BARRON'S

FEATURE | SATURDAY, NOVEMBER 30, 2013

How to Profit From Today's Shareholder Activism

By AVI SALZMAN | MORE ARTICLES BY AUTHOR

It is the best of all times for activist investors, says Carl Icahn. It is also a good time to follow this crowd.

Activist investing has entered a new golden age that could yield benefits for ordinary investors as well as the Wall Street pros.

Now that more mutual and pension funds are supporting hedge funds' efforts to improve corporate management and enhance shareholder returns, companies under scrutiny see little choice but to unbolt their boardroom doors. Their increased willingness to work with outside agitators, even if they don't always relish the job, has enhanced the potential for positive change and in many cases, led to benefits for all investors.

Few companies, it seems, are immune to such pressures. Almost a sixth of the members of the Standard & Poor's 1500 have faced activist campaigns since 2006, and the number of large-cap companies being targeted by activists has tripled since 2009, according to a recent Citigroup report. Targets have included some of America's best-known companies, such as Apple (ticker: AAPL), and Microsoft (MSFT), as well as Dell, Hess (HES), Sotheby's (BID) and Procter & Gamble (PG).

The results have been impressive: An index of 17 prominent activist hedge funds has returned 19% since 2009, versus 12% for the Standard & Poor's 500 and 7.5% for all hedge-fund strategies, according to the Citigroup report. Positions taken by star practitioners such as Carl Icahn and Ralph Whitworth of Relational Investors have smoked the competition in recent years. Icahn's fund, Icahn Capital, was up 26% this year through Sept. 30. Whitworth's fund is up 34% year to date, while the S&P 500 has gained 27%.

"There has never been a better time for activist investing," Icahn wrote in his third-quarter report to investors.

The strategy has risks, too; just ask Bill Ackman, head of Pershing Square Capital Management, whose success in foisting a new chief executive with a flawed business plan on J.C. Penney (JCP) led to steep losses.

But it's the winners investors remember when they hand over money to activist funds—and they have handed over billions in recent years. Activist vehicles managed $89 billion as of the end of the third quarter, up from $36 billion in 2009, reports Hedge Fund Research. That 146% growth rate, reflecting net inflows and investment gains, dwarfs the 57% increase in all hedge-fund assets in the comparable period. Investors pumped a net $7.2 billion into activist funds through September 2013, more than twice last year's haul.

Such numbers ought to render moot the long-running debate on Wall Street about whether activism is a force for good or evil in the economy and the corporate world. Certainly, today's version looks to be a more wholesome variant of the corporate campaigns of the 1980s, when managements and boards routinely were stalked by raiders who sought a quick killing without providing much longer-term value. Worse, many "greenmailed" companies into paying them to go away.

To run successfully with today's activist crowd, or at least alongside it, investors need to understand the new landscape. Successful, high-profile meddlers like Icahn, Ackman, and Third Point's Daniel Loeb continue to dominate the conversation, but other activist hedge-fund managers, including the five spotlighted nearby, and on the following page, also boast outstanding returns. Ackman protégé Richard "Mick" McGuire, of Marcato Capital Management, for example, forced auto-parts maker Lear (LEA) to boost its stock-buyback program and add a Marcato affiliate to its board. Lear's shares have risen more than 60% since McGuire revealed his stake in the company in February.

Movers and Shakers

The five activists below don't get as much ink as some of their more outspoken peers, but they deserve just as much credit for improving corporate management and performance.

Robbins: Courtesy of Blue Harbour; Smith: Jacob Kepler/Bloomberg News; Taxin: Jeff Chiu/AP Photo; McGuire: Amanda Gordon/Bloomberg News; Whitworth: Jeff Zelevansky/Landov

Clockwise, from upper left: Clifton Robbins, CEO, Blue Harbour Group; Jeffrey Smith, CEO, Starboard Value; Gregory Taxin, managing director, Clinton Group; Richard McGuire, CEO, Marcato Capital Management; Ralph Whitworth, co-founder, Relational Investors

TODAY'S ACTIVIST INVESTORS have been employing multiple strategies to achieve their goals. Firms such as Blue Harbour Group and Engaged Capital focus on "constructive" activism, acting more like consultants or private-equity managers to enhance the value of brands, and their campaigns typically take place behind the scenes. If an activist's holdings exceed 5% of a company's shares, the investor must file a 13D statement with the Securities and Exchange Commission, announcing the size of his stake and his intentions.

Blue Harbour CEO Clifton S. Robbins says companies have been much more open to activists' overtures since the financial crisis. "When we started the business 10 years ago, we'd call companies and their lawyers would call back," he says. "Today, if I call a CEO and say I have an idea to get the stock up 30% to 50%, there would be no CEO who wouldn't want to meet."

It might be tempting to jump into the shares favored by activists when a campaign is revealed, but experts caution patience. Targeted stocks typically rise 6% in the days just before and after an activist move is publicized, notes Lucian Bebchuck, a professor at Harvard Law School. Often, however, those gains don't hold. "Impatience and fatigue set in," says Gregory Taxin, an activist investor at Clinton Group. "That's an attractive time to buy."

So long as activist funds score big gains and are flush with cash, the virtuous circle will continue. Here's a look at two current, well-conceived activist campaigns that could yield big wins for shareholders, and five successful activist investors whose names aren't Icahn or Ackman. More information about activist positions is available in *Barron's* weekly Activist Spotlight column (see 13D filings), prepared by Kenneth Squire, founder and president of 13D Monitor.

DARDEN

The casual-dining company has amassed a portfolio of faster-growing, higher-end restaurants, including Capital Grille, Yard House, and Eddie V's. But overall growth has been kept in check by the poor performance of its two biggest chains, Red Lobster and Olive Garden, whose same-store sales fell 4% and 5.2%, respectively, in the latest quarter.

Reflecting such troubles, Darden's shares (DRI) have traded in a tight range between $45 and $55 for most of the past three years; they closed Friday at $53.33.

The company's poor performance has frustrated shareholders, including Barington Capital, which formed a small group of investors holding more than 2% of the stock to push for changes. The group thinks Darden could be worth as much as $76 a share.

Barington frequently takes activist positions, but tends to work with corporate managers to create change, rather than launching proxy contests or speaking publicly. In the case of Darden, news of its efforts leaked, prompting the firm to publicize a letter it sent the board in late September.

Barington proposes in the letter that Darden split into two restaurant companies, one for the legacy brands and one for the higher-growth chains. Similar spinoffs have propelled the shares of McDonald's (MCD) and Brinker International (EAT), it notes.

Brinker's stock more than tripled after the company sold its On the Border Mexican Grill & Cantina chain 2010. "The market makes managing a portfolio much more difficult," former CEO Doug Brooks said at the time.

McDonald's has more than doubled since spinning off Chipotle Mexican Grill (CMG) in 2006. Chipotle, in turn, has soared 2,200%.

Darden's sales, general, and administrative expenses have averaged 9.6% of revenue in the past decade, versus 6.7% for peers, says Barington. Operating profit margins trail competitors such as Cheesecake Factory (CAKE) and DineEquity (DIN), the owner of IHOP and Applebee's.

DARDEN ANNOUNCED IN September that cost cuts could save it $50 million annually. Barington wants the company to aim for $100 million to $150 million in reductions. Barington also thinks Darden ought to convert its real-estate holdings into a real-estate investment trust, or REIT.

Barron's warned earlier this year that if Darden's management didn't speed its turnaround plan, an activist investor might swoop in and force change ("Can Darden Fix the Menu?" March 25, 2013).

Darden hasn't commented on Barington's proposal, save to say it "welcomes input toward the goal of enhancing shareholder value." The company reportedly has hired Goldman Sachs Group (GS) to advise it. Darden declined to comment.

Darden needs shaking up, and a split could be a logical move. Management has been unable to reverse years of declines at the company's key restaurants. Net income rose just 1% between the fiscal years ended in May 2010 and May 2013. In that span, Darden added more than 300 new restaurants, ending the latest fiscal year with a total of 2,138.

Barington's group may need to amass a larger stake to force change. But Darden's weakness makes the company vulnerable. In a case like this, the presence of an activist can help the stock, even if Barington doesn't achieve all its goals. It could be a good time for investors to load up their plates.

CHICO'S FAS

Women's apparel retailer Chico's FAS (CHS) has all the makings of a strong turnaround story, and it now has an activist in its corner with a record of spurring change.

Chico's stock has fallen 1% in 2013, as same-store sales have slipped. Earnings are expected to drop to 99 cents a share from $1.09 last year, before rebounding to $1.18 next year.

Blue Harbour, which works with companies only on friendly terms, owns about 6% of the shares. It has urged management to use a portion of cash flow, which topped $200 million last year, to buy back stock. Chico's has $250 million in cash, and no debt.

Robbins, the firm's CEO, has never run a proxy contest or publicized differences with corporate managers. That can make it difficult to discern whether companies implement his suggestions. In Chico's case, though, Robbins appears to have made a difference.

Since Blue Harbour began amassing a stake in late 2011, Chico's has more than doubled the rate at which it repurchases shares. The company announced a new $300 million buyback program earlier this year, which could cut its share count by more than 10%.

Blue Harbour also has advocated for an expansion of Chico's fast-growing lingerie chain, Soma Intimates, which operates 235 stores and targets women over 30. Intimate apparel is a $10 billion market, and Soma's sales are about $265 million a year, versus $2.5 billion for Victoria's Secret, Robbins says. He thinks the company can expand to more than 600 units.

Chico's CEO, David Dyer, who turned around Lands' End, is on board. He wants to lift the total store base of 1,470 by more than 120 stores a year. Chico's didn't respond to requests for comment.

Chico's is "a growth stock trading like a value stock," says Robbins. The shares fetch about 16 times expected earnings, a discount to their five-year average price/earnings multiple of 38. Tagging along with Blue Harbour looks like a smart idea.

The *Other* Activist Investors

Clifton S. Robbins, Blue Harbour Group

Robbins' Greenwich, Conn.-based firm was founded in 2004 and targets companies with market values of $1 billion to $5 billion. It avoids aggressive tactics and works on a friendly basis to help companies improve balance sheets, reorganize operations, and arrange mergers or acquisitions. "A private-equity fund pays a 30% to 50% premium to buy a company," says Robbins, a former private-equity investor. "We can convince companies to make changes without paying that premium."

Assets: $1.9 billion

Average return on 13D activist positions: 37%

Total fund returns (gross):2012: 20%; 2013: 30%

Success:Convinced Jack in the Box (JACK) to turn more of its stores into franchises and buy back shares. Stock rose 75% while Blue Harbour was an investor.

Disappointment: Blue Harbour lost about 23% on its investment in CSK Auto, an auto-parts retailer.

Current positions: Chico's FAS (CHS), Progressive Waste Solutions (BIN), CACI International (CACI)

Richard "Mick" McGuire,
Marcato Capital Management

A protégé of Bill Ackman's, McGuire invests primarily in mid-cap companies, and is known for doing the same kind of hands-on research. He successfully pressured Lear (LEA) this year to buy back shares and add a new board member, and ran a campaign to spur change at DineEquity (DIN). Marcato posted a 29% gain in 2012, far outpacing other hedge funds. Institutional Investor named McGuire the 2013 Emerging Hedge Fund Manager of the Year.

Assets:$2.3 billion

Average return on 13D activist positions:43%

Total fund returns (net):2012: 29%; 2013: 19.6%*

Successes: Lear, DineEquity

Disappointment: Became a director of Border's after his then-boss, Ackman, launched an activist campaign. McGuire later became chairman of the bookseller, which filed for bankruptcy protection in 2011, and subsequently liquidated.

Current position: Sotheby's (BID)

Jeffrey Smith,Starboard Value

Starboard, spun out of Cowen Group in 2011, mostly takes activist positions in small-cap companies, and has waged more proxy battles than any other activist. It isn't hard to see why some managements resist Smith's overtures; Starboard has been urging Wausau Paper (WPP), for instance, to change its name and move its headquarters to another state. Wausau's shares have rallied 74% since Starboard first filed a 13D in 2011 disclosing a 6.3% stake in the company. It now owns 15.2%.

Assets:$1.5 billion-$2 billion

Average return on 13D activist positions: 26%

Success: Office Depot (ODP) merged with OfficeMax and cut costs after Starboard sought changes last year and won three board seats. Shares have nearly tripled.

Disappointments: Shares of Regis (RGS), a hair-salon chain, have trailed the S&P 500 by 38 percentage points since Starboard filed a 13D in 2011

Current positions: Wausau Paper, Emulex (ELX)

Ralph Whitworth,Relational Investors

Whitworth worked for T. Boone Pickens in the 1980s, lobbying for shareholder rights. He formed Relational in 1996 with David Batchelder, and has taken about 130 activist positions since then, sometimes buying only 1% to 2% of a target company's shares.

The firm helped to oust Home Depot's (HD) former chairman and CEO Robert Nardelli in 2007, when the chain was struggling. Its shares have nearly doubled since. Whitworth joined Hewlett-Packard's (HPQ) board in 2011 after buying 1% of the shares, and is now its chairman. "People have sometimes called us the quiet activist, because a Google search would reveal about a dozen projects out of all we have done," he says.

Most recently, Whitworth and CalSTRS, the California teachers' retirement fund, successfully agitated for change at Timken (TKR), convincing the ball-bearing maker to spin off its steel unit.

Assets: $6.5 billion

Average return on 13D activist positions: 62%

Total fund returns (gross):2012: 13%; 2013: 34%

Success: Home Depot

Disappointment: Sprint (S); Whitworth joined the board and helped oust the CEO, but failed to get the company to sell or spin off Nextel.

Current positions: Timken, SPX (SPW)

Gregory Taxin, Clinton Group

Taxin started his career as a lawyer at Wachtell Lipton, the most prominent law firm defending corporations from activist interventions. After a stint as an investment banker, he co-founded Glass Lewis, a proxy advisory service that gave independent advice to big investors. In 2009 he joined Clinton. Having once fought activists, he's now become one: "I've gone all the way to the other side," he says.

In most of the 31 cases Clinton has worked on in the past four years, Taxin has convinced companies to make changes without proxy fights. The fund typically buys less than 5% of a company, which means it doesn't have to file 13D reports with the Securities and Exchange Commission. It has filed

13Ds on just three of its 11 current campaigns. Consequently, the activist returns below provide an incomplete measure of performance, he says. Taxin says Clinton's activist fund has returned about 30% annualized in the past two years.

Assets: $1.5 billion

Average return on 13D activist positions:-6.8%

Total fund returns (gross): 2012: 15.7%; 2013: 30.7%

Successes: Clinton Group won a board seat at Nutrisystem (NTRI) and helped get the CEO removed. The company has begun distributing weight-loss kits at Wal-Mart Stores (WMT). Clinton now wants Nutrisystem to increase its dividend. Shares are up 141% this year.
Disappointments: Clinton got four directors elected at Wet Seal (WTSL) last fall. Shares of the teen-apparel retailer have risen 6% since, but fell 13% in the past three months.

Current position: ValueVision Media (VVTV)

Note: 13D performance figures reflect only positions that qualified for 13D filings. *Barron's* was unable to obtain gross returns for all funds; net returns are generally net of expenses and fees.

*Through 9/30.
Sources: 13D Monitor, SEC filings, company reports, interviews.

http://online.barrons.com/article/SB50001424053111904253404579208282663688954.html#articleTabs_article%3D0