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What to Do When an Activist's Letter Arrives

The question is no longer whether an activist will invest in stock, but when they might go active.

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This is the third in a series of columns based on a new book from EY Transaction Advisory Services, The Stress Test Every Business Needs. The first column dealt with portfolio reviews and the second with integration.

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» I often get the call asking, "An activist just reached out to us. They have taken a meaningful position in our company. What do we do?"

It's not surprising the first instinct is often to dig in for a fight. No executive team likes to have their effectiveness challenged, nor do boards like to have decisions put under a microscope. Unfortunately, many advisers still default to the outdated hostile defense playbook.

I am not suggesting activist shareholders are always right, or that companies should simply roll over. They need to engage high quality legal counsel, but that alone will not resolve the issues. Engaging swiftly in a substantive, factual conversation may prove to be a faster and less expensive option than going to battle.

Here are some steps to consider:

1. **Engage and set the right tone.**
Listen to what the activist has to say, and take enough time for a thoughtful response. Your first communication back to the activist will set the stage for many interactions to come.

A little-known fact in activism is when companies engage early — and effectively — many activist investors sell before their involvement ever makes headlines.

Craft the right tone by quickly determining which investment theses this activist is pursuing. After extensive study of all activist investments since 2010, we have learned they fall into four theses. Topics such as governance are means to these ends:

- Putting the company up for sale
- Restructuring the balance sheet
- Splitting the company up
- Improving the operations and return on capital

And then, do some homework on their interaction style, what they want to accomplish, and how they arrived at this investment thesis.

2. **Gather facts.**
Ideally, the company has previously done an outside-in evaluation through the eyes of an activist, considered which of the above four targets are likely to be areas of controversy, put together the facts that persuaded the board to pursue the path the company has chosen, and vetted them for potential public disclosure. The company also needs a well-designed playbook on the shelf, so it can readily engage the activist on their agenda.

Unfortunately, that is the exception, not the norm. If this data was created, everything is ready to go. If not, take the time to gather the data.

3. **Formulate your response.**
To maximize the chances of productive engagement with an activist, be aware of the three components to an activist encounter:

1. Tactics and processes — Proxy solicitation rules, Section 220 demands for books and records inspection, etc.

2. Defensive facts — What facts show the activist's arguments are mistaken or misguided?

3. Offensive measures — What is the plan to generate shareholder returns? Why should the shareholders support management's plan, and so on?

In our experience, companies typically spend 90% to 95% of their energy around tactics and processes, and around 5% on true defense. Almost no energy is spent on offense or asserting why their vision and strategy is the right one.

Consider this high-profile example: A company had two divisions and an activist asserted that management would create shareholder value if the divisions were separated. The company disagreed and engaged in a long and expensive proxy fight. The company won the proxy battle, yet never settled suspicions among the investor base that the activist might have been right. Less than a year after winning the battle, the company decided to separate the businesses. In the end, they lost the war because they were so focused on the tactical/process steps they failed to convince the investor base of their strategy.

A more realistic and effective mixture of the three factors is to spend energy and resources as follows: 30% on tactics, 30% on defense, and 40% on offense. What shareholders really want to hear is why and how your approach will enhance their shareholder returns in tangible ways. They want to know how the activist's position is factually wrong, not in terms of general principles, but in terms of specific facts. The activist laid out quantitative facts and arguments, and shareholders want to see quantitative arguments from you around those very same specific topics.

'We Thought About That Too'

Ideally, convey in initial discussions that the activist's ideas are directions that management has already considered. The company's position and underlying actions are in line with their understanding of what's happening, not divergent from the landscape or blind to it.

An activist doesn't want to get stuck in a bad investment. Let's say I'm an activist and think the way to get 50% appreciation is by having the target sell Division X and get $2 billion in free cash for it. After I buy the stock and we fight with each other for a while, I learn that there's a $1 billion tax bill that must be paid, and therefore I won't get $2 billion in cash for it; I will only get $1 billion. That is not good for my stock position, given I'm now active, and have taken a big position, filed a 13-D, and so on. It's nearly impossible for me to sell the stock without the price falling and handing me a very painful return.

By anticipating activist questions and requests, and then addressing them quickly with facts and details, management can get activists to quickly understand the flaw in their theses and get them to move on quietly. Or you may learn some of their ideas are sound and embrace those — avoiding a long and expensive fight — and enhancing shareholder value.

Activism is Here to Stay

Activism is not a fad. In fact, it is growing more pervasive by the year. It's not a question of whether activists are in the shareholder base, but of when they might go from latent to active. It's not a matter of finding activists; they are already there. Take the steps above to be in the best position to reduce, or even head off, any activist tendencies among your shareholders.

This article is adapted from the new EY Transactions Advisory Services book The Stress Test Every Business Needs, by Jeffrey R. Greene with Steve Krouskos, Julie Hood, Harsha Basnayake, and William Casey. The book has more than 20 other senior EY contributors including Shyam Gidumal. CFO

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