# *57 Lessons from Activists & Private Equity for "Creating Value"*

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*Lightly Edited*

I'm familiar with Kellogg for two reasons. One is that our daughter and son-in-law graduated from this outstanding business school. The other is that I spent 15+ years as CEO of Heinz, competing with the Kellogg Company on a number of fronts. So let's just say that I have warmer feelings for the school than the brand.

My topic tonight is "57 lessons from activists and private equity for creating value." Most of the lessons I experienced firsthand. It may not make me an expert, but the knowledge has given me a certain perspective and insights that I believe to be true.

I recognize that every person in this audience is smart and successful and brings a wealth of talent and experience to the companies you serve. I also know that hearing dissenting points of view can occasionally precipitate a knee-jerk reaction. Our current political climate is a stark reminder of this, no matter where you fall on the political spectrum. Clearly, we all need to do a better job of actively listening to and learning from one another. That's what I hope tonight will be about. What you will hear is what I believe.

As some of you know, I grew up in a football culture, which I mention because it greatly influenced how I developed as a manager and led as a CEO, and also affected how I view business. It's a very black and white profession with little ambiguity, complete objectivity, and a clear sense of results. My dad played professional football for the San Francisco 49ers for nine years, and then spent 35 more coaching with several NFL teams. His first coaching job was as an assistant with the 49ers and soon after he started they had a game against the Bears, here in Chicago, at Wrigley Field. At one point in the game, the 49ers were behind, but steadily moving the ball down the field. A 49ers player was called for holding, and as the offensive line coach, my dad went ballistic. One of the referees then called an unsportsmanlike conduct penalty. The 49ers' head coach, Frankie Albert, asked who had committed the penalty. When the referee pointed at my dad, Coach Albert said, "I've never seen that man before in my life."

The good news was that the penalty was nullified and the 49ers went on to win the game. The bad news was that the referees summoned security guards, who promptly escorted my dad out of the stadium.

I tell that story not only because it's always affected my view of Chicago but because it serves as an example of creative, but poor, crisis management – mirroring the way many boards and CEO's – including me — have responded to overtures by activists.

During my 15 plus years as CEO of Heinz, as well as my 20 years on its board, I both saw and experienced my share of crises. In order to reverse years of underperformance we downsized the company by a third, cut the dividend by a third, and replaced much of the executive team. The temporary drag on performance resulted in a proxy fight that *The Wall Street Journal* called the nastiest in American history. That experience was a great teacher, as I learned many things that surprised me, and more than a few that amazed me. It was very stressful, but the lessons and experiences made me a much better CEO and director. It's one reason why I prospered for another seven years as CEO, eventually culminating in the sale of the company in 2013 to Berkshire Hathaway and 3G, a Brazilian private equity firm from whom I also learned a number of valuable lessons.

I know that most public companies don't care for activist investors and seldom work with private equity sponsors. It's too bad because both have a lot to teach us. I know from my own experience that activism is as welcome as a surprise visit from Darth Vader. But over the years, I have evolved to embrace the attributes they can bring to a company. In my remarks I'm going to explain why, but rest easy – I'm not actually going to give you 57 reasons; instead I will focus on three overall themes that I hope will inform and resonate with you.

I have spoken about activism before a variety of audiences that were, at best, skeptical, if not antagonistic to my message. When the CEO of a Fortune 20 company asked me to speak to his Board, I was as surprised as his directors apparently were. The CEO's intent was clear – he wanted to alert his board to the reality of the environment and help them understand the need to prepare for the possibility of an approach from someone who had actually been through the experience and learned how to make it work. I suspect many of you here today may be similarly skeptical, but I hope you'll be open minded – not because I need the moral support, but because activist investors and private equity – for accuracy, let's call them highly engaged shareowners – are a bigger and bigger presence on the corporate landscape and have a lot to teach us. Besides… there is no going back. Companies, and company boards that ignore them, do so at their peril.

Let me start with a basic belief that the Board's most important role is to act like an owner because after all, that's who we represent. Not surprisingly, most shareholders want to see their investments prosper so consequently one of our key responsibilities as directors is to create an environment that focuses management on doing just that… creating value. While this may sound elementary, actions suggest that a significant percentage of public company directors disagree with me. That, combined with a lack of investor savvy on many boards, is a leading reason why companies are being successfully targeted by activists and private equity. *The Wall Street Journal* and *Financial Times* literally have a story nearly every day on the latest victim – reflect on stories about activists impact on CEO's or the recent publicity on Whole Foods.

I know that many believe that today's boards have become fully engaged and enlightened venues that have created the environments necessary to maximize value as most owners expect. That's fine. But if not, I'd ask, what do you believe the board's role <u>should</u> be? And if they are all doing a good job, why are so many companies targeted? And why do activists – and private equity groups – have so much money at their disposal? Just something to ponder, and discuss during the Q&A session that will follow my remarks.

I want to be clear that I am talking about engaged owners who target underperforming companies with a goal of improving operating performance to drive long term value, not those concerned solely about governance issues. The premise behind these successful activists and PE firms is a simple belief that the combination of active and engaged shareowners, aligned with talented and equally engaged management teams, can work together to build better companies for the benefit of all.

Consequently, it is my belief that these investors help improve boards, through a combination of focus, industry expertise, and development of an "ownership" culture that leads to better performance and long-term value creation. I say this based on my experience with public company boards, activists and PE over the past 25 years.

The first theme I want to discuss is that of focus and engagement. These firms are laser focused on value creation. Both business models agree that it's about improved performance and while they do consider many key constituents, like employees, customers and so on, their emphasis is always on value creation – which as owners is quite logical.

This doesn't mean that they don't care about these other constituents because they do; it simply means that they see them as part of an overall puzzle to be solved in the search for better performance. They also do not necessarily lack compassion, but rather they disperse it dispassionately. They are prepared to push tough, unpopular decisions, and are equipped to manage through the inevitable friction it precipitates. They become catalysts for change and this is a key to their success.

Given their passion – and ownership – engaged owners delve into details and learn the business quickly and thoroughly. They constantly work on shaping strategy while reviewing every cost – no matter how small. Most public company directors typically view this level of cost detail as best left to management. I was truly astounded watching the 3G due diligence process when they were acquiring Heinz. They wanted to know the basis for our plans, the underpinnings of our strategy, and cost details like how often we cut the lawn at our factories or painted the buildings. I'm not suggesting that public boards emulate this but it does clearly send a message about having an accountable, performance-based culture. As one of 3G's founders once said, "Costs are like fingernails; they always have to be cut."

Aligned with this is the attention engaged investors give to the balance sheet. Despite what you hear, it's not always about share buybacks – rather, it's about leveraging the balance sheet in creative ways that optimizes long-term value for the owners of the stock. These investors are not just focused on the short-term. Engaged owners are increasingly concerned that companies are stretching the balance sheet primarily to buy back stock, which is occasionally necessary and beneficial but abused. While it may help drive short-term price moves, it often does nothing more than hide performance issues and financially engineer a way around weak operating performance. PE and activists will, by contrast, leverage the balance sheet in ways that they believe create long-term value for investors. This was certainly my experience.

Working with highly engaged investors requires you to look forward, not backward. I am often asked how Nelson Peltz (at Trian Partners) and I developed such a strong relationship after such a stressful battle. Primarily it was because I never took his initiatives or thoughts personally and I always looked forward. Recriminating about why one ends up in an activist fight is fruitless. My advice is listen and move on.

One of my favorite movies is “A Few Good Men.” The quote from Jack Nicholson in response to Tom Cruise’s admonition about “wanting the truth” was curt but to the point. He simply said that… “You can’t handle the truth.” This appropriately summarizes how engaged investors often view the response from boards and management.

Engaged owners can provide valuable insights into how others really see the company. This perspective provides a basis for objective analysis that contributes to a clear understanding of the firm’s problems as well as potential solutions and opportunities.

Engaging with owners is key… and one truth for certain is that activists know your shareholders better than you do. This is often a source of their inspiration, many of their targets and some of their insights.

The second key theme evolves from activists and PE firms’ insistence on hiring and motivating good people. Private equity in particular is almost manic in its desire to have the best management team possible. Consequently, for both of them, the selection of the CEO and leadership team is paramount to success. This may seem a trite truism, but objectively, some public company boards do a less than stellar job in this area.

Many public company boards still appear to be afflicted with the so-called “Lake Wobegon effect.” Most believe their CEO to be an above-average star. After all, why else would they have hired the person? Unfortunately, many are not stars. By contrast, PE and activists are very attentive and objective when it comes to measuring performance and talent. I have heard more than once from engaged owners that you can’t get to the World Series with a Triple-A team. They ideally prefer to work with existing management but will seek to replace them with more talented leaders and stronger supporting casts if performance lags.

Active shareowners are very adept at establishing performance goals and expectations and enforcing incentives that properly align the management and board with the strategy and objectives they believe will lead to better value. I have always thought that public companies made a big mistake when we moved away from stock options and performance-driven equity grants as a primary source of compensation. I know why we did it. But the downside is that management is not always aligned with the shareholders. This is an absolute with Private Equity investors and a strong preference with activists.

Owners pay for performance, not promises and hold management accountable for results. Too often we see leadership teams compensated for best efforts or a concern about de-motivating them. This subjective view is anathema to most engaged owners.

The third and final area that I want to discuss is based on my perception that, engaged owners are what I call “*constructively impatient*.” They are not necessarily hair trigger but they are willing to force decisions and make mid-course corrections if the strategy is not working or the team is not delivering on its commitments. As owners, they are more focused on establishing an environment of accountability than many public company boards appear to be. Most boards are working to improve this aspect of governance, but are often very slow in recognizing shifting conditions and pressing for change.

These owners are clearly impatient when it comes to:

- Improvements in operating performance;
- Assessing leadership;
- Shifts in capital allocation;
- Setting strategy and a path forward; and
- Upgrading talent.

Mistakes or problems are expected to be addressed quickly and neither has patience for excuses. A well-known buy-side analyst once said to me, “If you’re explaining you’re losing.” This is how engaged shareowners think. Since PE and activists are so reliant on facts and data, company resources are often redirected from transaction to analysis. This provides them with the information necessary for evaluating performance and helps them understand how their companies are executing. Three years ago one of the PE owned companies I chair, hired an outstanding young CEO who appropriately focused on filling key leadership roles like sales, marketing and finance. The owners, however, pushed equally hard on filling key analytical and support roles like HR and FP&A as well, to accelerate data gathering and ensure that talent was being recruited and properly incented across all levels of the company.

Because they’re so focused on performance, these firms can be impatient which is sometimes interpreted as being heartless and ruthless. While there is some truth in how they are perceived, it all comes back to results and the ability to make tough, objective decisions while implementing them well.

There’s nothing preventing public company boards from adopting many of the principles used successfully by activists and PE investors. Indeed, it’s how they *should* be acting. Increasing levels of ownership - and frankly fear of the “barbarians at the gate” – <u>are</u> leading to better director engagement… but interaction and pressure on results are still hindered by a tendency to avoid conflict and maintain collegiality. Boardroom culture can be a positive or negative contributor to

performance. Engaged investors understand this well and it greatly influences their choice of director candidates.
Public boards, by their nature are generally patient and often reluctant to aggressively confront management – even during periods of obvious underperformance. While this is starting to change, the reality is that the level of skepticism needs to be ratcheted up. Why? Because it leads to better governance and superior decision making. Given the close social ties directors and managers seem to cultivate, these debates can seem personal at times. I know. I lived through more than one of these. Among PE and activists, emotion doesn't factor into decisions. They are driven to gather facts that lead to good results and little else.

The distinction between activism and private equity is blurring and there is increasing overlap between their business models. This is why I like the term "engaged owners." The goal of both kinds of ownership models is the same: Target underperforming companies, apply the appropriate medicine, and then turn these businesses into superior performers.

I have had the benefit of working with among the best of both in Trian and Advent. While there are clear differences, both are about improving operating performance through enlightened engagement, objective analysis, and productive partnerships and alignment with management.

Historically, the private equity model was based on acquiring entire businesses or controlling stakes which allowed PE to more easily upgrade management, set strategy, and build strong boards of owners and executives familiar with the particular industry in which the business operates. These folks eventually become owners as well. However, this is evolving as PE firms are now buying pieces of companies and trying to organize operational changes that enhance value without full control, while activists, in some cases supported by large investors, are purchasing increasingly large stakes in underperforming companies. Both put an emphasis on performance because they act like owners. Both are sitting on more fungible money than they've ever had – much of it from traditional pension and sovereign wealth funds.

Activists typically seek to improve results through the appointment of directors but when this isn't possible they stir up noise and support from investors – and occasionally the media – to keep pressure on.

Think about Trian and DuPont. While Trian may have "lost" the proxy fight, several months later, the CEO was replaced by a board that had been so resistant to Trian's overtures. It's important to remember that activists don't simply go away. They own the stock. And they'll continue agitating as long as they think it's productive to do so.

Finally, bear-in-mind that these engaged shareholders have invested funds they are responsible for. They are working to improve things, not make them worse, even if they have to break a little glass. I think most boards eventually find that the new directors are there to enhance value, and attempt to work within the existing structure to foment change. Many of these directors come to meetings better prepared, as they frequently have teams of analysts that brief them on industry trends or provide market insights that the rest of us simply don't have the wherewithal to develop or access. While they may cause some discomfort, they also can be a source of new insights and perspective.

They are not afraid to disagree with management and other directors even to the point of creating a little friction on the board if they think it's needed to achieve their goals. When I was CEO, I actually learned to use and leverage this attribute with both the board and my leadership team to get things done.

A clear example of this morphing of business models is the increased use of industry advisors by activists. This has always been the model for PE firms who solicited the help of high quality, capable executives from relevant industries to advise them and lead their acquired companies. They also gave them ownership opportunities to align them with other shareholders. Historically, these executives were either not sought by or would not work with activists for a myriad of reasons. Now all of these engaged owners are turning to and in some cases, competing for talent that can make a difference. These executives bring enormous industry knowledge and contacts while also helping to identify targets. They often urge a softer approach to make for a more productive relationship with the target. They are very useful in helping to build more compelling cases for changes in operations, and strategy, and make highly enlightened directors. There is no reason why public company boards can't leverage this same talent pool – particularly with retired executives who no longer may be conflicted.

Both of the Trian people who ended up on the Heinz Board were knowledgeable veterans of consumer packaged goods. More importantly their expertise helped make the board more aware of industry dynamics and trends that led to more insightful and productive dialogue in our meetings.

Most boards adopt the same posture we did: they want to avoid the anticipated disruption to their board – assiduously trying to keep them outside their tent. While this is occasionally warranted, I think this is often a big mistake. Sometimes it's better to have them <u>inside</u> the tent, where they must operate by the same rules as other directors and are forced to provide value without a lot of external noise.

Given the enormous time demands on public company directors, many are blind-sided when activists arrive. Oftentimes directors lack the perspective or training necessary to know how to respond to the occasionally ugly external pressure. My advice is to meet with activists. They will eventually get their message across anyway so why not hear it first-hand. I recognize that often this doesn't happen because the CEO, similar to the way I felt, feels threatened. But the communication has to happen. It's in everyone's best interests.

To recap my key points: The distinction between PE and activists is blurring; both are laser-focused on value creation… which should theoretically be job #1 for any public board; they are constructively impatient while serving as clear catalysts for change that can be leveraged to move recalcitrant boards or management teams to improved performance. They are obsessively focused on board culture as well as the big picture of getting the strategy right but also the seemingly detailed minutiae of controlling costs. They are also about driving growth. And these firms solicit help from talented people with industry knowledge and are not afraid to make changes to leadership, strategy or the balance sheet to build better companies, all in their effort to create sustainable long-term value.

Before I close I would like to return to a point I alluded to earlier, that is, the long-standing myth that public company boards are focused on the long term while PE and activists are obsessed with the short term. In both cases this is not always true.

Public companies do have to worry about quarterly performance and the daily movement of their stock price. They have to worry about quarterly analysts' calls and earnings updates. However, this occasionally breeds an obsessive emphasis on the short-term. By contrast, most engaged owners think about the balance between the short and the long-term. This means improving performance, fixing strategic or executional mistakes, more capably leveraging capital, or making substantive changes to reverse underperformance balanced with the need to manage near-in results.

Finally, one last insight which, while not directly transferable, is worth pondering. These firms all have their "exits" or "next steps" clearly mapped out. When PE firms acquire a company, one of the things discussed early on is the exit strategy. And when Heinz was being sold to Berkshire and 3G, they had very specific thoughts about what came next. That's why it only took two years until they moved on Kraft and then just another two years when they tried to acquire Unilever. This focus on "exit" or "what's next" means that activists and PE work diligently on getting the strategy right and setting clear, aggressive targets and operating hurdles that that they constantly monitor.

I appreciate your attention tonight. Having spoken about this topic before, I know that after listening to what I've said, some of you may be even more skeptical.

What you can't deny is the success these firms have enjoyed in creating value. They are incredibly well funded, generally well led, and are actively searching for investment opportunities. No one is immune!

So when–not if– an engaged owner calls your CEO, don't reach for your light saber, consider talking to them.

These engaged owners provide a mechanism for passive money to outsource the task of fixing sub-par performance. As public company directors, let's beat them to the punch and objectively analyze our companies with an eye on doing everything we can do to improve performance and drive shareholder value. I'll be happy to try to answer your questions– and if you disagree with me, try not to lose it the way my dad did in that game against the Bears. We certainly don't want anyone hauled out of here by security. Thank you.

**About William R. Johnson**

William R. Johnson is the retired Chairman, President and Chief Executive Officer of the H. J. Heinz Company (“Heinz”).

In a career spanning 31 years with Heinz, Mr. Johnson was only the fifth Chairman in the 144-year history of the company, which is based in Pittsburgh, Pennsylvania, where company founder Henry John Heinz started the business in 1869.

Mr. Johnson joined Heinz in 1982 as General Manager – New Businesses for Heinz USA. In 1984, he was promoted to Vice President – Marketing for Ketchup, Foodservice and Sauces. He was named President and CEO of Heinz Pet Products in 1988, and assumed leadership of Star-Kist Foods, Inc., in May 1992, when the pet food business and Star-Kist were reunited. These businesses were spun off and merged with Del Monte Foods in December 2002.

In 1993, Mr. Johnson was named Senior Vice President of Heinz and joined the company’s Board of Directors. His responsibilities included Heinz operations in the Asia/Pacific area, including Australia, New Zealand, China, Thailand and South Korea, in addition to the canned tuna and pet food businesses of Star-Kist Foods, Inc.

Mr. Johnson became President and Chief Operating Officer of Heinz in June 1996, and was appointed President and Chief Executive Officer in December 1997 officially assuming the role in April 1998. He was named Chairman, President and Chief Executive Officer in September, 2000.

Mr. Johnson is a member of the Board of Directors of United Parcel Service, Inc. (where he is lead director) and PepsiCo, Inc. He is also an Operating Partner with the private equity firm Advent International and serves as Chairman of the Board of their investment in Noosa, Chairman of Sovos Brands, as well as a director for Dawn Holdings (Serta Simmons). Mr. Johnson was inducted into the Hall of Fame at the McCombs School of Business at the University of Texas on October 26, 2007. Mr. Johnson earned his undergraduate degree from UCLA and his M.B.A. from The University of Texas.