



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.

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Activist investors¹ 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.

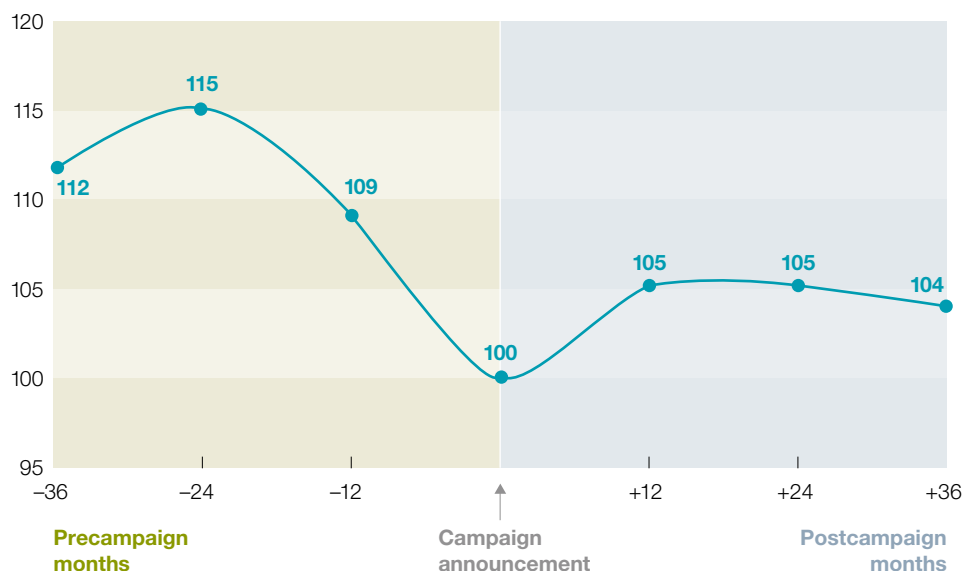
Shareholders generally benefit. Our analysis of 400 activist campaigns (out of 1,400 launched against US companies over the past decade) finds that, among large companies for which data are available, the median activist campaign reverses a downward trajectory in target-company performance and generates 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

Exhibit 1

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

Excess TRS¹ performance of activist campaigns, at companies with annual revenues of >\$1 billion, 2001–present²; index: 100 = day of campaign announcement



¹Total returns to shareholders relative to industry average.

²n = 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

activist 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).

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?

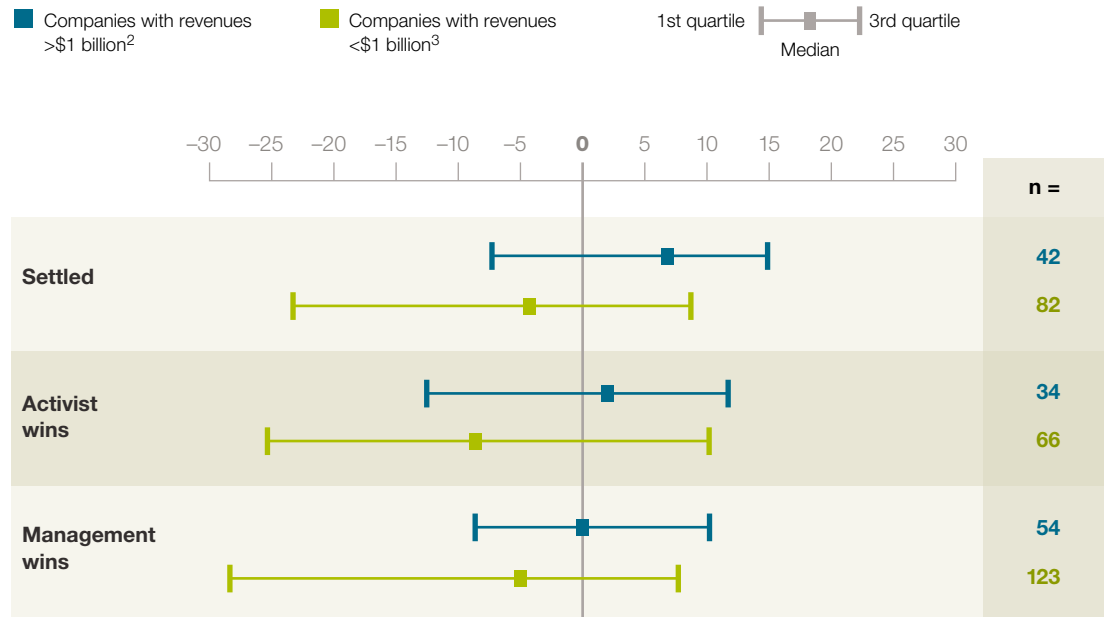
An activist campaign itself can be costly for management, both in direct expenses and in the significant time and attention diverted from

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

Exhibit 2

A collaborative settled outcome tends to lead to higher shareholder returns.

Median 3-year excess TRS¹ based on activist success,
% excess TRS



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

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.

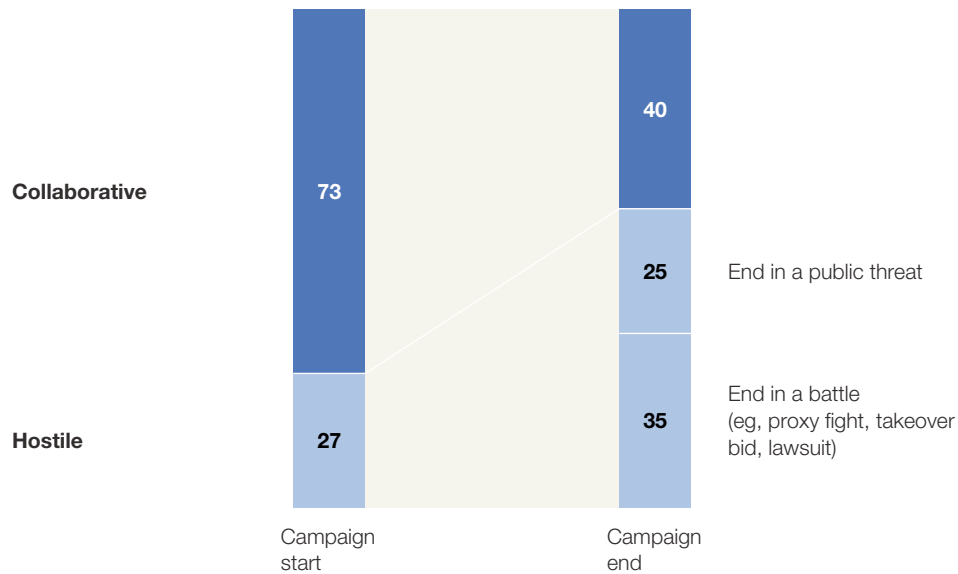
Executives can run a preemptive activist audit to evaluate their company's fundamental performance—and we've observed a growing number of companies doing so, proactively testing

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.

If a company shows signs of underperformance relative to peers, it's quite likely that an activist is already watching.

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

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 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, Juilan Franks, and Jeremy Grant, “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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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 transcript of a February 2014 video interview, Kanarek argues that activists often have valid reasons for pressing companies to change and urges executives to react more collaboratively when confronted. Working with activists, rather than against them, actually can create value for all parties. The video is available on mckinsey.com.

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 under way 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 are 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 “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 with 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. ○