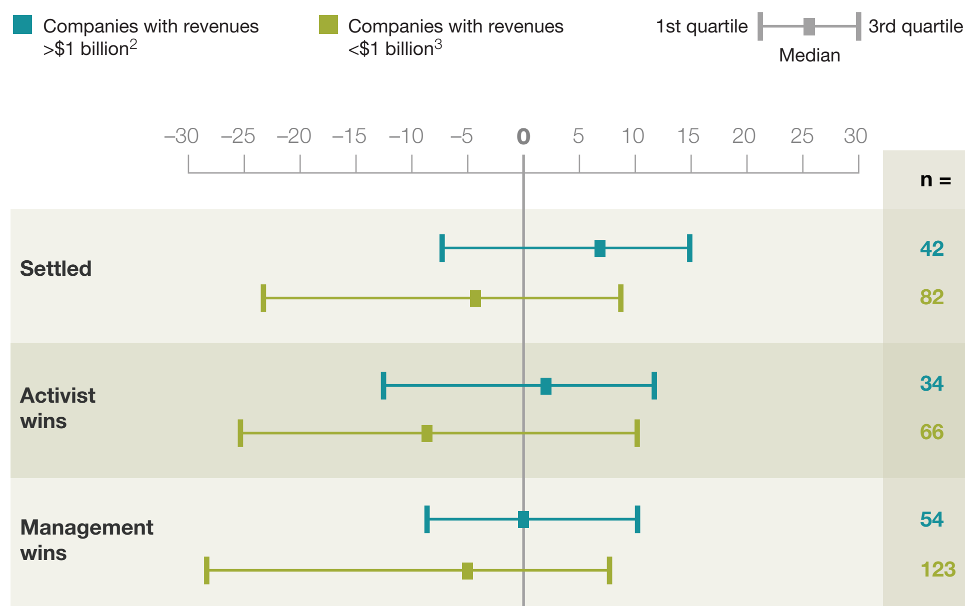
Source: Standard & Poor's Capital IQ; Thomson Reuters Datastream; McKinsey analysis

involvement.[4] Today, we encounter more awareness of the positive effects that an activist campaign can have—on improving strategy and operations, for example, or strengthening the board of directors, or even mitigating perceived pressure for short-term performance.[5]

But that presents a challenge for executives, many of whom reflexively resist activists, should they make an approach. Activists themselves often provoke that response, our analysis finds, with confrontational or even acerbic overtures. Those executives who can set aside tone and style, though, will find that some activists do indeed have ideas that create value and improve shareholder performance. In fact, a collaborative, negotiated, or settled response to activist initiatives tends to lead to higher excess shareholder returns than a combative one (Exhibit 2).

Exhibit 2

A collaborative settled outcome tends to lead to higher shareholder returns in the 3-year time horizon.



[1] Total returns to shareholders. Note that the TRS calculations baseline is 1 month prior to 13D filing, and excess TRS is benchmarked to the S&P 500. A management win is defined as a withdrawn complaint or scenario where shareholders voted down the activist plan. An activist win is defined as a campaign where management (independently or through shareholder vote) met all activist demands. A settlement is defined as a campaign where management or shareholders met some but not all activist demands.
[2] n = 130. Sample includes all campaigns at companies with annual revenues of >$1 billion for which data were available.
[3] n = 271. Sample includes all campaigns at companies with annual revenues of <$1 billion for which data were available.

Source: Standard & Poor's Capital IQ; McKinsey analysis

In order to shape the kind of relationship they want with activists, managers must first understand what attracts them. Then they can gauge their own vulnerability to undertake for themselves the kinds of value-creating actions an activist would likely propose. They should also have plans at the ready for responding, well in advance of an activist's overture.

What attracts activist shareholders?

An activist campaign itself can be costly for management, both in direct expenses and in the significant time and attention diverted from running the business. Our interviews suggest that each contested campaign costs a company between $10 million and $20 million—plus weeks of management time to develop plans and meet

with investors. Executives who can identify and address the weak spots that an activist would target before an activist gets involved can help a company reap the benefits without incurring the cost—whether through preemptive actions or a fast path to compromise should an activist launch a campaign.

What are those weak spots? Not unexpectedly, our research finds that fundamental underperformance is the most likely weakness to trigger an activist investor. Most often, activists focus on underperformance relative to industry peers, rather than absolute declines in performance, and they especially react to shareholder returns that have significantly lagged the industry in the previous two years, anemic revenue growth, and a growing gap in margins relative to peers. Large cash balances and recurring restructuring charges are also strong indicators of looming activism. Notably, in our research, we found that executive compensation and a company's gap in consensus earnings do not appear to be significant indicators of activist interest despite the frequent use of these metrics in activist-campaign rhetoric. If a company shows signs of underperformance relative to peers, it's quite likely that an activist is already watching.

Executives can run a preemptive activist audit to evaluate their company's fundamental performance—and we've observed a growing number of companies doing so, proactively testing whether they may be a target and reviewing their operating and strategic plans in that light. A rigorous and unbiased preemptive audit that identifies weak spots and evaluates all options can help keep activists at bay and uncover opportunities for value creation. One company took a detailed look at performance trends against peers and dug deep into the fundamental factors creating value for each of its business segments. Armed with this information, it was able to better understand the intrinsic value of each of its businesses and compare this with how the market valued the sum of the parts. Finally, it considered all possible options for closing the gap, including operational improvements, changes in capital allocation and financing, and fundamental changes to its portfolio.

In certain sectors, we have also observed a pattern of industry-specific investment theses. For example, industrial companies are attractive targets where the breadth of the corporate portfolio leads to a market value lower than the sum of the independent businesses. Other tempting targets are basic-materials companies with stranded or undervalued raw-material assets and pharmaceuticals companies with drug pipelines (R&D or production) perceived to be weaker than those of their peers.

What to do when approached by an activist

If an activist does reach out, how executives react plays a big part in how collaborative or hostile a campaign gets. Three in four campaigns start collaboratively, our research finds, but half of those eventually turn hostile (Exhibit 3). This suggests that management teams should think as much about how they engage with an activist as whether they accept activist proposals.

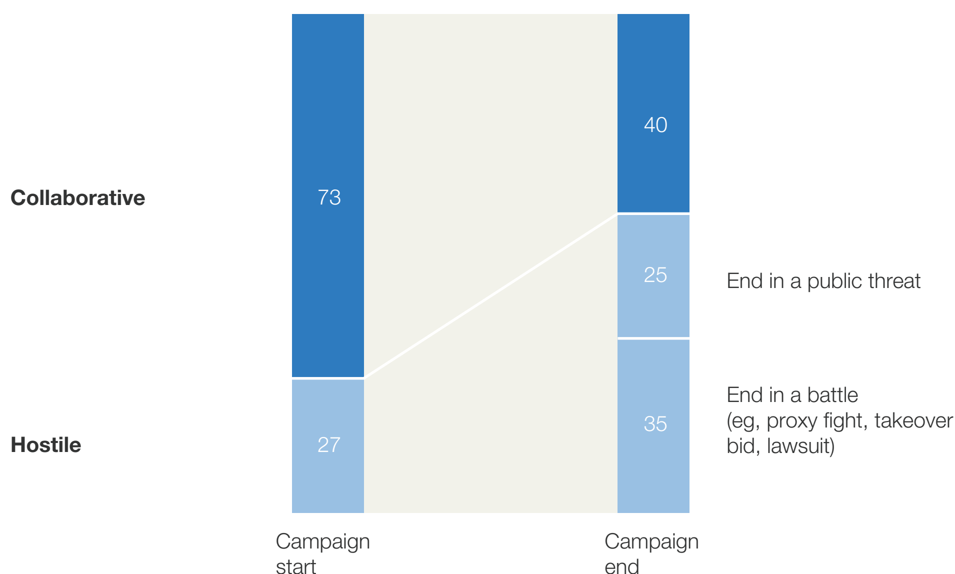
Some tips can help in planning response tactics.

Form a response team. When an activist engages a management team, executives should pull together an ad hoc team to respond. Those who respond without team support can easily make missteps, underestimating the gravity of the overture or overlooking the full range of options; this can lead to a rapid escalation of an activist's moves. In one recent instance, the chair of a health-care company's board, in the face of an aggressive overture from a large activist shareholder, made a unilateral decision to ignore an activist—which provoked the activist to campaign for board control. Contrast that with another recent example, where the CEO of a global industrial company quickly assembled a confidential working team including himself, his CFO, his general counsel, investor relations, and a support analyst. The team quickly assessed the benefits and risks of the activist proposal and

Exhibit 3

Most campaigns begin collaboratively but turn hostile.

Campaign-tactic progressions,[1] campaigns by progression type, %



[1] n = 575. Includes all campaigns for which data were available.
Source: Standard & Poor's Capital IQ; McKinsey analysis

Clear governance and process are the best defense against inadvertent decisions in the heat of confrontation.

generated a plan for compromise that enabled the CEO to settle an activist campaign by proactively gaining support from large shareholders for his plan.

This variability in response tactics exposes executives to significant risk—often driven by emotion. Agreeing on a team structure and governance in advance can be a highly effective tool for preventing unilateral decisions with great consequences. It matters less that the team members are known and named in advance and more that there is a clear set of guideposts in place for how an executive team will manage its reaction. Clear governance and process are the best defense against inadvertent decisions in the heat of confrontation.

Moreover, the right team will look different depending on whom activists first approach, for example, and what kinds of suggestions they bring. If they approach the board, members may want a team that includes more independent external voices than if they first approach the CEO, who may want a less public and even internally confidential team for tactical analysis, planning, and communication. And the types of recommendations the activist makes will also heavily influence the makeup of the response team, since the team will need different insights to weigh a proposed new strategic direction rather than potential structural changes or financial engineering.

Internal team members will naturally include the executive team, board members, general counsel, and investor relations. External advisers are also essential to the process. Legal advisers are often the first call, but strategic, financial, and communications specialists all play a valuable role in driving shareholder returns while preserving company leadership. Many advisers will push for a poison pill or other structural defenses. Yet this approach can give a false sense of protection as activists seek support from other large shareholders rather than attempt an outright corporate takeover. The experience at one global retailer highlights this dynamic. The shareholder involved continued his campaign even after the board adopted a poison-pill approach that would have diluted shareholders in the event of a hostile takeover bid. It wasn't until the company won shareholder support for its own plan by clarifying its intentions that the activist withdrew. The addition of strategic and communications specialists to help inform investors played an important role in management retaining control of the company.

Understand the activist. As with most negotiations, what actions you take will depend on what kind of counterparty is engaging you—

and response teams need to quickly develop a point of view on the specific activist's tactics, methods for engaging shareholders, track record, and industry experience. There are no clear-cut definitions of hostile versus collaborative activist investors, but the nature of their initial overture, the thoughtfulness of their proposals, and their track record at creating value offer important indications of the kind of campaign you're likely to face.

Campaigns tend to be hostile if the activist's objective is a change in governance or legal matters, such as revisions to bylaws, for example, rather than strategic or M&A-oriented proposals. Aside from that, certain activists have a propensity toward more collaborative interactions with management teams. They launch their campaigns with private letters to management and one-on-one discussions with executives. Less collaborative activists launch campaigns with more confrontational approaches, such as open letters or proxy statements. Our analysis suggests that more hostile investors will openly threaten a fight or launch a proxy contest in up to 70 percent of their campaigns, while more collaborative activists remain cooperative in 70 percent of their campaigns.

Similarly, some activist funds offer detailed and thoughtful perspectives on a target's strategic and operational challenges, while others offer only vague assertions and aggressive plans for engineered returns. In the first case, management can gain useful perspectives on increasing returns to shareholders. In the second, an activist's proposals could represent significant risks to long-term health. In interviews with executives, we have observed that companies whose managers engage in a dialogue with activist shareholders in advance of a 13D filing often gain important context and insight into the activist's intentions. We've also heard repeatedly that an early move to cooperate or compromise leads to a collaborative dynamic, whereas lack of engagement or outright rejection of activist suggestions leads to a more hostile dynamic.

Understand the activist's proposal. In addition to assessing the activist, the response team needs to evaluate the activist's argument, understand its potential for value creation, and assess any potential risks to the company. Managers at one industrial company, for example, assembled a response team of internal and external specialists in a structure similar to an M&A due diligence. Through this war-room format, they evaluated direct and indirect benefits and costs of the activist proposal compared with existing plans, applying the same rigor to the review of each plan in order to identify the best path. When they ultimately recommended that the board accept significant portions of the activist plan, managers did so with the same level of detailed support they would ascribe to their own strategic plans.

Develop a response plan. Most of the executives we interviewed commented that activists' initial rounds of communication often come across as confrontational and sometimes disrespectful. We believe that it's important to see past this and acknowledge the activist in a manner that encourages a constructive dialogue. Our research suggests that acknowledging activists respectfully, constructively, and quickly—within days, followed by real engagement within weeks—and engaging them on the merits of their proposal helps to avoid major disruptions and preserve management control.

As crucial, if not more so, is engaging other large shareholders in explicit, proactive dialogue about

an activist's proposal compared with management's alternative. In most cases, activist investors have themselves polled large shareholders and lobbied for support. In one recent example of a successfully negotiated settlement with an activist, the key success factor was a blitz of investor outreach that included clear management plans, the introduction of new team members, and examples of the company's management track record. In response to this outreach, large shareholders stood by management rather than supporting the activist. It would be naive for a management team not to open this type of shareholder dialogue and expect a beneficial outcome from an activist negotiation. ○

[1] Activist investors are defined as investment-management firms—most often hedge funds—that have acquired beneficial ownership of a company and filed a form 13D indicating intent to influence a management team.

[2] We defined large companies as those with at least $1 billion in annual revenues. The trends were similar for companies with revenues below $1 billion.

[3] Marco Becht et al., "The returns to hedge fund activism: An international study," European Corporate Governance Institute, finance working paper, Number 402/2014, January 2012, revised March 2013, ecgi.org.

[4] Lucian A. Bebchuk, Alon Brav, and Wei Jiang, *The long-term effects of hedge fund activism*, Columbia Business School, July 2013, columbia.edu.

[5] Dominic Barton and Mark Wiseman, "Focusing capital on the long term," *Harvard Business Review*, January–February 2014, pp. 44–52, hbr.org.

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