Identifying Good And Bad Activist Investors

We recently wrote an article that warned investors of profiteers masquerading as activists. Many prominent “activist” investors are not always what they pretend to be and do not have the best interests of other investors in mind. By encouraging buybacks, acquisitions, and other feats of financial engineering, these “activists” look to make a quick buck and get out, leaving regular investors holding the bag.

However, there are some genuinely good examples of shareholder activism out there. In the right context, activist investors hold management accountable and play a beneficial role in the market by ensuring that poor corporate governance and strategy don’t persist.

Here are a couple activist campaigns we’ve seen in recent years that have been good for shareholders.

Jeff Smith: Taking On Weak Boards

Jeff Smith’s Starboard Value took on Darden Restaurants (DRI) in 2014. He claimed that the board did not have shareholder interests at heart and sought to drastically change how the company was run. Starboard brought specific plans to improve operations such as separating the company’s real estate assets into a REIT, delay the spin-off of Red Lobster and, yes, buy back shares.

We don’t necessarily love all those financial maneuvers, but what was encouraging was the level of detail Starboard put into its operational plans. The fund released a 300-slide presentation in September of 2014 detailing its plans, which included:

- Cost-cutting affecting food quality and driving away customers
- Lack of communication with restaurant general managers leading to poor operating performance
- SG&A continually increasing as a percent of revenue
- Opportunity for technology to improve table turnover

Shareholders seemed to be convinced of the plans and voted to oust the entire Darden board and replace it with Starboard-nominated candidates. The new board brought in a new CEO, Gene Lee, and they’ve executed many of the changes Starboard suggested.

So far, those changes have been working. Darden’s return on invested capital (ROIC) increased from 5% in FY 2014 (ends in June) to 6% in 2015 and 11% through the first three quarters of 2016.

DRI has outperformed the S&P 500 since Starboard took its stake (up 22% vs. 17%) and now earns our Attractive rating, which means the company still has significant upside based on its fundamentals. Starboard has decreased its stake in the company but still owns over 5% and plans to hold on to that stake.

We saw a similar scenario occur at Tessera Technologies (TSRA), where Starboard criticized the board for sinking too much money into failing businesses and an overall lack of cost control. It managed to replace the entire board at Tessera and enact changes that helped boost ROIC above 50%.

Tessera is up 108% since Starboard disclosed its stake and now earns our Very Attractive rating. Starboard recently sold out of its stake entirely.

Ralph Whitworth: Reforming Executive Compensation

Ralph Whitworth, who founded Relational Investors, turned over the operations of the fund in 2014 and has been fighting cancer ever since. Losing Mr. Whitworth in the fight against misaligned and excessive executive compensation plans is a tough loss for the investment community. We think misaligned executive compensation plans are at the heart of most corporate dysfunction.

One of Mr. Whitworth’s most notable campaigns was waged against Home Depot (HD). In 2006, he took a 1.2% stake and began criticizing the pay package of CEO Robert Nardelli.

Mr. Whitworth understood that growth and value were inherently linked and that executive compensation that rewarded growth with returns on invested capital (ROIC) below the weighted-average cost of capital (WACC) destroyed value for investors. He pushed to eliminate the company's wholesale supply division that was growing revenues but had low margins.

He also reformed the company's executive compensation, shrinking pay packages and aligning them better with long-term shareholder value. Today, Home Depot is one of the few companies that links part of executive bonuses to ROIC.

Home Depot's stock has more than tripled since Whitworth took his stake as its ROIC has increased from 17% to 21%. The stock earns our Attractive rating.

Potential Good Activist: Norwegian Sovereign Wealth Fund

Norway's sovereign wealth fund, which has $870 billion in assets and has long been passive, recently announced that it plans to start putting pressure on companies that have excessive executive compensation.

Having such a massive fund take a stand against poor compensation practices could have a big impact. We hope Norway's fund will not only look at the size of executive compensation, but also the structure. We would like to see it push for executive compensation plans that reward ROIC and long-term value creation.

Bad Activist Example: Carl Icahn

While we like the activists above, they tend to be in the minority. Much more common are activists such as Icahn that make a lot of noise in the press, push for either buybacks or an acquisition, and then get out right away.

Take Icahn's investment in Apple (AAPL – Suspended rating). He took a stake in 2013, saying that the company was a great long-term value and that it would "dominate" new product categories such as TV's and automobiles.

However, instead of pushing for more investment in these new categories, he did the opposite, by driving for more stock buybacks and dividends.

Now, at the first sign of bad news from China and a quarterly earnings decline, Icahn is out of the stock entirely. He made himself some good money, but he did little to improve Apple's business. We think his goal was simply to create a short-term bump in the stock.

Bad Activist Example: Jeffrey Ubben

Along with Bill Ackman, Jeffrey Ubben's ValueAct Capital also had a significant position in Danger Zone stock Valeant (VRX), which, by itself, makes us wonder about his commitment to long-term shareholder value. We see from his history that he tends to focus more on financial engineering than improved operating performance.

For instance, his most recent campaign is an effort to break up MSCI (MSCI). The company, which offers indices and portfolio analysis tools, has rejected his efforts so far. Reports suggest that Ubben's main priority is to separate the highly profitable index business from the newer and growing analytics segment so that it can be sold to a strategic buyer.

MSCI has a high and rising ROIC, indicating quality management. Rather than trying to split up MSCI to create a short-term gain, Ubben should be working with management to create even more value in the future or just leave the company alone.

Conclusion

"Activists" are not always aligned with other investors. Pay close attention to exactly how they plan to improve the businesses with which they get involved. If they cannot articulate substantive plans to improve the business (like the examples above), then they are likely in the stock for the short-term and have little concern with creating shareholder value.

Disclosure: David Trainer and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

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