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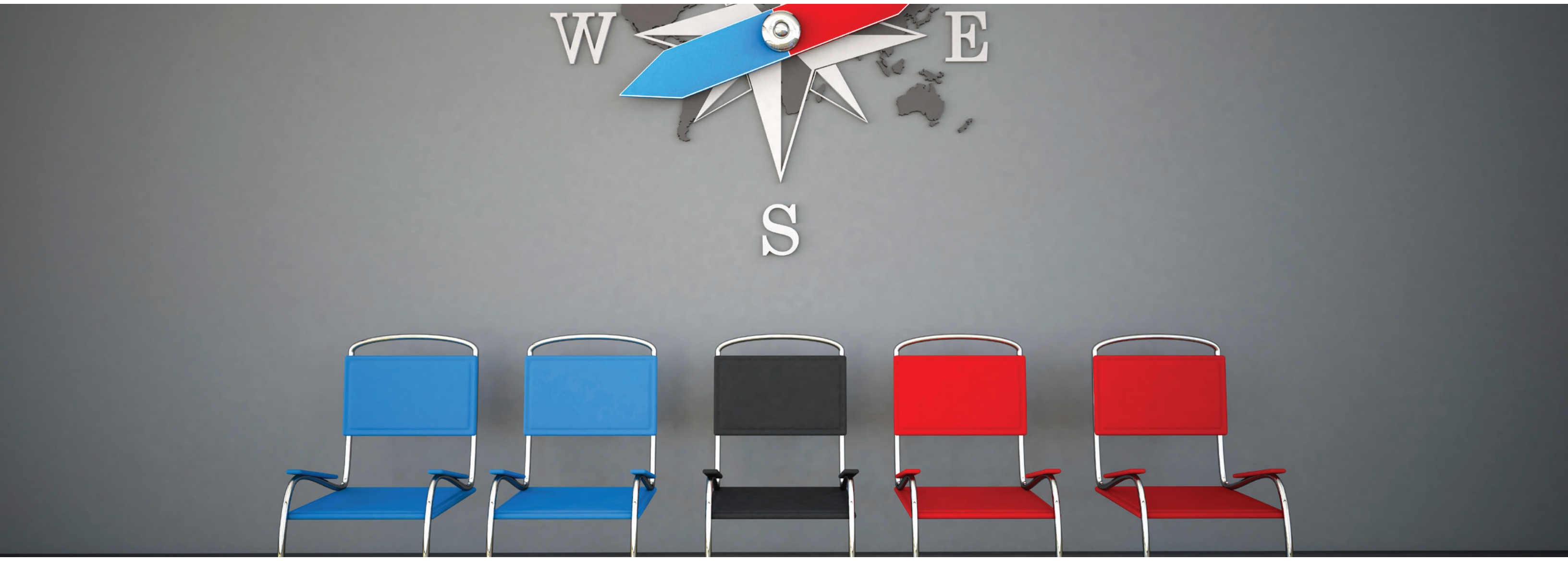


Corporate Finance

The benefits of thinking like an activist investor

Whether or not your company is in the crosshairs of activists, assembling a team to take a good, hard look at your performance can deliver benefits.

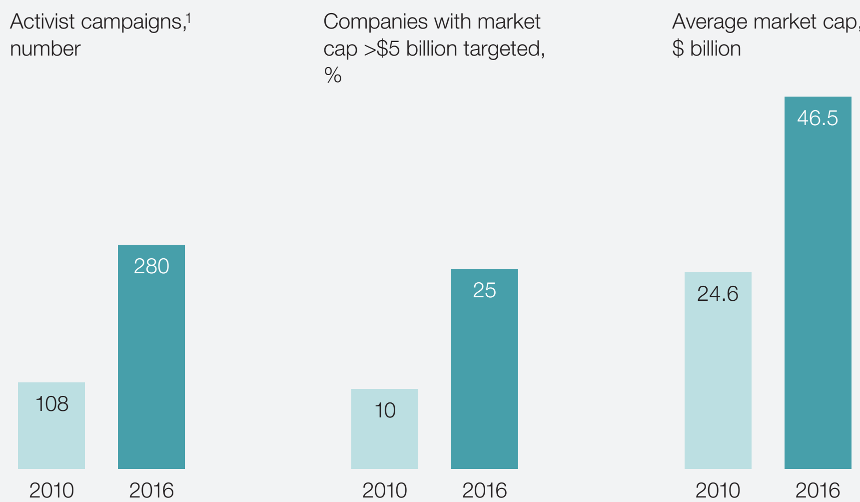
Joseph Cyriac, Snezhana Otto, and David Wells

The rapid growth and influence of activist investors has many executives nervously looking over their shoulders. Even large companies are increasingly vulnerable (Exhibit 1). But there is a benefit to be had by those managers with the courage to take as hard a look at their own company's performance as a performance-minded outsider might. The objective isn't necessarily for managers to do what activists would do—activists' performance is mixed, after all (Exhibit 2). Instead, the goal is for managers to examine their own strategy, governance, and operations with an eye to unearthing opportunities to improve performance.

Doing so, of course, requires acknowledging vulnerability. Managers, like all good leaders, are often successful because once they've made a strategic decision, they commit themselves psychologically to following through. Even those who invite dissent to challenge unconscious bias expect dissenters to fall in line once a decision is made. And in the absence of an occasional external point of view, that singular commitment can blind executives and board directors to opportunities as their company, the industry, and the economy around them change.

Shining light on those blind spots also requires more than just a typical strategy review. In our experience, that's where an activist role play can help. Managers give participants in such exercises (often called a "red team") deliberate license to

Exhibit 1 Activist campaigns against large US companies are on the rise.

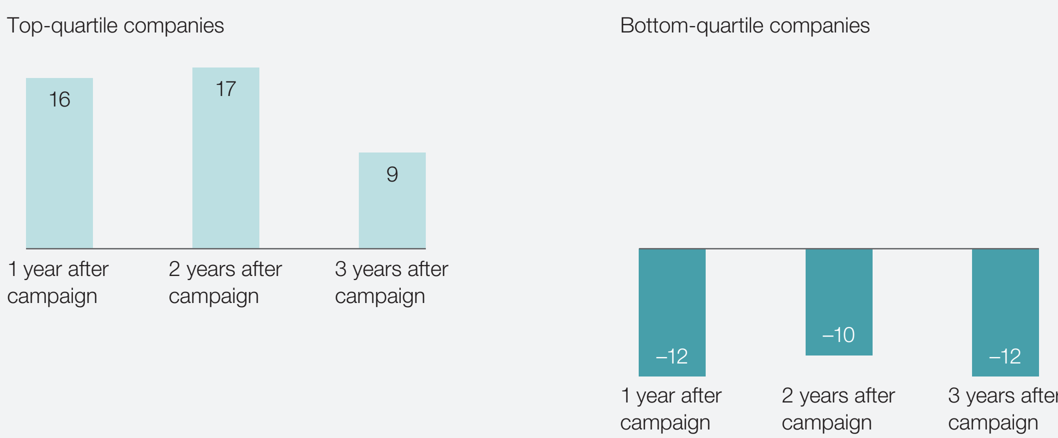


[1] Excludes short sellers and gadfly investors. US companies only.

Source: Activist Insight; Capital IQ; McKinsey analysis

Exhibit 2 Activism's track record on value creation is mixed.

Excess TRS performance of activist campaigns,[1] %



[1] N = 252 unique campaigns since 2007 across 151 companies trading on US exchanges that had 3-year TRS data available as of Mar 15, 2017 and market cap at campaign of more than $10 billion and revenues over $1 billion. Excludes activist short campaigns. Excess performance calculated vs S&P sector index.

Source: Activist Insight; Capital IQ; McKinsey analysis challenge their thinking across the board, including strategy, performance, governance, and even compensation, with no holds barred. That's the kind of exercise that many activists do when targeting prospective companies. For those who successfully emulate activist thinking, the opportunity can be striking: top-quartile activist campaigns are associated with sustained excess total returns to shareholders of more than 9 percent even three years out. It can also better prepare managers, who seldom prevail in disputes with activists (Exhibit 3), to better respond to their overtures.

Deploying an activist role play

The activist mind-set is, at its heart, a hypersensitive focus on shareholder value creation. Learning to think that way is usually only possible if senior managers agree to subject themselves to a role play that bulldozes through established patterns of thinking and deliberately looks for gaps and missed opportunities. The goal is to emulate the most constructive sort of activists who propose fundamental changes to improve long-term performance—typically supporting their case with sophisticated outside-in analyses of strategic and operational performance.

Done well, an activist role-play approach is substantially more provocative than a standard strategy review. The tone can be aggressive, even confrontational. In one pharmaceutical company, the red team's efforts sparked a much more drastic portfolio conversation than the usual incremental shifting of resources among therapeutic areas. Where there was a highly heterogeneous portfolio, adopting the activist's perspective drove consideration of much more drastic portfolio actions for parts of the portfolio that were not a natural fit. This approach helped compel executives to take an outside perspective and be a catalyst for overdue changes.

The setup matters. In our experience, the activist role play can liberate management thinking by creating an environment where all options are on the table and there are no sacred cows. It is one thing to read a report that suggests some changes to the operating model, and it is quite another to be the CEO in the hot seat and be questioned on performance, competence, board composition, and compensation. Moreover, while many CEOs may believe that everyone in their organization is empowered to speak out openly and freely, it's frequently the case that, at some point during a role play, one of the CEO's direct reports will sheepishly raise a hand and recall the time that his opinion on an important item was unceremoniously quashed.

Exhibit 3

Across sectors, management wins in less than a third of activist campaigns.

Results of activist campaigns against companies with market cap >$5 billion,[1] %

[1] N = 272 campaigns of companies with market cap more than $5 billion, excluding gadfly investors and short sellers.

Source: Activist Insight; Capital IQ; McKinsey analysis

Focusing on strategy, performance, and governance

Mock activist role plays needn't cover the entire landscape of a company's business. It's possible to anticipate where the activists who care about long-term value creation will focus their attention. That can give companies a good idea of where to deploy this approach to examine performance through the external lens of an activist.

Portfolio strategy and capital allocation. It can be hard for companies to admit that a business unit in their portfolio would be better owned by another business, or that a turnaround isn't, as many managers like to think, "just two quarters away." In our experience, this isn't a sign of empire building as much as it is an indication that management teams honestly believe that they are a business unit's best owner. To them, asking them to divest a business is akin to asking a parent which of the children would be better parented by someone else?

But activists have no such misgivings. An activist will take a hard look at the synergies among a company's different businesses—excluding general and administrative synergies in corporate overhead, since another owner of similar scale could reap the same benefits. They will challenge the ability of the owner to manage well all businesses in a diverse portfolio. And for activists, past performance doesn't guarantee that a business stays in the portfolio; they'll consider any unit that does not meet performance criteria as a candidate for restructuring, divesting, or harvesting.

At times, portfolio strategy may be right, but that may not be apparent to investors. One bank placed a significant premium on reporting the performance of each of its business units as if they were stand-alone businesses. While this approach aimed for transparency and business-unit accountability, investors saw it differently. The message they received was that these businesses were independent of each other and that the parent was effectively a conglomerate. By taking a skeptical outside-in perspective, managers realized they needed to change their communications with investors to highlight the value of cross-selling and other operational synergies among businesses.

Assuming that the right portfolio strategy and communication is in place, an activist would also evaluate whether capital was allocated to the most attractive parts of a company's portfolio. The skeptical view in an activist role play can highlight which businesses should be considered a growth and investment opportunity—or an efficiency and harvesting opportunity. It can also evaluate whether the company sufficiently redeploys resources to the businesses it intends to keep—new growth platforms or businesses with a clear competitive advantage in the market. Take, for example, the experience of one basic-materials company. By applying an activist's hypersensitive shareholder-value-creation perspective, managers realized that a legacy vertical-integration play had led the company to subsidize a unit that would have been loss-making as a stand-alone entity. As a result, they diverted growth capital away from this unit and toward a unit further downstream that could generate more free cash flow.

Financial strategy. Among the most visible targets of activist demands are financial strategies that don't appear to be friendly to investors. Activists will evaluate a company's leverage or debt-to-equity ratios by benchmarking to likely market peers. They'll ask hard questions about tax efficiency and whether a business has too much or too little debt. And they'll weigh a company's deployment of excess cash—whether it could be invested or returned to shareholders.

The activist lens can compel managers to take a different perspective on how a company conducts its benchmarking.

Activist role plays should raise the same questions. Consider the example of one large and high-performing technology company. Managers and the board of directors firmly believed that they should be investing for growth—as they had done since the company was founded decades earlier. Indeed, the company had never paid a dividend or done a large share-repurchase program. However, the company had grown to a market value of more than $30 billion and was enormously profitable. It took a hard push by the red team to make managers see that their commitment to the narrative behind the company's success had to change.

Operating performance. A savvy activist will use outside-in assumptions to benchmark each business segment in a company's portfolio against best-in-class peers, as well as the combined enterprise.

The activist lens can compel managers to take a different perspective on how a company conducts its benchmarking. For example, one large pharma company was accustomed to benchmarking performance against its peers. However, when it looked at individual business units in the role play, it uncovered a different story and highlighted a number of issues in the cost structure of different parts of the portfolio. It was also clear that in certain areas, such as consumer marketing, the company was underspending and there was too much R&D spend on business units that would not yield the same return on investment. That challenged the company's legacy of spreading savings targets equally across all the business units, which was at the heart of the company's operating mind-set.

Similarly, adopting an activist perspective can help set a higher bar for operating improvements. At one consumer-retail company, for example, managers took an activist perspective on operational benchmarking to review their performance goals. From the outside in, they realized, an activist would likely see incremental changes as insufficient. They then used that insight to build a case for change with expectations of doubling their margin improvement and improving working-capital efficiency by 50 percent. Companies could go even further. With a more radical margin aspiration and case for change, a company taking the activist perspective may contemplate going beyond industry benchmarks and applying a zero-based budgeting approach to fundamentally rethink parts of its cost base.

Governance. Activists will take a hard look at company boards to evaluate whether they constitute strong, competent oversight on behalf of shareholders relative to entrenched insiders. Companies will need to ensure board members have relevant, specific expertise. Ideally, boards would include both industry veterans familiar with what has historically determined success and functional experts from other industries that are ahead—in digital delivery, for example. Such functional experts can bring a perspective on the trends that will shape the industry's future. It is also critical that this expertise is communicated to shareholders.

Companies will also need to signal strong governance of the board of directors over management through the following measures:

- *Pressure-testing corporate strategy from an outsider's point of view.* Boards of directors often only think about the activist perspective reactively, after an activist has become involved. But considering an activist's mind-set proactively can also help directors to review their strategy more rigorously—and leave them better prepared to respond to activists when they show up. The board of one large healthcare company has found the outside-in activist role play so valuable in this regard that it involves the board in an activist role play as part of its annual strategy-refresh process.

- *Linking executive compensation to long-term value creation relative to the company's sector.* Compensation provisions can have the effect of encouraging executives to focus on near-term profits at the expense of long-term growth. An activist role play can help board directors compare compensation metrics with those of market peers to ensure that management compensation is aligned to performance that leads to growth, higher margins, and returns on capital. Where appropriate, they may also want to build in clawbacks to discourage short-term moves. That way, activists won't be able to argue that managers are being rewarded more than their peers for lower performance.

Thinking through these issues can help provide new insights into how to maximize business performance, and, in turn, deter activists. The process will also help companies develop a response should activists come knocking. By incorporating value-creating ideas into its plans and effectively communicating them to long-term shareholders, companies may find that even the most astute activists will be hard pressed to dazzle other shareholders with a better proposal.

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Thinking like an activist can help managers improve their own performance before they attract activist attention. It can also give them the confidence to push back if activists attempt to intervene. ■

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