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What CEOs can learn from activist investors

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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. □

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