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Activist Investing: The New Normal

Disruptive Forces in Investing

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Anu Rajakumar: Financial Times has called activism the new normal in corporate America. Investors like today's guest, Benjamin Nahum, are redefining the space by using their voices as key shareholders to effect positive change and increase value, one company at a time. Hello, and welcome to "Disruptive Forces," a podcast from Neuberger Berman, where we discuss insights and innovations in the investment management industry. I'm your host, Anu Rajakumar, and in today's episode I'm pleased to be talking to Ben Nahum, Portfolio Manager of the Small Cap Intrinsic Value strategy. Ben, welcome to the show.

Benjamin Nahum: Anu, it's a pleasure to be here.

Anu: Thank you. When many people hear the term activist investor, the names that come into mind are the big hedge fund managers, Bill Ackman, Carl Icahn, etc. But in recent years, we've been seeing a broader array of investors engaging with companies directly by launching campaigns, proxy contests, etc., yourself included. Why is that?

Ben: Well, I think, Anu, several factors are behind the broadening of the prospective activists, and there are public pension plans that have significant issues with companies that are in their communities and they want to see that their values are reflected by the companies that they invest in. I think institutional investors feel that there is a higher burden on them to demonstrate to their investors that they care that companies they invest in are good corporate citizens. And lastly this hedge fund community has also broadened out to people that are willing to engage in activism. But at the end of the day it's a small group that are willing to engage in proxy fights. That broader audience for corporate engagements has definitely happened. But the actual proxy contest remains, I would say, the area of a handful of institutional and hedge fund investors.

Anu: And to be specific, what are the main reasons why an investor like yourself might launch a campaign or a proxy contest?

Ben: Sure. From our perspective, we're sort of old school. The reasons for our proxy campaigns are really about disappointment with how the company has been managed, what kind of returns have been achieved by the management team and the unrealized potential that we see in a company that for one reason or another isn't appreciated by the rest of the investment community. So that I would view as the original old school activism. There's now a whole new genre of environmental, social and governance related campaigns. Those also tie into some of how we achieve our goals.

Anu: I think maybe as a value manager you're really trying to get more value out of value companies.

Ben: That is largely our agenda.

Anu: Great. And so at what point as an investor, do you decide that a more activist approach is really necessary?

Ben: So I guess, Anu, the question from you is really what's the tipping point.

Anu: Yes. Yup, absolutely.

Ben: And that can vary. It really depends. Company at a time. But I will caution this. We will always be long term. If we do launch a campaign it will have been after years of being invested in a company, having been patient with the management team, and having realized that something needs to change here. So that tipping point can be five years, 10 years, or even longer. We recently were involved in a behind the scenes campaign with a company that we've been investors in for 19 years. So there's no set formula as to when you're ready to engage; it's really driven by the circumstances, the stock price, and the management strategy. But what I would suggest is there's usually an event where the strategy has changed, the company is now signaling they're going in a different direction or there is going to be a significant amount of capital being deployed or alternatively there's been a major disappointment in how their earnings have progressed, where it becomes very clear that the company's strategy is not effective or is not being communicated clearly. And many times that becomes clear to us in our engagements face to face with the company's CEO.

Anu: So that's how you start off. You start off meeting with management and bringing up your grievances or what's the step by step plan that you have?

Ben: I would share a couple of examples where we reached that tipping point and we decided that we were going to take our issues to the board. The first would be in our proxy campaign vs. Ultra Tech. Where in our meeting with the CEO, a long-tenured CEO and founder, it became very clear to us that he had no management succession plan and that the board—one key function of every board is to insure that there is a team behind the CEO—and in our meeting it really crystalized to us that the board was negligent in creating a deeper management team. And when we confronted the CEO about these issues, he became very hostile and became clear in that case that he was actually saving the spot. That was the tipping point where we believed that the board failed in its commitment to create a succession plan, that we were going to raise this issue with other shareholders. In a recent campaign with Verint, in a meeting with the CEO, it also became clear that some of their capital allocation decisions, where, whether they were thinking about spinning off a business, started to vacillate. And whether they were going to make another large acquisition, started to seem like a likelihood. We felt, in our meeting, that the CEO needed to be very expressly clear, one way or another. Spin off this business or keep it. Verint is a company that we believe has tremendous potential, a lot of strong technology positions. And for a variety of reasons some external, macro-related and some internal, company strategy driven, that have resulted in a share price that really hasn't lived up to its potential. We spent a great deal of time thinking about should we go active here. I think in this particular case we spent three months deciding whether or not to bring our concerns in front of the board. And what really pushed us over the edge was what we felt is that the company was sending out inconsistent messages about its corporate structure, it was rather opaque in its disclosures, what part of the business was moving to the Cloud, how fast were they going to move to the Cloud. So we felt that after much deliberation that we should lay out our issues, address them to the board, and then try to work behind the scenes with them to come up with a commitment on their part to address the issues that I think investors were concerned about.

Anu: Activist investors are often criticized as corporate raiders looking to make a quick profit. But that's not your approach. You mentioned Verint Systems just now. And that's been in your portfolio since 2006, I believe?

Ben: Correct, yes. It's long term investment.

Anu: Yeah. So would you differentiate some of the other activists with your approach and that are long term holders of these companies that you engage?

Ben: It's a major differentiation on our part, and we believe it gives us a significant amount of credibility with other shareholders. I think that we have a natural asset at Neuberger Berman by being a long term anchor-shareholder in many of these companies. And if we do have an issue, and we do bring it to the board's attention, we get a very prompt and thoughtful response. So we differentiate ourselves in usually the first paragraph of our letter to these companies. We have been investors for 10 years or 15 years. And we use that as a sign of credibility, that we're not looking for short term quick fixes, that we're willing to commit for the long term. And we're willing to be patient. But something's not right here. And something needs to be addressed. So that's a major point of contrast between us and many other activists.

Anu: And with this Verint example, how did you assess the risks? And is there any sell discipline that you had that you'd follow if things didn't go your way?

Ben: Boy, that's a good question, because when you talk about risks, there's the noble risks and then there's the unpredictable risks.

Anu: Right.

Ben: Certain things happened along the path in the Verint engagement that took us by surprise. And while we had no intention of actually going to a proxy fight, those circumstances drove us into a position where we actually had to propose a slate of directors. And in this particular case the matter was compounded by a short seller who in the middle of our campaign released a 108 page report critiquing the company's business policies, management, a whole litany of issues. And on top of that, which we found particularly frustrating, was they piggy backed our complaints and said you see, even long term solid shareholder Neuberger Berman has issues with this company. So if they have an issue, we can assure you what we're saying is also based in reality. So they used their proxy fight to validate their agenda. So that was a risk that we had never anticipated and really led to, I would say, one of these curve balls that you have to figure out how to navigate your way through. So I would tell you, ultimately it brought both parties to the table where we felt that we didn't need to continue this public confrontation and we could work out a settlement. So the takeaway from a proxy engagement like this is that there will be risks, there will be unintended outcomes, and you have to figure out on the fly how you're going to navigate them.

Anu: So coming from Neuberger Berman, a reputable company, is obviously very helpful. What other steps can an activist investor take to maximize its bargaining power to effect change?

Ben: You know, an actual proxy campaign where you're looking to bring about change, has to bear in mind that there are really two different audiences out there. There are your active managers, and there are your passive owners. And while at the core everyone has, I'd say, common denominator set of issues, when you think about maximizing your bargaining power, you really have to create two arguments. One for that active owner and one for that passive owner. And if you have arguments on both sides, I think you have a lot of leverage in achieving your goals. But the key is to be able to talk to that active owner about traditional return on capital issues, shareholder value creation issues, and also learn how to address the concerns of the passives. And that's extremely important. And if you can line up both arguments, I think you have a very good chance of succeeding in your engagement campaigns.

Anu: And for those passives, what are some of the key characteristics that really help that conversation?

Ben: So the passives are very mindful about a broader set of constituencies. We all care about the communities, the employees, and they're very, in my viewpoint, reluctant to embrace short term action. You need to address the issues around key important governance issues, skill set at that board, diversity at the board. Do we have the right people, do we have the right gender, do we have a fair playing field at that board level? And usually you'll find the two issues tend to go hand in hand. A younger, more diverse board and a company that creates value many times are correlated. So, in two of our campaigns, we raise this issue about tenure and diversity. So we proposed younger female board members that we thought would be very helpful to these companies and we think we achieved two goals, bringing better skill sets, and accomplishing diversity.

Anu: We're reading more and more about activism spreading beyond the U.S. to Europe and Japan in particular. I know your portfolio is U.S. focused. But maybe you can comment on what catalyst may have given rise to activists globally.

Ben: The catalyst for global activism is the same one that we see here. It's about underperformance, companies who haven't realized their potential and where the frustrations of the owners are starting to mount. We find that in foreign markets there are very fertile grounds for activists, but there are substantial obstacles. There are cultural obstacles, there are regulatory obstacles, and there are many times complex cross ownership that make engaging in a company directly very difficult because you'll find that there are control shareholders; that's another company. But it's an area that I think will see more and more activism overseas.

Anu: So it appears as though active management is moving in this direction with investors increasingly engaging with companies directly to drive long term returns. Is this trend sustainable? Or maybe said another way, what's the future for activist investing?

Ben: Activism is here to stay. It's here to stay on the very simple premise that investors want their companies to be good corporate citizens. And ensuring good behavior at so many different levels is going to be extremely important. So the element of ESG investing and ESG engagement, that's a permanent part of the landscape now. The other part of activism, the unlocking value, is really very cyclical. It's driven by where we are at markets. So in that context I suspect there'll be more activism, if markets roll over and companies under-perform, and there's a bit less of it as there are fewer companies that are under-performing in bull markets.

Anu: And finally, Ben, I've heard sage advice for investors, which is: think like an activist. What does that mean to you?

Ben: We have a little bit of that concept built into our activist approach here, where we encourage board members to think like activists. And we want companies to treat their owners like board members. So we really do believe that there needs to be a breaking down of the walls, where owners need to be engaged, communicate their desires to the boards, and the boards need to be engaged and make sure that managements deliver on what the owners want. So directors need to be activists and owners need to be treated like directors. And I think a whole lot of shareholder value creation can happen if we go down that path.

Anu: Great. Well, that'll do it for this episode. Ben, thank you for being here today to discuss shareholder activism. You've set out a solid case that with thoughtful and collaborative engagement, activists can improve governance and increase long term shareholder value. I appreciate your time and thoughts.

Ben: It was my pleasure.