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Be Your Own Activist

by Gregory V. Milano and John R. Cryan, Fortuna Advisors

Why might an activist investor take an interest in your company, and what can you do to be prepared? Despite the proliferation of activist investment managers and the tripling of assets managed by these active investors in the last five years, the majority of corporate executives seem surprised and ill prepared when an activist knocks on their door. This puts these companies at a disadvantage from which it can be hard to recover.

Typically, executives put up walls to fight the activists as they would fend off a potential hostile acquirer. They refute every claim made by the activists and deride them as "short term," ruthless, and ignorant of the peculiarities of the industry and the wisdom of management's strategies.

It doesn't have to be this way. We believe executives should understand the motivations of activists and work to determine their own exposures. They should evaluate each possible demand an activist would make and adopt all strategies that create value without waiting to be told to do so. And for likely demands that don't create value, executives should develop planned, fact-based responses in advance and keep them ready for immediate release if needed.

In other words, if you are an executive with any potential activist exposures, we recommend that you "be your own activist!"

The activist investor "industry" is no longer a small group of outspoken trend setters. According to industry researcher HFR Inc., as of April 2015, there were roughly 70 activist funds managing $120 billion. And the success activists are having has a compounding effect on the growth and acceptance of the strategy. More passive investors are encouraging and supporting activists to help improve returns in their portfolio companies. In fact, many of the activists' "ideas" come from passive shareholders who don't have the mandate or aptitude to take on management. What they often do have is significant knowledge of the company and its shortcomings.

What does this mean for public company executives and boards? At some point, you're very likely to be engaged by a shareholder activist. Old rules of thumb about size and reputation as "defense" mechanisms are now out the window. In recent years, companies as large as Apple (Icahn), Microsoft (ValueAct) and Pepsico (Trian) have all been targeted. If these companies can find themselves in an activist's crosshairs, it is safe to say no company is too large or too "iconic" to be a target.

If you're a corporate CEO, you should expect to be speaking with an activist in the near future if you haven't already. And even if your company has already gone through one activist "campaign," there is nothing that says it won't happen again. So adopt the Boy Scout motto and "Be Prepared." How the early discussion goes may well determine how you as CEO will spend the next 6-12 months—and, indeed, whether you will have a job.

Stop Thinking of This as "Defense"

Despite the advice of a burgeoning cottage industry of corporate advisors, management doesn't need to "defend" itself as it did during the hostile takeover craze of the 1980s. An activist investor with a 2-10% ownership stake doesn't "control" the company. The old defense playbook is not an appropriate response to modern-day activists. There are many ways to find common ground and develop a working relationship that can benefit all shareholders, including the executives.

Admittedly, the initial interaction can be contentious, and it often turns into a highly public debate. The "winner" is the one who most completely makes the other party and the other investors agree with their point of view.

Companies typically wait for activists to arrive and then they do "battle." But executives should spend more time in advance of an activist's arrival doing what activists themselves do—that is, comprehensively reviewing their strategy, operations, and performance to identify and evaluate gaps, flaws, and opportunities. A proactive approach is better than being reactive.

Imagine you're a corporate executive and then ask yourself: Which of the following cases would play better in the media and with other investors? After the activist lays out their agenda and proposed strategy for unlocking value, the company executives either…

1. …listen carefully and say: "Those are good ideas and we have studied most of them. We are executing items 1 and 2, we studied items 3 and 4 but for tax and cost reasons they wouldn't be as valuable as we initially expected, and frankly

we hadn't thought of item five but it's interesting and we will study it further."

Or they:

2. …dismiss the activist out of hand and say: "We are sure we have the best possible strategy and strong operations, and we reject the demands of these ill-informed outsiders that don't understand how our business works. The market isn't valuing us correctly because we can't disclose aspects of our strategy for competitive reasons, but over the next few years we will show them."

If your initial response is like the second one, you're likely to find yourself in a brutal and public fight over the next six to 18 months. When fighting a motivated and well-funded activist investor, you should expect all of the extreme tactics at the activist's disposal.

While many activists prefer to work quietly behind the scenes with management, given the stakes involved, they're not opposed to being confrontational. For example, you and your board members may one day open the *Wall Street Journal* and find your picture beneath the caption: "Long Term Liabilities." This is exactly what Ralph Whitworth's Relational Investors did to the board at Philadelphia-based Sovereign Bancorp in 2005. Relational claimed the company was creating more value for its directors than its shareholders. Directors, executives, and rank and file employees were undoubtedly horrified, as were their families and friends.

So what is a company to do? If you want to "win the debate," you need to be ready well in advance. Be your own activist. Make internal activism a part of your company's culture by discouraging complacence and emphasizing continuous self-improvement. Encourage an ongoing dialogue at the board and senior executive level as well as deeper down into the business. Most importantly, if you identify performance weaknesses or catalysts for creating value, take action! Don't wait until you're confronted by an activist.

Many ideas presented by the activist have already been considered internally and are sitting in the "parking lot" of the latest strategic plan. As Xerox learned at the Palo Alto Research Center, or PARC, its not enough to have good ideas, you have to act on them. Even if you have thought of the ideas before the activist showed up, if you have failed to act on them, the credit for the value created by taking action should and will go to the activist not management.

For example, when Juniper Networks was engaged by both Elliott Management and JANA Partners in 2013, the company's initial response was that "the Board and management have been comprehensively analyzing the company's priorities for some time, and we are finalizing our review with a sense of urgency." Yet, it is the activists that are given credit for the strategic changes and resulting value creation, not the management team that has been analyzing the company's priorities "for some time."

What Do Activists Look For?

For the most part, activists are value investors seeking stocks trading at a discount to intrinsic value. However, they're also looking for catalysts to "unlock" value by actively closing the value "gap" between intrinsic and market values rather than waiting for "market forces" to work on their behalf. This willingness to take action provides a "campaign advantage" in favor of the activist.

Jeff Smith of Starboard explains his firm's investment process as follows:

> *Unlike traditional value investors, valuation is only one component of our process and what we deem to be undervalued may actually look expensive to another value investor. Most value investors are analyzing companies based on their existing business… We are different. We analyze companies' existing business plans and compare them to what we believe may be a better alternative plan. If our analysis shows that our alternative business plan has substantially higher expected return then we have a potential investment opportunity.*

The media, academia, and many advisors tend to lump all activist investors into one group. The reality is that activists vary greatly in their approach, expertise, "targets," investment horizons, and in many other aspects of how they run their funds.

But broadly speaking, activists will push for change in one or more of the seven "levers" that we discuss next. And the greater the perceived weaknesses, the greater the perceived opportunities for the activist.

Value Proposition One: A Change in Strategy

Challenging the status quo of a company to change its strategic direction is often the broadest "value creation agenda" proposed by an activist, since it encompasses several of the other value propositions discussed later. In such cases, the activist believes that the company is marching down a path that is not maximizing value for shareholders, and it is hoping to create a moment of reflection and redirection.

Why do these opportunities exist? Quite simply, because public corporations are often overtaken by inertia. Given their scale and the rigidity of their processes and culture, very few companies are truly flexible and adaptive. Very few companies make substantial changes to major strategic initiatives as the competitive and market landscapes evolve.

Behaviorally it's difficult for a senior management team to discontinue a meaningful corporate endeavor that they championed originally. Corporate identity and tradition often get in the way as well. Changing strategy may be perceived by management as a sign of weakness. And hubris may lead to the belief that "we can turn this around" when the better option might be to redirect their efforts elsewhere.

Ideally, the board of directors would play the role of "bad cop" if a strategic initiative isn't going well. Unfortunately directors often lack the information to detect problems, and many avoid challenging management as long as the situation seems manageable.

One recent high profile example was the engagement of Nelson Peltz's Trian with Pepsico. Trian's proposal was to separate PepsiCo's business into multiple stand-alone public companies. In one of their many public communications, Trian argued,

…2006 marks the beginning of current management's tenure. As importantly, it also coincides with the transformation of "Power of One" from a marketing slogan with limited operational impact to a pervasive strategy that increased the influence and control of corporate. We view this strategy—now described euphemistically as "connected autonomy"—as largely responsible for a diminished PepsiCo culture and deteriorating performance. We believe that separating snacks and beverages would create a clean structural break that would eliminate corporate bureaucracy, return power and autonomy to the operating divisions, increase accountability and re-energize division management."

Trian then went on to recommend that PepsiCo

… eliminate its holding company structure, along with layers of value-destructive overhead and excess costs. Standalone management teams should be "unshackled" to invest as they see fit, price as they want and take risks by moving quickly to introduce new products. Granting those running the divisions authority to control their destiny may make corporate leadership… uncomfortable—but we suspect division leadership and employees within Pepsi and Frito-Lay would be reinvigorated.

At the moment, Pepsi's shareholders are giving this proposal very serious consideration.

Value Proposition Two: A Change in Operations

Often accompanying a change in strategy is a change in operations, including calls for cost reductions, asset dispositions, consolidation of product lines, and shutdowns of operations. The last often includes closing ineffective international operations when shareholders would be better served by the company's staying domestic.

In developing proposals for creating value through operational change, activists will typically examine a company's historic and projected growth, costs, margins, capital deployment, return on investment, and risk profile. And they will also generally benchmark the company's performance against peers. Demands for operational change can often be quantified and recast as concrete objectives based on publicly available information that can be used to show how much "upside" can be achieved by following the activist's alternative plan.

Why do these opportunities exist? Operational vulnerabilities can often be traced to the common corporate practice of viewing each year's performance as "an island unto itself" instead of as one in a series of years. Management practices revolve around an arbitrary budget that, even if met, may not actually create any value. Since they know they will be measured against the budget, managers have an incentive to put forth the weakest budget they can convince the board to approve. They fail to ask themselves: "how much value will we create if we achieve this budget?," "is this just the easiest goal we can get approved?," or "what are our alternatives?"

What's more, the measures and metrics used by most companies to track performance don't tell the full story and can encourage counterproductive behavior. For example, companies that emphasize EBITDA, or Earnings Before Interest Tax Depreciation and Amortization, often overinvest in low-returning assets because virtually any capital expenditure or acquisition that covers its own incremental cash costs will produce more EBITDA. But because it increases EBITDA doesn't, of course, mean it's a good investment. Sure, most executives look at their returns and net present values when evaluating acquisitions. But if they are paid based on EBITDA, there is a clear motivation to make the acquisition at any price and a behavioral bias to believe in the most optimistic forecast that beats the return and NPV hurdles.

This understanding has led some companies to evaluate their performance using EPS, or Earnings per Share, which takes into account incremental depreciation, amortization, interest expense, taxes and share issuances that often come along with investments. But even though EPS is a tougher hurdle than EBITDA, it still doesn't ensure an adequate return on investment.

Still other companies emphasize ROIC, or Return on Invested Capital, which provides a more reliable way of predicting the value expected to be added (or lost). However, even ROIC does not tell the "complete" story. Consider a company with two business units with ROICs of 30% and 6%, and a cost of capital of 10%. If ROIC is the primary measure used for considering investments, the business unit with a 6% ROIC would be eager to invest at 8% to increase its average return while the business unit earning 30% would be motivated to forgo a 20% ROIC investment because it brings down their average returns. Over time this set of incentives could lead companies to invest far too much in their least profitable businesses while underinvesting in their strongest businesses.

Ultimately, management needs more robust performance measures that enforce accountability for delivering returns while motivating all growth investments that beat the cost of capital. And they must use these tools to drive continuous improvement through both innovation and efficiency.

One recent example of an activist pushing for a change in operations was the launch by Bill Ackman's Pershing Square of a proxy contest at Canadian Pacific (CP). They sought a change in CEO and board representation, but their ultimate goal was a change in operations as a means of creating shareholder value. In their presentation they explicitly stated, "We are not seeking a sale or change of control or financial engineering transaction. We are seeking board and management change to enhance the long-term performance and competitive position of the company."

Pershing went on to highlight CP's relatively poor operating performance compared to that of industry stalwart Canadian National, pointing out that "Canadian Pacific is 70% the size of Canadian National, yet has an enterprise value only 40% as large, due to its inferior profitability and asset utilization." They emphasized CPs declining market share and industry-worst operating ratio, a measure of operating leverage and profitability commonly used in the rail industry. Ultimately, Pershing pushed for a leadership change, both in the boardroom and CEO office, but the catalyst here was the opportunity to improve the operations—and in terms of revenue, cost, and capital efficiency, to close the gap with peers.

Value Proposition Three: Financial Engineering

Often an activist investor will push for a change in the company's financial policies, capital structure, or even its business structure. These actions may include initiating or increasing dividends, repurchasing shares, levering up, or adopting alternative ownership structures or domiciles that reduce taxes.

Why do these opportunities exist? Frequently, it's because management either has not evaluated the potential change correctly or has determined that they're happy with the status quo. For example, a company's whose strategy is to "grow" may be convinced that issuing a dividend is a sign that they don't have growth opportunities and shareholders will mark down the company's valuation. Or a company may choose to hold excess cash as "dry powder" for a future acquisition while the activist pushes to distribute that capital to force management to go back to the capital markets if the company needs future capital for a deal. Additionally, an activist who is confident their engagement will result in a higher share price over time may encourage leveraged buybacks to magnify the results on a per share basis.

In many cases seasoned activists started their careers in investment banking, private equity, or corporate law, and feel very comfortable structuring deals and exploiting advantages in the tax code. And such activists are able to capitalize on financial engineering opportunities because many companies don't view it as a "strategic activity" and therefore don't spend much time contemplating alternatives.

A recent example of an activist pushing financial engineering was the 2014 engagement of Mick McGuire's Marcato Capital's with Lifetime Fitness. Lifetime had a unique business model in that its facilities were becoming ever larger, with the vast majority built on real estate that was owned, as opposed to leased, by the company.

In a September 2014 letter to the company, Marcato stated,

We invested in the Company because we believed then, as we do now, that shares of LTM trade at a substantial discount to their fair value and this is due primarily to the nature of the Company's extensive real estate holdings. As a C-corp operating in a consumer-facing industry, the Company faces two significant disadvantages versus other traditional real estate owners: a higher cost of debt and equity capital and corporate level tax obligations. Given the considerable size of the Company's real estate portfolio, steps that improve the capital and tax efficiency of the real estate strategy can create enormous value for shareholders.

What is especially interesting about this campaign is that a year prior to Marcato's arrival, the executives demonstrated a willingness to consider conversion to a REIT. Yet, in this case, the credit ended up going to Marcato when Lifetime Fitness eventually announced its plan to create a REIT and was subsequently acquired by two leading private equity firms with significant real estate experience.

From the time Marcato's intentions became public until the acquisition was completed, the company's shareholder return was nearly 50%. Management could have pursued the REIT themselves, avoided the discomfort of having an activist on their heels, and achieved a substantial proportion of this upside for the shareholders without the intervention of an activist.

Value Proposition Four: A Change in Ownership

In the previous example, Lifetime Fitness was acquired after they started on the right path, but in many other cases, a change of ownership was the activist's intended goal from the start. In such cases, a transaction such as an acquisition, divestiture or spin-off can be the primary activist strategy to create value for shareholders. The pace of activist-demanded transactions seems to have accelerated in recent years, fueled by low interest rates, relatively high market valuations, and a favorable M&A market. Activists are seizing opportunities to dismantle conglomerates holding unrelated businesses through divestitures and spin-offs and to sell small companies to larger competitors that can achieve better scale.

Why do these opportunities exist? With regards to divestitures and spin-offs, there is a longstanding economic notion that businesses have "natural owners" with a comparative advantage in managing certain types of assets that enables them to produce consistently higher returns on invested capital. For example, a management team focused on a single fast-growing, high-margin business can often produce better returns than a management team trying to manage a larger company composed of a variety of diverse businesses with different growth rates, margins, and investment opportunities.

Like many of the corporate raiders of the 1980s and 1990s, activists have seized on this notion to convince many conglomerates they would be better off breaking up and allowing each management team to focus on their respective businesses. The activists point to excess cost created by the conglomerate structure, inefficient capital allocation across a variety of businesses that differ greatly in expected profitability as well as capital requirements, and inefficient capital structures that cannot possibly be optimal for all the conglomerate's divergent businesses.

In the case of acquisitions or asset sales, the argument offered by activists is often that the company's natural owner is another group that can potentially maximize value through growth, cost, and capital structure synergies. The "natural owner" may be a strategic or financial buyer who at certain times in the economic cycle might be willing to pay higher prices.

The act of exploring "strategic alternatives," which generally consists mainly of the process of evaluating transactions like M&A, divestitures and spin offs, doesn't happen with sufficient frequency inside most companies. This is because exploring strategic alternatives is time-consuming, distracts management from the day-to-day, and can be costly in other ways. Finally, it can attract unwanted attention or be viewed as an admission by management that they aren't able to create enough value for shareholders in their current form.

Also, in the case of a multi-business company with strong and weak performing businesses, management's "knee jerk" reaction is often to spend a disproportionate amount of time and energy trying to fix the weak business because being a "turnaround" specialist is often viewed as a badge of honor. In such cases, the best course of action may well be to jettison the poorly performing business and reallocate the time, energy, and capital to ensuring that a strong business reaches its max potential.

One study we published showed that, during the 10-year period 2001-2010, the top quartile S&P 500 companies had positive average cumulative total shareholder returns that were 20 times as large as the negative average of the bottom quartile companies. This finding suggests that it may be far more important for managements to make sure their best businesses get all the attention and capital they need—and to get rid of their distraction businesses, even if they need to do so at a low price.

Transactions are a common activist pursuit and recently there have been numerous cases of activists agitating for transactional outcomes, including Carl Icahn at eBay, Nelson Peltz at Dupont, Elliott Management at EMC, and JANA Partners at Qualcomm.

One case that attracted a fair bit of attention was Relational Investors' targeting of The Timken Company and pushing for the separation of the company's bearings and steel businesses. In pushing for this transaction, Relational, along with its partner in this campaign, The California State Teacher's Retirement System (CalSTRS), argued that the conglomerate company was trading at a steep discount and that there were only "soft synergies" between the businesses. They went on to say that "Investors are concerned that this [conglomerate] structure inherently carries the risk of poor capital allocation decisions as one business subsidizes the other."

Value Proposition Five: A Change in Leadership

To reinforce their push for change, activists will often seek to make a change in leadership of the company. While this is rarely the sole case for change made by the activist, it is a very frequent outcome. From the investor's point of view, bringing in new management helps to ensure that their "value creation agenda" is properly executed. For example, they may replace a sales and marketing oriented CEO with an executive with a history of reducing cost—or they may replace an accounting oriented CFO with a proven "capital allocator."

These opportunities tend to exist because a CEO or CFO is seen as ineffective—or they may be the wrong leaders for the future. Even if top management has been responsible for much of the company's past success, activists sometimes find it necessary to bring in new executives that can effect change without being wedded to the past. Additionally, replacing senior management sends a very strong signal to the rest of the organization that it is no longer "business as usual." Everyone up and down the organization will become a little uneasy and will be more eager to perform possibly in fear of also losing their jobs.

There are scores of examples of senior executives that leave either voluntarily or otherwise once an activist has taken a material stake in their company. For example, senior executives were replaced in activist engagements by Carl Icahn at Biogen IDEC, Chesapeake Energy and Transocean, and by Jeff Smith at Darden Restaurants.

One high profile CEO change that was well covered by the media took place when Dan Loeb's Third Point Investors engaged Yahoo! Third Point spear-headed a very public and challenging activist campaign that ultimately led to the ouster of Scott Thomson as CEO in 2012. Demonstrating the diligence of today's activist investors, it was Third Point that sent a letter to Yahoo!'s Board of Directors whose subject line read as follows: "Regarding Discovery of discrepancies in educational records of CEO Scott Thomson (and Patti Hart)." Third Point had discovered that Mr. Thomson claimed to have a degree in accounting and computer science. But upon further review, it turned out the Mr. Thomson's alma mater didn't begin to offer a degree in computer sciences until four years after he had graduated. Third Point used this finding to chip away at the credibility and integrity of Thomson to fulfil its ultimate goal of replacing him with another executive.

The Third Point campaign culminated in the appointment of Marissa Mayer as CEO. At that time, Daniel Loeb exited his stake and stepped down from the board of Yahoo!, allowing Third Point to sell part of its holding. In explaining his decision, Loeb said, "Since our Board's rigorous search led us to hire Marissa Mayer as CEO, Yahoo's stock price has nearly doubled delivering significant value for shareholders."

Value Proposition Six: A Change in Incentives

While not typically the primary catalyst, changing management incentives is often a reinforcing point in the activist's overall case for change—one that typically serves two purposes. First, the "right" incentive framework can better align management's interests with the activist investor's case. For example, if the investment thesis hinges on better capital allocation, an incentive program that holds management accountable for earning an adequate return on new capital investments is likely to prove valuable. Second, the existing incentives often reinforce the activist investor's argument for why a change is needed. For example, a CEO's compensation that went up year over year while the value of the company declined might be shown to be the result of badly designed performance measures or targets. Therefore it's appropriate to change incentives to strengthen the linkage between pay and performance.

Moreover, it's not just about cutting pay. Indeed, activist investor Jeff Ubben of ValueAct has said that to create more value for shareholders may entail paying more not less to CEOs while making sure the incentives are properly designed.

Why do these opportunities exist? The opportunity to change incentives exists because far too many executive compensation plans do a poor job of aligning the interests of executives with those of the owners, and too many executives earn too much for poor performance. Moreover, activists often use the charge of excessive or inappropriate compensation in their campaigns against a management team to create a lightning rod that will stir other more passive investors into siding with them.

A good example of "shock value" can be found in Marathon Partners' recent campaign against Shutterfly. In May 2015, Marathon issued a public presentation about Shutterfly that it called, "Delighting our Customers and our CEO… But not our Shareholders." When it went public with this statement, Marathon Partners had been an investor in Shutterfly for over seven years and had become frustrated with the company's performance and CEO compensation. In their presentation they went on to claim: "We Believe the CEO's Interests Are Misaligned" and "We Believe the Comp Committee Sets Easily Attainable Performance Goals."

These statements by Marathon proved to be very effective in rallying the rest of the shareholder base and getting them to see the activist investor's side of the story.

Value Proposition Seven: A Change in Governance

Like compensation, the possibility of change at the board level is rarely the primary catalyst, but it is very often part of a contested activist campaign. In rallying the rest of the shareholder base, the activist will often emphasize the poor performance that happened "on their watch" as a means of conveying why the activist's alternative plan requires fresh board members to ensure the execution of the plan.

For example, in the Third Point campaign against Yahoo! discussed earlier, Loeb questioned the leadership and commitment of Roy Bostock, Yahoo!'s chairman at the time. Loeb concluded from Bostock's failure to acknowledge any responsibility for the company's problems that he was neither aware of what it takes to be an effective leader nor likely to resign from the board. And then after informing Bostock and (Yahoo!'s Co-founder) Jerry Yang that Bostock was part of the company's problem, Loeb declared Third Point's intention to pursue whatever efforts were necessary to remove Bostock from the board.

From the activist investor's standpoint, having board representation ensures they are well represented, despite owning only 2-10% of the shares outstanding, and increases the likelihood that their agenda is embraced and properly executed by management and the board.

Why do these opportunities exist? Making changes to the board by replacing directors, expanding the size of the board, and nominating new directors is another means of strengthening the activist investor's agenda. It represents a change from the "old guard" to the "new guard." Activists will often contend that the existing board has become too close to management or has been in place too long to be objective, so the replacement of some of the directors becomes both a signal of change and a substantive revamping of governance. The reality is that, despite the best intentions of most corporate directors, it is very difficult to govern a company in today's world while spending only a handful of days a year focused on performance and strategy.

A recent campaign that was in some ways a watershed moment for activist investors was the highly contested proxy contest waged by Jeff Smith's Starboard Value that led to the replacement of the entire 12-member board of Darden Restaurants. Smith is credited with "out maneuvering" the board at every turn. When asked about it after the fact, he said, "They were blind to how their actions were going to directly lead to this result. It's kind of surprising."

Having gained effective control of the company while owning only 10%, Starboard is now in a position to effect change across multiple dimensions, including strategy, operations, financial strategy, transactions, incentives, and leadership.

Message to Executives: Be Your Own Activist

Not every demand of an activist investor is likely to add value, and not all activist investors are equally skilled. So none of the above discussion should be construed as saying that an activist investor's agenda should be followed with no questions asked. Nevertheless, when it comes to pushing for changes, most activists are looking for catalysts for change and ways of increasing value that fit into one of the seven "buckets" just discussed.

Enduring the onslaught of an activist can be difficult and unpleasant, to say the least. But there are actions executives can take to create substantial value without the prodding of an activist. Beyond such actions, they can prepare in advance for the possibility that an activist will arrive on the scene. They can level the playing field that otherwise often slants in favor of well-prepared activists whose preparation reflects their foreknowledge of when the debate is going to begin.

From management's perspective, the critical process is continuous internal "scoring" of the company's performance across the seven dimensions discussed above to determine (1) where there are vulnerabilities, and (2) what should be done about them. Answering those two questions should lead management to "be your own activist." The following provides a general guide to the "be your own activist" playbook.

What stands in the way of a company being its own activist? In many cases it's a combination of comfort with the status quo, pride, misinformation, insular thinking, compensation, and unintended obstacles in the strategic decision-making processes. To be your own activist, management and the board should be open to ideas, encourage debate, challenge the status quo, seek outside opinions, and most of all be proactive.

It is remarkable that activist investors can achieve the success they do, given they are limited to external information and sources. Despite their information disadvantage relative to management, they're able to produce impressively detailed fact-based arguments on how a company can improve. Clearly, with all of the internal information and industry expertise at the disposal of corporate executives, they are in a better position to become their own activist.

Executives and boards routinely underestimate the level of effort and sophistication that many of the well-established active investors put into their campaigns. For the activists, the stakes are very high. They typically manage very concentrated portfolios and their incentives are largely driven by performance in terms of returns for shareholders. It is not unusual for them to spend significant sums of money and months studying a company, its peers, and the industry before making an investment.

For example, when Elliott Management targeted BMC Software in 2012, they issued the following statement:

Elliott has performed exhaustive research on BMC over the last six months. This process included enlisting external consultants to advise us, as well as speaking with customers, opinion leaders, engineers, competitors, former employees, senior executives in the software industry, investment bankers, private equity firms and other investors. We have surveyed in excess of five hundred users of IT management software, following up with customers who have transitioned to or away from BMC. Our conclusion from this analysis is that BMC's assets are valuable and important, but that its future will be increasingly difficult if BMC remains a standalone, public company.

Step One in Becoming Your Own Activist: Seek outside opinions and be open to criticism

In many companies the formal strategic planning process is too narrow, too insular, and too driven by financial models for forecasting revenue, expenses, and investment. Not enough time is focused on assessing alternatives or unintended obstacles to success. These obstacles build up slowly over time, making them difficult for insiders to see since they're often culturally engrained—such as the idea that the biggest business unit of a multi-business unit company should get the largest allocation of resources, and the assumption, rarely challenged, that a "bigger business is a more valuable business."

For most companies the strategic planning process is designed to look at recent history and make minor tweaks to "improve" performance in the future. Typically, performance will be tough next year and then dramatic performance improvements come in later years, producing the classic hockey stick-shaped projections designed to provide easy targets in early years and reassure senior managements that there is a plan to create significant shareholder value. To gain perspective on the changing external business and competitive environment, companies should enlist the help of outsiders in their strategic planning process and challenge the status quo. In other words, take the view of an investor, a customer, a supplier, or a competitor.

Step Two in Becoming Your Own Activist: Step Back and Give Yourself Some Time

One clear advantage an activist has over most corporate executives is time. Too many executives are consumed by day-to-day firefighting and routine tasks. They don't have the luxury of time to sit back and contemplate bigger picture strategies for driving shareholder value.

The natural tendency to "fire fight" also leads to another widespread problem—an excessive emphasis on short-term results, in many cases at the expense of long-term value creation. To combat this problem, executives need to ensure that their business processes, staffing, and decision rights empower all levels of leadership to "run the business" in ways that allow the top executives to focus on strategy and execution more broadly.

As highlighted above, Elliott spent six months or more studying BMC Software. How much time do most CEOs dedicate to "strategic planning?" A few days at a management retreat? A month of boiler plate presentations and meetings? What should be one of the most critical management processes is often marginalized because of the demands of day-to-day operations. Top management needs to delegate enough responsibility to their management teams to free up their own time to focus on the long term. This may require redesigning organizational structure, decisions rights, management reporting, and incentives.

Step Three in Becoming Your Own Activist: Develop a Culture Focused on Shareholder Value

The term "shareholder value" has been much maligned in the media over the last several years. Critics denounce the notion of focusing on shareholder value as a euphemism for doing things that "help" boost a company's share price in the short run but "hurt" the company in the long run.

Such criticism picked up pace in 2009 when former GE CEO and management guru Jack Welch declared, "On the face of it, shareholder value is the dumbest idea in the world." But, as Welch went on to say, "The idea that shareholder value is a strategy is insane. It is the product of your combined efforts—from the management to employees."

This is absolutely correct, shareholder value is not a strategy, but rather an outcome—and it is the right goal to strive for. But a company's strategy comprises all the actions and decisions taken to drive towards that goal. And so we urge companies that embrace the "be your own activist" mindset to try to instill a culture of value creation, to create an organization in which management and employees think and act like owners. In this context, everyone inside a company can be their own activist.

As many executives have told us, "culture eats strategy for lunch." Regardless of how brilliant your strategy is, if you do not have the right culture, you will not be able to make it work. So, while Jack Welch is right that shareholder value is not a strategy, it can be a culture. And that will provide lasting benefits in terms of strategy, tactics, execution and results.

Business owners have an innate shareholder value culture. They can take an action that "hurts" performance in the short run and "helps" in the long run or vice versa. They simply need to make the decisions that will make the business run as well as possible for as long as possible. If they are correct, they will be the beneficiary—and if they turn out to be wrong, the value they destroy will be their own.

Inside large publicly owned companies it can be hard to create this type of culture. We encourage CEOs and CFOs to devote their attention to culture and aim to reinforce an owner-like culture in everything they do. This means worrying more about real performance results—best measured in terms of cash flows and returns on capital rather than earnings. It means trying different ideas in a quest for continuous improvement, knowing some of the new ideas will fail but seeking a portfolio of ideas that as a group lead to the sought-after improvements. It means driving as much performance as possible in the short and medium term while being willing to invest for the long term and never compromising the future to meet an unimportant short term goal. And, of course, it means treating the company's capital as if it were their own—eager to invest it wherever returns seem adequate to compensate for risk while enforcing true accountability for actually delivering returns.

Step Four in Becoming Your Own Activist: Understand the Trade-offs

Ultimately every decision taken inside of a company involves a trade-off. Therefore it is very important that all the executives who are empowered to take decisions understand the impact of their actions and have consciously weighed the trade-offs.

It is often one of these trade-offs that activist investors seize on when making their case against a company's strategy. For example, corporate decisions to emphasize price over volume or margins over growth, or to make acquisitions instead of paying dividends or repurchasing shares, or to expand internationally vs. domestically—each of these decisions is capable of attracting the attention of activists.

Therefore, in becoming your own activist, a management team must be able to communicate the well-articulated reasoning behind the decisions it has made. This requires a deeper level of analysis and insight than the typical budgeting process may allow for.

For example, what would happen if instead of investing in a new facility in Region A, we diverted some of our products produced in Region B where our margins are lower? Or what if we reduced our price and margins but gained market share? Or what would it take to build the capabilities of company X vs. acquiring company X. Think of it as doing strategic due diligence on your own company. What could we do differently and does it make sense?

Step Five in Becoming Your Own Activist: Communicate Completely

Many companies almost certainly disclose too little useful information to investors, and too many "stick to the script" too often. Their quarterly calls, for example, rarely deviate in terms of message, structure, flow, and details. This uniformity of presentation appears to be a sign of management's "capitulating" to the sell-side analysts who have to write narrative reports and update earnings models instead of the people they should be trying to reach: the buy-side investors who are making the buy/sell decisions.

Too much effort is spent trying to "spin" the story to turn negatives into positives, often by showing adjusted metrics, lowering future guidance and other "tricks of the trade."

Sophisticated activist investors see through these tactics. And ultimately, they can come back to bite management when confronted by an activist.

We believe it's best for management to communicate more freely and completely with investors and "the Street." When things go well, talk about it. When things don't do well, talk about that, too. Explain why it happened; and if it can be prevented, how that will be done. In both cases, talk about what's next. How will the company continue to do more good things? How will the company fix its problem areas? What alternatives has the company considered?

Management and the board have a public track record in the form of the company's financial statements that can be evaluated by anyone with a PC or calculator. Far too many companies believe they have a "value recognition problem," meaning that investors are failing to understand the company's strategy or prospects. The typical response in such cases is to step up public relations, corporate communications, and investor relations. In reality many such companies actually have a "value creation problem," and this is what attracts today's activists.

Step Six in Becoming Your Own Activist: Be Proactive, Not Reactive

As discussed above, many of the levers activists look to press on are already on the company's drawing board of the latest strategic plan. Therefore, today's executive teams and boards of directors should hold themselves accountable to taking action today rather than waiting for tomorrow. There is no need for an activist to tell you how to close a value gap if you've already identified the same issue. A proactive approach will leave you much better prepared for the initial debate with today's activist investors.

To be proactive means to be your own activist. Long before any activist shows up, work internally and seek outside help to identify all the likely areas an activist might pursue with your company. Would they criticize your margins or returns? Would they claim you allocate capital poorly? In too many unrelated businesses? Hold too much cash? Put together a full list of the likely demands an activist would make, and revisit the list at least annually. Analyze each idea to see if it would create value for the short and long term. If it makes sense, why wait for an activist to come tell you what to do? Do it now. And for those ideas that don't make sense, carefully itemize the fact-based reasons so that if an activist ever shows up demanding a course of action you have already considered and rejected, you are ready to respond instantly. And if an activist does show up with an idea you have not considered, analyze it fairly and implement it if it makes sense.

Conclusion

Being your own activist is as much about overcoming behavioral and cultural biases as it is about being savvy about corporate finance and strategy. Much of what creates the opportunity for activists is their ability to be unemotional in their assessment of a company's prospects, and management should aim to do the same. The right strategy and culture are the ultimate deterrents to an activist investor, ensuring that management's track record reflects actions that have been taken to drive performance improvements and increase the value of the company. As always, results speak louder than words in press releases or Power Point presentations.

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