



In an exclusive interview with Geneva Partners, Richard Breeden gives his vision of "activism"

What inspires a former SEC Chairman to become an activist investor? Is it a sign that activism is becoming more mainstream?

In 1996 I formed a consulting company to assist companies experiencing financial or other forms of difficulty to restructure and to enhance their market value. Over the ensuing dozen years, we assisted many companies, including the former WorldCom, in reshaping such factors as their strategy, cost structure, use of capital, transparency or governance practices. We proved to ourselves that we could help poorly performing companies to increase earnings, and also to achieve higher multiples on those earnings in value by enhancing credibility in the market. This experience inspired me to want to help even more companies replace policies that reduce market value with policies that enhance value. Most importantly, I was inspired to carry out these activities on behalf of my own investors, and not just all investors generally.

I don't think that I am a reflection that other traditional activists are changing the way they operate as much as I am of simply bringing my background, experience and orientations to this area of the market. There are enormous differences in how different "activist" investors operate. Some focus narrowly on financial engineering over a short time frame, while I try to look out over a longer term and focus on the full range of issues that can contribute to increased market value. Warren Buffett has been doing that for years, and I only hope I can achieve a fraction of his success.

As the owner of a large block of shares in a company, Breeden Partners can't make money unless all other shareowners also benefit from a rising share price. Therefore, in a sense I am still working to promote the interests of investors as I did at the SEC. The difference is that now I am doing it with an intense focus on a few specific companies where we believe that correcting identifiable mistakes creates the opportunity to achieve extraordinary gains. Since the result of our efforts is not only a more valuable, but also a stronger and better company, it is easy to stay excited about what we do.

How does your expertise in securities laws and corporate governance help you invest in underperforming companies?

My experience working with companies to adopt healthy governance practices, as well as enforcing the securities laws for thousands of U.S. companies, certainly helps me unravel the problems that underperforming companies encounter. At the same time, my leadership skills and my experience dealing with almost every imaginable type of corporate problem and finding workable solutions are probably even more important. It probably doesn't hurt to have the public credibility from having successfully handled problems like the U.S. banking crisis in the late 1980s, or WorldCom and similar disasters. Directors in companies we invest in know that my partners and I have created billions of dollars in value working with many different companies. That helps us persuade directors to listen to our suggestions,



and ultimately to take the difficult decisions necessary to establish a new path to greater value creation. During the course of my career I have worked extensively with legal, financial, accounting, governance and ethical issues, to name only a few. I have helped resolve problems as a public company CEO, bankruptcy trustee, independent director, senior advisor, regulator and legal counsel. So I have seen governance and performance issues from almost every side of the table. That helps me evaluate where a company seems to be going wrong, and what the options are for fixing the situation. It also helps me prioritize opportunities to try to find the ones where we can create the greatest returns for our investors.

My experience as chief regulator of U.S. securities markets, in particular, helps me cut through the

published disclosures by underperforming companies and identify what is really going on. Why is a particular company's performance #9 or #10, rather than #1 or #2, in an industry? What steps are necessary to get a company out of the bottom quartile and into the top quartile of performance? I am used to asking tough questions and not accepting self-serving or simplistic answers. Managers of badly performing companies almost always have rationalizations of why losses in value aren't their fault. You have to be able to force people to focus on the facts and force boards to impose discipline and accountability where they haven't done so on their own. In far too many cases today American boards just give up and sell their companies when they have issues rather than identifying what is wrong and fixing it. We are not content to sit back and watch portfolio companies

lose jobs, market share and value because of poor leadership or bad decisions. Fixing companies rather than waiting for them to fail or be bought out by private equity firms seems to be in everyone's interest, but someone must take the lead in forcing the necessary corrective action to occur before it is too late.

What could the SEC/regulators do in order to improve corporate governance in publicly traded companies?

All investors are benefitted by transparency, which the SEC's rules require. Yet in the recent financial market troubles we have found many large banks with off-balance sheet "SIV"s and other devices to obscure the bank's aggregate commitments and risk rather than making them transparent. Regulators need to do everything in their power to achieve greater transparency in reporting, as timely and accurate disclosure allows the market to price and police risk. Beyond encouraging transparency, the SEC needs to improve the ability of shareholders to nominate directors, or to remove them if they don't have the affirmative support of a majority of shareowners. Shareowners should be allowed to have more of a say in oversight of performance as board members. If that were to happen, I am convinced that we would catch our worst potential problems earlier. One of the biggest problems of the U.S. system is that unresponsive and disengaged directors often don't intervene early enough to control risk-taking or to force corrective action when performance begins to deteriorate.

For example, too many boards pay just as much for failure by a CEO as they would for success, and that really harms shareholders. The SEC ought to either allow shareholders to get together and nominate alternative candidates to appear on the company's proxy, or drastically simplify the rules and costs of running alternate stakes.

How do you consider the current market environment for activism? What is the impact of the credit squeeze?

I don't think there could be a better environment for activism, at least as we practice it. The credit squeeze makes companies and boards far more interested in solving problems. At the same time, in prior years it was much easier for private equity and other potential buyers to make an acquisition of a badly performing company.

There are a number of different types of activism (balance sheet v. P&L; Vocal v. Quiet; Large Cap v. Small Caps; Global v. Local; Pure long-only v. long/short). How would you describe your own personal investment style?

First, I am long-only, and I don't use any leverage whatsoever. I invest with a time horizon of 3-5 years, and I am not interested in steps to make temporary short term improvements at the expense of longer term risk or performance. Therefore we hold our shares through outright ownership, not short term option contracts or derivatives. I am patient, but forceful in wanting to see progress begin right away and be pursued continuously. It may take time to turn the ship, but it is essential to turn the wheel to start the progress.

We focus much more intensively on the balance sheet and the level of free cash generation than we do on reported income. U.S. GAAP allows so many accruals and deferrals of reported income that we like

to look at the real cash flow to understand the company's situation most accurately. Today we invest only in U.S. and Canadian companies, although in the next several months we plan to launch a fund to invest in European companies using the same investment principles and objectives we follow in the U.S. market. We invest primarily in "mid-cap" companies with market capitalizations ranging from \$1-10 billion. Those companies are large enough to put plenty of money to work, yet less resistant to change than the biggest companies. While I prefer a quiet dialogue, sometimes it is necessary to wage a proxy fight to force a company to act.

As an activist investor, is it realistic to try to avoid proxy battles?

Waging a proxy contest is never my first choice, but if you aren't prepared to wage a proxy fight you will not be nearly as effective as when the company knows that you are prepared to do so, and that if you run you will succeed. We could have had 100 years of meetings at H&R Block arguing for change without getting results because the CEO was dead set on continuing policies that had led to massive losses. We ran three candidates for election, and at the AGM we got 84% of the vote and

the incumbent nominees got 8%. As a result, we had a powerful mandate for change, and we used that mandate almost immediately. When it comes to activist investing, you can't create value unless your ideas lead to action. Companies have to know you won't give up and go away until the necessary reforms are made.

The irony is that boards should want to recruit large shareholders to become directors, not attempt to keep them away. Large shareholders bring independent analytic capabilities that the board can't get anywhere else. The result is a more diverse board that is more likely to make the necessary decisions to achieve greater market value.

How do you identify your potential targets? What are your current main holdings? Can you give a few examples of your investments as well as why they are in your portfolio?

It isn't hard to identify the underperforming companies. However, it is more difficult to identify what things should be changed, and to gauge the effect that changing specific practices will have. We use rigorous, bottoms-up research to quantify performance levels, and to model the effect that we believe changes will have on aggregate performance and value. However, given my

background we also look into a variety of special situations where we believe we might uniquely add value through leadership and credibility. Our major current holdings include H&R Block and Zale Corporation. Both companies have brands that are well-known and respected in the consumer marketplace. Both have recently suffered significant value losses that led to CEO changes. In both cases, we believe that the companies have strong brand power, high levels of free cash flow generation (giving them time to change), and large untapped opportunities. At H&R Block, for example, the company has the dominant market share in tax preparation services in the U.S., which is a business that generates enormous recurring fee income with very low required capital expenditures. Inexplicably, its CEO spent much of the previous ten years focusing on stock brokerage and subprime mortgage lending, areas where the risks were very high and the company had little if any comparative advantage. The company was literally ignoring the business that made it great, while also incurring billions of dollars in losses on an empire building program. We forced the company to get out of the mortgage business, and to refocus on its core business. If successful, our strategy of "back to basics"

will lead to a reinvigorated tax business that will exploit its dominant market position far more effectively than the company has in recent years. At Zales, the problem has been excessive costs and poor execution on business fundamentals. As we did at H&R Block, we joined the board, though in this case at their invitation. We believe the turnaround at Zales will be primarily one of greater focus on costs and basic fundamentals – an operating story rather than strategic repositioning. As with H&R Block, we believe that the poor earnings performance of Zales over the past three years offers us a strong opportunity to rebuild value.

Breeden Capital Management 13D filings Activity

Date of Filing	Target Company	Action	% Of Shares Outstanding
18 Jan. 08	Zale Corp. (ZLC)	13D Position Increase	18.09%
15 Jan. 08	Zale Corp. (ZLC)	13D Position Increase	17.66%
7 Jan. 08	Zale Corp. (ZLC)	13D Position Increase	15.85%
2 Jan. 08	Zale Corp. (ZLC)	13D Amendment	15.09%
2 Jan. 08	Zale Corp. (ZLC)	13D Amendment	15.33%
17 Sep. 07	Zale Corp. (ZLC)	13D Initiation	7.72%
29 May 07	ACCO Brands Corp. (ABD)	13D Initiation	9.71%
26 Apr. 07	Applebees International, Inc (APPB)	13D Amendment	5.40%
26 Jan. 07	Applebees International, Inc (APPB)	13D Amendment	
12 Dec. 06	Applebees International, Inc (APPB)	13D Amendment	
10 Oct. 06	Applebees International, Inc (APPB)	13D Initiation	