The Board's Role in Strategy

Thinking Like an Activist

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TOOL OBJECTIVE
This helps directors to evaluate the company's strategy like an activist and challenge assumptions.

One of the key responsibilities that boards of directors have is approving corporate strategy and monitoring management's execution of strategic plans. But it can be challenging for boards to provide strategic guidance, because the development of strategy is, by its nature, largely in the hands of management. Management proposes strategic initiatives and overall direction based on their assessment of business opportunities, informed by their understanding of capabilities and risks gleaned from the day-to-day operations of the business in the competitive environment.

As boards work with management to hone strategy, they can add value by thinking about the strategy like an activist:

- Question the status quo.
- Test management's assumptions underpinning the company's prevailing wisdom.
- Take a critical, outside-in look at the company's strategic direction.

Boards must proactively assess vulnerabilities and identify areas for potential improvement. This approach can have multiple advantages:

- It can lead to changes in the corporate strategy that drive shareholder value.
- It can ward off activists.
- It can put the board in a stronger position to defend the company's strategy if an activist emerges.

Boards should also *communicate* like an activist as to the company's strategy. Meaningful disclosures to shareholders about the company's strategy for delivering long-term value can help foster relationships with key institutional investors and improve their understanding of—and support for—the strategy.

ANTICIPATE LIKELY ACTIVIST CRITICISM TO INFORM STRATEGY

Viewing the company through the eyes of a potential activist can help inform corporate strategy. Sophisticated activists often publicize a detailed "white paper" describing a company's strategic or financial missteps. Activists typically advocate for changes like below, hoping that they will increase the company's stock price over the short term:

- An M&A transaction (e.g., a sale of the company or a divestiture of a business unit)
- A greater return of capital to shareholders (through share buybacks or increased dividends)

- Business or operational changes (e.g., replace management, eliminate business lines, or pursue cost-cutting measures)
- Governance changes (including changes to the board's composition and practices, shareholder rights, and compensation)

Directors should understand the degree to which the company is vulnerable to activism critiques. More important, a board should be aware of whether the company may be susceptible to criticism of its performance as compared to its peers, particularly based on total shareholder return (TSR) and operational metrics. The board should also discuss whether it would be appropriate to make any modifications to the company's strategy, operations, and governance in light of any identified vulnerabilities or weaknesses. As part of this, the board should consider the ways in which an activist could attack board composition by claiming, for example, that the board lacks a specific skill set, has very long-tenured directors, lacks diversity, has directors who could be considered "overboarded,"[1] or has directors who have served on boards of problematic companies.

QUESTION THE COMPANY'S STORY ON STRATEGY, AND TAKE CONTROL OF THE NARRATIVE

When making significant decisions on corporate strategy, a company's board and management team often go through rounds of deliberation and dissent toward building consensus. However, once a decision is made and management begins executing the strategy, leadership can become so committed to pursuing this strategic direction that they fail to take a step back and periodically consider if the rationale for the strategy is still sound and if it still represents the optimal path to long-term value.

The board is responsible for monitoring management's efforts to implement the board-approved strategy, but directors must also be prepared to change strategic direction when appropriate. Boards can benefit from adopting the mindset of activists in this regard. Activists challenge a company's strategic direction with an eye to identifying inefficiencies, weaknesses, and missed opportunities. They analyze every aspect of the company's performance, operations, governance, and compensation practices to look for blind spots that are inhibiting profitability. They often become experts not only on the company (and its segments) but also on the company's competitors and on its industry as a whole. They will highlight the company's vulnerabilities and propose meaningful changes to the status quo.

Armed with these insights, activists become powerful storytellers—they develop a thoughtful and deliberate alternative storyline for the company's strategy that they believe would lead to better results. The effectiveness of this narrative can have important consequences. When given the choice between the strategic direction of an existing board and that of a hedge fund activist targeting the company, many institutional investors say that a "credible story focusing on long-term strategy" is the most important factor in determining whether to support an activist campaign.

Boards can take control of the narrative around the company's strategy through disclosure in their company filings, shareholder engagement, and other efforts. Communicating with shareholders about corporate policies, plans, and strategies builds support for the company's strategy and the investments necessary for long-term value creation.

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[1] Kosmas Papadopoulos, "Director Overboarding: Global Trends, Definitions, and Impact," *Harvard Law School Forum on Corporate Governance* (blog), August 5, 2019.

Shareholders have long asked companies for more information about strategy. Shareholder input through engagement can help boards to understand and respond to investor priorities and concerns in a way that fosters relationships and builds support that might be put to the test if an activist emerges.

FOCUS ON THE LONG TERM AND ON THE OUTSIDER PERSPECTIVE

Corporate boards and senior management must be positioned to evolve strategy quickly in the face of disruptive threats, whether those threats come from new technologies, competitive innovations, or changing market conditions, including crises such as the current COVID-19 pandemic. This requires having a deep understanding of the company's industry and continually questioning and testing the assumptions upon which the company's strategic plans are based, all while scanning the environment for new opportunities and risks.

The majority of management's attention is given to pressing matters, as well as the day-to-day operations of the business. Roughly 86 percent of CEOs admit that they focus more on the short term than on the long term.[2] Directors, on the other hand, are well positioned to take a longer-term view of strategy in keeping with their role as mostly independent fiduciaries. They are able to bring external considerations and insights from across industries to the discussion, depending on their varying experiences and connections. By emphasizing the long term, considering external forces, and connecting trends across industries, boards can play a valuable role in helping management to identify emerging disruptors and longer-term opportunities.

The board should engage in a comprehensive review of corporate strategy with management at least annually. Directors should also feel free to ask questions regarding management's strategic plan, or to propose changes to it, during board meetings or even more frequently as warranted. For example, amid the current COVID-19 pandemic, boards should proactively discuss with management whether opportunities—such as opportunities for growth through distressed M&A—are likely to emerge that are aligned with the company's strategy, and if so, where.

INSIST ON A WELL-INFORMED BUT OBJECTIVE ANALYSIS

It is critical that every director be well informed about the company, its competitors, and its industry. The board should receive and review news and analyst reports and regularly hear the perspectives of both management and outside experts on the central issues facing the company. Special care should be taken to protect against information and feedback that has been overly filtered: the board needs to hear directly from, and listen closely to, large shareholders, analysts, and investment bankers to understand their concerns.

The board can add significant value to strategy development by insisting that analysis of opportunities and threats is not only grounded in insider insights (and thus very well-informed), but also based on an objective outsider's opinion. Insisting on objectivity means that you not only will be ensuring that decisions are guided by the best interests of the company and its shareholders, but also will be pushing back against any unconscious bias that might impact your decision making. Boards should seek to identify management's blind spots, minimize groupthink, and encourage directors to raise concerns and voice new ideas. They should also try to counter the natural tendency to place greater weight on established beliefs,

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2 CECP, *11th Annual Board of Boards Executive Report: Competing for the Long Run*, p. 2.

and instead strive proactively to seek out differing viewpoints on emerging issues. Outside perspectives can also help boards to move away from partly implemented strategies that are no longer optimal, avoiding the "sunk cost fallacy."[3]

CHALLENGE ASSUMPTIONS, AND DEMAND THAT ALTERNATIVES BE CONSIDERED

The board is a body distinct from management precisely so that it can provide a separate viewpoint on critical decisions; this requires prodding, questioning, and testing management's assumptions. Directors should master the art of asking challenging questions in a constructive manner. Board directors should set an expectation with the senior-management team that the board will be presented with alternatives regarding any significant strategic initiative or acquisition. The board should not hesitate to ask tough questions, even when performance has been positive:

- How does the proposed strategy further our corporate purpose?
- Why is the proposed strategy or course of action better than alternatives, and how does it align with the company's risk appetite?
- What assumptions underpin these judgments?
- How might those assumptions be in error, and what are the consequences if they are?
- How would a disruptor critique this course of action?
- What aspects of that critique have merit?

To perform this role effectively, the board should have assertive directors with a diversity of backgrounds, skills, experience, and expertise. Challenging the CEO and senior management on strategy also requires a strong, independent board leader (either an independent chair or a lead director with robust responsibilities) who is willing to ask probing questions and to focus the board's attention on critical issues that could otherwise be overlooked. This leadership role emphasizes the independence of the board from management and provides a counterweight to the authority of the CEO. When leading the board in evaluating the strategic plan proposed by management, the independent board leader must walk a fine line between supporting and challenging management.

HOLD MANAGEMENT ACCOUNTABLE FOR EXECUTION AND PERFORMANCE

A central element of the board's role is to monitor performance and hold management to account for execution of strategy. The board should evaluate management on financial and nonfinancial metrics that are agreed (in advance) to be in alignment with the key elements of the company's strategic plan. The board should set expectations for appropriate stretch performance against those metrics to ensure accountability, and they should challenge management to continually search for ways to improve performance (both by eliminating weaknesses and by pursuing opportunities). This requires not only looking inward with a critical eye but also continually assessing what competitors are doing better than the company, and why. The board should question management about decisions or predictions it made in the past that proved to be unsuccessful or overly optimistic. If a company is performing poorly compared to its peers, the board should insist that management provide the board with an explanation of the reasons why, as well as a plan to improve company performance.

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3 See Wikipedia's entry on "Sunk Cost."

IMPORTANT TOOL: ACTIVIST ROLE PLAY

Boards can pressure test their strategic direction by participating in activist role play designed to enhance the board's holistic view of the company's story. Create a "team of activists" made up of directors and management who are assigned with the task of evaluating the company's performance, operations, governance, and compensation. To be truly valuable, this exercise should be critical, should encourage dissent, and should not shy away from confrontation or hard truths. Here are some important things to consider during this exercise:

- What would an activist view as the company's principal vulnerabilities and opportunities?
- Does the company's capital allocation and business portfolio have the optimal mix?
- Are there M&A-related opportunities the company should be considering, such as a sale or a spin-off?
- Is the company's financial strategy sound (e.g., leverage, debt-to-equity ratios, tax efficiency, deployment of excess cash)? Would a share buyback or special dividend make sense?
- How does the company's operating performance compare to that of its peers? Is the company comparing itself to the right set of peers?
- Is the company's corporate governance appropriate and in line with market standards? Does the company have a good explanation for any outlier practices?
- Does the board engage in regular, meaningful evaluations of board and management leadership? Are any changes to the composition of the board or the management team advisable?

Taking an activist approach and, in effect, challenging members of the board to act as disruptors can spark important, and potentially difficult, conversations that could be critical to the company's long-term success. By thinking like an activist, the board can add significant value to the development of a competitive strategy, while also preparing for any activist situation that may emerge—perhaps even preempting an activism campaign altogether.