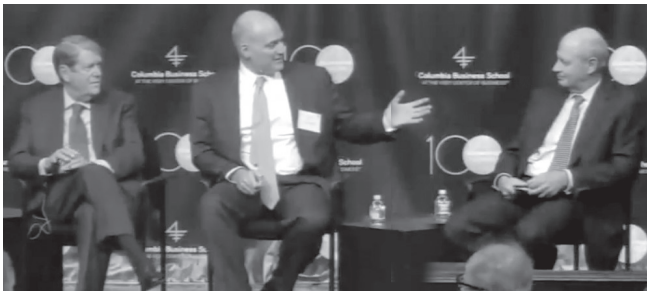
Value Creation by Active Investors (and Its Potential for Addressing Social Problems)

Columbia Business School Centennial Roundtable | New York City | May 2, 2016



Trevor Harris: Good afternoon, I'm Trevor Harris, the Arthur J. Samberg Professor of Professional Practice at the Columbia Business School as well as Director of the School's Center for Excellence in Accounting and Security Analysis. I want to welcome you all to this discussion of value identification, creation, and enhancement through active investing. To discuss this subject we have two very accomplished and successful investors. Let me start by telling you a little about each of them.

Russ Carson, after graduating from Columbia Business School in 1967, became the co-founder and general partner of Welsh, Carson, Anderson, and Stowe, which since its start in 1979 has become one of the country's leading private investment firms. One of the firm's distinguishing features is its emphasis on growing the companies it acquires, often through a "buy-and-build" strategy known as a "roll-up." Welsh Carson has leading practices in two major industries: information systems and healthcare services. Healthcare has been Russ's main focus, and we're going to ask him to share with us some of his experiences and expertise in working with and serving on the boards of a number of healthcare companies.

Our other speaker is **Paul Hilal**, a former student of mine who graduated from Columbia Business School in 1992. For ten years, and up until this past February, Paul worked as a partner and senior member of Pershing Square Capital Management. In addition to his broader contributions to the firm, Paul played a leading role in a number of highly successful passive investments and activist campaigns in companies in a variety of industries. And he has served very actively on several boards over the years. Paul is now embarking on a new phase of his career, which we may hear about at some point later this year.

Columbia Business School has a well-known association with a set of practices called "value investing." Value investing requires both a broader and a more fundamental understanding of companies' comparative advantages and how they can be used to create value than is attempted by most conventional securities analysis or analysts. To start, you have to identify opportunities for value creation and enhancement, and then you have to be able to carry out—or at least monitor and oversee—the increase in value. Reduced to its essentials, value investing requires that you estimate the fundamental, or "intrinsic," value of a business and compare it to its market price when deciding whether a proposed investment is likely to end up adding value and providing a competitive return for investors. Viewed in this way, value investing is the attempt to find good or promising businesses—businesses whose long-run efficiency and value are either being overlooked by the market, or can be increased through more effective oversight and management. This is the basic idea that underlies the field of value investing that was popularized by Graham and Dodd at Columbia in the 1930s.

What's more, some of us believe that value creation is not only the main goal of private enterprises, but also a necessary condition for the long-run effectiveness and viability of most public-sector enterprises or services, or any kind of government for that matter. In our panel this morning, Glenn Hubbard and the other business school deans all talked about their aims and accomplishments in terms of adding value for their different constituencies—for their students and local communities as well as the businesses that end up employing their students. One question I want to explore with our two highly successful investors is whether and how their investment successes have ended up having benefits for stakeholders other than their investors. In particular, how do they see their businesses contributing to solutions to a number of social problems?

Paul, can I ask you to start us off by telling us about one of your and Pershing's most successful investments, the $1.4 billion you used to buy a 14% stake in Canadian Pacific Railroad in 2012 that I understand is now worth close to $4 billion? And while you're at it, would you talk a bit about how you identified that opportunity, and what you have done since then to increase the value of the company. And, finally, can you comment on the effects of such changes on the rest of the company's stakeholders?

How Shareholder Activism Increases Corporate Efficiency and Value: The Case of Canadian Pacific

Paul Hilal: Sure, Trevor, and thanks very much for having me on the panel. The question you ask about value creation in the context of shareholder activism is an extremely important one. U.S. public companies are now worth over $25 trillion. It's a staggering amount. And to the extent that today's shareholder activists succeed in improving the labor and asset productivity of these companies, and the capital allocation decisions that often play a critical role in driving their

productivity, they have the potential to provide enormous benefits not only for the shareholders of our companies, but for the U.S. economy as a whole. For besides contributing to the wealth of shareholders—a group that directly or indirectly includes most of America's more than 100 million households—shareholder activism typically ends up having major benefits for the other largest corporate stakeholder groups, including a company's employees, its customers, its suppliers, and in fact all of the peripheral businesses that service it. Perhaps most importantly, shareholder activism, when done constructively and responsibly, helps U.S. companies stay competitive—which I think is the best assurance for all the many groups of people who depend on the long-run efficiency and staying power of our companies.

Before I tell you about our investment in Canadian Pacific, let me say a few words about shareholder activism and how I see it working. Over the past decade, I have worked to help a number of corporate boards identify and execute value-creating strategies—strategies that, as I suggested, have ended up benefiting most if not all of the companies' major stakeholders. Well-functioning corporate boards are receptive to good ideas for productive change from credible third parties; and, in many cases, they end up implementing those changes. The directors who serve on such boards tend to be intensely focused on their fiduciary duty—which is to serve the best interest of their companies' shareholders—and they don't typically care whether a good idea comes from the outside. They recognize that change is sometimes necessary, and that embracing change is not necessarily an indictment of the status quo, or of those who created or supported it. Committed and conscientious directors will pursue the interests of shareholders even to the point of persuading their CEOs and fellow directors—often people they have come to view as good friends—of the need for major change, including early retirement. Such directors are open to seeing the potential for creating value when a serious and committed shareholder agrees to join their board. The recent case of Air Products, in which the company's board responded in a constructive way to our proposal to change the CEO and restructure the board, provides a good example of a board whose judgment, decisiveness, and commitment to their fiduciary duty ended up rewarding the company's shareholders handsomely.

Sometimes, however, boards comprising capable and well-meaning directors receive proposals in a manner inconsistent with the interests and wishes of the shareholders whose interests they represent. Such boards may react more slowly than is appropriate—or they may reject critical elements of the new proposals. They may insist on hamstringing activists using standstill agreements or putting up other obstacles. The board leadership and CEO, the most powerful and often dominating voices on the board, have the hardest task of all -- objectively seeing opportunities for improvement to a system they have principally authored, and in which they have a great vested interest.

In such cases, activists can create an opportunity for the shareholders to replace some or all of the incumbent directors with directors whose vision of the company's path forward is more consistent with their own. And in the majority—though clearly not all—of those cases, shareholders eventually get their way, but only after a messy and expensive proxy battle, delays implementation of the desired changes, and traumatizes the company.

A good example of all this can be seen in our investment in the Canadian Pacific Railway, which Trevor has asked me to talk about. And let me start, as Trevor suggested, by telling you a bit about how we identified Canadian Pacific, or "CP," as an opportunity, and what we did to bring about change.

At the time we started to look at it, CP was operating at an 18% EBIT margin, while its only competitor, Canadian National, operated at a 40% EBIT margin. It was that difference that first attracted my attention.

Now, it's not uncommon for companies in the same industry to operate with different margins. And even when the companies are all well managed, there can be a number of good, "structural" reasons for such differences. For example, where, how, and with whom they do business, and how they finance their assets, could all have major effects on their EBIT margins. And there are also cases in which the differences arise mainly from differences in accounting policies, including recognition of revenue and expenses, and depreciation methods. In such cases, the levels of underlying operating efficiency can be similar despite the difference in financial metrics, which means that there is no clear opportunity for an activist to increase value.

On the other hand, sometimes the

There are large amounts of latent value in public companies waiting to be unlocked. All it takes is some fresh eyes and hard work. As our experience with CP suggests, major information and incentive problems can make it hard for even the best boards to always make optimum decisions about the management of these human, physical, and financial assets.

Open-minded boards, working with engaged shareholders, can help their companies seize these opportunities and realize much of this potential value.

Paul Hilal

competitors in an industry have similar financial metrics. In these cases, even engaged boards, management teams, and even shareholders and the research community might mistakenly conclude that all the companies are performing reasonably well. The CEOs of these companies will often believe that themselves, and will work hard to convey that impression to all concerned. But in such cases, a deeper look by fresh eyes often reveals a reality in which many—or in some cases all—of the companies in the industry are materially underperforming their realizable potential.

The challenge for the activist and his or her fellow shareholders is to determine whether the potential is actually there—and acquiring the knowledge required to make this determination involves a lot of hard work. In the case of CP, we did this work in the form of a benchmarking exercise and other research that led us to the conclusion that there was enormous potential at CP that could be unlocked by a board restructuring and CEO change. When we presented this conclusion—along with the proposal that they hire industry legend Hunter Harrison—to the CEO and Chairman of CP, they rejected both our conclusion and our CEO candidate. They argued that our analysis failed to take account of CP's network structure, geography, weather, freight mix and other considerations; and as a result, we had an exaggerated view of the company's potential. And they responded to our proposals by presenting the findings of a $5 million study they had commissioned to substantiate their claims. But our analysis had taken these factors into account. Management, their consultant, and the leading directors were not seeing clearly, and the board was therefore

misinformed about the company's potential.

We tried to educate the board and the CEO, and encouraged them to educate themselves by engaging in a discussion with the sell side and the shareholders. But we made no progress.

So, then there was a public contest of ideas in which both sides presented their case to the shareholders. The incumbents made assertions about us and the quality and integrity of our work, and its conclusions. But shareholders made their own decisions. In the end, all seven of our nominees were elected with 90% of the vote.

After we secured board representation, we worked closely and collaboratively with the reconstituted board on a broad array of changes. These kinds of changes are very heavy lifting, and required several years of work. The reconstituted board, the executives, and the employees all worked incredibly hard and well together.

Today Canadian Pacific is shipping 20% more freight than it did before we started, or than it has ever shipped in the past. And it's shipping that freight 40% faster than ever, with record on-time performance, 40% fewer locomotives, 35% fewer people, and 14% improved fuel efficiency—all while maintaining an industry-leading safety record. In sum, CP is doing much, much better and more safely—and with far less.

For our investors, these changes have resulted in an explosion of cash flows. When we made our investment five years ago, the company was worth only $8 billion, reflecting the poor performance of the railroad. Today, with the improvements cemented, it's worth $30 billion.

Bottom line, there are large amounts of latent value in public companies waiting to be unlocked. All it takes is some fresh eyes and hard work. As our experience with CP suggests, major information and incentive problems can make it hard for even the best boards to always make optimum decisions about the management of these human, physical, and financial assets. Open-minded boards, working with engaged shareholders, can help their companies seize these opportunities and realize much of this potential value.

Harris: Thanks, Paul, that is an impressive story. But I want to just push you on two points. You've done a great job of showing the role of activists in addressing inefficiencies, at least in general terms. But how deeply did your analysis have to go to understand what could be done to improve operations, to identify the bottlenecks and points where capital and labor were being wasted or misallocated? And my second question is this: When you say that CP now does much more with far fewer workers, this begs the question of what happened to all those workers who lost their jobs? Didn't these changes involve considerable losses to this group of people, and how do you take account of them if you're trying to understand the economy-wide effects of investor activism?

Hilal: Well, in answer to your first question, we put enormous effort into our analysis, into the quantitative and qualitative benchmarking. In so doing, we tried to get enough information so that we really understood the operations, where they had achieved a reasonable degree of efficiency and where there were still major opportunities. We spent many months, and hundreds of thousands of dollars, getting enough information to feel confident about these opportunities, and our ability to take advantage of them. And our investment in acquiring that information ended up having a big payoff.

As for your second question, CP today employs approximately 14,000 people, down from 20,000 before our project began. That is pretty astounding, considering the massive increase in volume, great service improvements and stellar safety record. And it's important to recognize that all but 500 of the 6,000 employees who departed volunteered to take an attractive early retirement package. They were not fired. Most rejoined the available labor pool and joined companies that were looking for human capital and could put it to good use. So, between the exit packages and the opportunity to be gainfully employed at healthy companies that needed them, I think it is hard to view the large majority of those employees as losers.

But what about the other stakeholders in the company? CP's customers have better service than ever. The long-term CP shareholders—the institutions and individuals who owned the stock before we invested, and have continued to hold the stock—have seen their investment quadruple. Finally, this example reminded directors on other boards of how easily capable and well-meaning CEOs and board leaders can sometimes lose perspective, and need the strongly voiced input from the board's periphery.

Private Equity and the Healthcare Industry: The Case of Welsh Carson Anderson and Stowe

Harris: That's a great story, Paul, thanks. Now we're going to switch to a different sector—the healthcare industry—and to another perspective—that of private equity investor Russ Carson and the investment firm he co-founded in 1979. Russ, I often tell my students that the biggest threat to the United States as a great country is the unaffordability of our healthcare system, especially given the current demographics. You and your firm have achieved some remarkable successes in the healthcare industry. Can you tell us about some of those investments and try to give us a sense of how you identify opportunities to create value? In the process, can you also show how your success in creating efficiency and value has helped to address this large and troubling social problem—or at least pointed toward possible solutions?

Russ Carson: Thanks, Trevor, for inviting me to be on this panel with you and Paul. And let me attack the question by giving you a couple of basic numbers about U.S healthcare that many of you in this audience may not have heard.

In 1965, when the U.S. government passed the Medicare Act, healthcare accounted for 6% of the gross national product in the United States. Today healthcare is 18% of GNP. This is an industry that since 1965 has grown literally every year, and in most cases it has grown at a rate well above the rate of inflation. With about $3 trillion in revenue, it is now a very large, and a very inefficient, industry.

Unlike Paul, I don't invest in public companies; I'm a private investor. My business is to either buy companies or start them. When we look at healthcare, we just see opportunity across the board. And much of this opportunity comes from the fact that healthcare is an extraordinarily fragmented industry. It has all different pieces to it, including hospitals, doctors, pharmaceuticals, and outpatient services—and so there are any number of different niches for us to consider.

The one thing that most of the niches have in common is that the service is delivered on a local basis. So, in one place you have a local provider who's providing that service; and in the community next door, much the same set of services are being provided by a different local provider. Hospitals are a great example. Every town has two or three hospitals—and most of them are not affiliated with any major chain. Most of them are also nonprofit, focused just on that one segment of the market.

In response to this fragmentation, our main strategy in healthcare has been what we call a "buy-and-build" strategy. It's one where you begin by identifying an interesting part of the marketplace, and you acquire a small player in that marketplace. Then, using that first deal as your platform, you go out and acquire a series of local businesses, and turn them into what eventually becomes a national business. And it's a highly repeatable formula; you can do it time after time. Now, I'm not saying that it's simple or easy to do. You inevitably make some mistakes along the way, but then you have lots of chances to learn from and correct them. And once you've gotten it right, you can create an enormous amount of value. One major source of this value is the economic reality that the price you have to pay for a local provider as a multiple of its earnings is a good deal lower than what a strategic buyer—or the public IPO market—will end up paying you for a national business that operates in multiple localities.

Let me just give you one example of an investment I was very involved in, and for a relatively long period of time. In 1998 we bought an oncology practice in Denver, Colorado that was owned and run by five oncologists. They were renting office space, but they wanted to build their own cancer center and expand the range of services they were offering. And because they didn't have the capital to do it, they started out looking for a real estate investor.

We ultimately convinced them that the right thing to do was to let us help them turn their practice into a company, and then make that company part of a much larger operating business and, at some point, even a publicly traded company. So we bought their practice by paying them a combination of cash and stock in their—and our—new business. And we built an outpatient cancer center, which allowed them to provide chemotherapy and radiation on site. And let me just mention here that the great advantage of outpatient cancer services is that the patient doesn't have to go into the acute care hospital. For people who are not feeling well and facing a potentially terminal disease, struggling through the maze of an acute care hospital is something no human being should have to go through.

So, we started with one small practice in Denver. And at that point we assembled a management team, recruiting a first class CEO, a CFO, a head of development head, and so forth. It took us about

a year and a half to get that management team and our strategy in place. Then we bought a second cancer center in Indianapolis, which was several times the size of the center that we bought in Denver.

And if you fast forward to five years ago in 2011, when we sold the company for the second time—after taking it public in 199_? and then buying it back in 2001—our company, US Oncology, had become a $4 billion business with more than 1,000 oncologists working in 90 outpatient cancer centers operating all over the United States. We were the single largest—and, by all accounts, most reputable outpatient provider of cancer services in the country.

What we accomplished by creating this business was to create enormous efficiencies out of an extraordinarily fragmented system. We were able to bring modern management techniques to a series of small business that had been run in a very seat-of-the-pants, nonprofessional way. We put in standards, and computerized as much of the operations as we could. And we focused very hard on getting the doctors to spend their time seeing patients, not looking for records, which is something a nurse or administrative person should be doing. It basically involved taking a series of mom-and-pop businesses, and converting them into a professional organization. And in so doing, I would argue that we significantly improved both the quantity and quality of cancer care in the 90 communities that we were operating in.

At the end of the day in healthcare, you're dealing with the ultimate consumer service. If somebody is sick, they are not at all happy if you're not helping them, or failing to communicate with them well enough to find out what they really want or need. We made customer service one of our principal strategies. We made it easy for our customers to do business with us. We took what would otherwise be a bad experience, and made it at least an acceptable experience.

So, with that as our basic mission, we ended up building a sizeable business. And as I mentioned, we actually owned the company twice. About five years after starting the company in Denver, we took it public. Then, when the company stock was trading at what we thought was an unrealistically depressed price, we bought it back in a going private transaction, and owned it for another ten years before we finally sold it again in 2011.

For us, it was an enormously attractive financial transaction. And it was enormously attractive to all the doctors that we recruited. Our doctors actually made more money after they joined us than they'd been making before, and that was after we took a 15% management fee out of each of the practices. Again, all this was done by efficiency, by modern marketing. And purchasing was, of course, an important part of our success. But it was just bringing all of the modern business methods to bear on what had been a set of mom-and-pop businesses.

Harris: Russ, is regulation of the healthcare industry going to facilitate this process of consolidation, and is your model something that you believe could be able to deliver the services to a broader population, especially given the demographics and inability of many people to afford medical services?

Carson: I think a couple of things are going on now, Trevor. Clearly, the growth of the industry as a percentage of GNP can't continue indefinitely. I'm not sure where the ceiling is, but my guess is that we're not going to spend more than 20% of our GNP on healthcare long term. We can't have a society that spends all of its resources taking care of its older citizens. So I think there's a natural cap on revenue growth, which is going to put enormous pressure on the industry, and that's happening right now.

As a result of that pressure, we're seeing massive consolidation of many parts of the industry. From our standpoint, we see opportunity during the next 10 to 20 years to play a role in that consolidation, which we think is going to occur over an extended period of time. And that consolidation is going to provide a lot of efficiencies and savings—efficiencies that could be used in part to reduce the rising costs of healthcare.

The other big factor in healthcare is the technological change on the horizon. For example, think about the effect on industry practice of the whole world of genomics, of the ability it offers to identify exactly what's wrong with somebody, and to figure out very quickly the right treatment for the person.

So there are a lot of changes that are going to hit this industry in the next five or ten years. And as a private investor we like change. It creates opportunity to buy things where there are price dislocations. Operating as a private business, we can do things that public companies can't do because we don't care much about quarterly earnings. So if we think we understand where the business is going to be in five years, we feel confident in our ability to make the investment required

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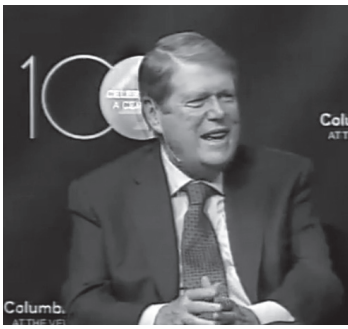

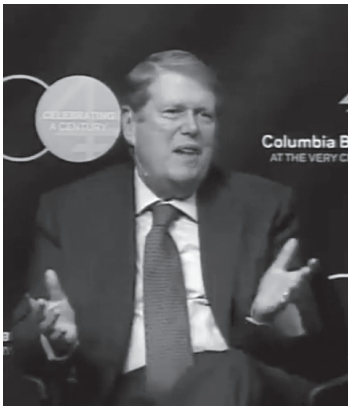

today to profit from our view. Despite what you may have read about private equity, we are long-term owners; we think of ourselves as taking a five- to ten-year horizon when making our investments in businesses.

Holding Periods and Investment Horizons for Private Equity and Shareholder Activists

Harris: Russ and Paul, you both mentioned holding for a period of time, and then selling. You've also created these unbelievably successful businesses, which appear to have improved the lives of many people. So why sell the businesses at all? Why not hang on to them?

Carson: Trevor, you've put your finger on one of the anomalies of the private equity business. Our firm was started in 1979, and has now been in business for 37 years. When we started in 1979, and it's still true today, most capital in the private equity industry was raised through limited partnerships. The standard contract for limited partnerships has a 10-year life, at which point the capital must be returned. Investors put up their money into what amounts to a blind pool. And using that money along with our own capital, we then go out and buy a bunch of companies without being able to say in advance what we're going to buy. Nobody is guaranteeing any of the returns. And investors like the idea that they have the

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right to demand that you give them the money back after 10 years—preferably with a high profit attached to it.

Now, I think that this arrangement is likely to change over time, at least in the case of some PE firms and some limited partners. What the industry hasn't yet figured out is how do we make the transition from one mode of LP investing to another system that enables investors with longer-term horizons to commit their funds to those PE firms that have demonstrated a special ability to make and manage such investments. As an individual, I would love to be an even longer-term investor in the businesses that we've been involved with.

Now I'm not suggesting that we scrap the existing system; those LPs who want to equity in a shorter time frame should have a way to continue doing that. But I think the industry may find there's a lot of interest among some LPs and PE firms in at least extending the ten-year term into something considerably more permanent, or at least more flexible. People in our industry are just beginning to think about this possibility.

Harris: Paul, what are your thoughts on this question?

Hilal: It's an interesting question. This is basically a function of the investors' expectations. Once activists have presented an idea and helped shareholders effect their will, their investors typically expect them to sell, and to return their capital. They are impatient for sure. As an activist, I have a balancing act. On the one hand, I want to return capital to my investors' capital as quickly as possible, and not a moment longer; on the other hand, I also want to remain involved long enough to ensure that the improvements we make to the target are cemented, and will in fact endure past my exit. The durability of their improvements play a major role in activists' ability to attract support in future campaigns.

Changes in Valuation, and the Market Processing of Information

Harris: I often hear the statement that the practice of value identification and creation has been changing so much during the last 10 to 30 years Russ and Paul, how do you react when you hear something like that?

Carson: Trevor, I agree that the world is constantly changing, and the trick is to be flexible, quick on your feet. And you want to get into things that are changing as early as possible, not the last one to join the party.

One of the great advantages we have as an investor is our ability to get into a business or sector, but then to get out if

and when things change too much. Our job, after all, is to buy low and sell high. Take the information services industry, which along with healthcare is our other main focus. This industry has gone through remarkable changes, and continues to do so, in ways that most people can't foresee. Yet there are all sorts of new opportunities that are being created everyday that we are finding ways to take advantage of.

Harris: Paul, let me ask you the same question, but with a little different twist on it. Is it possible that the market has acquired new sources of information or, in part because of technological advances, has become more efficient in processing that information over time? To the extent this is so, has that change cut into the competitive advantage of shareholder activists like you at all?

Hilal: Thirty years ago, it was hard for shareholders outside of the company to have a better perspective than the board or management on the best course of action. If you go back 30 or 40 years, about 80% of S&P 500 shareholders were retail investors with no formal training in analyzing corporate performance, and they certainly had very little available information. Today, by contrast, some 80% of the S&P shareholders are large institutions run by people who were trained at places like the Columbia Business School. They know where to find information and how to analyze it; and because they're so large and manage such a large volume of assets, they invest heavily in the information gathering and analysis that informs their investment decisions.

As a result, today's most sophisticated and well-informed public market shareholders can have a better sense of the company's best interest than the directors. Why? Because the directors often don't have either the incentives or the resources that would lead them to seek out the same information sources. And they very often don't have the experience and resources to interpret the information properly. A director who's being paid $150,000 a year is not going to spend $500,000 for the satellite service that tells him how many cars are parked in his company's retails locations every Saturday during the year versus how many are parked outside of the competitor's locations in the same zip code. He's just not going to do it because he can't afford to reach into his pocket to do it. And there's a good chance that the CEO and top management aren't doing it either. But at the same time, some institutional investors—and activists like us—may in fact be making such investments.

But what about the possibility you raise of "disintermediation," the possibility that more penetrating sell-side analysis is cutting into our competitive advantage? Some of the new technology-driven sell-side services are excellent at capturing important trends using data and quantitive methods. But much of what investing is—and a lot of what Russ and I do—has an important qualitative element to it as well. It's about using your judgment when evaluating leadership and managerial skills—something you can do only by synthesizing information in a way that often does not lend itself to computation. It's about the judgment needed to reconcile data points that support diametrically opposed conclusions. The information now being provided by some sell-side analysts is incredibly valuable, and in some cases even empowering; but it usually needs to be complemented by judgment and experience.

Harris: That seems like a perfect point for me to wrap things up with. One of the takeaways that we were hoping would come out of this panel is that Columbia Business School has been very focused on value for a long period of time. A lot of what you have heard today is that valuation is not just about determining the best price point, but looking deeply into all aspects of business—and in this sense, valuation is central to the goal of business education itself. One of the challenges—and the last question I would have asked had we more time—is whether business education truly has to adapt and change with all that we're seeing happening. You heard responses to that question from the business school deans in our first panel.