Reprinted from Directorship magazine

Directorship

Volume 33 No. 3 June/July 2007

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Whitworth: The Alchemist In the Boardroom

The activist shareholder effects boardroom change to increase value—what's so wrong about that?

By Aaron Bernstein and Jeffrey M. Cunningham

Board members could be forgiven if they reach for the aspirin when they hear that Ralph Whitworth is calling. After all, the co-founder of Relational Investors has played a highly public role in the ouster of chief executives, most notably Home Depot's Robert Nardelli last January. But the 51-year-old shareholder activist thinks most directors should welcome his call. Although companies that have been approached by his investment fund since its inception 11 years ago often react with skepticism initially, he says most directors come to value the role he plays. "Of all the boards we served on, we can use each board member as a reference, with maybe a couple of exceptions," says Whitworth.

In fact, he says, Home Depot board members responded positively when Whitworth and Relational Investors co-founder David H. Batchelder first called late last year to say they had bought $1 billion worth of the company's stock but wanted the board to consider major changes in the company's strategy and direction. The two men made clear in a letter to Nardelli that they were unhappy with the company's performance and buttressed this with voluminous proprietary research. Privately, the board itself had similar misgivings and elected to give the men a hearing.

"They have been terrific board members. Dave [Batchelder, Relational partner and Home Depot board member] has been a fabulous director, and I am confident he will make significant contributions to our company," says Ken Langone, lead director of Home Depot.

Whitworth has received plenty of attention recently as a leading example of the heightened shareholder activism spreading across corporate America. However, the former protege of T. Boone Pickens and Reagan campaign official says that his approach is highly focused on just a handful of companies. While most corporate boards aren't likely to hear from Relational, it's worth taking a minute to hear his philosophy of unlocking shareholder value and hear why he thinks many directors can learn from it.

Although Relational has a staff of a dozen or so analysts who scrutinize more than 1,000 companies with market caps of $2.5 billion or more, Whitworth is highly focused on a very specific kind of investment. He starts with companies in mature industries that are profitable and have had dependable cash flows for many years. Of those, he's on the lookout for

ones that are underperforming both their peers and their potential, as identified by Relational's analysis.

There are a fair number of companies that might fit this bill at any given time, Whitworth says, but even then he's not going to invest in many of them. Some might have deep structural issues that can't easily be altered. "But then there's another set that seems to have lost their way," says Whitworth, who founded Relational with Batchelder in 1996 with a $200-million stake from the California Public Employees' Retirement System. "Generally, the first indication is a history in the financial data of spending money in a way that doesn't get adequate returns for the investor. Sure, the company is still profitable and holds a defensible position in its industry with good products, but the question is, how are they spending the profits they make from that? Those are the ones we end up focusing on."

One of the things Whitworth says he's learned over the years is that almost invariably, there is a correlation between companies that fit his investment profile and the finding of major corporate governance problems. Usually, these come to light in their excessive executive compensation policies—and in the composition of the board. By the latter he doesn't necessarily mean what's ticked off in the governance metrics of proxy advisers such as Institutional Shareholder Services. Useful as those measures might be, to Whitworth they're only a starting point. To see what's really going on at a board, Whitworth says, "takes a lot more research than most outside groups are willing or able to do."

One example is Sovereign Bancorp, which Relational bought into in 2005. On the surface, the company had put in all the right board processes, earning it a 98 percentile corporate governance score. But underneath lay a jumble of related-party transactions and other conflicts that didn't show up in all the official filings. According to public records and media reports reviewed by *Directorship*, the lead director owned a company that did landscaping for the bank, which, though it involved small sums, was nonetheless undisclosed. Another director bought and sold Sovereign branch offices, sometimes in private transactions. Board members were paid $320,000 a year vs. $80,000, which is more typical among financial companies of a similar size. A good part of their pay came from bonuses triggered by management's bonuses, which the board itself was in charge of setting. Relational's analyst spent three months pouring over Sovereign's records and even traipsed off to Pennsylvania and New Jersey to dig through court records to flesh out what was really happening.

Last year, after months of warfare with then-CEO Jay Sidhu, Whitworth finally prevailed. He joined the board and within six months directors tossed Sidhu overboard. "When we see companies that are undervalued, it's usually a symptom of poor management, poor strategic planning, and dynamics in the boardroom that aren't working as they ought to—which is where we want to effect change," says Whitworth.

Indeed, he believes most of the problem at the companies he identifies lies in a deficiency at the board level. Many activists, whether they're at pension funds or hedge funds, tend to complain about cozy or conflicted directors and lash out at individual board members whom they see as derelict in their fiduciary duties to shareholders. However, Whitworth thinks that most directors want to do the right thing and are more than prepared to be honest brokers for the company's owners, but are blocked by management's domination of the governance process.

He describes the board dynamic at Waste Management, where he took over as chairman for three months in 1999 after allegations of dubious accounting and insider stock selling ahead of bad news. Right away, he had directors coming up to him after meetings and saying: "Glad you said that, I've wanted to bring that up for a year." Whitworth says that while his temptation was to say, "Well, why didn't you?" he knew all too well that the environment did not allow independent views to be expressed.

Many CEOs do call on individual directors for advice, especially on a particular topic in which they have expertise. But Whitworth's experience is that tough questioning may also be seen as an attack on their program and on them personally. "Of course,

Relational Investors' Board Membership

Ralph Whitworth

Apria Healthcare Group
Mattel
Sirius Satellite Radio
Sovereign Bancorp*
Tektronix
Waste Management
United Thermal

David Batchelder

Allwaste
Apria Healthcare Group
ConAgra Foods
Home Depot*
ICN Pharmaceuticals
Mac Frugal's Bargains Close-Outs
Mesa
Nuevo Energy Company
Santa Fe Pacific Gold Corp.
Washington Group International* (formerly Morrison-Knudsen)

*Currently on board

there has to be a line drawn between vigorous representation of shareholders' and management's role in running the company," says Whitworth. "Too often, however, in a CEO-dominated boardroom, the line is drawn at just asking a crib sheet of questions. In that situation, you're not expected or wanted to serve a deeper purpose, and certainly you're not expected to question management or call them to task."

Whitworth argues that every boardroom in America should have at least one resident devil's advocate. His or her role is to constructively challenge management and ask provocative questions—and by doing so, alert management to any blind spots or hidden turns. He even goes so far as to say that if one does not naturally emerge, the board should formally designate someone to the role. That way, when a director speaks up, the response is not just, "You're not supporting us, you're being disruptive, and you're not a team player." In fact, this is exactly the role Relational tries to play, says Whitworth. Even when it doesn't take an actual board seat, which is often the case with its investments, Relational provides a detailed analysis to directors often demonstrating deficiencies in the reporting the board has routinely seen from management.

It may seem counterintuitive to think that boards will behave differently simply because one director feels free to challenge management. But Whitworth thinks that breaking up the expected role can alter the entire dynamic between directors and management. "It really is alchemy," he says. "It's like a solution in a chemical lab; you add just one more element and it changes completely and really starts bubbling."

That's the reaction he and Batchelder hope to precipitate at the companies they buy into. Usually, it takes a few board meetings for other directors to gain trust in them, says Whitworth. But once they see that the two aren't there for some social or other agenda, they quickly say, "If there's a way to improve this place, let's do it." Of course, the catalytic role only works if Relational's research and insights bring not just fresh ideas, but the right ones.

Sometimes Whitworth has missed the mark despite the measured process. One early investment, in a company called Nuevo Energy, seemed a perfect candidate for reform. The chairman, says Whitworth, was the head of two public companies and also owned a private firm that sold to the public ones. Relational came on in 1997 and changed management, the board, and the company's strategy. But five years later, it finally pulled out with a 70-percent loss. "We were painfully reminded that when you invest in a company susceptible to commodity pricing volatility, you can still lose no matter what you do," says Whitworth.

Still, since its inception Relational has racked up a highly respectable average annualized net return of more than 18 percent through last year, double the S&P return over that period. Whitworth sees a common thread running through most of its purchases. Most companies have had a long period of growth, like Waste Management, Home Depot, or Mattel, another Relational investment. But when the easier opportunities in their core businesses begin to diminish, management must decide whether and how to find new sources of growth, and that is where Whitworth's analysis often finds the culprit. All too often, Whitworth believes, the CEO makes the mistake of taking money from the high-margin core franchise and sinking it into lower-margin businesses with illusions of higher growth. As a result, the company's returns get diluted.

Home Depot is a case in point. It had 22-percent returns in its retail stores, and Nardelli moved into wholesale supply where the margins were half as good. This is why Nardelli got such a poor reception on Wall Street, Whitworth asserts. "When the stock didn't move after he doubled earnings, he said that shareholders didn't understand what he was doing," says Whitworth. "But they understood too well that he was migrating to a lower margin sector. The multiple investors will put on 11-percent returns is far less than what they'll put on 22-percent ones."

Not surprisingly, after seeing Whitworth's boardroom alchemy in action, his view on Congressional efforts to force good governance is a bit cynical. "I don't think you can truly legislate unlocking shareholder value. What the government does best is provide a minimum standard, in effect saying to companies, 'It better not get any worse than this.'" He believes that fine-tuning legislation so that it will result in optimal business performance is a difficult, if not impossible, task.

"You just can't tweak the free market capital system. When it comes to disclosure in public filings, of course, I applaud those initiatives. But to venture beyond that bears the risk of serious unintended

Relational Holdings

Name of Issuer	Value (x$1,000)
ConAgra Foods	204,048
Prudential Financial	1,883,457
National Semiconductor	822,501
Baxter International	1,664,141
Sovereign Bancorp	800,726
UnumProvident	591,003
Home Depot	30,951,761
Analog Devices	5,105,462
Sprint Nextel	14,176,483
SPDR Trust Series 1	1,091,418

Source: SEC Form 13F, March 31, 2007

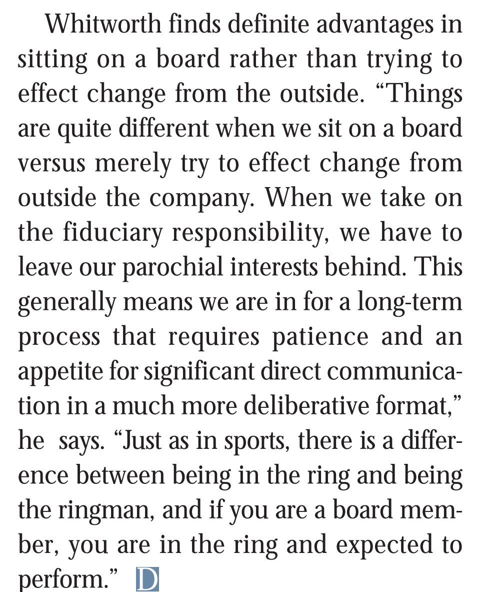
consequences. Generally, these approaches will focus on symptoms not causes; the analogy would be like cutting off dandelion heads in your garden. Soon they grow back and with a new vigor," he says. Whitworth believes his particular approach is effective because the problems he deals with are captured at the root level, and that means usually getting down to the dynamics of the boards themselves.

"Those dynamics won't change until we change how the board thinks and operates, and finally, until we change how we choose who sits on boards of directors. I am no advocate of government plebiscites or administrative labyrinths. I am just talking about marginal changes that would make it easier for investors to nominate and elect their true director leaders," Whitworth says. "The reality is that we won't truly be serving shareholders properly until we have a process in place that allows us to determine who sits on boards and provides a mechanism to remove and replace directors. The free market is the right place to police the system."

Whitworth claims that the problems in most companies emanate from poor board dynamics not the CEO. "Just as with excessive executive pay, chronic underperformance is usually symptomatic of the problem, not the cause." The problem with underperforming companies, according to Whitworth, is a lack of accountability in the boardroom to shareholders. "Even at Home Depot, in the case of Bob Nardelli, he did what the incentives contractually told him to do—meaning increase revenues and increase profits, but without any particular view to the quality of those earnings. So Nardelli performed brilliantly under the incentives he was given. Yes, the buck stops with the board."

What Whitworth wants is a more vigorous input to the board, in both hiring and firing of company leaders, setting incentives, and making sure strategy is consistent with long-term shareholder interests. To do this, he says, "requires a great deal of hard work, diligence, and independent analysis to validate what management is saying or proposing. Then it takes courage to challenge strategy—and this presumes the board has the smarts and experience and the counsel to know when and how to challenge."

These attributes are what Whitworth brings to his board of director roles, and why he claims boards actually find out his participation has such value. The board sees numbers he offers that they have never seen before. That leads to changed behavior. "It is supposed to be a robust process and that is why in our board reviews, we look for true diversity that can bring to bear differing perspectives, personalities, and experience. If all a board does is ask perfunctory questions that management has already thought about, then that is merely a rubber stamp and you reap what you sow."



Whitworth finds definite advantages in sitting on a board rather than trying to effect change from the outside. "Things are quite different when we sit on a board versus merely try to effect change from outside the company. When we take on the fiduciary responsibility, we have to leave our parochial interests behind. This generally means we are in for a long-term process that requires patience and an appetite for significant direct communication in a much more deliberative format," he says. "Just as in sports, there is a difference between being in the ring and being the ringman, and if you are a board member, you are in the ring and expected to perform." D