ACTIVIST INVESTORS IN EUROPE: WHO WILL THEY TARGET NEXT?

BOARDS IN CHALLENGING TIMES

A&M ACTIVIST ALERT (AAA) – APRIL 2019 UPDATE

ALVAREZ & MARSAL

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Principle observations

Shareholder activism is becoming increasingly prevalent across Continental Europe as the methods adopted by value-seeking investors gain wider acceptance. Our updated Alvarez & Marsal Activist Alert (AAA) finds a growing concentration of companies across France, Germany, Italy and Spain that, based on their current and recent performance, we predict are likely to become targets for public activist campaigns. In total, our analysis has identified 150 such predicted targets.

The U.K. remains the single largest hunting ground for activists with a fairly stable number of potential targets, thanks in part to its relatively shareholder-friendly company laws. There is no clear Brexit effect in the figures so far, but we anticipate that the disruption created by Brexit will lead to greater opportunities for activists. The corporates that do not respond well will bring themselves to the attention of activists via weakening results and losses in value. In addition, a weakening of sterling could prompt greater interest in buyouts and public-to-private deals involving U.K.-focused companies.

Although the U.K. continues to dominate in numbers, our projections suggest its share of activist targets in Europe is falling, from 38 percent in 2017 to 36 percent last year and a forecast 35 percent in the next 12 months – a statistically significant trend. This is not driven by there being less activism in the U.K. but rather by activist campaigns increasingly reaching the boardrooms of more Continental European businesses.

The case of Pernod Ricard is of particular interest given the major voting powers retained by the founding family and its status as a stalwart of the French corporate establishment. If Elliott Management are ultimately viewed as a positive influence on behalf of all shareholders, this case will help lay even stronger foundations for the wider acceptance of activism across the continent.

As noted in our November 2018 report, Industrial companies are again the top predicted group of targets for activist investors, accounting for 34 percent of the "at risk" companies identified. This contrasts with the Consumer sector, which has previously been the most targeted sector but has now become much less attractive. Part of the reason for this relates to the fact that activists generally target good companies that are underperforming but could be made better. The Consumer sector includes retailers, many of whom are performing so poorly, in the face of extremely tough market conditions, that they are no longer of interest to activists.

Campaigns abound calling on companies to release value by breaking themselves up and focusing on fewer businesses – our analysis shows that in the first three months of 2019, activist demands involving M&A accounted for 17 percent of the total, up from 12 percent in 2017 and 2018. Groups on the receiving end of future calls to release value by selling divisions will join a group that includes BT, Akzo Nobel, Thyssenkrupp, Energias de Portugal (EdP), Whitbread and Just Eat.

With the recent campaign against eBay in the U.S., tech conglomerates are also on notice: once considered almost immune to this kind of pressure, they are now a target for value-seeking activists. These investors argue that tech conglomerates' various businesses should be rationalised to better focus the available capital and eliminate the so-called conglomerate discount in their share price.

Finally, our analysis continues to show that if corporates wish to avoid a public activist approach, they have less than two years from when they first show weakened performance to demonstrate tangible improvements in their published results. Given that any performance improvement programme typically takes 6 to 12 months before there is a meaningful impact on the bottom line, time is very much of the essence.

Activism is spreading – and it's in the news

The past six months have produced major new activist campaigns against companies across Europe. Among those we predicted would become targets in our November 2018 report but, in line with our confidentiality practices, did not publicly name, were BT Group (U.K.), Agfa-Gevaert (Germany/Belgium), Aryzta (Switzerland), Bayer (Germany), Comet Holding (Switzerland), DIA Group (Spain), EssilorLuxottica (France) and Just Eat (U.K.).

However, one case we did not predict was the approach to Pernod Ricard by Elliott Management in December. One of the key reasons why our AAA analysis did not predict this case was the relatively high voting rights retained by the founding family – such large retained shareholdings have historically deterred activists, a factor that our regression model has recognised and built into its resulting predictions of future targets. This case suggests that the existence of major voting blocs is likely to be less of a deterrent in future – especially if Elliott's intervention is seen to produce a positive outcome for all shareholders – the AAA model will learn from this and adjust its future predictions accordingly. This case may therefore signal an important trend across Continental Europe, where founding families continue to hold significant interests in many companies.

There were several high-profile boardroom disputes between major shareholders. Leonardo Del Vecchio, founder of Luxottica and chairman of EssilorLuxottica, became involved in a public disagreement with his French merger partners over the choice of the company's next CEO. Russian Oligarch Mikhail Fridman, 29 percent shareholder in struggling Spanish supermarket group DIA, offered to buy the rest of the company via his LetterOne vehicle.

As well as challenging boards publicly on their governance and performance, activists are also questioning their decisions to release value through M&A. Elliott's opposition to the €9 billion takeover of EdP is a case in point: it has outlined an alternative value creation strategy for EdP, including the sale of its Brazilian assets. Moves to break up conglomerates, a favourite strategy among activists, have taken a significant step with the campaign in the U.S. against eBay, launched in January by Elliott and Starboard Value. Their demands that the company release capital by selling StarHub and its classified advertising business kill off the idea that major tech companies are immune to the scrutiny that old-economy conglomerates have come to expect.

Another trend that we expect to see grow in Europe is the emergence of activists operating more like Private Equity in seeking to take companies private. This will allow them to retain the full benefit of improved performance rather than holding a minority public stake and so sharing any benefit with other shareholders. In December, Elliott offered a prime example of this trend when it teamed up with Siris Capital to acquire U.S.-listed Travelport in a $4.4 billion deal. Elliott had previously acquired an 11 percent stake in Travelport and had pushed the company to put itself up for sale. Private Equity has a long history of seeing opportunities around activism, often as a buyer of the divisions of target companies that activists prompt them to sell. Signs of activists taking entire companies private in Europe could prove an important trend to watch.

As well as challenging corporates and boards on their performance and governance, activists are also applying greater pressure for asset sales

The red and amber lists: who are the future activist targets?

Our latest analysis flags 150 companies that are at significant risk of becoming activist targets. In the data we publish, we do not disclose the names of the "at risk" companies we identify, although the country and sector trends are included. Of the 148 companies we identified as being at risk in our November 2018 report, 21 have already been publicly targeted by activist investors.

What do red and amber warnings mean?

A red warning indicates that a company is likely to become a target within the next 6 -12 months. An amber warning signals a medium-term risk of becoming a target within 12 -18 months.

On the following pages we summarise and illustrate comparative data from our twice-yearly analysis of the number of companies at risk of activist approaches across countries and sectors.

You can view full previous reports at www.alvarezandmarsal.com/insights/am-activist-alert

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Corporates that do not respond well to disruption will bring themselves to the attention of activists via weakening results and loss of value.

Numbers of predicted activist targets: changing profiles since May 2018

Countries

U.K.				
April 19	23	Total: 52	29
Nov 18	26	Total: 56	30
May 18	28	Total: 60	32
Germany				
April 19	9	Total: 23	14
Nov 18	8	Total: 17	9
May 18	9	Total: 18	9
France				
April 19	8	Total: 20	12
Nov 18	7	Total: 17	10
May 18	8	Total: 17	9
Scandinavia				
April 19	6	Total: 14	8
Nov 18	6	Total: 13	7
May 18	6	Total: 13	7
Benelux				
April 19	6	Total: 13	7
Nov 18	7	Total: 18	11
May 18	7	Total: 16	9
Switzerland				
April 19	5	Total: 11	6
Nov 18	6	Total: 11	5
May 18	7	Total: 13	6
Italy				
April 19	5	Total: 11	6
Nov 18	4	Total: 10	6
May 18	4	Total: 12	8
Spain				
April 19	3	Total: 6	3
Nov 18	3	Total: 6	3
May 18	3	Total: 7	4

Apr 19: **150** | Nov 18: **148** | May 18: **156**

Sectors

Sector	Date		Total	
Industrial	April 19	23	Total: **51**	28
	Nov 18	20	Total: **45**	25
	May 18	20	Total: **45**	25
Consumer	April 19	12	Total: **35**	23
	Nov 18	20	Total: **43**	23
	May 18	22	Total: **46**	24
Technology	April 19	10	Total: **21**	11
	Nov 18	10	Total: **23**	13
	May 18	9	Total: **21**	12
Materials	April 19	5	Total: **11**	6
	Nov 18	5	Total: **10**	5
	May 18	6	Total: **11**	5
Healthcare	April 19	5	Total: **10**	5
	Nov 18	5	Total: **13**	8
	May 18	7	Total: **16**	9
Communications*	April 19	3	Total: **6**	3
	Nov 18	0	Total: **0**	0
	May 18	0	Total: **0**	0
Energy	April 19	2	Total: **5**	3
	Nov 18	2	Total: **4**	2
	May 18	4	Total: **10**	6
Other	April 19	5	Total: **11**	6
	Nov 18	5	Total: **10**	5
	May 18	4	Total: **7**	3

April 19: **150** | Nov 18: **148** | May 18: **156**

*New sector


Assets and Liabilities
Equity value and structure
Profitability
Timescales
Country
Board/governance
Sector

A&M Activist Alert: results in detail for April 2019

What are activists' priorities?

The AAA model analyses changes over time in 44 variables broadly grouped under the following headings:

- Country
- Sector
- Board/governance
- Profitability
- Assets and liabilities
- Equity value and structure

Our analysis this time makes clear that M&A is becoming an increasing feature of activist campaigns. In 2017 and 2018, 12 percent of demands made by activist investors related to potential M&A – during the first three months of 2019, this has risen to 17 percent.

A clear driver for this trend is the large number of calls for conglomerates across all sectors – including tech – to exit underperforming divisions and focus on core activities. Conglomerates under recent attack have ranged from AkzoNobel and ThyssenKrupp to Just Eat and EdP.

However, while sector disruption is a major draw for activists because it helps highlight companies that have not responded effectively but could do so, our analysis also demonstrates that when disruption contributes to increased financial distress, as in offline retail, activists lose interest in those corporates most heavily impacted. Their priority is to identify fundamentally sound but underperforming companies that can be turned into strong performers through targeted action.

Country

Both the pattern of recent activist activity and the results of our forward-looking research confirm this year's major trend: a rising tide of shareholder activism is spreading across Continental Europe, with recent targets including Bayer (Germany), Dia Group (Spain), EdP (Portugal), EssilorLuxottica and Pernod Ricard (France).

This time, the increasing concentration of Continental European companies in the amber and red "at risk" groups is particularly marked in France, Germany and Spain. Between our first report in September 2017 and this report, the number of German companies with red or amber ratings has risen from 16 to 23. In France, the figure has jumped to 20, from a steady 17 in all previous reports.

That said, the U.K. remains by far the largest market in Europe for activist investors, accounting for almost 35 percent of all amber and red flags, despite providing less than a quarter of the companies in our dataset.

Among the key reasons for this are the U.K.'s relatively shareholder-friendly legal and regulatory framework – just 10 percent of shareholders are needed to force an Extraordinary General Meeting at which activist resolutions can be voted on – and the wide acceptance of shareholder activism as a legitimate strategy.

Although there is no clear Brexit effect in the latest figures, the related disruption will highlight the corporates that do not respond proactively and hence make themselves potential targets. In that way, we see Brexit as creating more opportunities for activists over the next 18 months or so. It is also clear that any further weakness in sterling will increase the attraction of U.K.-focused corporates to foreign buyers.

Continental Europe comes into sharper focus.

Sector

Industrial companies have retained their position as the largest target group in the AAA, representing 29 percent of the dataset but 34 percent of our predicted targets. The number of Industrials earning amber and red flags has climbed steadily since our first report in September 2017, and at 51 companies the total is up more than 50 percent over that period.

However, the AAA's increasing focus on Industrials also reflects the declining presence of consumer companies in the "at risk" group, their number dropping from 43 last time to 35 now. In some cases this results from an improvement in performance, but it also indicates that some areas of the consumer sector, especially offline retail, are now too distressed to attract activist interest.

We also see growing potential for campaigns against Technology companies, a sector thrown into the spotlight by the activist campaigns against eBay in the U.S. and Just Eat in the U.K. Tech companies have a higher average price-earnings multiple than the overall pool of companies we analysed. This makes them attractive targets given that every pound or euro that activists can add to the bottom line of a tech company should translate into relatively larger share price gains.

Industrials are prime targets as appetite for consumer sector sinks.

Board/governance

Activists frequently seek to hold seats on the boards of target companies – sometimes by ousting existing external directors – to exercise greater influence over corporate strategy. Between 2016 and 2017, 67 percent of European companies targeted by activists and analysed by A&M faced calls for boardroom changes. From 2018 to date, the proportion has declined to 58 percent, possibly indicating a change in activists' tactics as they adopt a less confrontational approach and seek to co-operate with the existing board.

There is also a continuing small but significant association between gender imbalance on boards and companies becoming targets: the average percentage of women on the boards of target companies was a little lower than those that were not.

We also continue to observe the "Goldilocks" effect around the age range between board members: having either too high a range, or too low a range, are both associated with activist activity. A range of c.22 years is statistically just right. Having too high an age range and thus attracting activist interest is a notable factor in France, Germany and Spain, and may well again be associated with family/"dynasty" businesses where multiple generations may be appointed to the board.

Calls for boardroom change gently declining – a sign of changing times?

Profitability

Where profitability is concerned, a key measure for activists is how big a divergence in performance is emerging between a company's best-performing division and its weakest. Our detailed analysis of trends in operating profit margins generated by individual divisions over the past two years reveals an interesting and telling factor. Among companies targeted by activists, the gap in operating margins between the best and worst-performing divisions had increased by an average of 6 percent over the past two years. Among those not targeted, the average gap had narrowed by an average of 4 percent.

We see this as illustrating the importance activists place on return on capital. Capital tied up in weaker divisions may be better deployed in stronger ones. There may of course be strong, perhaps strategic, reasons why a corporate should continue to invest in weaker divisions, but it becomes incumbent on the corporate to demonstrate exactly why that makes sense.

Divergent divisional performances offer warning of potential activist action.

Equity value and structure

PE ratios, relative share price performance, price-to-book valuations and enterprise values continue to be important factors in the AAA analysis. However, further to our comments above concerning family voting rights (e.g. Pernod Ricard) and boardroom dynasties, the focus on family-dominated corporates is increasing. This again contributes to the growing presence of activists in Continental Europe where there is a higher concentration of companies where founding families retain significant interests and voting rights.

Family-dominated corporates may well be a growing area of focus.

Assets and liabilities

Our AAA model includes an assessment of a range of cash measures. From simple cash balances, through levered and unlevered Free Cash Flow, to cash return on capital, it is clear that cash is a key focus for activists. The measurement and management of cash and cashflows should be a key performance indicator for all corporates, and its clear importance to activists only increases this imperative. Weakened cash generation undermines investment opportunities and can lead to a downward spiral of further underperformance, driving yet lower cash generation. Activists are unlikely to stand by and allow an opportunity to correct such weak cash management, and so drive future value, pass them by.

Cash – a vital resource and measure of success.

Timescales

The average period between a company showing weakened performance and activists becoming involved remains unchanged at 1.83 years. Company boards therefore do not have long to demonstrate they are addressing underperformance and driving bottom line results.

There are two key elements to this requirement to demonstrate that underperformance is being addressed: Firstly, a rapid and focused transformation programme, that addresses investors concerns, needs to be developed and implemented, with its success clearly shown in the reported results. Secondly, the existence, strength, focus and momentum of the transformation programme needs to be clearly communicated to the market. Both of these elements require the firm commitment of the board and management.

Activists wait less than two years to pounce.

Methodology

Companies covered by the analysis

A&M's Activist Alert model is based on an extensive and rigorous analysis of activist activity in eight European countries and regions from 1 January 2015 to 31 March 2019. The latest analysis includes the U.K., Germany, France, Scandinavia, Switzerland, Benelux, Italy and Spain. We gather data via the A&M Global Insight Centre on corporates listed and headquartered in those countries or regions with a market capitalisation of $200 million or more.

Our research team analysed 181 situations in which activist investors had made public requests to company boards, an increase from 153 in the November 2018 report. We then compared those 181 publicly targeted companies with 1,292 corporates which had not experienced such activist campaigns.

We have focused solely on public campaigns because we cannot track private discussions between boards and activist shareholders in a robust and consistent way. In addition, private campaigns do not bring the high level of financial and reputational risk to the target company associated with public campaigns.

What we measure

In order to provide a forecasting model and associated scoring system to gauge the likelihood of a company being targeted by activist investors, we analyse each company using 44 quantitative and qualitative variables derived from publicly available information. Most of the quantitative variables assess a company's relative performance against sector peers.

The variables analysed can be broadly grouped into the following categories: Country, Sector, Board/Governance, Profitability, Assets & Liabilities and Equity Value & Structure. The analysis undertaken then enables us to identify key messages and underlying truths that bring heightened awareness to corporates, such as:

- Key variables – factors that have the greatest influence on the likelihood of becoming an activist target, and how the corporate rates against all such factors
- Timescale – on average how long do activists wait before launching a public campaign?
- Sectors – which industries are currently at most/least risk of public activism, and what are the best companies in those sectors doing to outperform their peers?
- Geography – which countries or regions are forecast to be at most/least risk of public activism and why?
- Evolution – how is the importance of each of these factors changing over time?

Our predictive model calculates an AAA score for each company on a logarithmic scale between zero (low risk) and one (high risk) and calculates the probability that it will be targeted by activists. Most importantly, it identifies the key steps the company could take to reduce its AAA score and probability of being targeted.

We monitor the success of the AAA in successfully predicting which corporates will have been the subject of a public activist approach over a rolling two-year period. Over the two years to March 31, 2019, the success rate was 59.6 percent.

Monitoring performance trends

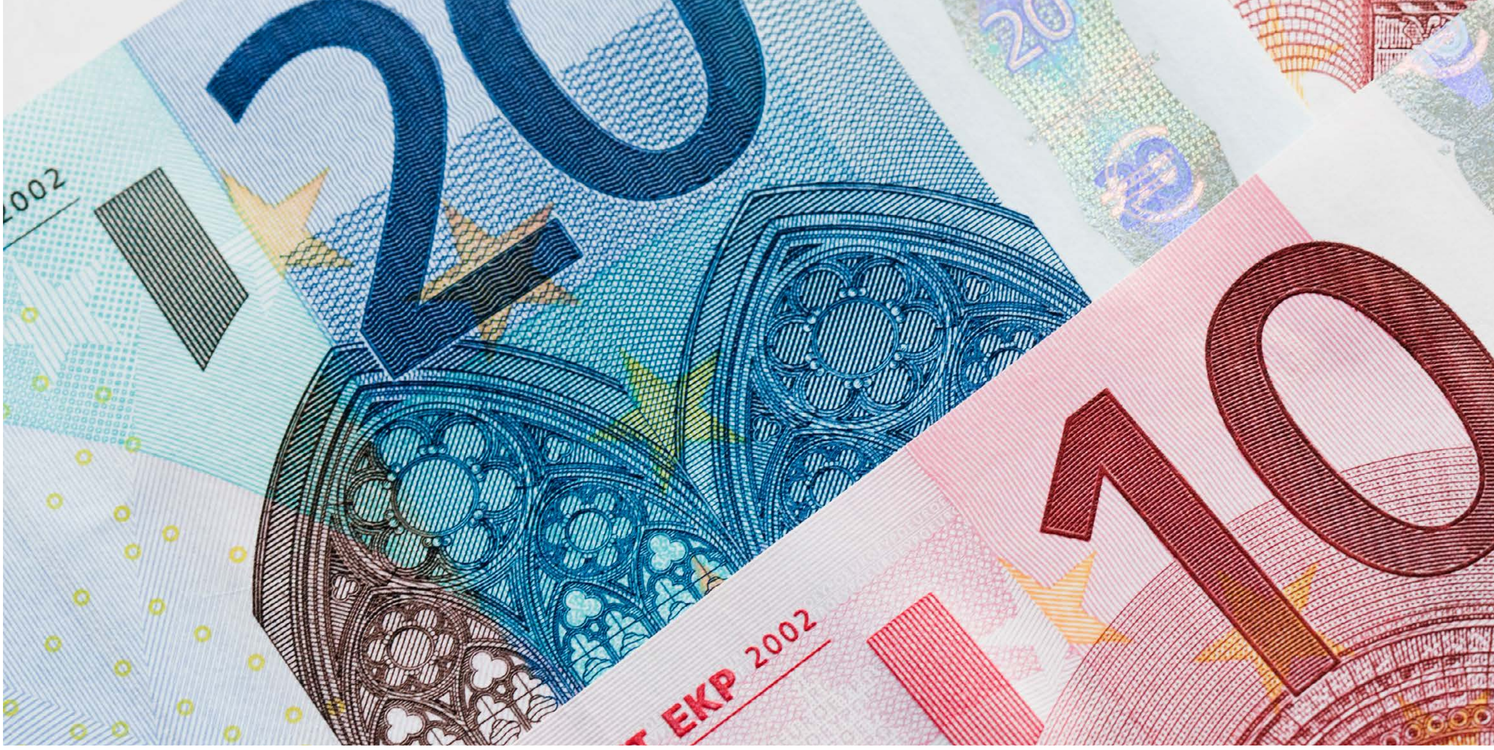
In creating performance transformation programmes, Alvarez & Marsal and our clients have found analysis of changes in the company's AAA score over time particularly helpful:

- A company with high AAA scores over both the previous year and two-year periods is at high risk of imminent activist intervention and should act immediately.
- A low two-year score followed by a high one-year score (a so-called "rising amber") also indicates a problematic trend in performance. Corrective action should be taken without delay.
- A high two-year score followed by a low one-year score ("falling amber") suggests the company is already improving its financial performance. However, vigilance is required as it is likely to remain on activists' watch lists.

The table below illustrates how the AAA red and amber warnings are applied:

		Two-year score	
		Low	High
One-year score	High	**Rising amber warning** – AAA score is increasing, suggesting potential activist action within the next 12 months if corrective action is not taken.	**Red warning** – High chance of imminent activist action. Urgent and targeted actions required immediately.
	Low	**Low risk** – This does not mean no risk. Ongoing vigilance is necessary, including the continued monitoring of key indicators.	**Falling amber warning** – Corrective actions are being taken but corporates will remain on activists' watch lists. Improvements must continue.

Footnote: 1 The Pseudo R^2 scores from the logistic regression element of the model (based on different statistical approaches) are 0.183 (Cox & Snell), 0.216 (McFadden) and 0.274 (Nagelkerke) thus implying a good fit.



A valuable warning system against public activist campaigns

The A&M Activist Alert model is a valuable early warning system against public activist campaigns. Our model produces detailed results showing the actions individual companies should take to improve performance and shareholder returns. The key factors are different for each business and we work hard to understand what they are and tailor a transformation programme accordingly.

How A&M can help

In predicting and avoiding a public campaign by an activist investor, A&M supports boards during three key stages:

Stage 1: Current position/AAA score

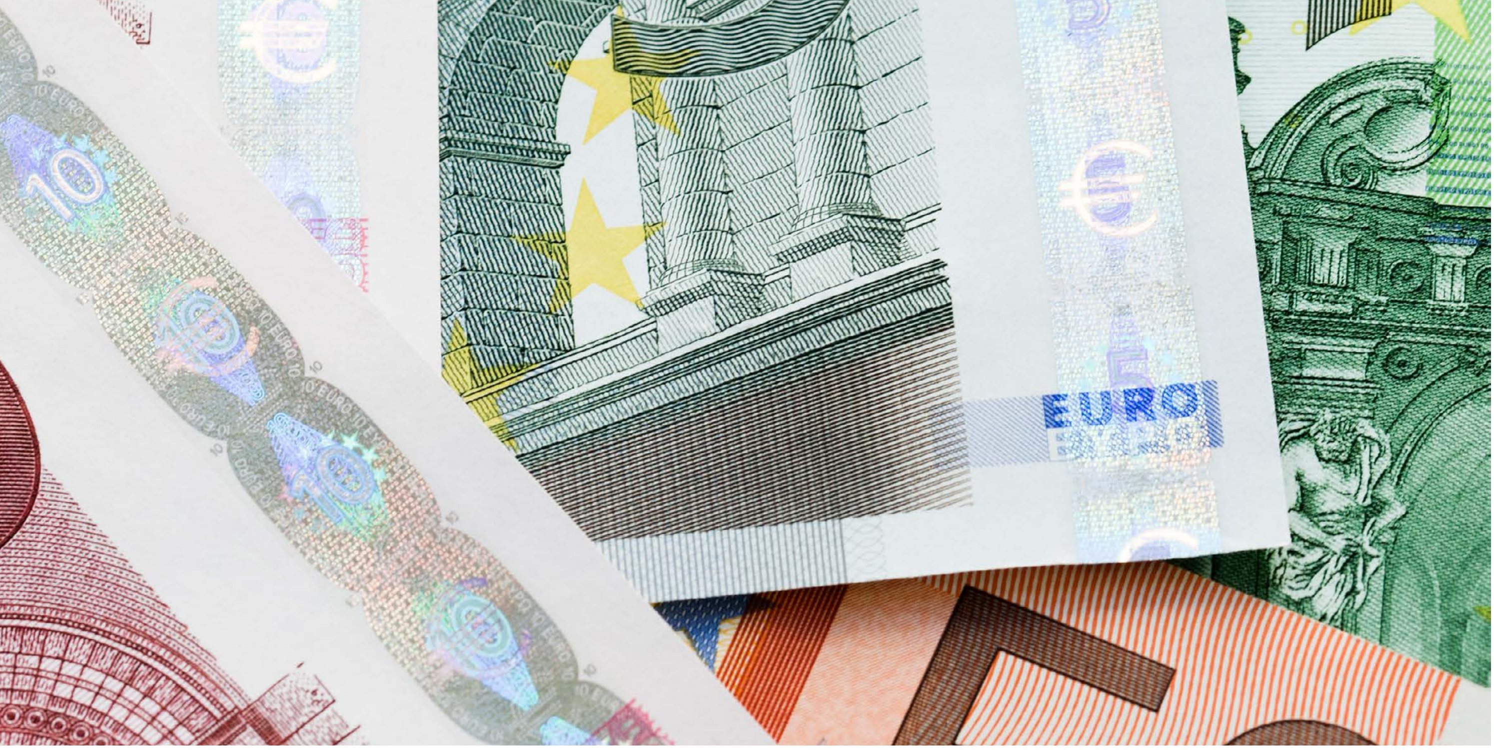
Adopting a focused “outside-in” perspective, we assess how an activist would view the corporate, provide the company’s AAA score, predict the probability of public activist action, discuss the key variables driving the company’s score and benchmark these variables against sector peers. This can help pre-arm a board against private approaches from activists seeking non-public discussions.

Stage 2: Corporate transformation/route planning

Using these insights, we create a robust transformation programme to deliver measurable benefits in a timeframe that meets investors’ expectations. This may include assisting in identifying potential disposals and/or improving underperforming and non-core business units or assets.

Stage 3: Transformation implementation

We work with the board and management to deliver the benefits set out in our transformation programme on time. Our unique restructuring heritage and experience ensures that the transformation is robust and sustainable.



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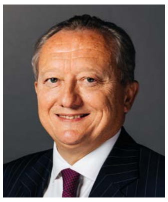

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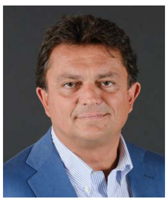

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ABOUT ALVAREZ & MARSAL

Companies, investors and government entities around the world turn to Alvarez & Marsal (A&M) when conventional approaches are not enough to make change and achieve results. Privately held since its founding in 1983, A&M is a leading global professional services firm that provides advisory, business performance improvement and turnaround management services.

With over 3500 people across four continents, we deliver tangible results for corporates, boards, private equity firms, law firms and government agencies facing complex challenges. Our senior leaders, and their teams, help organisations transform operations, catapult growth and accelerate results through decisive action. Comprised of experienced operators, world-class consultants, former regulators and industry authorities, A&M leverages its restructuring heritage to turn change into a strategic business asset, manage risk and unlock value at every stage of growth.

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