Issue 1, October 5, 2017

WHAT MAKES COMPANIES VULNERABLE TO ATTACKS FROM ACTIVIST INVESTORS?

Activist investors are becoming a more prominent fact of corporate life due to the success of other activist investors; if Dan Loeb can successfully push for change at Nestlé, Europe's biggest company, the sky's the limit.

ON THE DEFENSIVE

Some CEOs and boards feel defensive about the implied criticism that accompanies an activist shareholder. What made them vulnerable?

"Activists come in because you're performing below your potential or you're very bad at telling your story to the market, so they don't know how well you're doing," says Malcolm McKenzie, Corporate Transformation Services leader for Alvarez & Marsal in Europe.

Of course, there are any number of reasons why companies underperform, but they fall into two broad categories: bold initiatives that aren't accretive, or failing to keep up with a changing market due to technological change or other disruption.

"Most developed countries have not seen 3 percent annual GDP growth since 1999. Low growth combined with low inflation has made it difficult to raise prices and margins without transformative changes through technology or organizational realignment," says Joel O'Driscoll, Managing Director at Alvarez & Marsal in San Francisco. "Bottom line, managements don't know what to do to grow the top line and they are looking for a way out."

WHAT'S NEXT?

The economic environment could be about to get even tougher; market analysts have been on alert for a correction since the summer, and the world's largest central banks expect to start raising interest rates and unwinding stimulus programs in the near future – the Fed has left open the possibility of raising interest rates before the end of the year. This would leave businesses' weaknesses even more exposed than they are today. Shareholder dissatisfaction or uncertainty in a business can foster activist involvement. Changing market dynamics coupled with management teams reluctant to make the hard decisions, long-held board seats and a bleak horizon set the stage for the meaning of vulnerability. Stagnancy or lack of action becomes a breeding ground for activist investors to launch their campaigns.

Shareholder dissatisfaction or uncertainty in a business can foster activist involvement

"There are more activists coming to play now, who can build more of a wolf-pack of other investors and as a result feel more empowered to launch campaigns," says Paul Kinrade of Alvarez & Marsal in the UK.

STORIES OF ACTIVISM

Third Point and Nestlé (2017)

"It is rare to find a business of Nestlé's quality with so many avenues for improvement," wrote Third Point, the hedge fund run by activist investor Dan Loeb, in a letter to investors in June. The letter stated Nestlé had not kept up with "changes in consumer tastes and shopping habits, as well as an influx of new competition from smaller, local brands." This September, Nestlé bought a majority stake in upmarket US coffee chain Blue Bottle, which uses coffee beans roasted only within the last two weeks, sourced from local roasters. Nestlé also announced a CHF20 billion share buyback program days after Third Point's stake was disclosed, another move that the activist investor had called for.

ValueAct and Rolls-Royce (2016)

US activist investor ValueAct became the largest shareholder in UK-based engine maker Rolls-Royce in the summer of 2015, and went on to indicate it would prefer the company to become solely an aero-engine manufacturer. In March 2016, ValueAct's chief operating officer, Bradley Singer, was appointed to Rolls-Royce's board in exchange for a promise the fund would not publicly lobby for a breakup of the company or take its stake above 12.5 percent.

Trian and Mondelez (2014)

Nelson Peltz, the activist investor at the helm of Trian, had an eventful history with Mondelez and its predecessors Kraft and Cadbury; he had pushed for the spinoff of Dr Pepper Snapple Group from Cadbury, and was then influential in Kraft's purchase of Cadbury and the subsequent breakup of Kraft into Mondelez and Kraft Foods Group. In 2014, he joined the board of Mondelez in return for ending his campaign to have the company merge with PepsiCo (where he was also a board member), but continued to push for better cost control to improve earnings per share.

VULNERABILITY IS SECTOR AGNOSTIC

Retail is perhaps one of the most obvious sectors at the moment where failing to keep up with a changing market is most apparent, with venerable brands falling victim to the Amazon effect. However, digital transformation has crept up on companies in every sector; a company may have started selling on-line, but if management is also struggling to meet the cost of running a decades-old catalogue business (plus bricks and mortar premises) how can you compete with on-line only rivals? A company being unable to compete is a glaring vulnerability. Fortunately (or unfortunately), many companies are sharing the spotlight in their angst around cost reduction, digitization and, most importantly, looking at how to enhance the customer experience.

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THE “OUTSIDE IN” VIEW

So, what practical steps can leaders take to ensure they are living up to their potential for shareholders – and avoid a potential confrontation with activists?

A key first step is to get the “outside in” view, says McKenzie.

“We would do some work for the board to set out what a different owner – for example, a private equity firm – would do with the business, to challenge management,” he says.

Armed with that information, boards can assess which actions they believe would be of benefit and the reasons others would not: “If an activist does appear then you can say you’ve done A and B, and you have reasons not to do C and D,” adds McKenzie. “You’ve done the thinking and you have a defense.”

A&M has helped numerous clients through rigorously scrutinizing the company through the lens of the activist investor therefore offering a significant benefit to shareholders for the long-term future of the business.

THE HARD STUFF
Triggers that activists prey on

Bold initiatives: When bold new initiatives are announced by management, stock performance often improves. The business might buy back stock and issue special dividends at the expense of investing in transformational change. There is a belief that, with confidence, growth and earnings will follow. It is often very difficult when those bold initiatives aren’t accretive and managements are not inclined to admit the mistake and move on.

Information arbitrage: independent directors rely on management prepared analysis. Often times, activists invest months in primary and secondary research with potentially more insight into the company and the challenges it faces.

Low-growth economy: sluggish progress becomes the norm.

Easy money: When cash is cheap and plentiful, it is easier for companies to borrow to fund growth, costs balloon and the cost of servicing debt is not a pressing concern.

GOT A QUESTION? CONTACT AN INFLUENCER

ANSWERS ARE ONE CLICK AWAY

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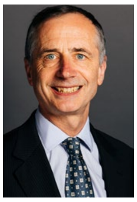

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