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Activist shareholders are here to stay – and investors should be glad

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It is human nature to draw sweeping conclusions from very recent experience, so it was little surprise to read a New York Times article in late August that argued: "The credit crisis may have just claimed its latest casualty: the so-called activist shareholder." The reasoning was that with cheap capital drying up, activists' attempts to "have the company sold, break the company up or push it to take on debt so it can buy back stock or issue a big dividend" would dry up along with it.

If the takeover binge is over – which I consider likely – we'll surely see a decrease in the prominence of activists who Jeffrey Ubben of ValueAct Capital calls "yellers and screamers whose biggest asset is that they don't care what anybody thinks about them".

However, what I don't expect, or want to see diminish, are the efforts by increasingly vocal and aggressive investors to hold managements accountable for the strategic and capital-allocation decisions being made on behalf of shareholders.

Michael McConnell of venerable activist investor Shamrock Capital Advisors describes this vital role well. "Activism to a large extent is trying to truncate risk by eliminating the misallocation of capital, which is less likely when those responsible truly act as if they're spending their own money," he says.

"When making a decision on a new factory or product launch or hiring plan, people should feel the weight of the capital they are entrusted with. Understandably, given the corporate form, many people running corporations don't operate that way. So when that isn't happening, the ability to improve those decisions through activism is a key way to create shareholder value."

Even when the agency relationship between owners and management is well aligned, activist investors can play an important role. Ubben purchased a significant stake in Mentor Corp, the industry leader in breast implants for aesthetic and reconstructive purposes, because of the scientist founder's reticence to hand over the company to more professional management and move away from long-held businesses that diverted focus from the company's core strengths.

Partly as a result of ValueAct's efforts, chief executive officer Joshua Levine took over in late 2003; the company has exited its legacy urology business and the shares are up 125 per cent.

Another example of successful activism is the case of McDonald's, where Bill Ackman of Pershing Square became involved more than two years ago. While Ackman did not persuade the company to spin off the restaurants it operated, which led many to believe his activism was unsuccessful, in fact McDonald's listened and implemented many of his thoughtful suggestions.

Among these suggestions were changing its financial reporting to highlight the attractive characteristics of the company's real estate and franchising operations, beginning an active re-franchising programme and returning billions of dollars to shareholders via huge increases in the dividend and share repurchase programme. These measures, along with continued superb execution as the company has upgraded what had become out-of-date menus, have resulted in a near doubling of the stock price.

Funds I manage continue to own McDonald's, along with a new Pershing Square activist investment, Target. The innovative and well-managed discount retailer has long been on our radar screen, but the stock – while somewhat undervalued – was never quite cheap enough to buy, given the lack of any catalyst.

But that changed with the July disclosure of Pershing Square's nearly 10 per cent stake in the company. Barring a large decline in US consumer spending, we see limited downside for the stock, trading at about 18 times this fiscal year's estimated earnings and 16 times next year's.

As for the upside, there are two key areas of unrecognised value: the company's large credit card portfolio that could be monetised without materially affecting Target's earnings, and its large real estate portfolio, including the land and buildings for 85 per cent of its stores, 24 distribution centres and its corporate headquarters.

Since Pershing Square announced its stake, Target has hired Goldman Sachs to explore the sale of the credit card portfolio and I expect Target to announce a highly accretive deal by the end of the year. We don't know precisely how the company might unlock the value in its real estate, but this is an area in which Pershing Square has expertise.

Smart activists are not going away, regardless of credit market conditions. I agree with McConnell, who notes: "In the end, there will always be companies in need of more active and engaged owners to better shepherd the agency relationship between owners and management. I'm perfectly comfortable that won't go out of style."

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