ACTIVIST INVESTORS IN EUROPE: WHO WILL THEY TARGET NEXT?

BOARDS IN CHALLENGING TIMES

A&M ACTIVIST ALERT (AAA) – NOVEMBER 2018 UPDATE

ALVAREZ & MARSAL

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Executive summary

Principle observations

Since our last update report in May 2018, new public interventions from activist shareholders across Europe have shown no signs of abating. From the heavily reported targeting of Premier Foods and Whitbread before the summer, through to the demands made against BT Group in the U.K., Edison SpA in Italy and Aryzta in Switzerland, activists have continued to press for change. The pointed involvement of Elliott Management and others in the contest for Sky is yet another example.

Where such interventions are focused on driving greater value for all shareholders, they can be a positive influence. However, even when they are ultimately positive, a public action by an activist can also be accompanied with a range of managerial, reputational and financial challenges for the targeted corporate. Avoiding such a public targeting by presenting excellent performance across a range of key areas should clearly be the aim of all corporates.

Throughout this year, we have continued to hone the accuracy of our predictive A&M Activist Alert (AAA) model, and indeed our analysis predicted all the above activist actions. With the latest variables added in this refresh, and other adjustments made, it is pleasing to see a further increase in the predictive power of the model which is now 60 percent accurate in identifying the future targets for activist investors.

In this update, we have again drilled down into the performance and underlying dynamics of over 1,700 European companies. As we have previously seen, the operational underperformance of a corporate relative to its peers is one of the principal factors driving activist interest. Further, the more underperformance is driven by weaker divisions within a conglomerate, the more activists will be tempted to launch an action. Whether such action seeks the turnaround of weaker divisions and/or their sale, activists increasingly see releasing perceived conglomerate discount as a value accretive route to increasing their return. The agreement by ThyssenKrupp to split into two publicly traded companies is a recent example.

This update also again brings into stark focus the short time that corporates are afforded before activist shareholders intervene when they identify perceived underperformance. This window of tolerance continues to be less than two years. This means that a corporate's reported results and commentary need to clearly show that the improved performance has been achieved within two years of the underperformance being identified – simply forecasting future improvements is not enough. The ultimate agreement of Whitbread to sell Costa earlier than they initially intended is a notable example of this.

From an overall country perspective, we see that the U.K., Germany, France and Italy continue to be more attractive to activists, whilst Swiss and Scandinavian corporates are relatively less so. Benelux is predicted to attract greater interest which would make 2018/19 the busiest period for activist action in that region.

Boards should have a wide age range – but not too wide

For the first time, this update also includes an analysis of additional corporate governance factors, notably the impact of age diversity amongst the Board of Directors. In summary, greater age diversity on a Board can help deter activists – but only if the age range isn't too great. The more detailed results include the following;

- If an average European corporate wishes to maximise its chances of avoiding being the target of an activist investor, the data indicates that the oldest Board member should be no older than 66 and the youngest no older than 44 (a range of 22 years).
- This range in Board age of around 22 years is statistically significant. The average range for European companies that have been targeted by activists is considerably lower at 17 years. Also, on average, the oldest and youngest Board members for targeted companies were both significantly older than those not targeted.
- The average age of the Board is not a significant factor – for corporates that were targeted by activists since 1 January 2015, the average Board member was 58.1 years old. For corporates that were not targeted it was 58.3 years.

When looking at individual countries, a more varied picture emerges. As stated above, the ideal age range for a Board of Directors is relatively constant at around 22 to 24 years in all of the countries analysed. Compared to that ideal, in the U.K., Benelux, Switzerland and Scandinavia the corporates targeted by activists generally had smaller age ranges than those not targeted. However, in France, Germany and Spain it was the opposite with the corporates targeted having larger age ranges. France is a good example where the average age range for a target was 34 years as compared to 24 years for non-targets.

It is also notable that France, Germany and Spain are the countries that generally have the lowest levels of freely floated shares – the privately retained tranches being held by individuals, family trusts or other vehicles. This raises the question of whether the influence and voting power of the privately held tranches may encourage the appointment of Board members that span the generations. There is nothing wrong with this in principle, but it may be that activists perceive Boards with very wide age ranges as being less able to reach agreement on strategic priorities. Conversely, it seems that a lack of age diversity may contribute to a lack of diversity in thinking and consequent underperformance.

Our findings with respect to age diversity represent another demonstration of the Goldilocks principle – to help avoid activist interest, corporates should have Board age ranges that are neither too low, nor too high, but rather "just right".

Good is not good enough

The AAA model assigns a score to each company, predicting the likelihood of it being a target of a public activist campaign in the near term. Our analysis continues to show that activists are interested in good companies which could be great – those that are perhaps second quartile performers in their sector but could be (and maybe recently were) first quartile. For corporates in such a position, it is essential that they plot and implement a route back to first quartile performance without delay. As mentioned above, our analysis makes it clear that two years of weakened performance is more than enough for activists to launch a public action.

This report offers an expanded explanation of our methodology and how the predictive algorithm is constructed and applied. It also offers a more in-depth analysis of how each of the variables affects activist interest, and how A&M uses the findings to work with Boards that want to take action to improve financial and operational performance on their own terms.

Board structure, diversity and dynamics can be a key driver behind activist interest – it is notable that 67 percent of activist situations include demands for changes on the Board.

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

This refresh of the AAA model identified 148 companies considered to be at significant future risk of activist targeting, either in the short- or medium-term, out of the total number of corporates reviewed of 1,771. We do not disclose the names of the companies on the list publicly, however the country and sector trends are included.

It is interesting to note that **of the 156 companies similarly identified as being at risk over the short- and medium-term in our May 2018 report, 21 have already been publicly targeted.**

As summarised in the tables below, the total of 148 is made up of 67 on the red list (short-term risk – within the next 6-12 months) and 81 on the amber list (medium-term risk – within the next 12-18 months).

Countries (as at 30 September 2018)**:**

26 ▼	**U.K.** Total: **56** ▼	30 ▼
6 ▼	**Switzerland** Total: **11** ▼	5 ▼
6 –	**Scandinavia** Total: **13** –	7 –
7 ▼	**France** Total: **17** –	10 ▲
8 ▼	**Germany** Total: **17** ▼	9 –
7 –	**Benelux** Total: **18** ▲	11 ▲
4 –	**Italy** Total: **10** ▼	6 ▼
3 –	**Spain** Total: **6** ▼	3 ▼
Total: 67 ▼	**Total: 148** ▼	**Total: 81** ▼

Sectors (as at 30 September 2018)**:**

20 ▼	**Consumer** Total: **43** ▼	23 ▼
20 –	**Industrial** Total: **45** –	25 –
5 ▼	**Materials** Total: **10** ▼	5 –
10 ▲	**IT** Total: **23** ▲	13 ▲
5 ▼	**Healthcare** Total: **13** ▼	8 ▼
2 ▼	**Energy** Total: **4** ▼	2 ▼
5 ▲	**Other** Total: **10** ▲	5 ▲
Total: 67 ▼	**Total: 148** ▼	**Total: 81** ▼

Indicators showing change compared to our May 2018 report ▲ ▼ –

A&M Activist Alert: results in detail for September 2018

What are activists' priorities?

Regularly updating and revising the AAA model enables us to keep pace with activists' changing priorities over time and gives our clients and other corporates an early picture of potential vulnerabilities. The AAA model has now evolved to consider 44 distinct variables that can broadly be described as falling under the following five categories;

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

Importantly, we also review the changes in these variables over time. This enables us to assess the timescales over which activists may hold back from public action before deciding to act.

It continues to be clear that, generally speaking, activists are interested in good companies that could be great. Stellar performers do not attract activists, but companies also drop off the radar altogether when continued weakened performance becomes chronic and threatens a timely route to recovery. Following are the key updates from our latest analysis:

As Shareholder Activism becomes increasingly prevalent and seen as a potential force for good, so their demands will increasingly find existing shareholders willing to listen.

Country and industry

The U.K. remains the favourite market for activist investors at least partly due to its attractive legal and governance regime. In 2017, the U.K. accounted for 33 percent of all public activist approaches in Europe, broadly flat compared with 34 percent in 2016. However, this had increased to 39 percent in the first nine months of 2018. It is interesting that the uncertainties around Brexit do not seem to have dented this attraction. Indeed, the recent negative shareholder reaction to Unilever's proposal to centralise operations in the Netherlands, and in doing so scrap its 89-year-old Anglo-Dutch structure, seems to emphasise the point.

Interestingly, particularly given the example of Unilever's change of heart, the predicted attraction of corporates in Benelux as a target for activists is also increasing. Targets this year have included NXP Semiconductors, Ahold Delhaize and Telenet Group, and the AAA is predicting that there will be more.

Interest by industry sector continues to be correlated to macro trends. A good example of this is the energy sector where the steady rise in oil price over the past 12 months has continued to boost revenues and performance, and so diminish activist interest.

The broader IT sector is predicted to be of increasing interest to activists as positive market dynamics combine with continued disruptive forces to allow activists to identify suitable targets. By contrast, the attraction of companies in the consumer sectors appears to be declined slightly, seemingly driven by two opposing forces: a) the continued disruption from changing shopping habits highlighting corporates that continue to be slow in adapting, and b) the number of potential targets that have now simply become too weak to be attractive.

The U.K. continues to be a prime target for activist funds, notwithstanding the continued uncertainties surrounding Brexit. The focus on industry sectors continues to fluctuate depending on broader market trends.

Profitability

As part of our overall assessment of the impact of varying profitability on the likelihood of activist interest, we have continued to study the particular impact of varying divisional performance. The results reinforce that two factors made a particularly significant impact on the chances of being targeted: the range of divisional performance (best division compared to worst division by operating profit) and the change in such range – a growing range acted like a magnet for activists seeking to improve the performance of weak business units or force a spin-off.

One element driving the trend mentioned above is the continued growth in fund raising and deal completion by European-focused private equity firms. Such high levels of capital are hungrily hunting deals. This, combined with more voices arguing for the sale of underperforming divisions, helps drive deal flow.

The growth in private equity capital looking for divisional acquisition opportunities increases the focus on corporates with underperforming business units.

Assets and liabilities

Whilst the AAA model includes a wide range of asset and liability related variables, for this update we thought it useful to explain a little further the inclusion and impact of cash on the AAA analysis. From simple cash balances, through levered and unlevered Free Cash Flow, through 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 idly by and allow an opportunity to correct such weak cash management, and so drive future value, pass them by.

Cash generation and management are important areas of focus for activists.

Board/governance

The inclusion in this refreshed analysis of the impact of greater age diversity amongst Board members has revealed some interesting insights. These include:

- The "perfect" age range on a corporate Board is 22 years and the youngest Board member should be no older than 44.
- In the U.K., Benelux, Switzerland and Scandinavia, corporates targeted by activists had, on average, Board age ranges of less than 22. In France, Germany and Spain, the opposite was true with companies targeted having, on average, Board age ranges higher than 22.

Given the above results, in particular the clear national differences, we undertook further analysis on what factors might be driving those differences. This further analysis soon established a strong correlation between the countries where Board age ranges may be seen as too high, as also being the countries that generally have the lowest levels of freely floated shares.

There is further work to be undertaken in this area, but perhaps the influence and voting power of the privately-held tranches may lead to the appointment of more Board members that span the family generations. Perhaps this is another demonstration of the Goldilocks principle – to help avoid activist interest, corporates should have Board age ranges that are neither too low, nor too high, but rather "just right."

The Goldilocks principle of Board age ranges – corporate Boards should have age ranges that are neither too low, nor too high, but rather "just right."

Equity value and structure

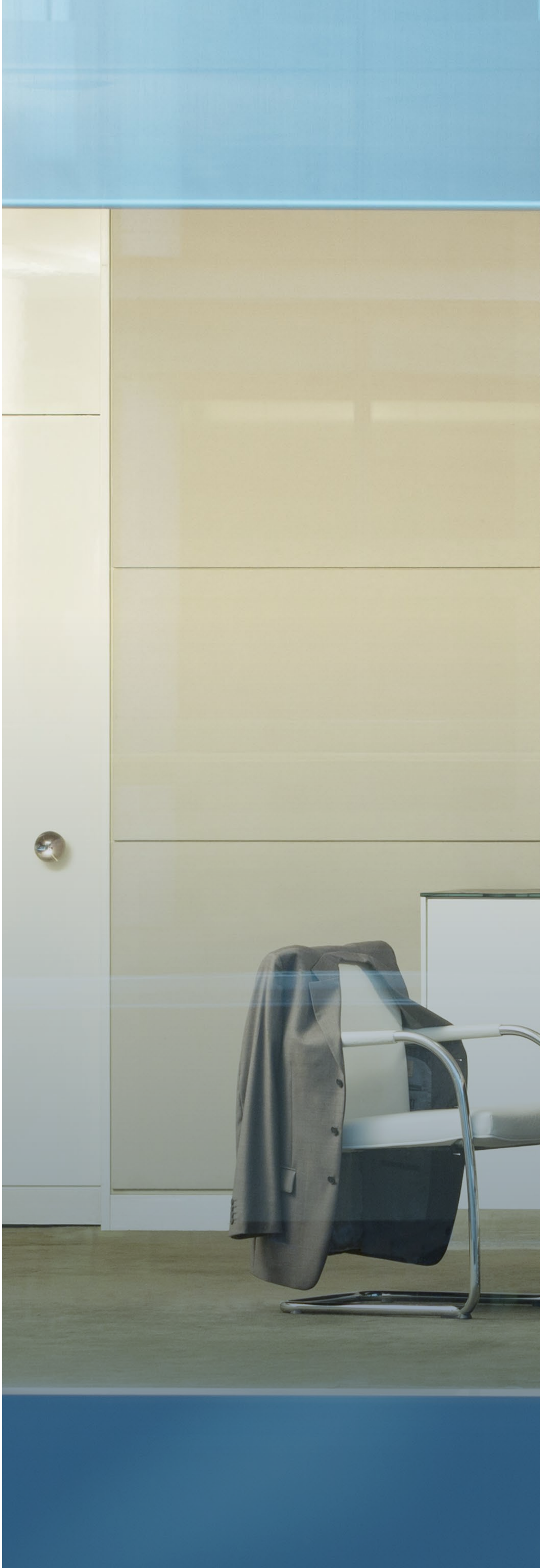
Declining shareholder returns, relative to the market sector, continue to be a common spur for initial interest by activists. In this latest report, various equity-related variables continue to feature prominently in the AAA model. These include PE ratios, market-to-book valuations and enterprise values. The relative change in share price also remains a very important factor. Other key factors include shareholder concentration and free-float percentages. This latter point has also taken additional significance given the national differences in our findings around Board age ranges commented upon above.

A favourable shareholder register, combined with a relative underperformance in the share price, lays a foundation for potential activist interest.

Timescales

The analyses we have undertaken over the past 18 months have clearly shown that activists have been becoming more impatient. The time they wait before launching a public campaign has steadily become shorter (the average wait was 1.84 years when we ran our update in May 2018). This update has shown no significant change in that timeframe. In our update planned for April 2019 we will be intrigued to see whether this is a temporary pause in the ever-shortening grace period afforded to corporates, or does it mark the arrival at a new norm. Time will tell.

The time afforded to Boards to address underperformance before activists lose patience continues to be less than two years.



Methodology

Companies covered by the analysis

A&M's AAA model is based on an extensive and rigorous analysis of activist activity in eight European countries and regions from 1 January 2015 to 30 September 2018. The latest analysis includes the U.K., Germany, France, Scandinavia, Switzerland, Benelux, Italy and Spain. The A&M Global Insight Centre uses data from companies listed and headquartered in those countries or regions with a market capitalisation of $200 million or more.

Our research team undertook a detailed analysis of 153 situations in which activist investors had made public requests to company Boards, an increase from 139 in the May 2018 report. We then compared those 153 publicly targeted companies with 1,618 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

The analysis includes an assessment of each company against a wide range of quantitative and qualitative variables, with the majority of the quantitative variables based on the relative performance of an organisation against other companies in its sector. This analysis included 44 variables, the detailed list of which remains confidential.

Having compiled the detailed data, a series of analyses, including logistic and other regression models, were then applied. The objective was to establish a multi-layered model and associated scoring system based on publicly available information, to gauge the predictability of a company being the subject of an activist campaign. To offer more than simply a score to the companies we work with, we also built the model to be able to show the following:

- Key variables – which factors have the greatest influence on the likelihood of becoming an activist target, and how does any company rate against all such factors?
- Timescale – on average how long do activists wait before launching a public action?
- Sectors – which industries are the most/least at risk of public activist targeting at that time?
- Geography – which countries or regions are the most/least at risk of public activist targeting at that time?
- Evolution – how does the importance of each of the factors above change over time?

What the AAA score means

The predictive model was developed using all of the data described above. It assesses the factors and calculates an AAA score for every company included, based on a logarithmic scale between zero and one. A higher score indicates a greater likelihood of activist action.

Based on the AAA score, the model also assigns to each company a statistically derived probability of it being targeted by activists. Most importantly, it identifies the key levers and actions the company should take to reduce the AAA score and the probability of that happening.

For this report, the model had a 60 percent success rate in identifying which of the companies in the analysis had indeed been targets.

The value of monitoring performance over time

In order to create and tailor a performance transformation programme, A&M and its clients have found the analysis of the AAA score and its direction of travel over time to be particularly useful.

Comparing the AAA score based on the past two years' performance with the 12-month score, for example, produces red and amber warnings. A company with high AAA scores on both a one-year and a two-year basis should consider itself at high risk of imminent activist action and seek to make changes urgently. A low two-year score followed by a high one-year score (a so called "Rising Amber") also indicates a concerning direction of travel for the company's performance: a focused course of corrective action should be planned and carried out without delay.

Conversely, a high two-year score followed by a low one-year score ("Falling Amber") suggests that the company is already taking the right steps to improve its financial performance, but vigilance must be maintained as the organisation is likely to remain on activists' watch lists.

Footnote: 1 The Pseudo R^2 scores from the logistic regression element of the model (based on different statistical approaches) are 0.190 (Cox & Snell), 0.222 (McFadden) and 0.292 (Nagelkerke) thus implying a good fit.

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

		Two-year score: Low	Two-year score: 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.
One-year score	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.

Keeping the model relevant

The AAA model is fully reassessed and refreshed every three months, including a full updated review of all known activist actions. This allows us to see how the key variables, timescales, country and industry factors have moved in terms of relative importance.

We also review which companies have moved in or out of the red or amber warning zones.

A valuable warning system against public activist campaigns

A good activist working in the best interests of shareholders is a force for good. But what attracts an activist to its target? A Board that sees the warning signs and recognises the challenges can act pre-emptively to strengthen profitability and shareholder returns.

Avoiding a targeted public programme of activist demands saves a company – its Board, management and employees – from the associated high costs and from distraction, disruption and reputational damage.

The A&M Activist Alert model is a valuable early warning system against such public activist programmes. Our model produces detailed results showing the particular levers that individual companies need to pull 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.

As our latest analysis shows, the timescale for activist approaches is shortening, and larger and larger companies are in the sights of activist funds. To avoid becoming the next public target, Boards should act now to address underperforming divisions and offer shareholders clear evidence of high financial and operational performance.

How A&M can help

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

Stage 1: Current position/AAA score

We work with Boards by providing the results of the AAA model specific to their company and explaining the associated score and likelihood of public activist action. We apply an "activist lens" and discuss the key variables driving their specific score and provide full benchmarking of such variables relative to other key players in their industry sector. Such analysis can help pre-arm a Board should an activist investor appear and seek non-public discussions.

Stage 2: Corporate transformation/route planning

Armed with the specific insights from Stage 1, a bespoke transformation plan is developed with a particular focus on driving maximum change in minimum time against the key identified variables. The intention is to develop a plan that delivers clear and measurable benefits in a timeframe that does not test the investors' patience. This may include assisting in identifying opportunities to unlock shareholder value by divesting and/or improving underperforming and non-core business units or assets.

Stage 3: Transformation implementation

Delivering the promised plan and benefits on time is vital. Failure to do so only accelerates the likelihood of future public campaigns. A&M works side-by-side with the Board and management in driving the transformation programme. A&M's experience ensures that the transformation is robust and sustainable.

We appointed A&M as we wanted a firm that would make us all feel uncomfortable. Many of my board colleagues expected us to appoint 'the other lot', but we thought A&M were going to do the job that we actually needed. And I must say, at times A&M have made us uncomfortable, and we made the right choice."

CEO, FTSE 100 (with activist investor involvement)

"While the A&M analysis was as solid and rigorous as you would expect, the real difference was in the firm's practical recommendations and clear action steps to get results quickly."

Head of strategy, global logistics firm

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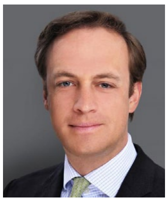

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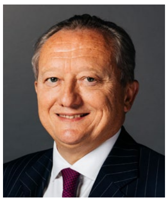

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ABOUT ALVAREZ & MARSAL

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 3000 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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