CORPORATE TRANSFORMATION SERVICES
FROM THE INSIDE OUT

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The Best Activist Defense? Improve operational performance and capital structure

Activist investors followed a record-breaking 2017 with a record-breaking 2018. Last year, they deployed the most capital, targeted the largest number of companies and won the most board seats ever, according to figures from Lazard. They are likely to keep up the pressure this year - as the era of cheap money comes to an end, companies with underperforming operations and poor capital positions will find themselves exposed.

Companies which could be vulnerable to an approach for these reasons, or that already know they have an activist fund on their shareholder register, should act quickly and decisively to tackle the operational and/or capital weaknesses that are damaging shareholder returns.

“Activists serve a specific and necessary function in free capital markets,” says Nate Dwyer, Managing Director with Alvarez & Marsal (A&M) Corporate Transformation Services in San Francisco. “Activist Investors have typically done six to twelve months of due diligence before deploying capital. They’ve committed time, capital and concerted thought. Once they make an investment, they’re going to see it through.”

Ignoring an activist investor and hoping the situation will get better with time is a common reaction in boardrooms, but activists’ success rates make it clear that companies need a better form of defense. In activist campaigns against companies with a market capitalization of $5 billion or more, activists were successful in their campaigns 68 percent of the time, while management teams had success just 32 percent of the time.

Citigroup for example, this month agreed to a deal with activist investor ValueAct that gave the fund access to confidential information and opportunities to work with its management and board, although it did not give the hedge fund a seat on the board. In return, ValueAct agreed to support Citi’s management team and board until the end of this year.

From the time an activist makes public his or her position in a company and publicly discloses the changes being sought, the management team typically has around nine to 12 months before shareholders vote on issues such as overhauling the board, according to Mr. Dwyer of A&M.

“That’s a lot of time for markets to re-rate you,” he says. In an activist situation, feelings will inevitably run high on both sides, but “the common thread with everyone involved is that they want to see better returns for shareholders. That is where we begin our work – on the common ground between each party and how to proceed respectfully and honestly.” Mr. Dwyer adds.

Following four interest-rate increases in the U.S. last year, companies that borrowed heavily when interest costs were at record lows, in some cases to fund stock buybacks above the current share price, find themselves now struggling as the cost of repaying debt increases, particularly if their sales and profit growth are weak. Rising borrowing costs also make leveraged buyouts more expensive, meaning funds must drive greater performance improvements in the businesses they chose to invest in to achieve attractive returns for investors.

Banks can advise management teams on improving their capital structure, and changes can be made quickly. However, fixing underperforming sales and profits takes a concerted effort by the company’s leaders. In most cases, they will need to work with outside advisers to identify and start to tackle the biggest problems, whether that is a poorly integrated acquisition or a lack of focus on the core business.

One of the key measures of performance that activists focus on is return on invested capital (ROIC) – (the measurement of capital investments against their financial returns). When ROIC is out of whack, it demonstrates poor decision-making pertaining to the deployment of corporate assets against projected return profiles. When activists chase growth, the cost for acquisitions is too high.

"If the base business is not firing on all cylinders, righting the ship requires a forensic post-mortem to understand the governance behind this and identify the pathway back to value creation," says Jim O'Donnell, Senior Director with A&M Corporate Performance Improvement. "Often, an aggressive focus on customer needs is repaid, or non-core assets are shed."

Identifying the right changes and beginning to transform performance puts companies in a strong position to either counter the changes sought by an activist investor, or to agree with them and carry them out under their own initiative rather than ceding control.

"You *can* drive change," says Mr. O'Donnell. "It's either going to be you or somebody else, but it's going to happen, so the best defense is a good offense."

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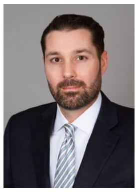
JOE BERARDINO
jberardino@alvarezandmarsal.com

MALCOLM MCKENZIE
mmckenzie@alvarezandmarsal.com



NATE DWYER
ndwyer@alvarezandmarsal.com

JIM O'DONNELL
mmckenzie@alvarezandmarsal.com

For general inquiries, please email us at corptransformationnewsletter@alvarezandmarsal.com

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