CREDIT SUISSE

2016 Third Quarter

Corporate Insights

The activism agenda: What are activist investors looking for?

Introduction

Carl Icahn, Bill Ackman, Dan Loeb and Nelson Peltz have become household names. To many CEOs and corporate boards, these investors represent an investment strategy that evokes unease, a strategy often viewed as creating distractions and which may lead to a public war of words and even struggle for control of a company. Icahn, Ackman, Loeb, Peltz and many others hail from the swelling ranks of investors collectively known as activists.

Activists take sizeable minority equity stakes in publicly-traded companies … and then they agitate. Their methods and objectives differ as widely as their personalities, but in general they seek change in these companies – the return of excess cash to shareholders, the sale of underperforming divisions, sale of the company, or outright change in the management team, the board, or both. Often they will do this in very public ways, with open letters to shareholders and public fights over board seats. Activists' stated purpose is to "unlock value" and ultimately earn "alpha" through their agitation. For this reason, they are sometimes called "value investors on steroids."

Although activist investors often promote themselves as being focused on value creation, we question the veracity of that in practice. In reality, the true intention of an activist is maximizing returns in the minimum amount of time. So it is questionable whether activists actually have the best interests of long-term shareholders in mind.

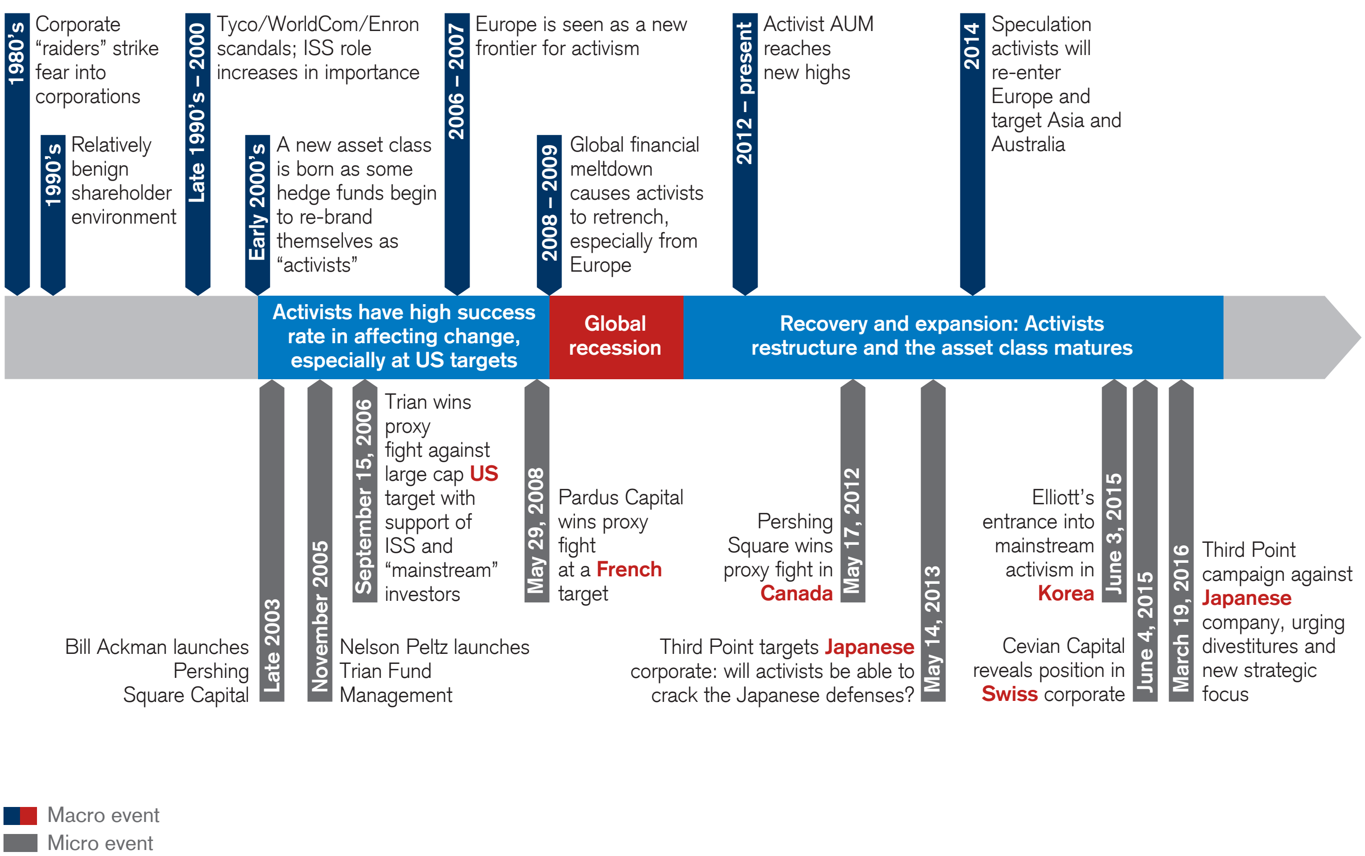
While there has been an awful lot written about activists in recent years, we offer a unique take on activism based on our proprietary HOLT framework which relies upon return on capital (CFROI) metrics. In this, the fourth in our ongoing series of **Credit Suisse Corporate Insights**, we trace the origin, development and current state of activism as a strategy. Our differentiated approach will help us explain what it is that most activists tend to target, especially considering returns on capital are a proven focus of activists. Knowing what these activists look for will empower our clients to better understand – and to anticipate – whether they may be vulnerable to activist attention and – if they are – to take steps to avoid or prepare for that unwelcome phone call or letter.

The evolution of activism

From activist investing's inception in the 1980s, activist investors were viewed as intimidating and ominous "corporate raiders", striking fear into corporations with their hostile demands. The relatively few "activist" campaigns in the 1990s stood out as the overall shareholder environment was much more friendly, supportive, and even complacent.

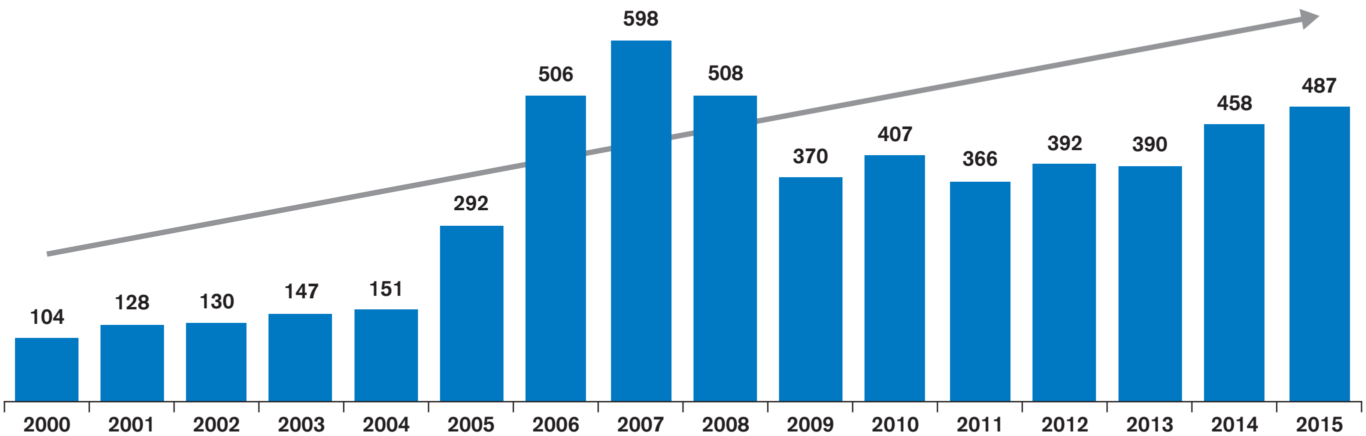
In the late 1990s and early 2000s, in the wake of notorious accounting scandals including Tyco, WorldCom and Enron, investors began to focus increasingly on issues of corporate performance, strategy, and governance. By the early 2000s, some hedge funds began to re-brand themselves as "activists", claiming to be value-focused investors with shareholder interests and shareholder value creation in mind.

Exhibit 1: The evolution of activism



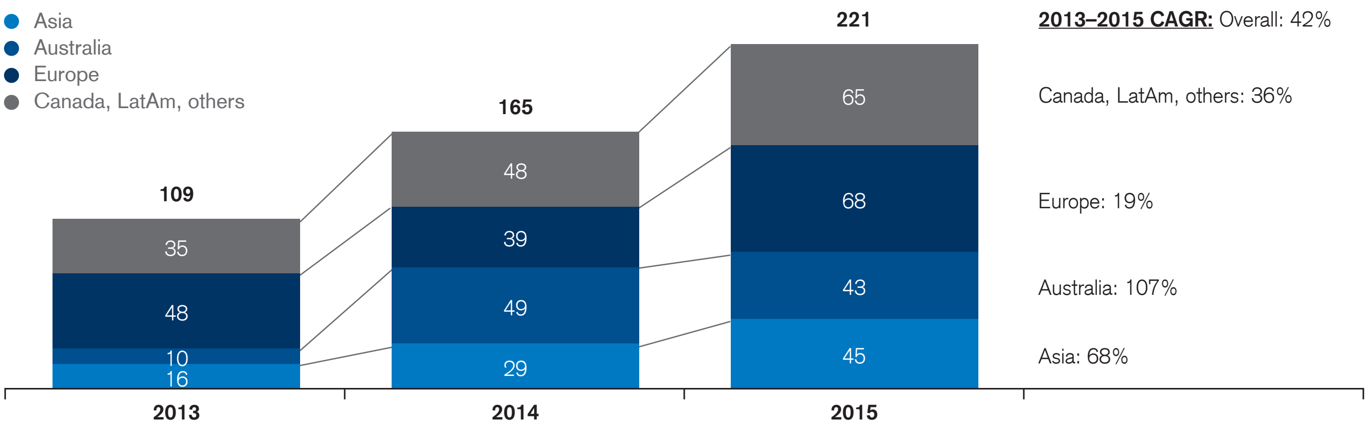
Over the course of the last decade, activism has gained meaningful momentum. Post the financial crisis, activism has surged, with both assets invested in activist funds and the number of activist campaigns reaching new highs. In the last several years, activists have even begun to go after large, blue-chip companies that were previously viewed as unassailable (e.g. Apple, Microsoft, Procter & Gamble, DuPont). Since the early 2000's, the number of activist campaigns has increased nearly five-fold.

Exhibit 2: The growth in activist campaigns in the US[1]



The number of activist campaigns continues to rise year over year as activists spread their wings across new sectors, regions, and market cap sizes. According to the *Financial Times*, "between 2009 and 2015, more than 40 percent of the 500 largest US listed companies were subject to activist scrutiny, with 15 percent facing such investors in a public stand-off."[2] Even private equity firms are now beginning to look beyond traditional buyouts and are testing the waters of shareholder activism.[3]

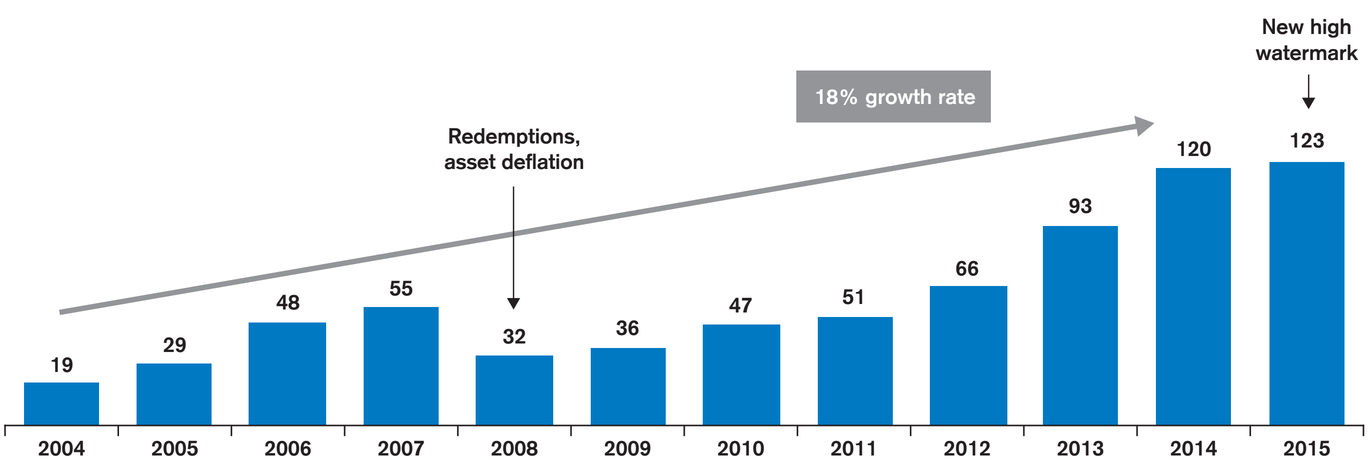
Exhibit 3: Activism campaigns across ex-US regions[4]



Outside the US market, activism is still very much in its infancy and the mature form it is likely to take in each jurisdiction will be determined by local idiosyncrasies. But, as the US activism space becomes more crowded, activist investors are increasingly looking abroad for new targets. Activism is gaining momentum and now taking root in other regions with developed market economies across North and South America, Europe and Asia.

Currently, North American activist hedge funds manage $107 billion, more than three times as much as their European counterparts. However, Bill Ackman notes that, "Europe is probably 10 years behind [the US] in terms of the degree of shareholder activism … but I think it's going to happen." Ackman went on to note that the demand for returns by pensioners in Britain and the rest of Europe "will drive shareholder-run activism".[5]

Exhibit 4: Estimated activist fund AUM[6]
$ in billions

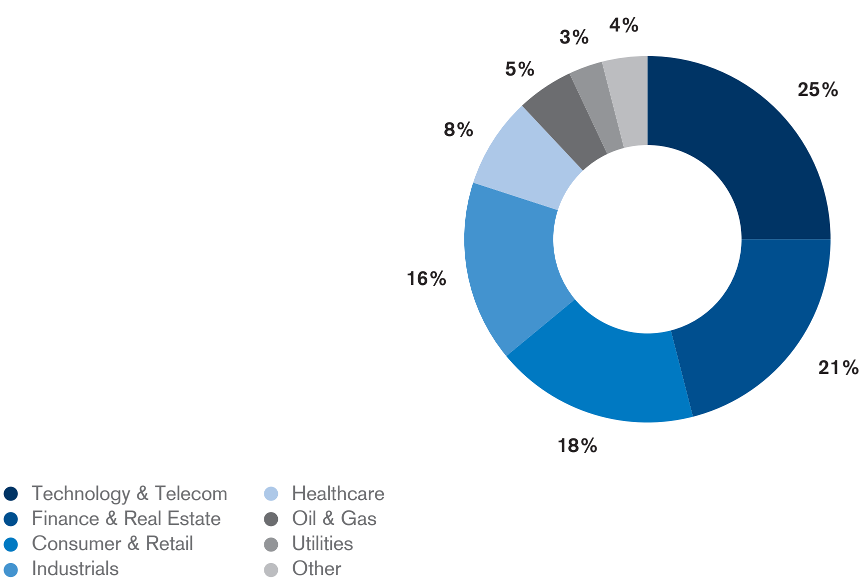


Yet even these large numbers of funds dedicated to activism may understate the firepower that activists can deploy for campaigns. These numbers represent assets dedicated solely to activist strategies. Activists also have additional funds under management that could be diverted to specific campaigns. Furthermore, there is a growing chorus among traditionally passive funds that seem willing to throw their considerable weight behind specific activist campaigns.

With at least 15 years of history, assets under management at all-time highs and an increasingly global presence, activists will remain a force to be reckoned with. So what do they look for and what should corporate managers focus on in order to avoid attracting their attention? While some sector preferences appear to exist, activists do not appear hamstrung in terms of who they target, attacking companies in every industry, including those in the Technology, Healthcare, Finance, Industrials and Consumer spaces.

Exhibit 5: Number of activist campaigns across sectors[7]

US activism by sector



What do activists want?

Like other investors, activists seek to earn superior returns for their stakeholders. But this common objective may be achieved through a wide range of different strategies. Our research and experience show us that the activist playbook has four common strategies or levers for helping them to unlock what they believe is hidden value: M&A, balance sheet, operations and governance. Let's look at each of these in turn.

The **M&A** strategy for activists is where they seek to put a targeted company into play, agitating for the sale or break up of the company. In some ways, this M&A strategy is one of the most appealing to activists, as it often allows them to quickly capture upside through a takeover premium, simply by kick-starting the sale or break-up process of a targeted company. Activists pursue M&A as a lever to realize high returns in a short period of time.

Activists focused on M&A tend to seek out sectors where they expect meaningful consolidation, or where consolidation is already underway. They may canvas financial sponsors or strategic acquirors prior to approaching the target to ensure sale-ability. If an outright sale is not viable, activists may otherwise seek to maximize value by agitating to break the company up altogether. Importantly, in nearly half of the activist campaigns we have evaluated since the financial crisis, the targeted company was ultimately either sold outright or broken up.[8]

A second activist strategy relates to corporate **balance sheets**. Balance sheet activism often simply involves putting pressure on companies with large cash balances. While identifying companies with lots of cash is relatively easy, activists may find that achieving their desired outcome is not as easy. Many companies have cash balances which are swollen due to overseas cash which is "trapped" due to tax considerations. Other valid reasons for large cash balances exist as well, including corporate liquidity, concerns about rating agencies views, covenants, or even expected strategic needs in the near term.

Still, activists may see companies with sizable cash balances as plum targets. An activist employing this balance sheet strategy often makes demands that the targeted company do something with the cash sitting on its books: such as returning "excess cash" to shareholders through stock buy-backs or dividends. This strategy has become increasingly common in recent years given the record amount of cash sitting on company balance sheets today.[9] The number of these balance sheet campaigns rose to a record in 2015, accounting for about 15% of total activist campaigns in that year.

Activism campaigns targeting **operational performance** are newer arrivals on the menu and probably the most complex, requiring industry expertise and, often, patience. This strategy requires more time to realize any value creation since implementing change, fixing any perceived faults in the business, and then capitalizing on the investment all take time to achieve.

Activists pursuing this strategy focus on driving improved returns on capital for the targeted company. They can do this by seeking to rationalize cost structures or wring efficiencies out of working capital or capital spend. In response to the growing noise that activists make about returns on capital, companies increasingly focus on returns on capital, and the financial press has noticed. A recent *Wall Street Journal* article on ROIC mentioned that, "in 2015, 672 US companies cited [ROIC], up 42% from five years earlier…" and "more investors care about ROIC than any other financial metric." For activist investors, returns on capital represent "the most critical skill of management: how they allocate capital."[10]

The fourth lever or strategy that activists typically deploy in seeking to unlock hidden value is **corporate governance**. Activists pursuing this strategy often seek to replace directors on the corporate board, via a proxy fight. This activist strategy is often a means to the end and is usually coupled with one of the other three strategies above.

To that point, the activist playbook is not one dimensional, meaning that activists often pursue one or more of these tactics simultaneously. For example, ValueAct's campaign against Microsoft in 2013 included balance sheet, governance and operational demands. Jana's stake in PetSmart in 2014 included demands related to all four of these levers of balance sheet, governance, operational and M&A.

Knowing *how* activists do what they do is useful. But our corporate clients also need to understand *who* activists target and *what* are the characteristics that seem to attract them in the first place? Fortunately, we have answers to those questions.

What attracts activists in the first place?

There are very few companies which can be considered immune to activist attention. Examples of activist activity exist across virtually all sectors, geographies and market caps – Apple, Microsoft, DuPont, Hologic, Adidas, Canadian Pacific, Abercrombie & Fitch. From lists like this it is hard to detect themes that can help prepare companies for activist attention; every activist campaign is different, with unique demands made by the activist.

But, in our effort to identify some common themes and overarching drivers – using our proprietary Credit Suisse HOLT framework – we analyzed and back-tested several dozen financial and operating metrics across more than three thousand activist campaigns over the past decade.[11] This work enabled us to tease out some common and relatively unique characteristics that seem to attract activists.

We identified eight specific metrics, each of which were screened as statistically significant precursors to these activist campaigns. In our analysis of historical activist campaigns, these eight factors proved to be up to 30% more statistically distinct as compared to the broader market. These eight metrics can be put into three broad buckets: **valuation**, **operating performance**, and **cash**. Let's take a deeper dive into each bucket.

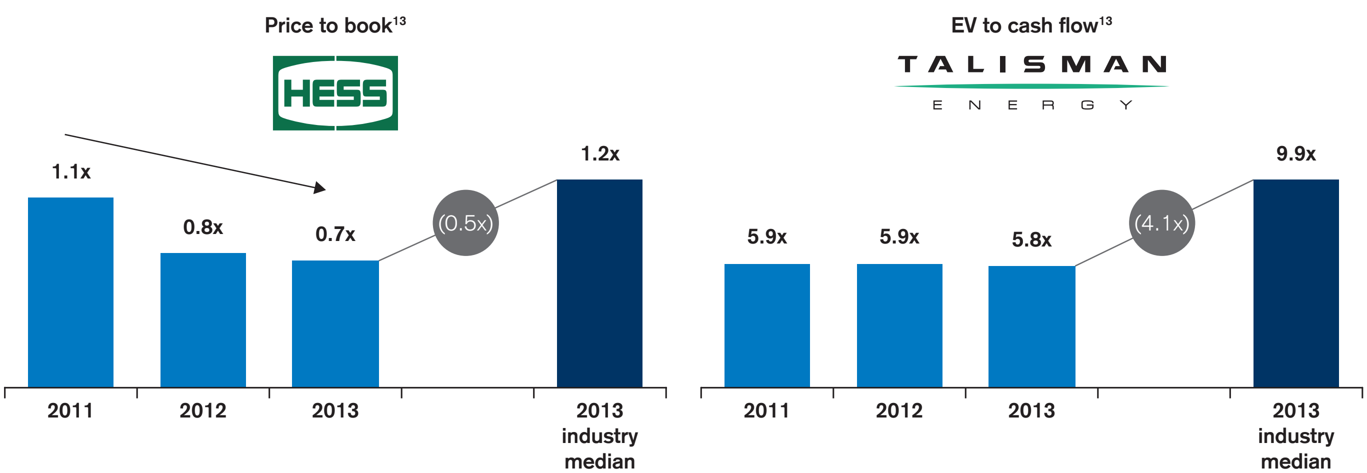
A. Valuation:

Since activists think of themselves as value investors, it should be no surprise that a discount valuation can often attract activists in the first place. Our empirical analysis proved this point, and showed that valuations at a discount to peers are highly associated with the onset of a public activist campaign. So what are the right metrics to assess in thinking about whether your company is trading at a discount to your peers? Is your company in fact "cheap"?

We have tackled the concepts of embedded expectations and valuation in a prior paper.[12] Our work around activism reveals that discount relative valuation metrics – in particular, holistic ones – seem to anticipate activist attention.

Among the metrics we evaluated that were statistically significant are Credit Suisse HOLT's price to book metric and a measure of enterprise value to operating cash flow.[13] Our analysis shows that companies that traded at a discount on either of these ratios have often soon thereafter become targets of activist attention. In the case of Hess, which was targeted by Elliott in 2013, our price to book metric shows that – by the time Elliott began their campaign – the company's multiple had fallen to about 40% below the median for its peers. Similarly, before the activist campaign against Talisman Energy in 2013, their EV / cash flow metric was also 40% below peers, where it had remained for several years before. At that point, both Carl Icahn and Elliot took a substantial stake in the company and began agitating for change.

Exhibit 6: Discount valuations often precede activist campaigns



Clearly, staying abreast of current market valuations, relative to your peers in the market, will help to avoid getting surprised by an activist. But assuming you discover that you are "cheap," what can you do about that?

B. Operational performance:

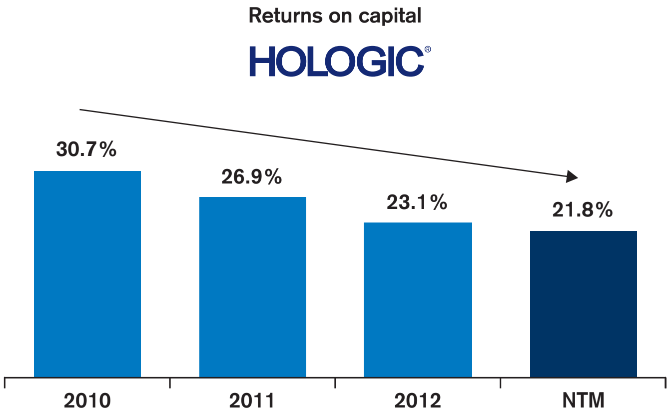
As we have shown in our prior work[14], valuations represent market expectations about performance. So if it turns out your company is trading at a relative discount, weaker operating performance may be the culprit. These are often the same operating drivers that activists will focus on as a lever to drive change in the business and – thus – to drive upside in the stock.

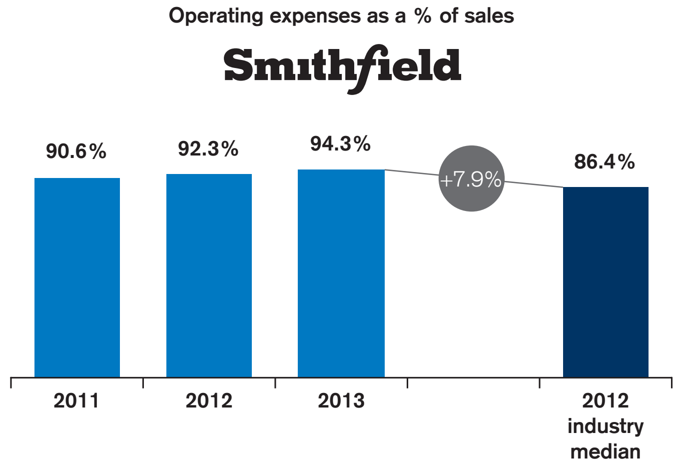
Companies with *any* operational challenges relative to peers may be sufficient for an activist to agitate to change, to turnaround or to restructure. Some of the pressure points activists may point to are cost structures (which they may suggest require restructuring or consolidation), inadequate investment in new technology, R&D or growth capex, etc. Activists may also seek to pressure those companies whose operating performance may not be that weak, in relative terms, but deteriorating.

So how can a company monitor so many and varied operating metrics, to try to avoid the attentions of an activist? Our analysis suggests that there are a few discrete metrics which seem to be associated with activist campaigns. Foremost among these is a return on capital for the business, but another is a measure of operating expenses as a percentage of top-line sales. High operating expenses are straightforward and may present low-hanging fruit for activists in terms of cost reductions. For returns on capital, we use Credit Suisse's HOLT CFROI, which measures the rate of return on the operating assets of a business. CFROI is a proprietary metric to Credit Suisse and is highly correlated to market valuations.[15] Returns on capital have the benefit of capturing both the cash flow generating prowess of the business, as well as the asset efficiency of it.

Disconnects in both of these metrics are statistically significant indications of activist interest in a company. For example, in 2013, Carl Icahn took a stake in Hologic in the wake of the company's significant declines in its returns on capital over the previous few years. Similarly, in 2013, Starboard Value began a campaign against Smithfield, whose operating expenses relative to sales were nearly eight percentage points greater than its peers.

Exhibit 7: Weakening operating metrics can lead to activist attention

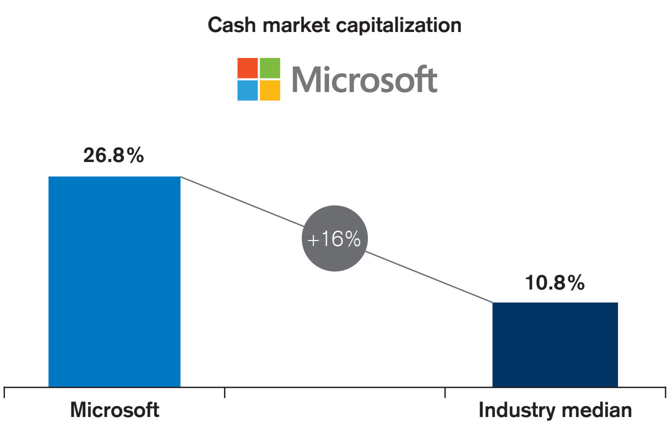




C. Cash:

We have saved the most obvious – and easiest to define – factor for last. As mentioned earlier, the existence of relatively out-sized balances of cash appears as a juicy target to many activists. Once they take a stake in a company, the activist can then agitate to use that cash to buy back shares or to pay dividends. The metric we have found which seems to work well in identifying balance sheets that are attractive to activists is total cash as a percentage of the company's total equity value. ValueAct's stake in Microsoft during 2013 is a textbook example of this type of attention. Not only had Microsoft accumulated a cash balance of $77 billion, its cash as compared to its market capitalization was more than double that of its industry median (in an industry well known for cash accumulation).

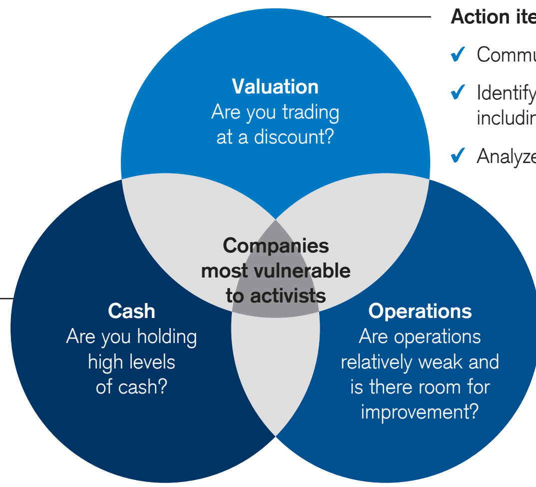
Exhibit 8: High cash balances attract activists



A framework to monitor vulnerability

Taken together these factors – valuation, operational performance and cash on the balance sheet – serve well to anticipate activist attention. As a result of our analysis, we have created a framework to assess relative vulnerability. Our backtesting shows us that the more vulnerable a company appears on our framework, the more attractive it is to an activist … and the more likely the company is to face an activist campaign. The results speak for themselves … our framework, incorporating all three buckets of valuation, operations, and capitalization, is *76% more likely* to identify a company as vulnerable to activist attention than random chance.

Exhibit 9: The Credit Suisse vulnerability framework



Action items:

- ✓ Communicate equity story
- ✓ Identify drivers to close valuation gap, including strategic changes
- ✓ Analyze activist claims and quantify impact on valuation

Action items:

- ✓ Evaluate tradeoffs between organic growth, M&A, or returning capital to shareholders

Action items:

- ✓ Position equity story and identify main supporting drivers
- ✓ Review business segments and capital allocation

But scoring poorly on any of these metrics does not imply a *fait accompli* with respect to activists. Discount valuations, excess cash and deteriorating operating performance need not be a permanent state of affairs. It is important to realize that any relative issues in a company's story also have solutions. If a company's valuation is at a discount to peers, consider examining the market's expectations for profits, growth and cash flow generation. If operational weaknesses appear, raise questions about segment contributions and capital allocation decisions. If excess cash is the culprit, consider earmarking it for strategic uses, investment and growth.

We have used the word "relatively" a number of times when evaluating activist interests. This is because activists do seem to be conscious of and react to industry-specific themes. Meaning, a level of cash or of operating performance that defines vulnerability in one industry may be very different in another. Our framework also adjusts for this relative industry dynamic, which is difficult to account for without Credit Suisse's unique metrics.

Not all aspects of activist interest are quantifiable. Macro-economic trends, industry-specific dynamics, and company-specific factors including governance can all influence and drive activist decision-making. Our analytical framework is a simplification of the activist landscape … but it provides a vital leading indicator of a company's vulnerability underscored by our rigorous, comprehensive and back-tested analysis.

Conclusion: Become your own activist

Activist investors are here to stay. Their ranks are growing, the money flowing into those funds continues to rise, and activist campaigns are spreading across the globe. Their campaigns can be public and massively distracting to the Board and to management. Activists also often agitate for board seats – or more – and they may stick around for a long period of time. All in all, it is best to try to avoid attracting their attention in the first place.

These campaigns do not necessarily appear out of nowhere. As our research and this paper have shown, it is possible to anticipate – even to predict – what an activist will find attractive. Monitoring the kinds of metrics that activists focus on requires rigorous and ongoing analysis, not just of your company but of your performance relative to peer and market benchmarks. But we recognize that our clients have many daily obligations, not the least of which is running their businesses and managing their employees.

Because of all of this, we work together with our clients to help monitor their vulnerability, in order to keep them aware of any changes in performance that might attract an activist in the first place. A comprehensive activism assessment needs to be objective and multi-dimensional. Our expertise lies in identifying the metrics that activists look for and then proactively addressing any apparent issues before an activist comes calling. Such a proactive stance is not limited to awareness of the metrics we discuss here, but often includes more fulsome audits of defenses in place. Actively monitoring the vulnerability framework and being on top of the state of your defenses constitute advanced preparation, and good housekeeping, thereby enabling our clients to control their own destiny and to not be caught off guard.

In addition to using our vulnerability framework to understand the current conditions, a company can prepare itself by undertaking an enhanced review of its current performance, especially in comparison to its longer term strategic plans. Such reviews help inform management about long-term value creation potential of the company. They can also empower management – and the Board – with compelling reasons for continued execution of the plan, facilitating the creation of counterarguments to preempt activist demands, and provide proof points to demonstrate the company's progress towards value creation objectives. Such an approach will help position the Board to take the "high road" and take control of the narrative rather than leaving it in the hands of the activist.

At the end of the day, the strongest defense for any company is a track record of sustainable shareholder value creation, which is generally rewarded by higher valuations in the market. Monitoring the factors we identify here can help guard against activists. After all, a business with strong operating performance, a healthy valuation, and a disciplined capital deployment strategy is less likely to end up on an activist's target screen. Like most disruptions in the market place, it all comes back to value creation in the end.

End notes

1 Source: SharkRepellent. Excludes campaigns by corporations, labor unions, pension funds, and religious groups.
2 Financial Times, “Activists’ battles with companies played out in the classroom” (June 20, 2016). Analysis based on FactSet data.
3 Source: Hanger Inc. 13D filings.
4 Source: SharkRepellent.
5 Source: Bill Ackman, CEO of Pershing Square Capital Management, speech at University of Oxford’s Saïd Business School.
6 Source: Hedge Fund Research, report as of March 2016.
7 Source: SharkRepellent.
8 Source: SharkRepellent. In 44% of exited 13Ds filed (January 2008-January 2016), the target company ultimately was sold or broken-up.
9 See Credit Suisse Corporate Insights, 4th Quarter 2015, “The Capital Deployment Challenge.” www.credit-suisse.com/corporateinsights.
10 The Wall Street Journal, “The Hottest Metric in Finance: ROIC” (May 3, 2016). Forbes, “To Really Understand Shareholder Value, Look at Return on Invested Capital” (February 5, 2016). Value Creation Thinking, Bartley J. Madden (2016).
11 Two-tailed T-tests with significance level of 0.01 were used to test for statistical significance in terms of valuation, operational, and capitalization metrics between the universes of companies that have13Ds filed against them, and the reference universe of the Russell 3000.
12 See Credit Suisse Corporate Insights, 1st Quarter 2016, “Managing the Multiple: Weighing growth against profitability.” www.credit-suisse.com/corporateinsights.
13 The market price to book assets metric we used is the Credit Suisse HOLT Value to Cost ratio, which measures the total market value of debt, debt-equivalents, and equity versus inflation-adjusted net assets. The enterprise value to cash flow metric is Enterprise Value divided by Credit Suisse HOLT’s gross cash flow. That cash flow metric captures nuances that an EBITDA measure misses (e.g., R&D, rent, pensions, etc.)
14 See Credit Suisse Corporate Insights, 1st Quarter 2016, “Managing the Multiple: Weighing growth against profitability.” www.credit-suisse.com/corporateinsights.
15 Credit Suisse HOLT CFROI (cash flow return on investment) compares a fiscal year’s operating cash flow (essentially EBITDA less taxes plus rent expense, R&D expense and stock-based compensation) to that year’s gross plant, adjusted for inflation, to make the plant value current, plus capitalized leases and R&D, plus cash and net working capital.

Authors and acknowledgements

Authors from Credit Suisse Investment Banking and Capital Markets

Chris Young, JD, CFA, Managing Director, Global Head of Contested Situations
Rick Faery, Managing Director, Global Head of HOLT Corporate Advisory
John Bordes, Director, HOLT Corporate Advisory
Charu Sharma, Vice President, HOLT Corporate Advisory
Qin Tuminelli, Vice President, Contested Situations
Raj Patel, CFA, Associate, HOLT Corporate Advisory
Austin Rutherford, Analyst, HOLT Corporate Advisory
Andy Hao Yan, Analyst, HOLT Corporate Advisory

With thanks for their time, contributions and valuable insights:

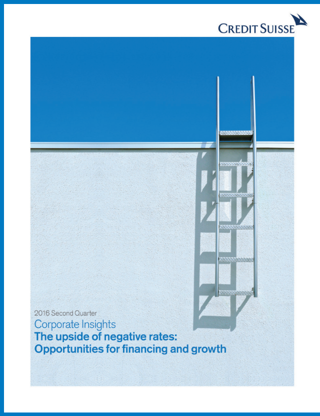
Tom Hillman, CFA, Managing Director, HOLT Equities
Richard Curry, Ph.D, Vice President, HOLT Equities
Special thanks to Matt Kunke

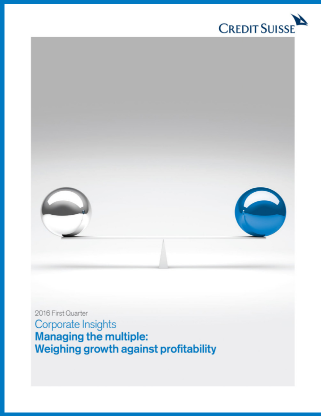
About Investment Banking and Capital Markets

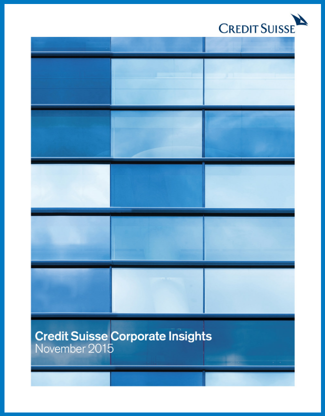
We offer a broad range of investment banking services to corporations,financial institutions, financial sponsors and ultra-high-networth individuals and sovereign clients. Our range of products and services includes advisory services related to mergers and acquisitions, divestitures, takeover defense mandates, business restructurings and spin-offs. The division also engages in debt and equity underwriting of public securities offerings and private placements.

Credit Suisse Corporate Insights

Our Credit Suisse Corporate Insights series provides our perspective on the key and critical corporate decision points many of you face, regarding corporate strategy, market valuation, debt and equity financing, capital deployment and M&A. For more information, please visit: credit-suisse.com/corporateinsights.







CREDIT SUISSE SECURITIES (USA) LLC
Eleven Madison Avenue
New York, NY 10010
credit-suisse.com