



Think Like an Activist

**To maximize value, CEOs can
borrow from the activist playbook.**

KPMG research shows how activists use a combination of portfolio moves and investments in performance and growth to beat the market. Here's how "Activist CEOs" can use some of the same techniques to unlock value in corporations.

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To maximize value, think like an activist

CEOs can get higher valuations by applying lessons from the new activist playbook

CEOs who are serious about maximizing shareholder value can profit from studying the playbook that activist investors use. Generations of CEOs have been told they could maximize value by managing a portfolio of businesses. Some of these would be cash cows and others might be fast-growing stars, requiring investments and management attention. The growth-share matrix guided CEOs to divest dogs, milk cash cows, and invest in stars. It worked in a world where investors bought shares of publicly-traded companies and trusted management to deliver results over the long term. There was no need to worry about the valuation effects of running businesses that required different amounts of capital and management attention, or that had disparate rates of return.

Contrary to what most CEOs believe, divesting businesses can create more value than acquiring them.

This conventional wisdom no longer works well. As we showed in our earlier paper, *Can your valuation be improved?*, markets today penalize companies that hold onto businesses with disparate growth, margins or capital intensity. This means that milking a cash cow to invest in a star could reduce the value of the overall portfolio if those businesses require different amounts of capital and management attention, or have disparate rates of return. And it may not just be the dogs that need to be divested—some businesses may be candidates for divestiture, even if they are strong performers, simply because they are too different from the rest of the portfolio.¹

¹ Source: [Can your valuation be improved? KPMG 2018](#)

² Price-weighted index of NYSE, Amex and Nasdaq indices

An in-depth study of more than 1,400 activist campaigns by KPMG shows how these investors use portfolio actions—divestitures, acquisitions, etc.—as well as investments in performance and growth to beat the market. The most successful activists use multiple portfolio moves and multiple performance-improvement initiatives to realize gains of nearly 7 percent over the market.² In this paper, we share our insights about the activist playbook and how it can be adapted for an “Activist CEO.”

The most important lessons for CEOs of public companies in this research:



Divesting can create more value than acquiring.



Combining portfolio actions—acquisitions and divestitures—with performance improvement leads to the best results.



CEOs can look at their businesses through the activist's lens to identify untapped sources of value.

Activist CEOs who heed these lessons—shedding assets that don't fit while investing in performance improvement and growth—will find more opportunities to maximize value. An activist CEO might never match the best activist fund on total returns. But activist CEOs can enhance value and outperform their peers by applying the activist lens to consider the cost of owning businesses that detract from valuation and deciding when to divest and where to invest.

The new activist playbook

In-depth research conducted by KPMG into activist campaigns reveals that the best-performing activist funds generate excess returns in two ways: by taking multiple portfolio actions—forcing the sale of assets that are not contributing sufficiently to value—and by investing in performance and growth.

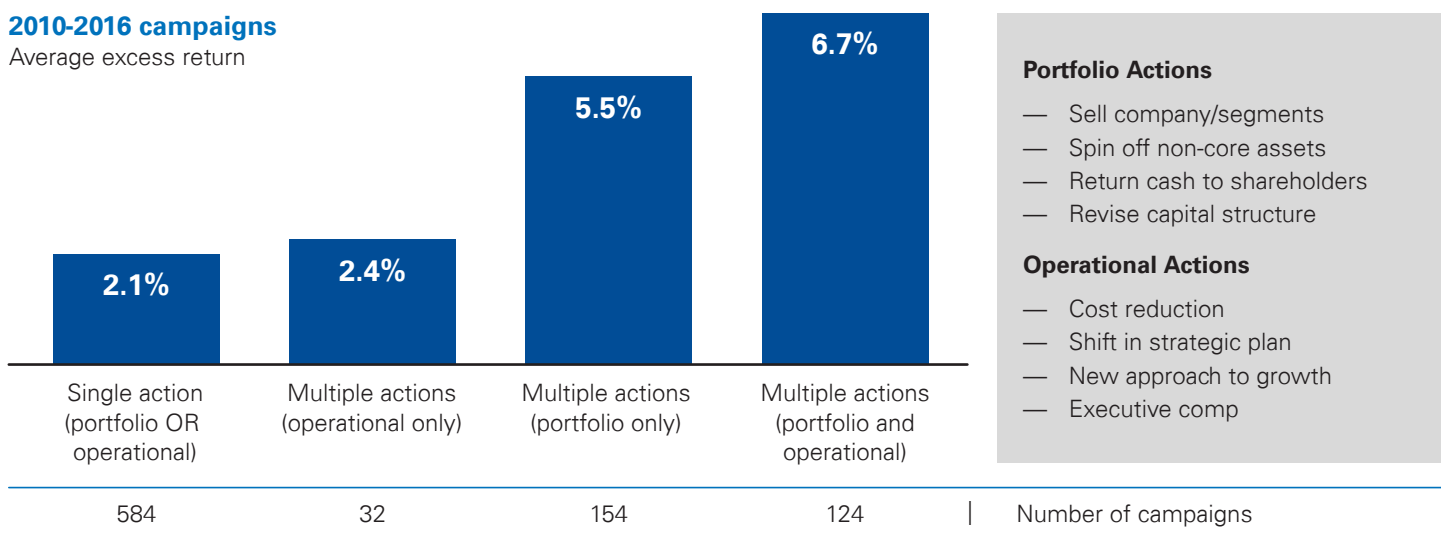
As Exhibit 1 illustrates, when an activist takes a single portfolio action or a single initiative to improve operations,

the average “excess” gain (increase in stock price vs. the overall market a year after the 13D filing) is more than 2 percent, on average. When activists make multiple portfolio actions, the premium over the market jumps to 5.5 percent. And when multiple portfolio actions were combined with multiple performance initiatives, activist returns averaged 6.7 percent over the market.

Exhibit 1 - Activists have demonstrated that combining active portfolio management with performance improvement creates the highest excess returns

2010-2016 campaigns

Average excess return



n = 817 campaigns characterized into action categories

Source(s): KPMG analysis, Factset database

This intense focus on active portfolio management is the result of three decades of evolution in capital markets. In the 1980s, private investors purchased publicly-traded companies through LBOs and relied largely on financial engineering strategies to release value—before making a rapid exit. Today, activists focus more on selling businesses that don't fit and investing in improving the winners.

This new activist playbook was on display in 2019 when Elliott Management, a venerable Wall Street activist, took a \$3.2 billion stake in AT&T, demanding “increased strategic focus, (and) improved operational efficiency” at the telecom giant.³ In short order, AT&T management agreed to sell a non-core subsidiary, Central European Media Enterprises, for \$2.1 billion and divest a total of \$14 billion worth of assets by the end of the year.⁴ AT&T shares rose by 32.3 percent in 2019, vs. 26 percent for the S&P 500.

³ Source: Paul La Monica, “Activist investor takes a big stake in AT&T, pushing for spinoffs and major changes,” CNN Business, Sept. 9, 2019

⁴ Source: Sheila Dang, Svea Herbst-Bayliss, “AT&T to add directors, sell up to \$10 billion in assets next year,” Reuters, Oct. 28, 2019

A playbook for the “Activist CEO”

A corporate CEO and an activist investor operate under similar mandates. They both have a common objective: to increase value for their investors. But corporate leaders have assumed that they do not have the same degree of freedom that a private investor has in the pursuit of value.

In today’s environment, this is no longer strictly true. If a business is not making the contribution that the company requires—and if the market penalizes the company for holding it—the reasons for keeping it have to be extremely compelling. The growth of private capital has produced a highly liquid market for both large and small transactions, increasing competition for deals and raising valuations for spinoffs and divestitures (See “The growing role of private

capital”). In other words, it is relatively easy to find a better home for a business that no longer fits. And, as their sophistication has grown, private-equity players are able to take on more complex carve-out and spinoff transactions. Knowing there is a market for assets helps CEOs start thinking more like activists—looking at the business as an activist would, and considering the kinds of portfolio moves and investments that activists make.



The growing role of private capital

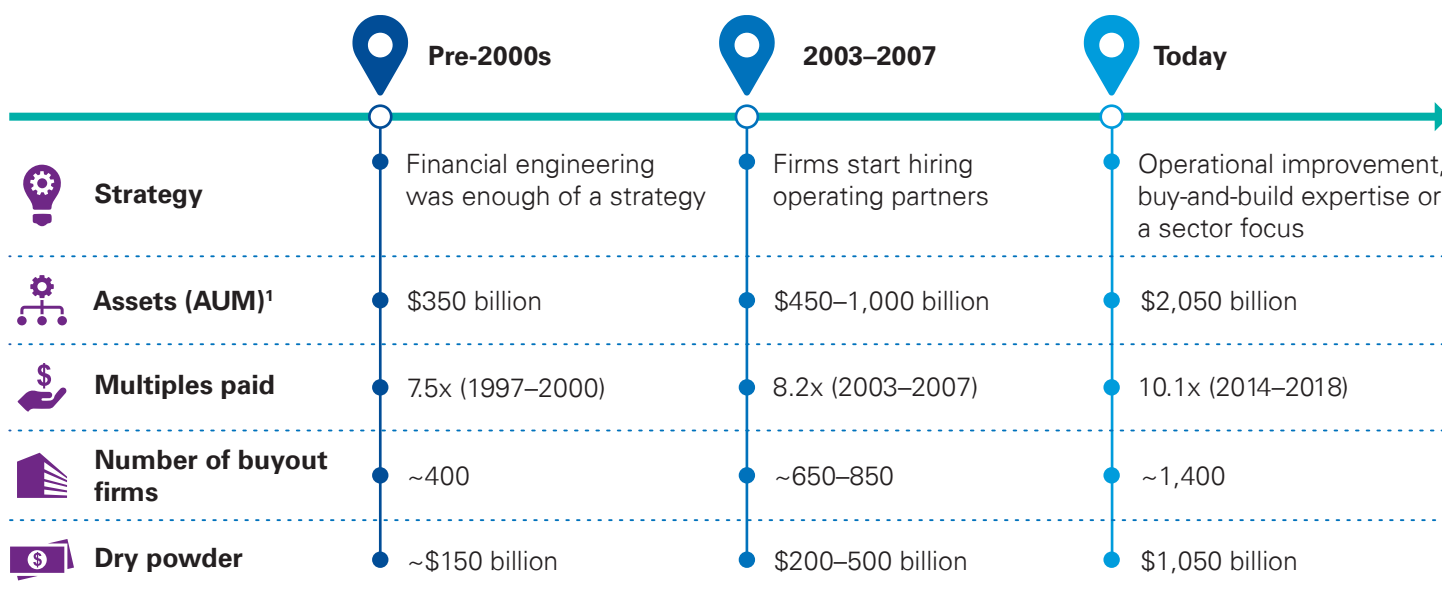
The private capital sector—including activists—has evolved in size, influence and sophistication. In 1995, private capital investors held just 4 percent of publicly-traded equities⁵, totaling around \$100 billion. By 2019, that figure had ballooned to \$1.7 trillion—or 10 percent of the market⁵—moving from a niche strategy to a major market participant.

The increased PE presence not only means that there are many more buyers in the market competing for assets, but the competition has also spurred more transparent price discovery—and higher valuations (Exhibit 2). In fact, market

multiples were so high by late 2019 that even private equity managers were asking whether they were the best buyers for some businesses. This is a question for CEOs, too.

High valuations, of course, can spell opportunity for sellers. Even as the competition for deals remains intense, there is huge liquidity in private-equity funds. Buyout firms have an estimated \$1.05 trillion in “dry powder” waiting to be deployed. In the current environment, virtually any business can be sold—or any business unit can be divested. And the sellers are likely to be rewarded with higher valuations for their remaining businesses a year out.

Exhibit 2 - As private capital has evolved, so has its success model



Source: KPMG Research; Preqin

¹ Preqin data is for buyout firms in particular

⁵ Excludes top 10 companies by market capitalization since they are unlikely to be targets for private capital

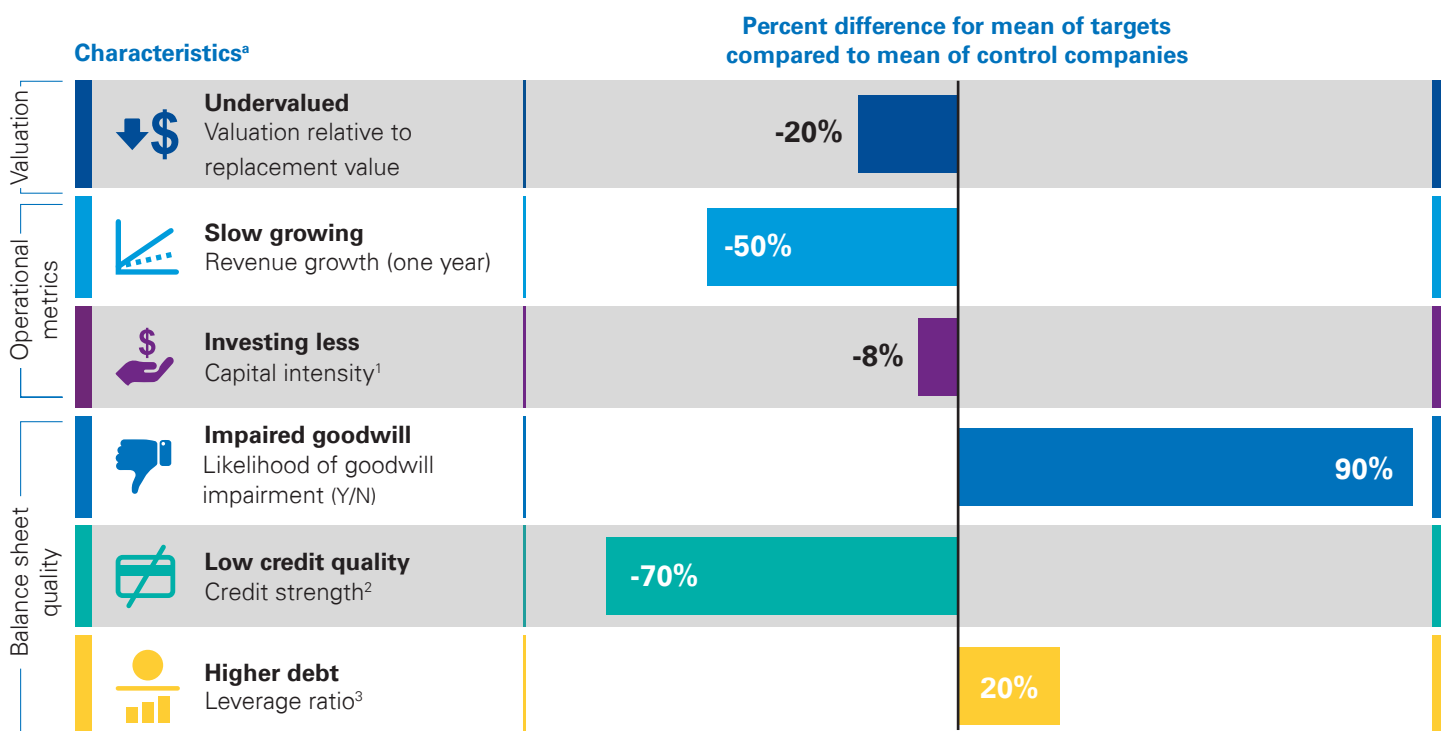
Apply the activist lens

If companies want returns approaching those of activist investors, they can start by learning what activists look for. Thinking like an activist also has an added benefit: it can help companies avoid an unwelcome investment by activists. KPMG has identified the key signals that activists use to spot companies with untapped value.

Activists tend to target fundamentally sound companies that have specific deficiencies. The first “tell” for activists

seems to be when a company’s revenue growth is significantly below that of peers and it is undervalued relative to peers, despite having comparable gross margins. Targets also usually have problems on the balance sheet such as goodwill impairment or higher leverage ratios (and poorer credit quality). Using the activist perspective, CEOs can look for signs of vulnerability—and opportunities for value capture—across the corporation and in individual businesses (Exhibit 3).

Exhibit 3 - What stands out about companies that activists target



Activist targets and companies in the control group have statistically similar core business characteristics such as gross margins and dividend yields.⁴

n=400 deals

Note(s): ¹ capital expenditures divided by net property, plant and equipment; ² Based on Z score; ³ Debt divided by debt plus equity ; ⁴ Other similar characteristics between targets and control group companies include goodwill as a % of assets, cash as a % of assets and market-to-book

Sources: Factset, Capiq, SharkRepellent, KPMG analysis

Sell assets that don't contribute to excess returns

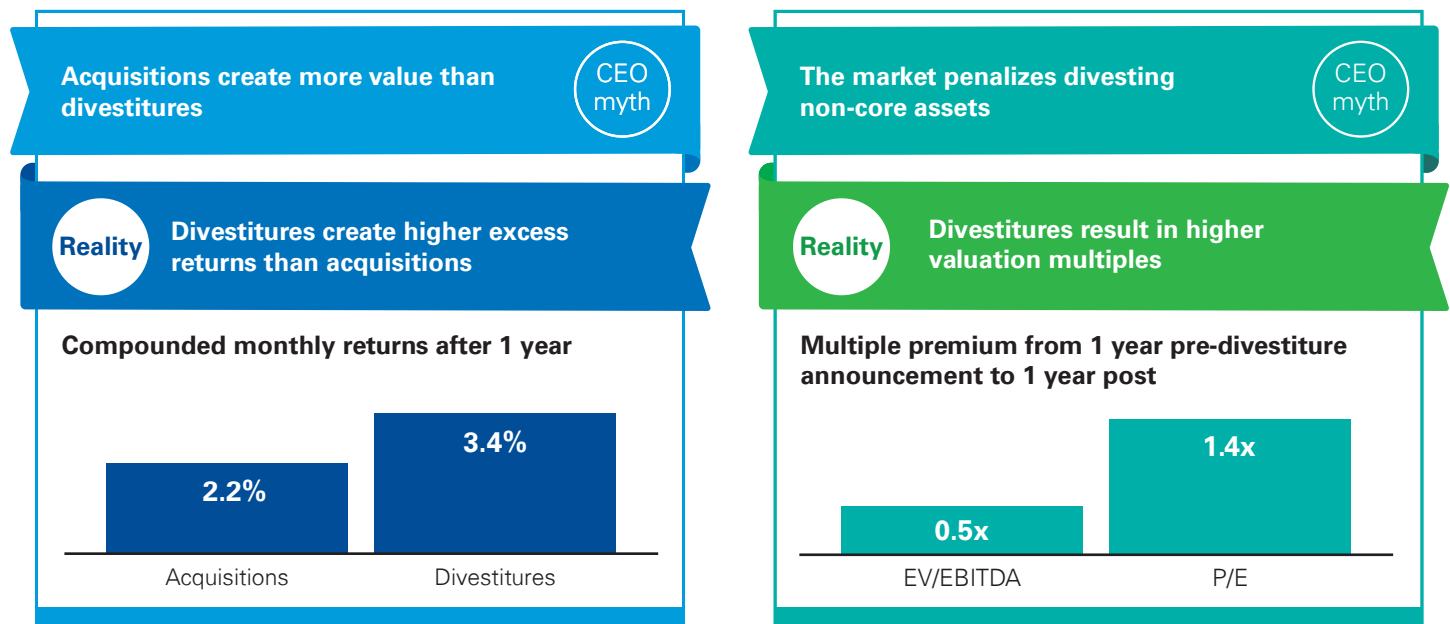
For many CEOs, it remains an article of faith that acquisitions are the best path to enhanced shareholder value, even though the data don't always bear this out. In a KPMG study of 17 acquirers in the consumer packaged goods industry, for example, 41 percent had lower returns than an index of the top 50 companies in the industry.⁶

Our research demonstrates that when companies announce divestitures, their market valuations actually tend to be higher 12 months after the transaction. Conversely, there is a penalty for not selling. In *Can your valuation be improved?*, we shared research confirming that the market imposes a significant "diversification discount" for corporations composed of businesses with disparate

rates of return because investors assume this leads to sub-optimal capital allocation. There is also evidence that delaying divestitures destroys value.⁷

However, market data show that companies often create more value through divestitures than through acquisitions. In Exhibit 4, we show that a year after the transaction, shares in companies that had divested businesses had 3.4 percent excess returns vs. the overall market, compared with only 2.2 percent for companies that had made acquisitions. Yet when KPMG surveyed top executives, only 10 percent said that divestitures were a better route to higher valuation; 72 percent said they would do better through acquisitions and organic growth.

Exhibit 4 - Costly myths: CEOs still believe that acquisitions create more value than divestitures and that markets penalize companies that divest assets



Note(s): Compounded monthly returns after 12 months, estimates based on Research by E. Feldman; Average of Manufacturing and Services industry; In a CEO survey (n=50) conducted by KPMG with GLG, 72% of CEOs agree that acquisitions have created more value than divestitures over their careers and will do so in the future

Source(s): Research by E. Feldman, based on KPMG analysis, KPMG CEO survey, and CEO discussions

⁶ *Winning in M&A: Best practices from leading consumer companies*, KPMG 2018

⁷ Dranikoff et al., "Divestiture: Strategy's the missing link," *Harvard Business Review*, May 2002.

One explanation for the lack of enthusiasm for divestitures is that CEOs find it hard to part with businesses that have long been part of the company or that have been acquired and nurtured over many years. In behavioral economics, this is known as the endowment effect—also “divestiture aversion.”⁸ This may explain why activists—outsiders with no emotional attachments—are quick to identify assets that might be better off in other hands.

Holding onto unneeded assets is costly in many ways. Managing these assets inevitably diverts attention and resources from other businesses, detracting from value creation. This can be especially true of smaller assets, which may take a disproportionate amount of management attention compared with the potential return.

Part of the activist strategy is to refocus capital and energy in more rewarding ways after an asset sale. “Improvement in focus is one of the key benefits of divestitures,” notes Emilie Feldman, associate professor of management at the Wharton School at the University of Pennsylvania. “Divestitures are beneficial because they remove businesses that may be contributing to distraction. Then, managers can focus solely on the remaining businesses whose subsequent performance generally improves.”

A recent example of an activist program to refocus a company is Lowe’s, a home-improvement retailer. D.E. Shaw, a hedge fund that employs an activist strategy, convinced the company to take on three new independent directors and unlock value by focusing on the core retail business and divesting assets. Within six months, Lowe’s closed a chain of hardware stores, wound down two other non-core units, and shuttered its Mexican operations.

“Our top priority,” CEO Marvin Ellison told the *Financial Times*, “was positioning Lowe’s for long-term success by identifying underperforming or non-core businesses and stores for divestiture.”⁹ Over the two years, from January, 2018 to January, 2020, Lowe’s shares increased 26%, compared to 19% for the S&P 500.

Activists also took aim at United Technologies, a conglomerate with holdings in aerospace, elevators, and air conditioning. The activists, led by Pershing Square, argued in May, 2018 that the diverse parts would be worth more as independent companies.¹⁰ In November, the company acquired Rockwell Collins to bolster the core aerospace business and announced plans to spin off the elevator and air conditioning divisions into a standalone company.¹¹ Shares of United Technologies, which has subsequently announced a plan to merge with Raytheon, rose by 38 percent in 2019, vs. 26 percent for the S&P 500.

A key lesson from activist investors is how to choose what to sell. It’s not always the slow growers that catch the activist’s eye. Sometimes it’s a fast-growing business that is consuming too much management attention and too many resources. Or it may be a business that doesn’t really fit in terms of rate of return, increasing the firm’s diversification discount.

One company that understood this is Trinity Industries, which crafted a winning value-building strategy. In November 2018, Trinity decided to focus its business on its core rail transportation products and services. So it spun off the parts of the company in the infrastructure construction, energy and non-rail transportation into Arcosa, a new public company.

⁸ Source: Shih-Chi Chiu, Seemantini Madhukar Pathak, Robert E. Hoskisson, and Richard A Johnson, 2014: CEO Human and Social Capital and Corporate Divestitures: An Investigation of Endowment Effects. Proceedings, 2014, Academy of Management.

⁹ Camilla Hodgson, “Lowe’s Sees Profits Dive as Cost of Slimming down Rises,” *Financial Times*, November 20, 2018

¹⁰ Ciara Linnane, “Bill Ackman Calls for a Breakup of United Technologies,” *Market Watch*, May 20, 2018

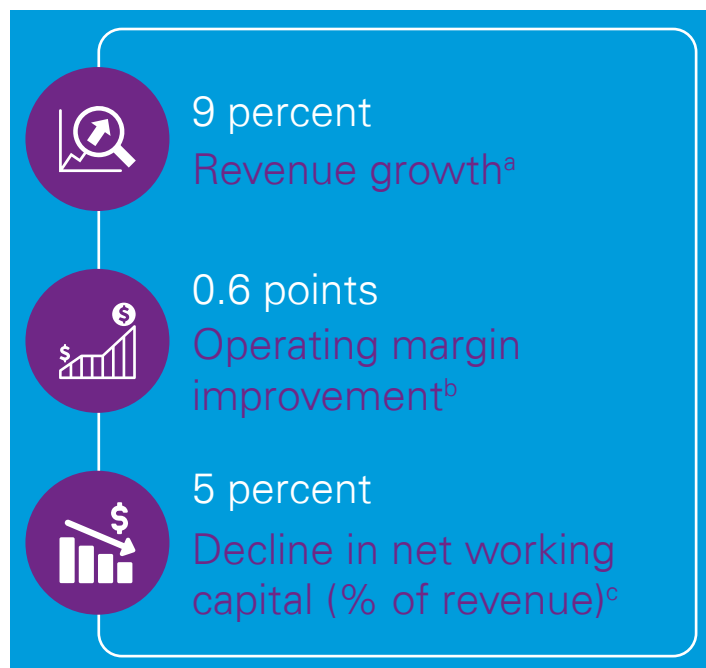
¹¹ United Technologies Announces Intention to Separate Into Three Independent Companies; Completes Acquisition of Rockwell Collins (press release), Nov. 26, 2018

Invest in the “keepers”

The other half of the activist investor’s winning formula—investing in the businesses that are deemed “keepers”—should come naturally to CEOs. After all, finding ways to grow the top and bottom lines are part of the CEO job description. Yet CEOs can also learn something from watching how activists go about growing the businesses they invest in. We analyzed more than 100 campaigns that focused on operational improvements and found that target companies had increased revenue growth by 9 percent over three¹² years and racked up improvements in both operating margins and use of working capital (Exhibit 5).

For example, in 2015, activist investor Trian Fund Management took a 7 percent stake in Sysco, the global food distribution company, and Trian cofounder Nelson Peltz took a seat on the board. Trian said it was impressed with the company’s growth prospects, but also said it saw opportunities to reduce costs by \$600 million (FY 2015 sales were about \$49 billion). By the end of fiscal 2019, Sysco’s operating margin had increased by 50 basis points and its net working capital as a percent of revenue had decreased by 1.6 percentage points.¹³ Trian’s shares were up 108 percent since 2015, vs. 66 percent for the S&P 500. In January, 2020, the company replaced its CEO of seven years with a former CVS executive to focus on additional operating improvements. Peltz remains a director and in a statement, Trian applauded the move, saying Sysco still has “significant additional potential.”

Exhibit 5 - How operational improvements create value for activists



Note(s): (a) 121 campaigns, 2010-2016; revenue growth is the change in revenue from 12 months prior to the 13D filing date to 24 months after the 13D filing date (each period calculated on a rolling annual basis); Operating margin and net working capital are the ppt difference for the same time periods (13D-12 months to 13D+24 months, rolling annual basis) (b) Operating margin = operating income / revenue; (c) NWC as % of revenue = $([Current_Assets]-[Current_Liabilities])/[Revenue]$
Source(s): KPMG analysis, Factset database, Capiq

¹² revenue growth is the change in revenue from 12 months prior to the 13D filing date to 24 months after the 13D filing date

¹³ From the end of FY2014 (approximately 12 months prior to the Trian investment) to the end of FY2019

How can you be an activist CEO?

Increasing value for shareholders is an endless endeavor for corporate leaders. The search for value is complex—a combination of long-term strategies to make the company a top competitor in its markets, continuous improvements in processes, and shrewd financial management. In this paper, we have shared our findings about how activist investors increase value through disciplined portfolio actions and investments in growth. The question now is how—and to what extent—can CEOs apply the lessons of activist investors to create value for their shareholders.

To start, would-be activist CEOs and their boards should view value-creation opportunities broadly. They should apply a strategic lens first when considering potential investments and divestitures. But they should be dispassionate about their strategies. Do not presume that the company's strategy is the only correct way—or remains the correct way.

We believe that adding additional perspectives—looking through the lens of an activist—will help make clear whether a business is truly a fit. If the market is penalizing the company for owning an asset because of its rate of return, management must determine if the strategic benefits of holding it outweigh the valuation penalty. Management should also think carefully about the implications of owning a business that exhibits the tells that activists look for. To make sure the company knows about such value opportunities before they are brought to their attention by investors, CEOs can borrow a standard practice from private-equity. PE firms, as part of their reporting obligations to investors, mark their portfolio to market every quarter. Corporations can conduct a similar routine assessment to check how assets are performing relative to the market and get an early signal of possible performance issues.

The first steps toward thinking like an activist CEO:

1

Assess whether the company is showing the signals that activists use to identify attractive investment candidates.

2

Conduct a strategy review and determine if the strategy is creating sufficient value to overcome the statistical headwinds we identify in this paper, such as the penalty for disparate growth rates.

3

Look for ways to be more aggressive in divesting assets. Selling assets tends to create more value than acquisitions.

4

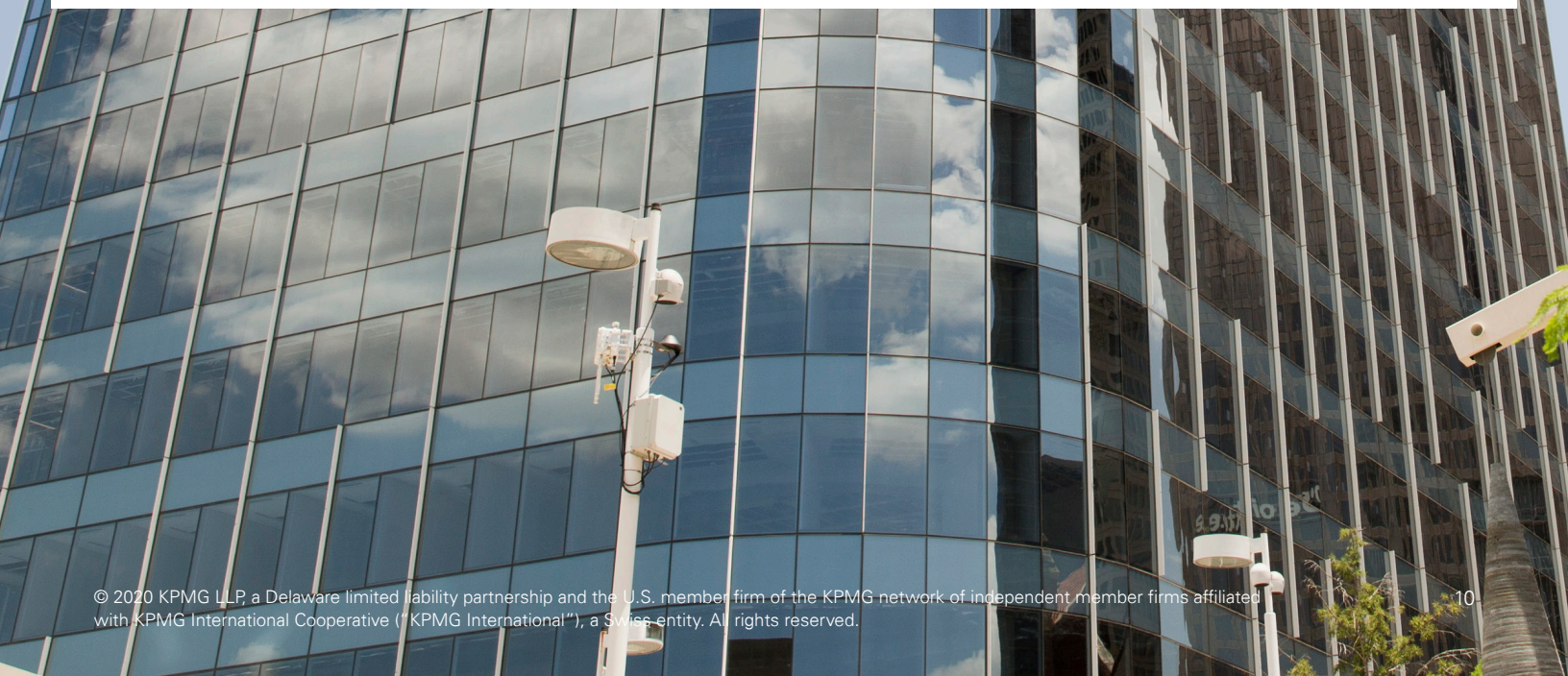
Invest in performance improvements to increase the efficiency of operations and enable “keeper” businesses to grow.



How KPMG can help

KPMG Strategy provides a new perspective on how to design and implement strategies that win in today's market. Our professionals help organizations and executive teams change, grow, adapt, shape and respond to disruptive forces. We support organizations in defining their ambition and executing innovative organic and inorganic strategies to redefine "where they play" and "how they win".

Through proprietary solutions, leading industry perspectives, advanced data and analytics, and interlock across KPMG service lines, we support our clients where they are in their journey, helping them realize value from "innovation to results".









Appendix: Methodology

We looked at a total of 1,377 activist investments between 2001 and 2016. Over that period, the number and size of deals increased, and so did returns. In the transactions that took place after 2010, returns were 3.7 percentage points higher than for the S&P 500 a year after the activist began its campaign with a 13D filing. For the earlier activist campaigns—for which data are more limited—we found the average excess return a year out was 0.7 percent.

Analysis sample

The analysis is based on a sample of more than 2,500 activist campaigns sourced from Factset's SharkRepellent Database with 13D filing dates¹ between 2010 and 2016. After mapping campaigns to S&P Capital IQ, we excluded activist targets with the following characteristics:

-  Companies in Finance, Insurance, and Real Estate sectors (based on SIC code)
-  Bankruptcy-related actions
-  Low stock prices (<\$1 in the year prior to campaign)
-  Microcaps (market values below \$50M) and companies with OTC/pink-sheet listings
-  Outlier sales growth (<5th percentile or >95th percentile)
-  Campaigns without information or classified as "Environmental, Social, Governance" (ESG)

Our final "KPMG Database" included 817 campaigns, which were grouped according to goals: operational, portfolio, and general (a campaign can have more than one goal). We focus in this paper on operational and portfolio campaigns.

Excess return calculation

Excess return is defined as the difference between the target's stock return and an index that attempts to represent "broad US equity returns" for one year starting

¹ Or announce date as listed in the Factset database if a 13D was not filed

² Yahoo finance tickers used: AMEX: ^XAX, NASDAQ: ^IXIC, NYSE: ^NYA

³ Hedge Fund Activism, Corporate Governance, and Firm Performance" (Alon Brav et al., Journal of Finance, August 2008)

with the 13D date.¹ The index's constituents (price-weighted) are the NYSE, Amex and Nasdaq composite indices, replicating the methodology of academic papers on this topic². When a campaign has more than one goal, the excess return of that campaign is included in the analysis of all goals.

Activist target characteristics

We compared summary statistics of activist targets' characteristics with a population-matched control group: the sample was limited to target companies in the KPMG Database that have at least one corresponding company with financials in the same year, the same two digit SIC code, and market value and book market deciles; or failing that, with the same year, three digit SIC code, and market value and book market quintiles (N = 571, of which 302 are portfolio actions and 110 are operational actions). Corresponding companies were also filtered out if the firm fell into extreme percentiles (both high and low) for any of the characteristics considered. Characteristics are as of the first year prior to the campaign for which financials are available and the difference between target and peer firms is considered significant if the t-test and Wilcoxon signed rank test both indicated a two-tail significance of at least 10%.³

Note: Goodwill Impairment (Y/N) uses a dummy variable to represent whether or not there is a goodwill impairment

CEO survey

KPMG and the Gerson Lehrman Group ("GLG") conducted an online survey of 50 CEOs in September 2019. The CEOs lead companies across a broad range of industries with market capitalization from \$500 million to over \$10 billion.

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We gratefully acknowledge the contributions of our KPMG colleagues who conducted the research for this paper:

Scott Mishara, Michael Moore, Patrick Collier, Ritwik Chaudhuri, George Jose, Kanika Aggarwal, Ashwin Date, and Sakshat Kapoor

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