



The Activist Investor

May 2010

A Concise Guide to Activist Investing

This guide is intended for investors of all types (fund managers, institutions, and individuals) that seek to improve the performance of individual equity holdings in their diversified portfolios.

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Why investor activism?

In recent years, investors have expressed their views more and more vocally about how executives of firms in their portfolios invest and manage investor capital. These investors typically do this when a portfolio firm underperforms peers to that firm, or perhaps the overall market.

Frequently, investors become active when they find, unexpectedly, that a firm in their portfolio has underperformed. Rather than merely selling the investment, investors seek constructive change in how management runs the business. These investors cannot or choose not to exit for a number of reasons:

- Their portfolio requires them to continue to hold the firm, say in the instance of an index fund that must hold a firm in order to replicate an index.
- Their investment represents a sufficiently large proportion of outstanding shares, so exiting would depress the share price.
- The cost of becoming active is small relative to the potential increase in value.

A few investors look for underperforming firms for their portfolio, seeking to increase the value of the investment through an activist approach. These full-time activists thus adopt something of an extreme version of value investing. Rather than waiting for a portfolio firm to naturally or organically achieve a target value, the investor participates actively in that firm's management.

Occasionally, one investor learns that another investor, say a full-time activist, has targeted a firm in the investor's portfolio. Then the question becomes, how does the investor respond? Should the investor support the activist effort, and if so how?

Either as an accidental or deliberate activist, an investor has a range of strategies and tactics available to rectify that underperformance, which constitutes the remainder of this discussion.

The activism that I have in mind here differs from the activism of takeover investors. Certain investors agitate for change (mostly related to governance) so they may acquire control of a firm. I do not address this discussion to these investors (although they may find it interesting and useful). If instead you are an investor that has an underperforming firm in your portfolio, or are a value investor that would rather not wait for management or market cycles to increase the value of your investment, or are an investor with a portfolio firm targeted by a full-time activist investor, this discussion is for you.

Types of activist investors

Activists tend to come in three types: social, governance, and business. Some investors act in more than one type of capacity, such as when business improvement requires changes in corporate governance.

I must say a few words about social activism. Some investors seek to persuade firms to abide by specific ethical standards or to adopt particular policies concerning current social issues. Examples include investors that want firms to adopt environmentally-friendly or worker-friendly manufacturing processes, to stop using genetically-modified raw materials in their products, or to end the manufacture of objectionable goods such as tobacco.

Few executives take social activist investors seriously. They tend to view such investors as owning shares of the firm for the sole purpose of expressing their particular views. I object to this subversion of the corporate governance process and US securities laws. In my view, a serious activist investor (indeed, any investor at all) should have no other agenda other than to create a profitable investment.

Thus, there remain two types of appropriate activism: governance and business. Governance relates to how the firm conducts its relations with investors. It tends to have four elements:

- Board of directors structure, membership, and operation
- Executive compensation
- Transaction restrictions (i.e., poison pill)
- Corporate mechanics (i.e., amending bylaws).

Most executives should find it difficult to object to the range of governance changes that investors advocate. While they may argue the detail about whether one or another specific proposal makes sense for a given firm (say, a staggered board or separate chairman and chief executive positions), most governance propositions make sense, in theory, for most firms.

The problem lies in the effectiveness of these types of proposals. Academics and investors alike have researched extensively the correlation between governance changes and overall business performance, with at best inconclusive results.¹

Business activism pertains to the structure, management, and operation of a firm. You probably have opinions about various elements of firm performance, including overall business direction and strategy, expense levels, or even wasteful or counterproductive business practices. At its extreme business activism extends to whether management should sell given assets, a business unit, or the entire firm.

¹ Gompers, P., Ishii, J., Metrick, A., 2003, "Corporate governance and equity prices." *Quarterly Journal of Economics* 118, 107-155; Brov, Alon, Wei Jiang, Frank Partnoy, Randall Thomas, 2008, "Hedge Fund Activism, Corporate Governance, and Firm Performance." *Journal of Finance* 63, 1729-1775.

Business activism can have a significant positive impact on a firm. On many occasions investors agitated for a sale of a business unit or the entire firm, and made substantial gains that would otherwise take incumbent management many years to achieve.² However, unlike the logic and common sense of governance changes, management and investors frequently disagree deeply on whether one or another investor idea for a business will actually achieve the desired result. For what it’s worth, executives resent your meddling in business decisions, and argue that you hire *them* to research, make, and monitor these very decisions.

Let me explain a fourth, new type of activism, related to risk taking and risk aversion. This pertains to the alignment of investor and management views of risk. It begins with the observation that most executives are more risk averse than investors. This wasteful risk aversion manifests itself in many interesting and unexpected areas of firm strategy and tactics, including balance sheet structure, cash balances, insurance and hedging, asset purchases, and internal controls. Risk activists seek to align executive risk behavior with investor risk appetite, through many of the activist strategies and tactics discussed below.

Risk activism differs from the other three areas in ways that should generate less controversy and more executive cooperation. Excessive risk aversion represents an interesting example of inferior business performance, and might prompt the same deep disagreement as other business activism efforts. Yet, many of the potential improvements that align executive risk behavior with investor risk appetite are more specific and targeted than investor proposals for improved business strategy and management. Business activism frequently entails fundamental and controversial restructuring of a business, or sensitive headcount and expense reduction initiatives. In contrast, risk activism typically entails refinements to a firm’s capital structure, or elimination of or reduction in less prominent financial (hedging or insurance) transactions. The main challenge to executives is to think in new, different ways about risk.

This table summarizes the different types of activism:

Type	Advantage	Disadvantage
Social	None	Not taken seriously
Governance	Logical, common sense	Inconclusive relation to increased value
Business	Direct results	Open to reasonable debate with management
Risk	Direct results Logical, common sense	Requires unconventional thinking

² Greenwood, Robin and Michael Schor, 2008, “When (not) to Listen to Activist Investors.” Harvard Business Review, January 2008

How to become an activist

The first and possibly most important step is to have the will to do it. Too many investors have grown accustomed to passive investing, in which you only hold or sell an underperforming firm. US securities law, and indeed the principles of public equity ownership, gives you an important say in how executives manage the capital that you entrust to them. Once investors understand that management works for them and no one else, they confidently can become active in the direction and operation of a firm using the strategies and tactics explained below.

The other steps, then, follow a straightforward logic: business assessment, business improvement planning, and activism planning.

Business Assessment

Business assessment and a business improvement plan should be familiar to any good investor, so I will not devote much space here to these subjects. Business assessment reproduces and updates the very analyses that prompted you to invest in the firm in the first place. Such an assessment might include review of markets and competitors, relevant assets, and internal structure and processes. An update of these analyses should reveal the nature and extent of underperformance, and identify the various improvements needed to return the firm to the profitability that motivated the original investment.

Business Improvement Plan

The business improvement plan follows the business assessment. It identifies the specific changes that the investor thinks the firm should undertake. These could include expense management initiatives, asset sales, or process improvements. Sometimes the identified problems relate globally to management competence, so hiring or firing of one or more executives is in order. Specific changes can extend to sale of entire businesses or divisions, or even sale of the firm.

You may also target wasteful practices, such as excessive perks or large corporate staff. These days, with improved SEC disclosure and increased penalties for these sorts of things, investors thankfully find less of this than before. Still, plenty of firms make themselves an inviting target for this particular kind of improvement.

Investor concerns about risk aversion can lead to a particular set of business improvements. These include returning surplus cash to investors, issuing floating rate debt instead of fixed rate, and ending wasteful hedging and insurance programs. I have included as an appendix a more detailed discussion of managerial risk aversion as a target for investor activism.

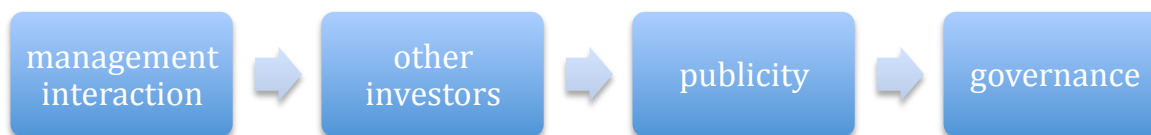
Activism Plan

You might hope and trust that a sound business assessment and a targeted business improvement plan would suffice. Say, send copies of the assessment and plan to the

CEO, perhaps meet once or twice to explain your ideas and answer any questions, and watch returns increase as management implements the plan. As numerous activist investors know, it seldom works that way. Executive ego leads to cordial but fruitless discussions of your ideas, and more likely to indifference, or even willful defiance. So, an investor that wants to see management implement a business improvement plan should also create an activism plan for engaging executives (and potentially other investors, the SEC, and even the media) in the process.

An activist investor can choose from numerous strategies and tactics. Above all, the activism plan should follow logically from the business improvement plan. That seems sensible and even obvious. Yet, too many times an investor becomes frustrated with the performance of a portfolio firm, and even creates a compelling business improvement plan, but stalls by becoming active in the wrong ways. High expense levels do not necessarily require an investor to demand a board seat, or a revamped executive compensation system may not necessarily follow from the suggested sale of a failing division.

All the available strategies and tactics, then, revolve around doing whatever it takes to persuade or force management to implement the business improvement plan. One way to think about the strategy and tactics entails how you escalate the pressure on management to do this. I think of this as a rough continuum:



Management interaction: typically the first step, of course. You should almost always begin by engaging current executives in the business assessment and improvement plan. Perhaps one or more private meetings, to present and discuss your views of the firm, will suffice. It might involve only detailed analysis of the current business prospects, or extend as far as a civil yet serious discussion of the activism plan that you have designed. How this goes depends on your existing relationship with these executives, your credibility in assessing the workings of the business, and management’s ability and willingness to listen to your perspectives.

Other investors: you may need or want to bring other current investors in the firm to the discussion. There is strength in numbers. For a sufficiently compelling assessment, you might even persuade others to invest in the firm for the very purpose of supporting your case. You generally can’t lose by engaging other investors. However, a large-scale assault can intimidate or threaten management, which you may in fact desire depending on how poorly management responds to your plan.

Publicity: you can do this in many ways. News media is a favorite, through press releases, interviews, paid advertising, and the like. You can attract publicity merely

through SEC filings, particularly 13D disclosures. Sometimes a proposal at the annual meeting gets noticed, especially by individual investors and mutual funds that must vote on the proposal, although winning a spot in the annual meeting proxy materials usually is difficult. And, if you succeed in placing such a proposal on the annual meeting agenda, proxy advisors must then analyze that proposal, potentially validating your business assessment and improvement plan. By whatever means, public disclosure and promotion of the plan increases the pressure on management to consider it, especially after customers, suppliers, and other stakeholders hear about it.

Governance: a range of governance changes can prompt management to consider and adopt your improvement plan. These are largely the same mechanisms that one finds under the earlier “governance activism” discussion, but with a subtly different goal. Governance activists want firms to adopt these measures for their own sake. Business activists want them as a way to force executives to implement business improvements. For this reason, you must aim specific governance changes at the particular business problems of the firm. These mechanisms generally fall into four categories:

- ***Board of Directors structure, membership, and operation***
 - Term of membership, including whether the board has staggered terms
 - Number of members, including insiders and outsiders
 - Separate Chairman from CEO, or need for and role of Lead Independent Director
 - Number of meetings
 - Type of committees
 - Election to Board, including role and operation of Nominating Committee, and qualifications for Board membership
 - Board member compensation structure and amount.
- ***Executive compensation***
 - Overall compensation system, including cash and equity components
 - Non-cash perquisites and benefits
 - Post-employment (retirement and termination) compensation
 - Process of analysis, approval, and oversight of executive compensation through the Board of Directors.
- ***Transaction limits***
 - Process for initiating, analyzing, and approving purchase and sale of assets, business units, or firm
 - Shareholder rights (poison pill) provisions in bylaws.
- ***Corporate mechanics***
 - Shareholder voting, including broker votes
 - Bylaws amendment.

Of all the governance changes available, perhaps the most extreme is running for one or more seats on the Board of Directors. Management usually (and wrongly) considers Board membership, and the nominating and election process, as their prerogative, or at least the prerogative of the existing Board members through the Nominating Committee. Challenging that prerogative will almost certainly lead to a very public and spirited battle for what management views as control over the firm. It will also lead to serious costs, related to retaining an independent proxy solicitation firm and publicity efforts. Again, depending on how poorly management responds to a business assessment and improvement plan, you may desire that exact response.

Again, the continuum is quite rough. You might find that you need to elect a Board member sooner rather than later, or wait to engage other investors until you take some other steps. It all depends on the business improvements that you desire. But, there are some general links between governance and business improvements:

	Board structure	Executive Compensation	Transaction limits	Board seat
High expense levels		Provide incentive to executives to manage expenses		Investor monitors expenses
Executive competence	Structure Board to allow independent monitoring	Structure compensation system to attract suitable executives		Investor monitors and changes executive team
Wasteful practices	Structure Board to allow independent monitoring			Investor monitors practices
Asset, business unit, or firm sale	Structure Board to consider sale		Structure bylaws to allow sale	Investor monitors sale
Risk aversion		Allow executives to diversify personal assets		Investor monitors risk behavior

Cost of Investor Activism

It varies, of course, and can be surprisingly inexpensive or costly. At its most basic, it costs only your time – for business assessment and an improvement plan, and for meetings and interaction with management, and perhaps other investors. Other costs can include:

Public relations: for promoting the business assessment and improvement plan through the media and other channels. This might start at \$5,000 per month to retain a firm for simple efforts, and reach over \$50,000 per month for very sophisticated and elaborate campaigns.

Advertising: paid advertising, usually print media, in national and local newspapers and (sometimes) magazines. A full-page in the Wall Street Journal can cost \$25,000 or more, and may need to appear weekly or even more for the duration of an activism program. For activist efforts that require it, figure \$100,000 to \$200,000 per month for a couple of months around the time of a key event, say an annual meeting.

Legal: mostly for reviewing SEC filings, but also useful for assuring that public relations and advertising campaigns remain within the boundaries of securities laws. This could average \$20,000 per month for the duration of an activist effort.

Proxy solicitor: relatively rare, and used only for a proxy fight, when an investor seeks votes for their Board member, proposed transaction, or annual meeting proposal. That's good, too, because it can cost millions of dollars for a single effort.

Appendix Risk Activism

Investor and Management Risk Preferences

As a general rule, investors (both institutional and individual) tend to seek risk. They expose themselves and their assets to variability, because they believe that over time and in the aggregate over enough different investments, they will earn an appropriate return on those assets.

A given investor's preferred level of variability (or risk preference) can change over time, and different investors prefer different levels of risk. And, the risk that investors seem to be willing to absorb appears to have increased in the past few years. Overall, though, investors can, should and do tolerate a degree of risk in the value of their assets.

As much as investors want and like risk, executives dislike it. Of course, few executives will admit, to others or even to themselves, to having this attitude. But, for some perfectly natural reasons, they do not desire the same level of risk in asset values as investors desire. Scholars have researched and debated extensively this difference in risk preference, with some general conclusions emerging related to how investors can diversify their holdings in ways that executives cannot³. Nonetheless, the difference does exist, and can cause an otherwise decent investment to underperform dramatically.

This difference in risk appetite manifests itself in interesting and unexpected ways. Investors typically label an executive "risk-averse" when he or she avoids new or different business ventures, or resists expanding a business into new markets. Most astute investors can probably think of numerous examples where executives exhibit that sort of behavior. Investors seek to encourage appropriate levels of risk-taking through various means, including appropriate pay incentives or changes in a firm's organization and culture.

There is a subtler, yet potentially more wasteful manifestation of executive risk aversion. Executives that at first glance appear to take all sorts of interesting risks may also negate that risk-taking by how they manage those risks. Risk management activities take on one or all of three forms:

Hedging activities that transfer risk to others, including customers, suppliers, or counterparties. This includes hedging of a variety of financial risks (for instance, foreign currency, interest rate, and credit risks),

³ Shapira, Zur, 1994. Risk Taking: A Managerial Perspective. New York: Russell Sage Foundation.

commodity risks (usually related to the price of commodity inputs to the firm's products and services), and insurable risks (including property and casualty and employee benefits insurance).

Control activities that affect a firm's internal processes. These include the size and nature of specific internal control functions, such as internal auditing and compliance departments, as well the overall attitude and philosophy (and attendant headcount and vendor costs) related to assuring that management has complete control over their operations.

Capital structure decisions. A firm's capital structure reflects executive risk preference through its approach to liquidity (through its levels of cash and working capital, and through its use of standby or contingency liquidity facilities) and attitude toward fixed and floating rate debt.

In all three areas⁴, evidence of executive risk aversion continues to mount. Investors can measure the cost of that risk aversion both directly, in terms of excessive expenses in these areas, and indirectly, in terms of lost opportunities for more profitable investments.

Possible changes in risk management that would increase a firm's value include elimination or modification of:

- hedging of interest rate risk, such as using swaps or other derivatives
- hedging of foreign currency transaction and translation risk, using various currency derivatives
- liquidity protection, including standby credit facilities and reserves of cash and cash equivalents
- hedging of commodity price risk, such as various derivative products related to agricultural, energy, or other raw materials production inputs
- corporate insurance programs, including property and casualty policies, employee benefit stop loss insurance, and other similar transactions
- hedging of credit risk through factoring and similar credit derivative transactions
- active management of equity investments, such as pension asset portfolios, relative to indexed investment strategies
- purchased warranties for capital and office equipment, and other similar transactions designed to reimburse companies for costs related to damage to such equipment
- certain internal control functions, such as internal audit, regulatory compliance, safety and security, and similar corporate control mechanisms.

⁴ Meulbroek, Lisa; "Total Strategies for Company-Wide Risk Control"; Financial Times, May 9, 2000, p. S1

Impact of Risk Management

A firm's risk management approach affects its financial results in two distinct but related ways:

- it entails some sort of cost (both direct expense and indirect cost) that reduces current cash flow
- it reduces variation in financial performance, which is reflected in the amount of economic capital that the firm requires from investors.

In our view, risk management at most firms leads to a material cost and reduction in cash flow, without a material (to investors) decrease in variance of financial performance and corresponding reduction in economic capital. It may also, indirectly, hide unprofitable projects from investors.

The direct impact on cash flow entails the cost to the firm of the individual components and programs. These costs include premiums paid for options and insurance, fees paid to vendors, and the cost of internal headcount and systems for managing these risks. Costs also include unnecessary diversion of cash flow, such as interest expense under fixed rate debt when floating rate debt would cost less.

The impact on economic capital follows from how much this approach reduces variance in financial results. Now, these various risk management programs in fact reduce a firm's variance in financial results, at least by a slight amount. However, it appears that the actual reduction is not material to investors, and hence the impact on economic capital is slight.

The indirect impact is difficult to quantify, but may be significant. At least one scholar has identified a possible agency cost related to risk management, in which executives use risk management programs to stabilize cash flows in their firm. This reduces the likelihood of needing to obtain funds from investors for less-than-optimal projects.⁵

An analysis of firms reveals how significant risk aversion affects financial results. Based on this analysis, these firms could add as much as 10-15% to their share price by eliminating or at least limiting most risk management programs.⁶

⁵ Tufano, Peter, 1998. "Agency Costs of Corporate Risk Management", *Financial Management*, Vol. 27, No. 1 (Spring), pp. 67-77.

⁶ Proposal for McDonald's Corporation 2008 Annual Meeting agenda

The Activist Investor

Resources and Advisory Services

The Activist Investor serves as a comprehensive resource for equity investors that seek to enhance returns of poorly-performing portfolio companies. We provide a range of professional services to assist investors with their activist efforts.

Management listens to the Activist Investor

For further information, or to discuss a specific turnaround situation, please contact:

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