Predicting the next corporate targets for shareholder activists in Europe

Boards in challenging times

The A&M Activist Alert (AAA)
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ALVAREZ & MARSAL

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Overview

Shareholder activism in European companies is a growing and evolving reality for the Boards of quoted corporates. But how can a Board predict, and as a result prevent, a public activist campaign?

From an historically low level of European activism, greater capital is being dedicated to the area from a larger number of sources with a wider country focus. Whilst international (notably U.S. and increasingly Asian) activist related funds continue to seek targets in Europe, European based funds are growing at an even faster pace. Indeed A&M analysis shows that European based funds currently account for 26 percent of global activist or event-driven funds, which is up from 22 percent in 2016.

A public campaign by an activist shareholder can be expensive for the targeted corporate and its Board. Defence, meetings, advisory services and other costs can add up to tens of millions of £ (or € or $). Chairmen, Executives and Non-Executive Directors can all suffer damage to their reputations, and a public defence can be a significant distraction and disruption for the Board, management and employees. A&M analysis shows that of all public activist campaigns in Europe from 1 January 2015 to date, 69 percent included a demand for changes on the Board.

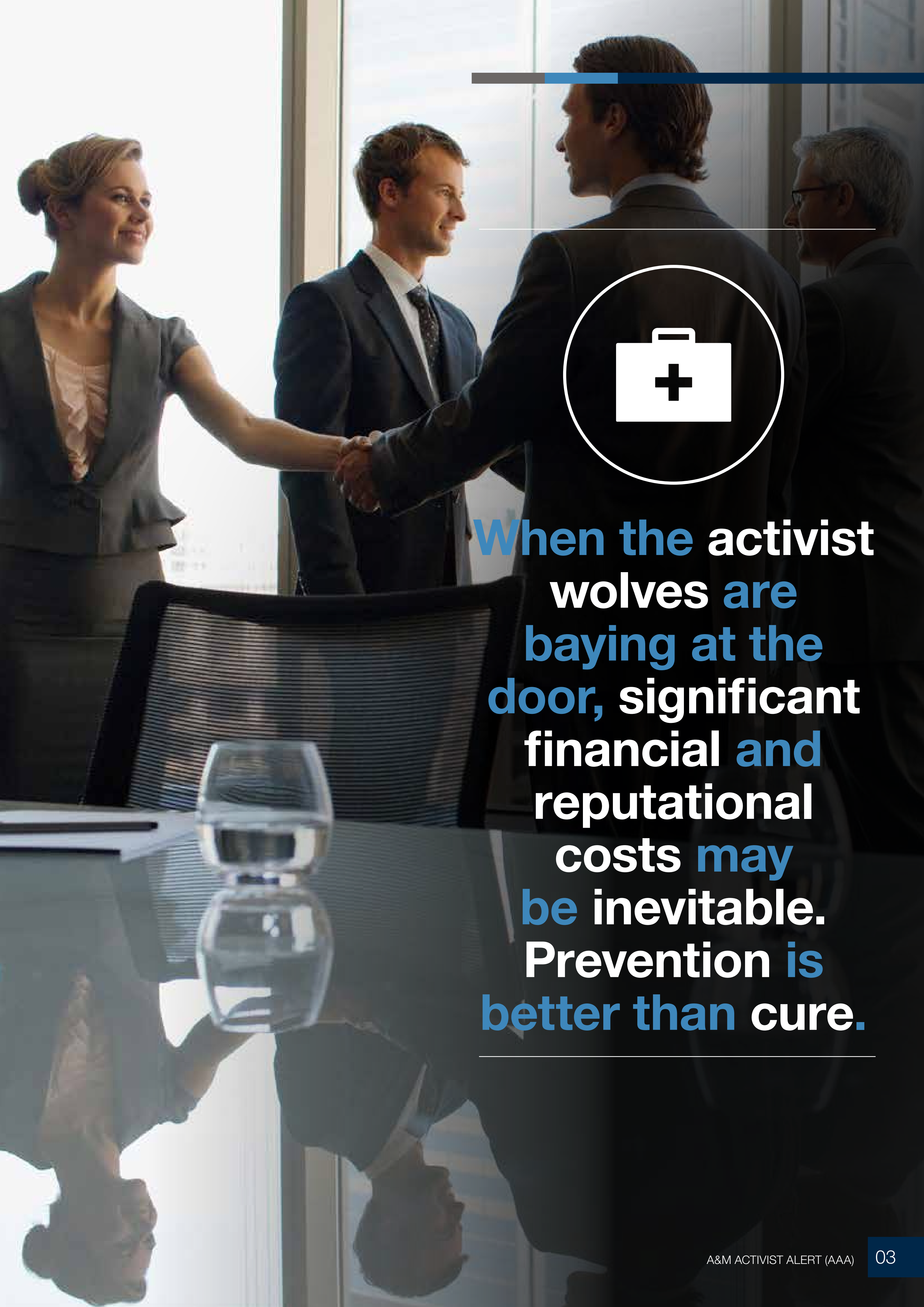
However, a public activist campaign can often lead a Board to ask “why us?”, “what did the Activist see that perhaps we didn’t?”, or perhaps “could we have predicted the potential for activist interest, and if so, how?”

Driven by these questions, A&M has undertaken a wide-scale statistical analysis of European public activist campaigns between 1 January 2015 and 31 July 2017. Initially this analysis focused on corporates based in the U.K., Germany, France, Scandinavia and Switzerland, but has now been extended to include Benelux and Italy.

As part of our analysis we reviewed in detail 108 corporates that were subject to public activist campaigns, and compared these to an additional 1,456 corporates against which there was no known public campaign. In total, 1,564 corporates were analysed with a focus on those with a market capitalisation of at least U.S. $250 million or higher (broadly Small Cap firms and above). A multi-layered statistical model was prepared based on a series of quantitative and qualitative variables. This model then generated a predictive algorithm that correctly predicted 63 out of the 108 known targets – a success rate of 58 percent.

The predictive algorithm was then reapplied to the latest available data across the full sample population of corporates to identify likely future targets. The model, known as the "A&M Activist Alert (AAA)" assigns a score to each corporate that predicts the likelihood of them being a target of a public activist campaign in the near term. The model also generates an AAA Score based on a two-year lookback and an additional score over the past 12 months. Corporates with high scores on both the two-year and one-year bases are considered at high short-term risk (next six to 12 months) of public activist action and may already be subject to non-public approaches. Such high-risk corporates feature on our “Red List.” Corporates with a high score on either the two-year or one-year bases are likely to be monitored by activists who may not yet be at the door but are on the hill and watching. Such corporates are considered to be at a moderate level of risk and feature on our “Amber List”. We consider that the corporates in this Amber category will see the risk of a public programme increase if corrective action is not taken (and the resulting benefits clearly observed) within 12 to 18 months.

In total, the latest refresh of the AAA model has identified 68 corporates on the Red List and 80 on the Amber List. Whilst the Red and Amber Lists are not shared publicly individual companies can find out their position on the Alert List by contacting A&M. The report presents some important trends from a country, sector, financial, governance and other key perspectives.



When the activist wolves are baying at the door, significant financial and reputational costs may be inevitable. Prevention is better than cure.

Methodology

The corporates included

As mentioned above, the A&M Activist Alert model (AAA) is based on an extensive and robust analysis of activist activity in seven European countries/regions from 1 January 2015 to 31 July 2017, including an analysis of how such activity has evolved in scope and focus. The countries included in this updated analysis has been extended so that it now includes the U.K., Germany, France, Scandinavia, Switzerland, Benelux and Italy. Our focus is on corporates listed and headquartered in those countries/regions with a market capitalisation of U.S. $250 million or more (broadly Small Cap and larger).

The A&M Global Insight Centre undertook a detailed analysis of 108 known situations where activist investors had made public requests to the Boards of corporates in one of those seven countries/regions. It is worth emphasising that we have focused purely on public campaigns. There are many situations where corporates have private discussions with activist shareholders but, by definition, we cannot track these in a robust and consistent manner. Also, such private discussions do not bring the high level of financial and reputational risks associated with public campaigns.

We then sought to analyse the 108 known publicly targeted corporates against a further 2,377 corporates (again focused on the seven countries/regions) where there was no known public activist action. Of these 2,377 additional sample companies, we were able to obtain sufficient robust and consistent data in respect of 1,456 of them. Therefore, a total of 1,564 corporates were analysed in detail.

The analysis undertaken

The analysis includes an assessment of each corporate against a wide range of quantitative and qualitative variables, with the majority of the quantitative variables based on the relative performance of a corporate against other companies in its industry sector. There are over 30 variables included and whilst the full details remain confidential, they broadly fall under the following five categories:

- Country and industry
- Profitability
- 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, to gauge the predictability of a corporate being subject to activist action. This predictability was also assessed from a series of perspectives, namely:

1. Key variables – measures which of the variables were most influential and by what factor.
2. Timescales – provides an analysis of how variations in the variables over differing timescales affected the predictability (i.e. on average how long do activists wait before launching a public action?).
3. Industry sectors – measures which sectors are the most/least at risk of public activist targeting.
4. Country specific – measures which countries are the most/least at risk of public activist targeting.
5. Evolution – assesses the observations under each of these perspectives as they manifest and change over time.

The AAA Predictive Model

Utilising all of the above data points and perspectives, a predictive model was developed. The model assesses all of the underlying factors and calculates an A&M Activist Alert “AAA” Score for every corporate. The AAA Score is based on a logarithmic scale between zero and one, where a higher score indicates a higher likelihood of activist action.

Based on the calculated AAA Score, the model also assigns a statistically derived probability to each corporate of it being targeted by activists. The model also identifies the key levers and required actions that would reduce the AAA Score and associated probability of being targeted.

When applied against all of the analysed corporates, the model had a 58 percent[1] success rate in identifying which of the 1,564 analysed corporates had indeed been targets. With such a meaningful successful prediction rate, we can then use the AAA model to act as a radar in identifying corporates that are at risk of future public activist targeting.

1: The Pseudo R^2 scores from the logistic regression element of the model (based on different statistical approaches) are 0.182 (Cox & Snell), 0.201 (McFadden) and 0.291 (Nagelkerke) thus implying a good fit.

AAA – 1 year lookback		AAA – 2 year lookback: LOW	AAA – 2 year lookback: HIGH
	HIGH	**Amber warning –** AAA Score is increasing suggesting potential activist action within the next 12 to 18 months if corrective action is not taken.	**Red warning –** High chance of imminent activist action (next 6 to 12 months). 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.	**Amber warning –** Corrective actions are being taken but corporates will remain on activists watch lists. Improvements must continue.

Red and Amber warnings

The model also allows us to assess how the AAA Scores, and the associated likelihood of activist action, have changed as the corporates' performance/position has changed against all of the key variables. A particularly interesting perspective is derived from seeing how the AAA Score based on the past two years' performance compares to that based on the past 12 months. As illustrated in the table above, a corporate with high AAA Scores on both one year and two year bases should consider itself at high risk of imminent activist action and seek to take urgent corrective actions. A low two year score combined with a high one year score suggests a concerning direction of travel. A corrective and focused course of action would need to be planned and enacted without delay. Conversely, a high two year score combined with a low one year score suggests that corrective actions are being taken by the corporate, but vigilance must be maintained as the corporate is likely to remain on activists watch lists.

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 to be particularly useful.

Quarterly Refreshes

The A&M Activist Alert model is fully reassessed and refreshed every three months including a full review of all new 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. The next review will be completed in January 2018.

A&M Activist Alert
Results for September 2017

Lessons from analysis of the known activist targets

One of the benefits of the model is that it clearly shows the impact of individual variables on the AAA Score. Which variables are more important than others?

Which variables have a positive impact in reducing the risk of a public activist programme, and which are negative in making a such a programme more likely? Being armed with its own AAA Score and analysis, this then also allows a corporate to understand which of the variables are of particular relevance to them and tailor a bespoke change programme accordingly.

In addition to the specific messages contained within the AAA analysis for each individual corporate, there are broader lessons to be learned from the analysis of the known targets. We highlight some of those learnings here.

Timescales

Boards have less than two years to deliver improved performance

How long do activists wait before launching a public programme? Put another way, how long does a corporate and its Board have to address underperformance before activists launch? Our analysis shows that in 2016 the average time lag between first evidence of underperformance and public activism was just over two years. However, looking at activists' actions launched in the 12 months ended 31 July 2017, the time lag had reduced to 1.9 years.

Quarterly refreshes of the model going forward will provide updates on how this timeframe continues to evolve.

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

Country and industry

Legal, cultural and market specific factors all play an important role

It is clear that the U.K. remains a key target given the "shareholder friendly" legal and governance regime, but the activist's crosshairs are increasingly also focusing elsewhere. In 2015, U.K. corporates accounted for 57 percent of all known public activist approaches in Europe but in 2016 that fell to 34 percent. Of essential importance to this broadening approach is the ability of activist funds to adapt their approach to the local environment and comply with local cultural sensitivities. Daniel Loeb's Third Point approach to Swiss domiciled Nestlé being but one example of this adaptive approach.

The rise and fall of different industry and market sectors as being of interest to activist investors is also thought-provoking. One clear message is the role of market disruptions in driving activist interest. Such challenges tend to increase the performance gaps between corporates in the sector as their individual readiness to manage the market challenges is exposed. Such gaps become clear and enable focused targeting – identifying the corporates that were high performers but have fallen back.

Market disruptions highlight underlying weaknesses. It's not about whether your market has disruptions – it's about how, and how quickly, you react to these challenges.

Profitability

Being flexible, nimble and pro-active pays dividends

Building on the industry points made above, the financial performance of a corporate relative to the average of its market sector is clearly also an important factor. The weaker the relative performance, the greater the attraction. Interestingly revenue performance is generally less important than gross margin percentage and EBITDA percentage. Sales, general and administration ("SG&A") costs as a percentage of revenue is also a key factor. It is therefore important that corporates can reduce their cost base as revenues fall.

If and when revenues fall or growth stalls, corporates are expected to be able to react and adjust their cost base (both direct and indirect) accordingly.

Assets and liabilities

Activists don't target bad companies

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 changes in net assets which the analysis shows is a positive factor in attracting activist interest. In other words, activists statistically target corporates whose net assets are growing more than the sector average. This illustrates the point that in general (there are clearly exceptions) activists do not target weak and underperforming companies. They prefer companies that are perhaps second quartile performers but could become, or maybe recently were, first quartile.

Activists target good companies that could be doing better. Good is not good enough.

Board/governance

The perceived strength of the Board matters

We incorporated several governance related variables in the latest version of the model with interesting results. Average Board tenure was one such variable and this proved to be of limited impact with the model ascribing a very small influence to it as a factor. Indeed, a review of the 108 known targets showed an average tenure of 5.91 years as compared to 5.98 years for those that were not targeted.

We also included gender mix on the Board as a variable. This proved more interesting. Whilst the influence ascribed by the model was relatively low and further work is required, a higher percentage of women on the Board may be associated with lower activist targeting. This merits further analysis and inclusion along with a more detailed focus on the perceived strength of the Board.

Whilst not a major factor, there are early indications that increasing the number of women on a Board may be associated with a slightly reduced risk of shareholder activism.

Equity value and structure

Declining shareholder returns are often the initial point of attraction for activists

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 latter factors act as enablers for activist action. A low free float percentage limits an activist's capacity to build a vote-winning block of support. Greater shareholder concentration also makes such block building easier.

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

Predicted future activist targets – the Red and Amber Lists

In total, the September 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 1,564 corporates. Whilst the names of the corporates on the list will only be disclosed to the companies concerned upon request, there are some country and sector trends of note that are included here.

As summarised in the tables below, the total of 148 corporates includes 76 on the Red List (short-term risk ie within the next 6 to 12 months) and 80 on the Amber List (medium-term risk ie within the next 12 to 18 months).

Countries (As at 31 August 2017)**:**

Red	Country	Amber
27	**UK** Total: **54**	27
9	**Switzerland** Total: **17**	8
8	**Scandinavia** Total: **15**	7
8	**France** Total: **17**	9
7	**Germany** Total: **16**	9
6	**Benelux** Total: **19**	13
3	**Italy** Total: **10**	7
Total: 68	**Total: 148**	**Total: 80**

Sectors (As at 31 August 2017)**:**

Red	Sector	Amber
18	**Consumer** Total: **40**	22
15	**Industrial** Total: **33**	18
7	**Materials** Total: **15**	8
8	**IT** Total: **17**	9
7	**Healthcare** Total: **16**	9
6	**Energy** Total: **12**	6
7	**Other** Total: **15**	8
Total: 68	**Total: 148**	**Total: 80**

Country

The U.K. makes up c36 percent of all companies on the Red and Amber Lists but only 28 percent of the 1,564 total sample. On average therefore, U.K. corporates are 32 percent more likely to be targeted than those from the other six nations/regions. Benelux also stands out as on a similar basis it makes up 12.8 percent of the Red and Amber Lists but 10.3 percent of the sample, and is therefore 25 percent more likely to be targeted.

Germany stands out from the alternate perspective in that it makes up 16.1 percent of the sample but 10.8 percent of the Red and Amber Lists. A key element of this result is the relative commonality of significant non-floated equity tranches in German corporates.

Industry sector

As would be expected given the number of corporates in the sectors, Consumer and Industrials make up the largest number of entries on the Red and Amber Lists. However, the Materials, Healthcare and Energy sectors are also worthy of note. On the same basis of analysis used in the country comments above, the Materials sector is 27 percent more likely to attract public activism whilst Healthcare is 17 percent more likely. Energy is 101 percent more likely and this again reflects the effect of market challenges highlighting variances in relative performance as mentioned in the lessons learned comments above.

Final observations

Shareholder activism in Europe continues to grow and is increasingly seen as a culturally acceptable method of increasing shareholder value. Recent campaigns against Nestlé, AkzoNobel and Volkswagen show that no company can consider itself too big to target. This echoes the trend seen in the U.S. over recent years.

Avoiding a targeted public programme of demands from an activist investor can save a corporate and its Board, management and employees from the associated high costs and potential negative distraction, disruption and reputational implications. From another perspective, if shareholders see no reason to challenge a Board as custodians of their investment, the Directors may take some comfort from their track record of shareholder value generation.

As an early warning system for such public activist programmes the A&M Activist Alert model is therefore a valuable tool. The particular levers that individual corporates would need to pull to reduce the risk of an activist approach will be different for each business and it is important to understand what they are and tailor a transformation programme accordingly.

Timing is also very important. Activists are becoming increasingly impatient with Boards and perceived sub-optimal performance, and are launching targeted programmes earlier. Boards therefore need to ensure that meaningful change is delivered, with positive results being clearly shown, without delay. Any change programme that takes more than 18 months to deliver hard results may well be too little, too late.

Corporate transformation programmes need to be delivered with real rigour and real vigour.

How A&M can help

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

Stage 1: Current position/AAA Score – we work with Boards in providing the results of the AAA model specific to them 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 under-performing and non-core business units or assets.

This approach is fundamentally different to the typical defence planning – we are identifying and addressing the root causes of vulnerability rather than putting in a tactical defence.

Stage 3: Transformation implementation – delivering the promised plan and benefits on time is vital. Failure to do so only accelerates the timeframe to likely future public campaigns. A&M works side-by-side with the Board and Management in driving the transformation programme. A&M's deep operational experience ensures that the transformation is robust and sustainable.

If you would like to understand more about the our services, or where your individual firm falls on the AAA Alert, please get in touch with one of our key contacts.

> *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

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

CEO, FTSE 250 (under activist attack)

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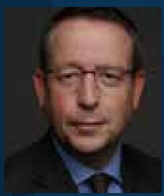

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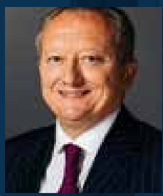

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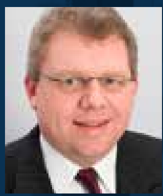

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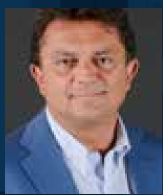

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