ACTIVIST INVESTORS IN EUROPE: WHO WILL THEY TARGET NEXT?

BOARDS IN CHALLENGING TIMES

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

ALVAREZ & MARSAL

Contents

Executive summary

Activist investors in Europe have continued to scale up in ambition, as shown by the recent fight for control of Telecom Italia and the activist-backed takeover of U.K. industrial group GKN (and the resulting threat of government intervention). So, what can Boards do to avoid becoming the next target of a costly and distracting activist campaign?

The simple answer is to improve financial and operational performance, and the associated shareholder returns, to the point where activists have nothing to pursue. Taking action to address underperforming areas of the business keeps companies ahead of the activist pack. A stronger performance and share price makes stake-building expensive and reduces the likelihood that activists will be able to enlist the support of other shareholders.

Alvarez & Marsal (A&M) has again drilled down into the performance of thousands of European companies for this May 2018 refresh of its A&M Activist Alert (AAA) model, which for the first time includes an analysis of corporate performance by business unit. The results strongly support the case for pre-emptive action to forestall an activist attack.

The inclusion of divisional performance in the AAA model represents a further advance in the depth of analysis now applied to European listed corporates. Of the 1,854 companies analysed by A&M, 1,129 reported performance by divisions. For those companies, two factors made a particularly significant impact on the likelihood they would be targeted by activists. Firstly, the range of divisional performance between the best-performing unit and the worst (measured by operating profit); and secondly, the change in such a range. A growing range was more likely to bring out the activist pack, looking to either improve the performance of the weak division or spin it off.

The AAA model assigns a score to each company in the analysis, predicting the likelihood of it being the target of a public activist campaign in the near term. The new divisional data mentioned above supported the findings of our September 2017 report, which made clear that activists are interested in good companies that have the potential to be great – those that are perhaps second-quartile performers in their sector, but could be (and maybe recently were) first-quartile performers.

In light of this latest modelled analysis, we know that uneven operating profits by division can act as an attractor to potential activist investors, although there are a number of other significant factors.

With a greater number of activist funds targeting more European companies, Boards should be keenly aware of the changing investor environment. Our analysis shows that:

- Activist investors are becoming more impatient: the timeframe for them to launch a public campaign has shortened slightly to 1.84 years, compared to 1.91 years as seen in the year to the end of July 2017, and compared to slightly more than two years as seen in 2016.
- The size of companies being targeted is growing: the average market cap of a predicted target company is now $17.58 billion, up from $16.48 billion compared to our September report. This is a 6.7 percent increase when the FTSE All Share Index was up just 1.3 percent over the same period.

Activists are also targeting different sectors and countries:

- Energy has become notably less attractive as oil prices have recovered, boosting profits and share prices. Materials companies are also dropping off the activist radar as commodity prices recover.
- In their place, consumer, industrial and IT companies are more likely to be targeted by activists.
- By country, companies based in the U.K., Germany, France and Italy all became more attractive to activists, while Swiss and Scandinavian companies became less so.

This report offers a detailed explanation of our methodology and how the predictive algorithm – which had a 59 percent success rate in the May analysis – was built 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.

Recognising the challenges and the warning signs and knowing what actions you can take to avoid activist action, can eliminate the associated costs, distraction, disruption and reputational damage.

Analysis undertaken

Companies covered by the analysis

The A&M 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 30 April 2018. The latest analysis includes the U.K., Germany, France, Scandinavia, Switzerland, Benelux, Italy and, for the first time, 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 139 situations in which activist investors had made public requests to company Boards, an increase from 108 in the September 2017 report. We then compared those 139 publicly targeted companies with 1,715 corporates that had not experienced such activist campaigns. Our initial sample across the eight countries and regions totalled 2,771 companies, which we narrowed to 1,715 for which consistent data was available.

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. The May 2018 analysis included 42 variables and, while the full list and details remain confidential, they broadly fall under the following five categories:

- Country and industry
- Profitability, including the new divisional analysis
- Assets and liabilities
- Board/governance
- Equity value and structure

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, and 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 a 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 above factors 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 59 percent[1] success rate in identifying which of the companies in the analysis had indeed been targets, up from 58 percent in the previous report.

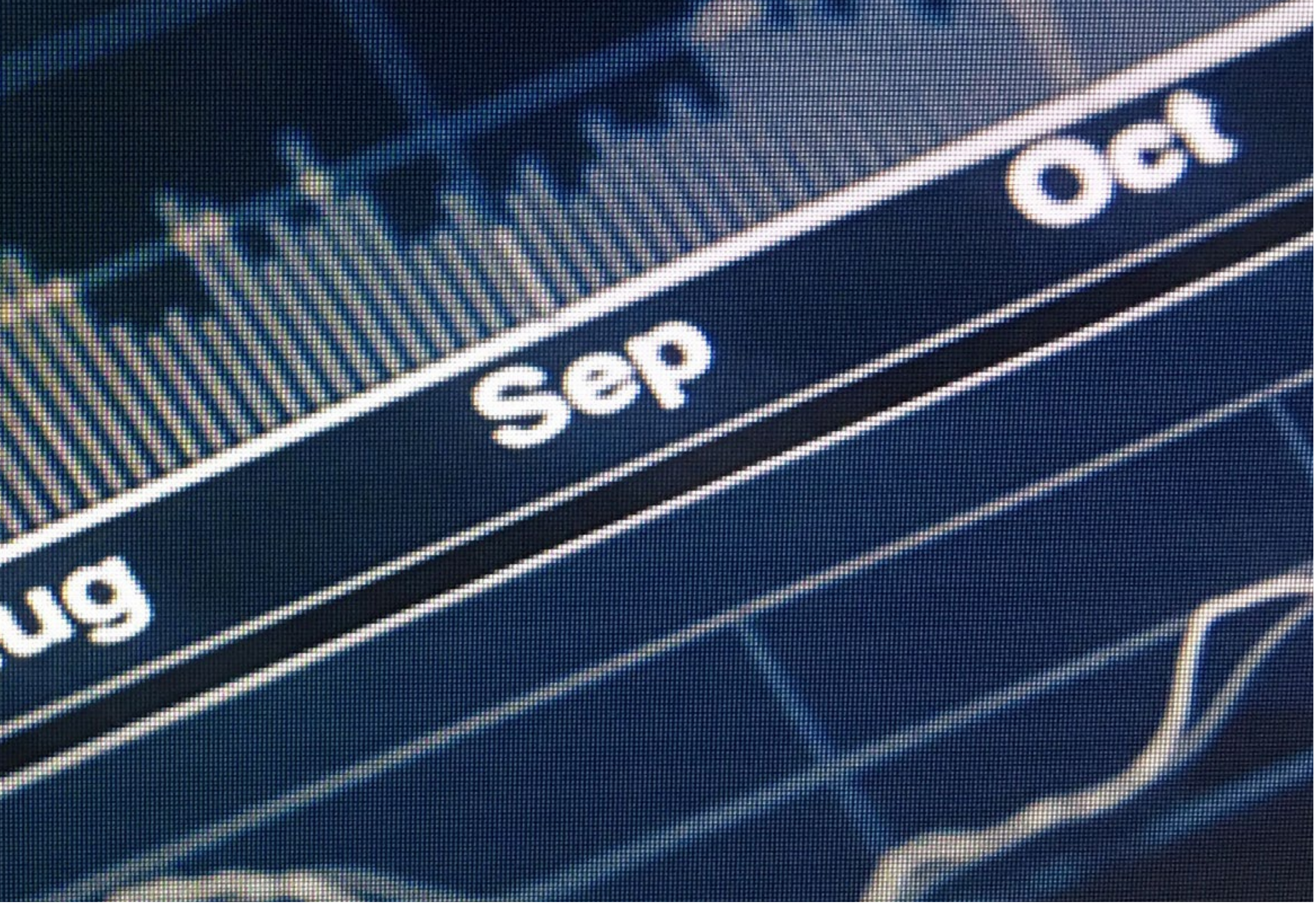
The value of monitoring performance over time

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, for which 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 because the organisation is likely to remain on activists' watch lists.

Source: 1 The Pseudo R^2 scores from the logistic regression element of the model (based on different statistical approaches) are 0.187 (Cox & Snell), 0.219 (McFadden) and 0.288 (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 fully 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&M Activist Alert: results in detail for May 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 clients the most accurate picture of where vulnerabilities lie. In this refresh, for example, we have included operating profit by division for the first time. This has revealed a preference of activist funds for companies with a wide and/or growing range between the performance of their most and least profitable divisions.

Over time, the model has demonstrated by means of data what we knew anecdotally – that activists are interested in good companies that could have the potential to 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. Below are the key updates from our latest analysis.

Timescales

Activists are becoming more impatient. The time they wait before launching a public campaign has steadily got shorter since we launched the AAA model. The time between the first evidence of underperformance and a public announcement by an activist was 1.84 years in the May 2018 analysis, compared to 1.91 years as seen in the year to the end of July 2017, and compared to slightly more than two years in 2016.

One of the drivers behind this shortening timeframe is the continued growth and relative acceptance of shareholder activism across Europe, with more funds willing to join the activist investor. More capital and more willing participants mean that 'wolf packs' of like-minded investors, with the critical mass to force a debate, can form more easily and more quickly.

Our quarterly refreshes of the model will help monitor and evaluate how this timeframe evolves.

As activist campaigns become more accepted so the time afforded to Boards to address underperformance shortens.

Countries and industry

The U.K. remains the favourite market for activist investors because of 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. Despite the uncertainties of what Brexit will bring, these proved no deterrent for high-profile activist-backed campaigns such as Melrose's successful takeover bid for engineering group GKN.

However, activist funds are also becoming more adept at honing their approach to suit local markets, something that is vital in Europe.

Interest by sector is often correlated to macro trends. Energy companies lost appeal in the May 2018 analysis, for example, as the oil price continues to improve, boosting forecast profitability in the sector. Materials companies also dropped out of the crosshairs as commodities prices increased. By contrast, consumer focused companies have increased in attractiveness along with industrials, healthcare and IT.

Activists keep an eye on macro trends and hone their approach to suit local markets.

Profitability

For the first time, we included revenue and operating profit by division in the model, and the results have generated one of the key findings of this May 2018 report. Of the 1,854 companies analysed, 1,129 reported operating profit by division (65.8 percent of the total). For these companies, two factors made a particularly significant impact on their 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.

We know that activists target good companies which could be great – and the existence of underperforming divisions which would be improved or spun-off can be a key factor in identifying such targets.

Assets and liabilities

A wide range of balance-sheet data forms an important part of the AAA model. Cash, working capital, goodwill and debt all play a part. Of particular interest is the role of net assets, which the analysis shows are a positive factor in attracting activist interest. In other words, activists statistically target companies whose net assets are growing more than the sector average. This further illustrates the point that, in general, activists do not target weak and underperforming companies.

Activists statistically target companies whose net assets are growing more than the sector average.

Board/governance

We have incorporated several governance-linked variables in the model, producing a variety of noteworthy results.

One interesting result of the model is that gender balance continues to have a significant, albeit small, impact; companies with a higher percentage of women on the Board had a slightly lower chance of being targeted by activists than those with fewer women. We also assessed the impact of the average length of Director tenure but found this to have limited influence.

The perceived strength of the Board impacts the likelihood of being targeted by activists.

Equity value and structure

Declining shareholder returns are often the initial point of interest for activists, and various equity-related variables feature prominently in the AAA model. These include PE ratios, market-to-book valuations and enterprise values. The relative change in share price is also a very important factor. Other key factors include shareholder concentration and free-float percentages. These factors act as enablers for activist interest. A low free-float percentage limits an activist's capacity to build a vote-winning block of support – one reason German companies are lower on the activist radar is because a higher proportion have large tranches of unlisted shares.

A favourable shareholder register combined with a relative underperformance in the share price makes the activists' objectives very much more achievable.

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

The May 2018 refresh of the AAA model identified 156 companies considered to be at significant future risk of activist targeting, either in the short or medium term, out of the total 1,715 corporates. We do not disclose the names of the companies on the list publicly, however the country and sector trends are included.

As summarised in the tables below, the total of 156 is made up of 72 on the red list (short-term risk – within the next 6-12 months) and 84 on the amber list (medium-term risk – within the next 12-18 months).

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

U.K.	**28** ▲	Total: **60** ▲	**32** ▲
Switzerland	**7** ▼	Total: **13** ▼	**6** ▼
Scandinavia	**6** ▼	Total: **13** ▼	**7** –
France	**8** –	Total: **17** –	**9** –
Germany	**9** ▲	Total: **18** ▲	**9** –
Benelux	**7** ▲	Total: **16** ▼	**9** ▼
Italy	**4** ▲	Total: **12** ▲	**8** ▼
Spain	**3** –	Total: **7** –	**4** –
	Total: 72 ▲	**Total: 156** ▲	**Total: 84** ▲

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

Consumer	**22** ▲	Total: **46** ▲	**24** ▲
Industrial	**20** ▲	Total: **45** ▲	**25** ▲
Materials	**6** ▼	Total: **11** ▼	**5** ▼
IT	**9** ▲	Total: **21** ▲	**12** ▲
Healthcare	**7** –	Total: **16** –	**9** –
Energy	**4** ▼	Total: **10** ▼	**6** –
Other	**4** ▼	Total: **7** ▼	**3** ▼
	Total: 72 ▲	**Total: 156** ▲	**Total: 84** ▲

Summing up

A valuable warning system against public activist campaigns

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 prepare 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.

> *A&M identified and got our management team to focus and deliver on the key improvement levers that stabilised our business within 12 months."*

Interim CEO, FTSE 250

> *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

Key contacts

Malcolm McKenzie
U.K.
+44 20 7663 0433
mmckenzie@alvarezandmarsal.com

Tarek Hosni
France
+33 6 82 81 82 56
thosni@alvarezandmarsal.com

Paul Kinrade
U.K.
+44 20 7663 0446
pkinrade@alvarezandmarsal.com

Stefaan Vansteenkiste
Benelux
+31 20 7671 114
svansteenkiste@alvarezandmarsal.com

Dhruv Sarda
U.K.
+44 20 7863 4700
dsarda@alvarezandmarsal.com

Alberto Franzone
Italy
+39 028 596 4123
afranzone@alvarezandmarsal.com

Patrick Siebert
Germany
+49 151 2747 3376
psiebert@alvarezandmarsal.com

Fernando de la Mora
Spain
+34 917 815 521
fdelamora@alvarezandmarsal.com

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.

Follow A&M on:

To learn more, visit: alvarezandmarsal.com

ALVAREZ & MARSAL