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OCT 15 2013 **What To Do When an Activist Comes Knocking**

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Activist investors are currently the darlings of the equity markets and the financial media. Many of the leading activist investors (Bill Ackman, Dan Loeb, Nelson Peltz and Carl Icahn, to name a few) appear regularly on business news channels, have their investment forays avidly covered by the media and are literally household names. In part due to (mostly fawning) press coverage and a perceived track record of success, activist investing has emerged as a well-recognized and growing alternative asset class, estimated today to total about \$85 billion. It is not hyperbolic to call activist investors the rock stars of today's equity markets.

While activist investors may have rock star reputations, their actual performance is often not rock star caliber. One needs to look no further than Bill Ackman's recent track record – including his retreat from JC Penney, his failure at Target and his current under-water short position at Herbalife – to see that not all activist campaigns are the equivalent of chart-topping hit records.

Nor is Ackman the only activist whose game plan for change at a target company has delivered less than promised. Nelson Peltz' foray at Heinz is usually viewed as a triumph for activist investors who preach operational reform rather than financial engineering. However, the data doesn't support the assumption that there was meaningful margin expansion during Peltz' involvement in Heinz. It may be that Peltz' successful investment was more a product of picking the right stock at the right time than a result of superior skills in optimizing operating performance.

Carl Icahn has likewise had a number of epic failures among a career of predominant success and financial gain. Indeed, on some occasions Icahn has won the initial war and succeeded in gaining control, only to see the company under his aegis slide into near or actual bankruptcy. And while he has been nimble enough to make money on some of these failed equity investments by buying bond positions prior to or during an ensuing restructuring, his fellow shareholders have not done as well.

These are only the headlines. There is growing evidence that activist investing performance is regressing to the mean, as the amount of capital it controls overwhelms the quality of its investment opportunities. Moreover, there is increased recognition that activist investing's claimed performance often outruns the underlying reality.

However, while the activist investing scorecard may be spotty and its continued success subject to question, today's truth is that activist investing is waxing, not waning. Activism's increasing financial firepower means more companies are at risk for an attack. The critical issue for company executives and boards in today's vibrant activist investor environment is how to best prepare for the day when an activist's sights are set on them.

One critical lesson from the past several years of activist investor successes is that pejorative attacks on activist investors and their investment styles will not merely be

ineffective—they will all too often backfire and lead investors to dismiss company boards and managements as being out of touch with reality. Negative campaigning on ideological grounds is rarely a way to win votes from anyone other than fellow ideologues. A target company campaign based on the conceptual evils of activist investors—for example, their alleged focus on short term gains at the expense of long term growth—may resonate with a small group of investors who already hold that view but is not likely to influence most investors and other equity market participants. Demonology only works when the audience intuitively believes your opponents are demons, not when the audience views your opponents as heroes.

That being said, it is important that companies and their advisors not cede the reputational high ground to activist investors. The simplistic view that activists are always right and management always wrong has always been overblown. But it is less prevalent today than it was even six months ago, and there have been a number of recent articles indicating that the strong reputational advantage formerly enjoyed by activists is beginning to recede.

As a result, meaningful blemishes on an activist's track record should be an effective and important ingredient in a target's message to its shareholders. While it is true that a company cannot win simply through negative campaigning, investors are willing to take an activist's history into account when weighing the credibility of its game plan for creating value at a target company.

A second critical lesson is that even a well-founded, factually based critique of an activist's track record is not sufficient ammunition to win an activist challenge. An activist investor's biggest weapon is its championship of change. A company under attack risks quick defeat if it is perceived as only advocating the status quo. Given a choice between doing nothing and doing something, dissatisfied investors too frequently will choose change for its own sake. As a result, the best defense against an activist attack is almost always offense. The target's primary goal should be to put forward a constructive program for change, one that is better substantively than the activist's program for change and can be sold as such.

Effective communication of the company's substantive message is obviously the critical challenge. The target must seize the initiative by defining its strategic and financial goals and a clear path to achieve them. Positive messaging should be at the heart of a target's strategic communications plan to win the campaign for the hearts, minds and votes of its investors.

Given the prevalence of activist investors and their increasing fire power, every public company today should engage in a serious evaluation of its vulnerability to an activist investor attack and preparation for its occurrence. Here are some additional important principles of an effective activist investor defense.

- It is important for management and boards to understand that no company is too large to be a target of activist investors—witness Apple, Kraft, PepsiCo, P&G and Microsoft, to name a few. Nor are many companies too small, as plenty of activist investors regularly target small and micro-cap companies, some with market values as low as \$100 million or so.
- Companies also need to understand that an activist investor attack is very much like a political campaign. While activists may target investors and equity market participants who influence investors, rather than the voting public, the campaign dynamics are not very different—campaigns are lengthy, positive and negative messages fly back and forth and are constantly being revised and honed, key constituencies can be volatile and

surprise lurks at every turn. Moreover, as in political campaigns, good communication of a target's positions are every bit as important as the substance of its positions, and the target's messaging has to be clear, on point and relentlessly consistent.

- To fashion a winning campaign, a target must understand the true views of its investors. If you do not know and understand your voters' actual thinking, both the substance and communication of your messaging may miss the mark, sometimes quite widely. Conventional investor relations programs often fail to gauge the true sentiments of investors who may be reluctant to openly discuss a company's perceived shortcomings with management. Just as in politics, third party surveys and polling are far more likely to discover what investors really think.
- Target companies, by hypothesis, come with warts. Ignoring them will not be helpful and can easily undermine the credibility of the target's defense against an activist attack. A cardinal rule of public relations is that a proponent must own his or her mistakes and acknowledge them before he or she can claim credibility and achieve trust. The same is true for target companies and their boards and management.
- From a communications perspective, an activist investor has the benefit of needing to address a relatively small and connected audience: equity investors and influencers of equity investors, such as buy-side analysts, the financial press and the proxy advisory services. A target company, on the other hand, faces a more complex communications challenge. It obviously must meet the activist in the equity capital markets arena where the ultimate decision will be made by the target company's shareowners. And, as noted above, success in this arena almost always will come with commitments for change, sometimes wrenching change. On the other hand, the target must remain singularly conscious that, in winning this critical battle, it cannot afford to lose the larger war of retaining the trust and confidence of its employees, customers, suppliers and partners. To achieve this in the face of a principal message trumpeting change, thoughtful and consistent communications by the target to all of its key constituencies is required, a far more complex challenge than that of dealing only with the equity market place.
- Finally, activist investor campaigns are often long and full of unexpected surprises. Effective communication will require tenacity, flexibility and constant monitoring of all media to keep up with shareholder and commentator sentiment, to refine messages and tactics as necessary and to spot issues before they turn into unpleasant surprises. Today's world of disaggregated, internet based reporting and social media as a prime information source mandates 24/7 monitoring of all media, including social media, to allow the communications team to spot emerging campaign issues early enough to counter them before they turn into large problems.

Our conclusion is simple. Activist investing is continuing to thrive, so companies and their management and boards need to be prepared—both with substantive business plans which seize the mantle of change and communications plans that reinforce the achievability of these strategies while pointing out the flaws in the activist's proposals and track record.