Institute for governance
of private and public organizations

Why was Pershing Square so successful at Canadian Pacific Railway

Yvan Allaire, PhD (MIT), FRSC
Executive Chair, IGOPP
Emeritus Professor

François Dauphin, MBA, CPA, CMA
Project Director, IGOPP

(The authors are solely responsible for the opinions expressed in this text)

Toward Value – Creating Governance®

OCTOBER 29TH, 2014

In 2011, Pershing Square Capital Management, an activist hedge fund founded by William Ackman, was buying shares to bring its ownership position in Canadian Pacific Railway (CP) to 14.2%. Ackman then proceeded to advocate publicly for several changes in the management and governance of the company to boost its financial performance. The CP board resisted fiercely his entreaties. A memorable proxy fight ensued, which was won by Pershing and resulted in a new CEO, new board members and a new strategy for CP.

Results of this palace revolution were, in share price terms at least, remarkable, astounding actually. From September 2011 to September 2014, CP's stock jumped from less than C$49 to north of C$225, a compounded annual rate of return of 67% (excluding dividends).

Why was the CP intervention such an apparent success, when, in several other instances, Pershing's brand of activism was far less successful. His forays into J.C. Penney, Target, HerbaLife and Borders gave results ranging from mediocre to abysmal.

A close examination of the CP saga reveals a number of differentiating features absent from other less successful interventions:

1. A RARE CASE OF PERFECTLY TRANSFERABLE TALENT

The recently retired CEO of Canadian National Railways (CN), the best performing railroad company in North America, was soon to be freed from the legal (if not the ethical) constraints on his joining a direct competitor. This man, Hunter Harrison, is acknowledged as a highly skilled and innovative railroader…and he was ready and willing to take over as CEO of CP.

In the Canadian context, such behaviour is not quite gentlemanly. Imagine the high performing CEO of the Royal Bank who, soon after retirement, would join the Bank of Montreal as CEO. But both Ackman and Harrison are Americans who could not care less about the mores and values of the Canadian business world.

Of course, recruiting Harrison came at a price, some $44M in 2012. Harrison then turned around and recruited Keith Creel (then executive vice-president and chief operating officer at CN) to follow him as CP's President and Chief Operating Officer (and most probably Harrison's successor).

This sort of opportunity to recruit the recently retired CEO of the company's best performing competitor is rare in practice. Ackman has learned that lesson when as the largest shareholder of J.C. Penney (a chain of department stores), he pressured its board of directors to replace the CEO by Ackman's choice: Ron Johnson, at the time president of Apple retail. That turned out to be a disastrous choice. Johnson was let go 17 months later to be replaced by the very CEO he had replaced.

So, an "activist" hedge fund unhappy with the performance of the current CEO of a targeted company calls on the recently retired CEO of a direct competitor who happens to be ready to jump ship and hit the ground running. How rare is that?

2. A SIMPLE, WELL-DEFINED INDUSTRY

The North American Railroad Industry is extremely well defined. The same companies have been serving this market for decades; their networks are well-established. Performance measures are standard across the industry, which makes for easy comparability across firms. Thus, it is a simple task for management, the board of directors and investors to benchmark any company against its peers. Unfortunately for CP, its score was substantially lower than its peer group and the gap was widening year after year. But, it was widely acknowledged and accepted (including by financial analysts following the industry) that there were structural factors which explained a good part of this inferior performance. As for the part under the control of management, vigorous action plans were being implemented to bring CP's performance much closer to its peers within five years. That was certainly the firm conviction of the CP board.

3. A PRESTIGIOUS AND EXPERIENCED BOARD OF DIRECTORS

The board of CP had a *nec plus ultra* membership drawn from the Canadian business elite: former CEOs of the Royal Bank, Cargill, Ipsco, Shell Canada, and Corby Distilleries; current CEOs, scions of old families, a former minister in the Government of Canada. These people had a wealth of business experience and were proud to serve on the board of an iconic corporation whose history is enmeshed with the very history of Canada.

They surely did not lack confidence in their ability to govern the corporation. Indeed, their collective wisdom and governance skills had been recognized repeatedly by various agencies making a business of rating the governance of corporations.

Here comes an upstart "hedge fund" manager from New York who has the gall to criticize their stewardship and to pretend he knows what CP should do to improve its performance. His bright insight involves, first of all, the disgraceful suggestion that the CP board chairman go and try to persuade the former CEO of a rival Canadian company to jump ship and join CP!

There is here more than a whiff of cultural clash between American and Canadian business practices, or perhaps more accurately, a clash between the loyalty-stakeholder model of yore and the fiercely driven maximization-of-shareholder-value of contemporary times. The traditional model had some admirable features, some of which have been retained in modern corporations, such as the policy of promotion from within. This policy is still alive and well at many large corporations, from GE, Johnson and Johnson, Procter & Gamble to Canadian banks and certainly CN Rail and CP Rail (and receives strong empirical support from several academic studies (including Jim Collins' book "***From good to great***").

Not only was Ackman arguing for CP to drop this policy of strict "promotion from within" but was urging CP to hire someone from a direct competitor.

Of course, it is also plausible that a prestigious board, a board made up of experienced former or current executives would be more likely to reject out of hand any suggestion coming from a "financial" sort of player.

4. MASSIVE SUPPORT FROM INSTITUTIONAL SHAREHOLDERS

Yet, indifferent to these considerations, large Canadian institutional investors supported Pershing Square's attack on the board of CP. Perhaps tired of the mediocre performance of CP's stock price, they saw in the hedge fund a vehicle to channel their frustration. Often, these institutional investors are also invested in the hedge fund they are supporting. If it turns out that the hedge fund's activism is successful, they benefit twice: from the gain on their investment in the targeted company and from the increase in value of their stake in the hedge fund.

Canadian institutional investors have become, broadly speaking, "americanized" in that their investment policies generally speaking do not give any special consideration to Canadian issues or values. They are now basically "short-term investors" financially driven and motivated to beat indices and post a performance that ranks them in the top percentiles among their peers.

In the case of CP, Pershing Square even got support from the president of a large CP employees' union embittered by a recent and difficult negotiation.

We believe these four features of the CP saga are collectively rather unique.

Yet, the proof is in the pudding

Under a new leadership, CP has quickly and remarkably improved its performance. What did not seem achievable was achieved. Structural impediments to CP's performance seem to have vanished.

How come the CP board at the time, presumably savvy and experienced, did not wake up to inefficient management, did not challenge the common assertion that structural factors explained CP's mediocre performance? How come no one seemed to notice that the CP performance had been deteriorating? Why were they satisfied with the level and rate of progress proposed by management?

After all, the critics formulated by Pershing Square were all based on publicly available data. Why could the CP board not see what outsider Pershing Square could spot in a few weeks? The initiatives that Harrison was able to implement swiftly after taking over as CEO constitute a damning indictment of the board (and management) of CP at the time.

In the singular case of CP, an activist investor was able to benefit from a providential alignment of circumstances that resulted in sustained (thus far) value for shareholders.

Conclusion

On Wednesday night the 1st of October, the beginning of CP's day with financial analysts, Mr. Hunter Harrison stood in front of a screen with a Power Point presentation. The first slide was made up of an assemblage of quotes from financial analysts (many of them in the room although names were retracted), which he used to deride them for their scepticism about his projected improvement in CP's operating performance back in 2012. He obviously took great pleasure at rubbing in how analysts had been wrong and pointedly reminding them that financial analysts cannot understand what a true railroader knows.

"Railroading is all about execution", says Harrison.

Well, hedge fund activism is rarely about execution; most of the time, it is about some form of financial engineering producing a boost in stock price but often at a cost in longer term flexibility and growth for the targeted company.

The CP saga is not exemplary but an exception. It should not be used to elicit support for all forms of shareholder "activism". Indeed, if the board of CP had not been inhibited by such trivia as ethics and corporate values, it could have jumped at the opportunity to hire Hunter Harrison. No need then for Pershing Square!

About IGOPP

THE REFERENCE IN GOVERNANCE MATTERS

Created in 2005 by two academic institutions (HEC Montréal and Concordia University – The John Molson School of Business) and the Stephen Jarislowsky Foundation, the Institute for governance (IGOPP) has become a centre for excellence about governance of public and private organizations. Through research, training programs, policy papers and participation in public debates, IGOPP has become a key reference on all issues of governance in the private and public sectors.

OUR MISSION

- Strengthen fiduciary governance in the public and private sectors;
- Make organizations evolve from a fiduciary mode of governance to a **value-creating governance®;**
- Contribute to debates, and the solution, of governance problems by taking positions on important issues and by a wide dissemination of information and knowledge about governance.

OUR ACTIVITIES

The Institute's activities focus on the four following areas:

- **Policy papers**
- **Training**
- **Research**
- **Knowledge dissemination**

List of IGOPP Policy Papers

Dual-class share structures in Canada: Review and recommendations
2006

Corporate citizenship and the right to vote: A proposal
2006

The Independence of Board members: A Quest for Legitimacy
2008

The Status of Women Corporate Directors in Canada: Pushing for Change
2009

Giving Shareholders a Say on Pay: A measure leading to better governance?
2010

Pay for Value: Cutting the Gordian knot of Executive Compensation
2012

The Troubling Case of Proxy Advisors: Some policy recommendations
2013

Scan this QR code
with your mobile reader
to access all IGOPP Policy Papers.

Don't have the app?
Search for "QR code reader" in your app store.

This article is available online in PDF format at www.igopp.org

Design: Karine Bellerive

1000 De la Gauchetière St. West, Suite 1410, Montréal (Québec) H3B 4W5

Telephone 514.439.9301 | **Fax** 514.439.9305 | **info@igopp.org** | **www.igopp.org**

Institute for governance
of private and public organizations