INVESTOR ACTIVISM

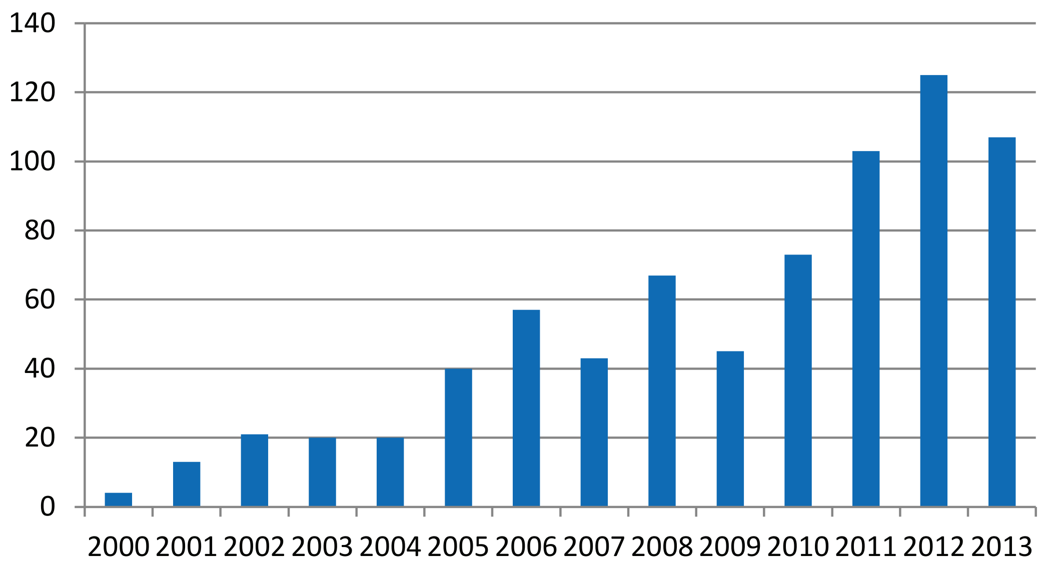
What are Activists Looking For?

IPREO SPECIAL REPORT

Better IR SERIES

Shareholder activism can take many forms, but generally refers to times when an investor uses an equity stake in a company to put pressure on the management. These pressures are meant to convince management of making a change that ranges from financial policy changes, or non-financial ventures such as adopting environmentally friendly policies or changing corporate governance. Dealing with activism has always been an important component of IR, but has recently risen to the spotlight and now occupies the forefront of many IROs' concerns. Additionally, the number of activist campaigns against companies has dramatically increased in the past few years. It is only natural to wonder, how has activism changed over the years, and what characteristics of companies are activists finding more attractive?

Figure 1: Number of North American Activist Campaigns since 2000

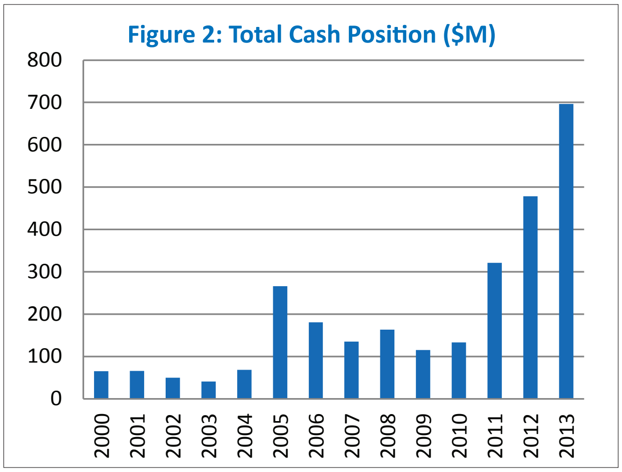


Source: S&P Capital IQ, Ipreo Research

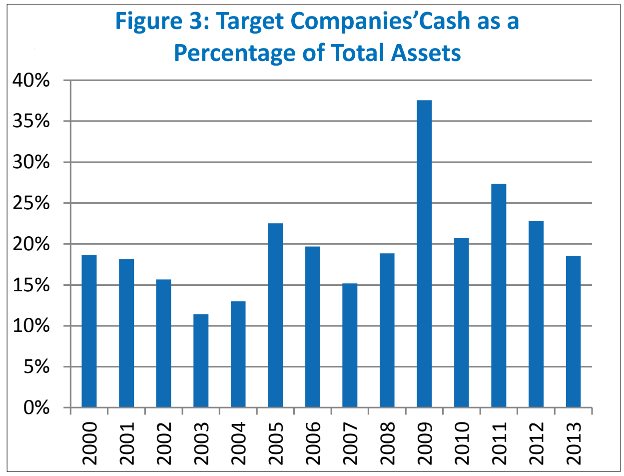
Historically, activists take equity positions in companies in order to "unlock shareholder value," which is traditionally done through management changes such as replacing CEOs or board members, or "financial engineering" methods including share buybacks, changes in dividend policy, or selling off underperforming divisions. These campaigns have traditionally targeted companies that are undervalued (low P/E, etc.), underperforming (multiple quarters of missed guidance), or going through major change (crisis, restructuring, etc.).

ValueAct's recent activist campaign against Microsoft is an example; Microsoft had missed fiscal Q4 earnings and saw decreases in valuation throughout early 2013, and subsequently became a target of ValueAct. The activist's campaign primarily centered on redistributing foreign cash reserves to shareholders and restructuring core businesses (open Windows to iPad, create new options for search business and Xbox, etc.). Microsoft eventually reached an agreement following periods of pressure from the activist and offered ValueAct a seat on its board. However, it is important to note that while it is true that many target companies like Microsoft have large, sometimes increasing cash positions year-by-year, they also have decreasing cash as a percentage of total assets year-by-year.

Misconception #1: Activists tend to target companies with large cash positions to either reinvest into the company or distribute to shareholders.



Source: S&P Capital IQ, Ipreo Research



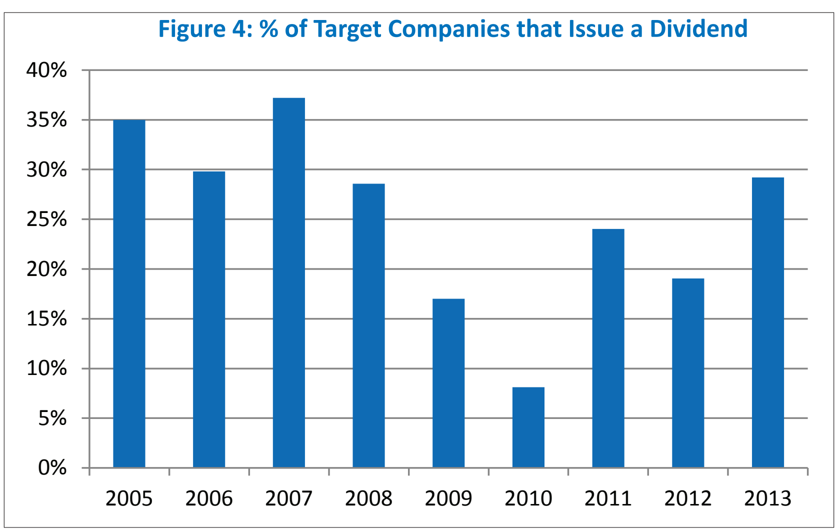
Source: S&P Capital IQ, Ipreo Research

Straight cash positions seems to indicate that target companies with higher cash positions tend to get targeted by activists, but in reality, the average cash as a percentage of total assets of target companies is actually decreasing. While the case of Apple and Microsoft are exceptions to this rule, cash is not as important of a factor of attracting activists as previously believed.

An example of a management change campaign in recent news is Carl Icahn's bid to takeover Dell. As the PC market continued to suffer, Dell founder Michael Dell proposed a solution of a company buy-out in order to transition Dell into the mobile space and according to ISS, "transfer the risk of the deteriorating PC business and the company's ongoing business transformation to the buyout group." Icahn did not support Dell's transformation strategy, believing that a buyout would keep stockholders from sharing the gains from a potential turnaround, and planned to replace Dell's board in order to implement a recapitalization plan that would keep the stock public. Icahn ended his takeover bid following a court decision involving the status of unvoted shares.

However, the markets have recently seen a shift in activist behavior in that activists are no longer going after just "distressed" companies. In February 2013, David Einhorn of Greenlight Capital started to pressure Apple to redistribute its large reserves of cash. Apple yielded to Einhorn's pressure with both a stock buyback program as well as an increase in in its quarterly dividend by 15%. More recently, Carl Icahn announced his interest on Twitter to discuss a larger buyback with Apple CEO Tim Cook. While Apple did see a large drop in stock performance throughout the first half of 2013, the company is still widely seen as a well-performing company that saw its first profit decline in a decade, hardly a company in "distress."

Misconception #2: Following the examples of Microsoft and Apple, many believe that Activists tend to target companies that do not issue or issue very low dividends in order to provide greater consistent revenue for shareholders.

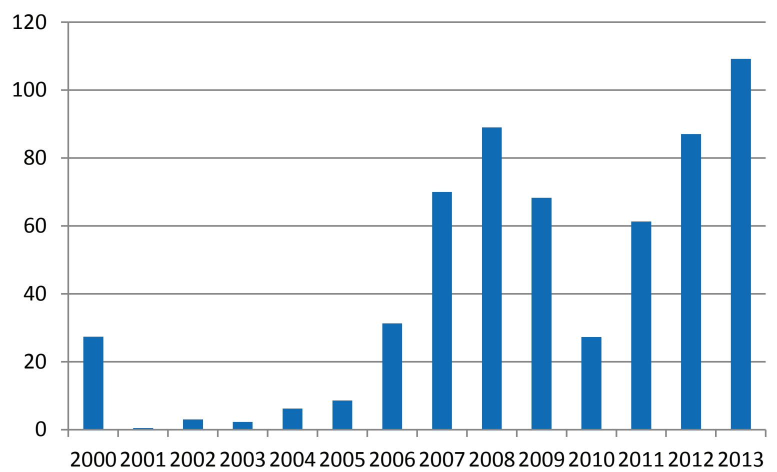


Source: S&P Capital IQ, Ipreo Research

Rather than attacking companies that are not paying dividends or pay low dividends, targets companies have increasingly been dividend payers. Other than in 2009 and 2010, dividend payers have consisted of about 20% or more of companies that have been targeted, almost 30% in 2013. Of these dividend payers, the average dividend yield is about 1.8%, just slightly below the market average. While activists can certainly target companies with the pressure to initiate or raise dividends, this does not tend to be a factor that attracts activists to a campaign.

Misconception #3: Along with dividends, many believe that activists are also targeting companies that do not have a buyback program in order to unlock shareholder value.

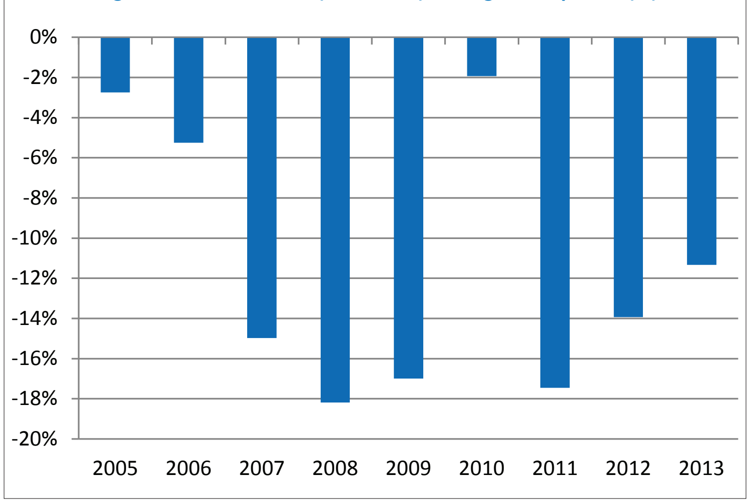
Figure 5: Target Companies Share Buyback Expense ($)



Source: S&P Capital IQ, Ipreo Research

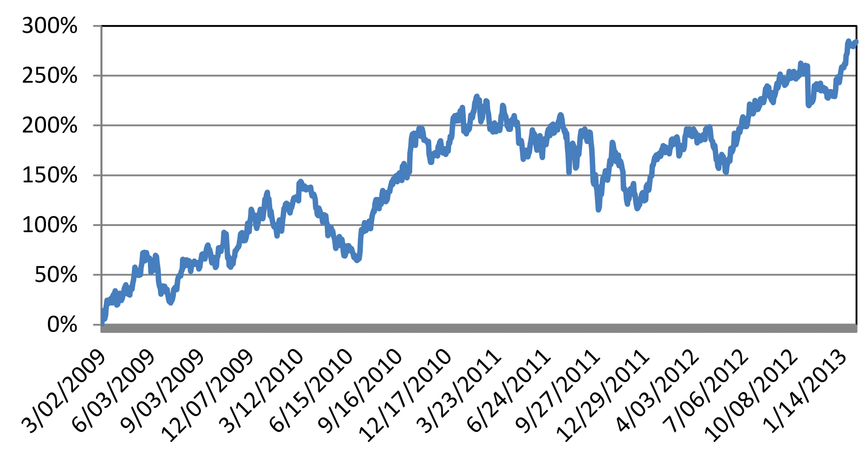
Companies targeted by activists have increasingly already been buying back shares.

Figure 6: Excess Return (12-Month) of Target Companies (%)



JANA's recent involvement with Agrium is another example how activists are no longer going after distressed companies. While it is true that activists traditionally seek companies that are underperforming, the average 12-month excess return of target companies, although negative, are approaching 0% in recent years, indicating that both underperforming and well-performing companies are equally targeted. Despite Agrium's reduction in valuation multiples, the company had seen a 4-year increase in price performance of almost 300% as of February 2013 prior to Agrium's victory. Even with the large returns that Agrium has provided to its long-term shareholders, JANA hoped to win board seats with the ultimate intention of spinning off the company's retail business, believing that it would further unlock shareholder value. Apple and Agrium are just two examples where mature companies that have been outperforming and beating earnings expectations can still be the targets of activist campaigns.

Figure 7: AGU 4-Year Price Performance



Source: Factset

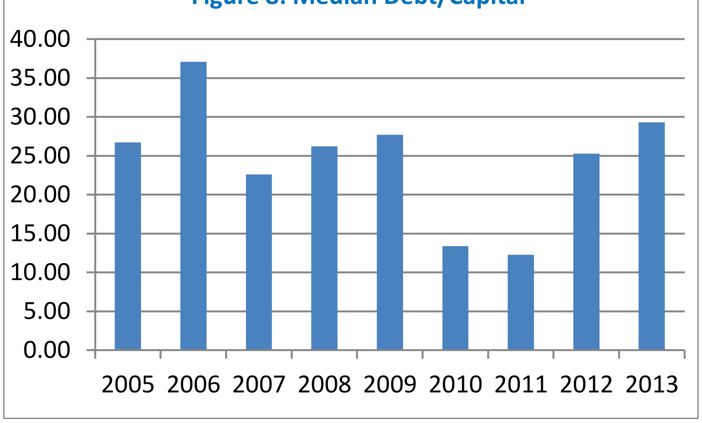
As mentioned, activist campaigns have historically focused on management changes and "financial engineering" to unlock shareholder value. However, several investors have recently taken on a more long-term interest in companies to the extent of remaking the entire business, changing the customer base, and providing new strategic directions.

The most obvious case of this has been the case of Pershing Square Capital's Bill Ackman with J.C. Penney. While on the board, Ackman made many changes to J.C. Penney's business, notably bringing in Ron Johnson as CEO in order to alter the retailer's business and consumer base, which ultimately ended with Johnson leaving the company in April and Ackman leaving the board in August. This new trend is a particular bold move, as many industry experts question whether an investment manager has the expertise and experience to successfully guide a company's operations. Regardless, issuers should be aware that this trend may become increasingly common in the long-term even if such campaigns have not been successful in the past.

Oftentimes, when activists seek to make strategic operational changes (or even to finance polices such as dividends or buybacks), they will push the target companies to issue debt to finance such changes. Theoretically, it makes sense to assume that under-levered companies a popular target for activists. However, low levels of debt may not be as important a factor in selecting companies as many had previously thought.

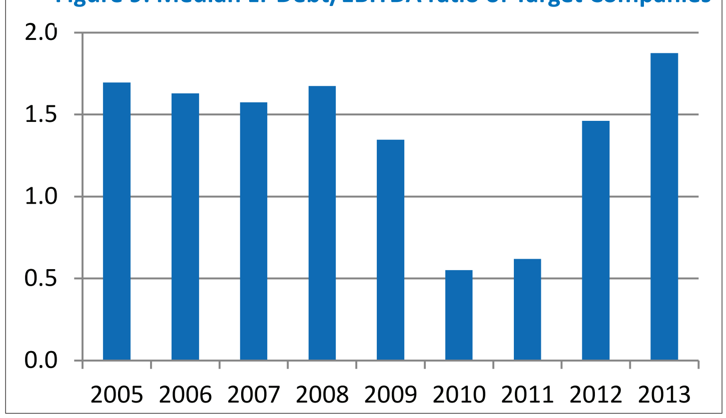
Misconception #4: Activists target under-levered companies, in the hopes of using leverage to create benefits for equity holders.

Figure 8: Median Debt/Capital



Source: S&P Capital IQ, Ipreo Research

Figure 9: Median LT Debt/EBITDA ratio of Target Companies



Source: S&P Capital IQ, Ipreo Research

While activists can certainly pressure companies to increase their debt issuance, debt is not a major factor in attracting activists. In fact, targets are higher-levered now than at any point in the last 5 years. Simply maintaining mid-leverage AA/A/BBB balance sheet does not mean activists won't see opportunity.

Overall, it appears as if many of the traditional features that attract activists, such as high cash position, low dividend, low debt, and lack of buyback, are not characteristics of target companies in the past 5 years. In fact, it even appears that the target companies have already been taking the same actions that activists would normally pressure companies to do. One possible explanation is that as activist campaigns have become more frequent in the past five years, companies have begun to start implementing these financial changes so that they can avert an activist's attention. As the data shows, however, implementing these policies does not mean that activists won't see opportunities; in fact, companies that already underperform or miss earnings that quickly implement policies that affect cash, debt, dividend, buybacks, etc. might actually grab the attention of activists even more.

As a result of many evolving changes within the activist environment, activist investors are increasingly taking deep, long-term positions that are looking for changes beyond simple board representation or a higher dividend. Throughout 2012 and 2013, we are seeing increased activist involvement in companies' long-term strategy and business operations. As a result of this evolution within the activist space, the market is also seeing increasingly sensitive reactions to activist behavior, especially as target companies have increasingly been those who already issue dividends and debt, and buy back shares.

Ipreo has also noticed many issuers that have become increasingly concerned whenever an activist name buys a small position or shows up on a meeting list; ultimately, issuers must remember that some of the more high-turnover activist investors may be taking a position as a fast money move for capital gains, or may be taking a meeting simply for research purposes, perhaps as a channel check for other investments.

Needless to say, issuers should always adapt their strategies in dealing with activists whenever they do take an interest in the stock. Companies that have been struggling or in early growth stages should still always prepare for activist involvement. Ultimately, especially for mature companies, whenever an activist is seen taking a position and requesting multiple meetings (usually on a deeper level, perhaps even requesting meetings with top management), the best way to identify the risk of an activist campaign is to analyze their history, identify the characteristics of the companies they usually target, see what they traditionally do (13D and proxy battles vs. letters to management), and thereby formulate a plan to deal with the activist specifically.

Author: David Shi

David is an analyst with Ipreo's Corporate Analytics Group