Secrets of the Activist Manager

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BY LARRY JONES AND JOSEPH DUERR
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In theory, management and shareholder activists have the same goal: maximizing long-term value. A stronger and more valuable company not only benefits its shareholders financially, but lays the economic foundation for the company to serve the interests of other stakeholders, including customers, employees, suppliers, and its community. Many activists — institutions and individuals who take a position in a publicly traded company with the intent of improving its value by changing its strategy, financial structure management, or board — share these long-term objectives. But some, the type often branded as dangerous corporate raiders, take a short-term view. They believe it is possible to push share prices higher (and soon!) by reducing costs, increasing leverage, and selling assets. According to a 2015 PwC report (“Shareholder Activism: Who, What, When, and How?”), the number of hedge funds pursuing such strategies has increased dramatically since 2005, and they collectively have more than US$100 billion in assets.

But the reality is that in many instances, although activist investors are successful at improving margins, they struggle to drive growth. We analyzed 55 companies over the past 10 years in which shareholder activists had a significant impact on company governance and strategy, and compared their performance to that of their industry peers. (The aims of activist actions included business focus, board composition, business restructuring, director election, focus on growth, board representation, general cost cutting, operational efficiency, and removal of CEO.) In each of five industries, we found at least seven instances of what we identified as highly “activated” companies. In four of the five industries, the targets improved EBITDA margins relative to their “non-activated” peers during the three years after being activated. But in all five industries, highly activated companies grew revenues much more slowly than their non-activated peers in the same time frame.

Why is growth so important? When breaking apart an average company’s stock price in the S&P 500, we find that a third of the value of the company is driven by future profitable growth. So short-term activism that focuses only on imminent margin improvement is missing a large part of what drives long-term shareholder returns.

And yet management often has difficulty responding to specific activists. To respond more effectively, and increase the chances of boosting long-term value, management should develop a solid plan before being approached by an activist. Senior managers can do so by making use of their chief advantage: information.

What does management know that the activists don’t? Plenty. As
insiders, senior managers have access to a deep and detailed understanding of the company’s operations, customers, markets, and competitors. Because they know how the business works, they can determine which customers, geographies, and business lines are creating value for the company and which are consuming it, and where profit pools exist in the market. They can translate this information advantage into a performance advantage by developing new strategies to capture a greater share of these profit pools and by making better resource allocation decisions.

Accordingly, the activist manager should follow a three-step approach. First, evaluate, systematically and dispassionately, where the opportunities for value creation exist. Second, evaluate and execute options to deliver on those opportunities. And finally, communicate the growth plan to value-oriented investors.

Understanding Where Value Lies
Value is always highly concentrated within a business — by company attribute, segment, product, customer, and geography — often to a degree not evident on the surface. Despite the wealth of disclosures that companies make in regulatory filings, investor presentations, and media releases, outside activists get only snapshots (often fuzzy ones) of what’s going on inside the company. By contrast, management has the ability to see in high resolution and in three dimensions. Understanding where and why value is concentrated enables management to prioritize investment in the highest-potential areas for growth and identify areas where margins need to be improved. Management should use this information to develop a plan that is more effective than any an outsider could create — and do it in advance of being approached by an activist investor.

In most customer and product markets, only a third of customers or products create value for shareholders; another third are value-neutral, and the final third are actually destroying value. Understanding where and why value is concentrated at this granular level allows management to reduce investment in areas where value is being destroyed and to increase investment in areas with the highest potential for profitable growth.

In fact, the further you dig down within a company, the more concentrated value becomes. In one industrial products company, the top 5 to 10 percent of the company’s customers in a single market represented 60 to 70 percent of current profitability and 70 to 90 percent of the potential profitable growth for the entire market segment. Before this analysis was done, managers had a hard time justifying investments in new offers, services, pricing, and support. Why? They were attempting to serve the needs of their average customer, including the vast majority who were not producing much value. An outside activist likely would have made the same recommendation. But as soon as inside managers identified the 5 to 10 percent of customers who were truly creating value, they felt compelled to make investments to capture a greater share of these relation-

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Plan of Action
Once opportunities for improving margins and enhancing profitable growth have been identified, the activist manager will also have a better-informed view than the outside activist of the best course of action. Short-term activists often assume, as a default response, that areas where value is being destroyed

stakeholders. In these cases, management will take many of the same actions an outside activist would — but the managers’ information advantage will enable them to carefully cut with a scalpel, rather than wield an ax.

ships. Within a year, the territories that employed the new techniques for priority customers were growing 10 times as rapidly as those employing the standard approach.

Management also can best understand which areas of the business are consuming value, and then use that knowledge to improve margins through a combination of improving price, enhancing mix, and reducing costs. Doing so will improve the company’s long-term health and enhance its ability to serve all its

Illustration by Robert Neubecker
business segments or groups of customers that are consuming value today should be exited or abandoned. But “firing” customers should be done only as a last resort, because it closes the door on any potential future growth from those customers or segments. In many cases, managers can use their detailed understanding of their customers and operations to fix the underlying issues that have caused these relationships to be unprofitable. In the process, they can unlock hidden value and future growth.

For example, a global consumer packaged goods company was struggling to make one of its European businesses profitable. Management was considering divesting the business. But a thorough review revealed that the business could be profitable if management could successfully provide new and more valuable offerings to customers, become more disciplined about pricing, reconfigure the supply chain, and streamline support. Rather than sell, management embarked on an 18-month turnaround that made the business profitable, and generated tens of millions of dollars more in shareholder value than it would have with a quick sale.

Not every strategy will work for every company, as each has a unique history and set of capabilities. For that reason, these strategic options need to be grounded in the set of distinctive capabilities that enable the company to deliver in its key markets in a way that competitors can’t match, and in management’s understanding of what additional capabilities need to be developed or acquired to support the growth plan. In the example of the consumer packaged goods company, if the management team had not had the capability and capacity to fix the European business, exiting the business would have been a preferable choice. This capabilities-driven strategy can create a cycle of continuous renewal that leads to top-line growth in both existing and adjacent markets.

Once strategies have been agreed upon, they need to be translated into a specific implementation plan that lays out clear roles, responsibilities, actions, resources, key performance indicators, and financial commitments. This detailed plan is essentially the road map for a corporate transformation. Execution of the plan should be a top priority for management, and must encompass the alignment of current resources, budgeting, performance management, and incentives.

**Communicating the Plan**

The value-maximizing plan must be communicated not only to preempt or respond to an activist, but also to attract shareholders who voice their objectives for long-term value creation. Here, again, management should focus on building an information advantage — this time about investors. Understanding and attracting the right type of investors is like understanding and attracting the right type of customers. Management needs to know the motivations of the company’s current shareholder base, and to be able to identify investors who don’t hold the stock today but who would benefit from holding a position in the future. Senior managers can make their investor relations (IR) function a proactive force rather than an entity that merely responds to investor questions. The IR team should research and understand the motivation of current and potential investors. In particular, companies should identify and target shareholders who are making decisions based on the long-term intrinsic value of the company. Management needs to understand which key variables these investors are using to assess the company, and adjust the company’s messages, metrics, and methods to tell the value story most effectively.

Leaders of companies in which activists express interest should start from a position of confidence. They already know which management practices work best for the company. And the secrets of the activist manager are embedded in the informational advantages that management already possesses. By seizing these advantages — unearthing them, understanding them, acting on them — leaders can reinvigorate their company and create long-term profitable growth in ways that competitors, upstarts, and activist investors won’t be able to match.

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