THE ACTIVIST REPORT

13D Monitor

Volume 10 Issue 2

February | 2020

10 Questions with Joe Berardino

Joseph Berardino is a Managing Director with Alvarez & Marsal and leader of the Corporate Transformation Services solution. He is based in New York. Alvarez & Marsal brings a differentiated transformation offering to corporations, leveraging the functional expertise offered by performance improvement talent coupled with the firm's renowned restructuring and private equity capabilities. As businesses are vulnerable or looking to keep pace with constant disruptors, A&M is ideally positioned to bring the experience and skills needed to address activist investors and position corporations for success through enterprise-wide change. With more than three decades of executive leadership and Board service experience, Mr. Berardino has a proven track record managing complex Board and C-Suite dynamics to enact change. Previously, Mr. Berardino was an audit partner with Arthur Andersen where he spent more than 30 years in various client-serving and leadership roles, including CEO of Andersen Worldwide. Mr. Berardino has lectured extensively on corporate governance, leadership and ethics before senior corporate executives and college campuses. He served in various capacities, from CEO to Chairman of the Board for Profectus Bio Sciences. He is currently a member of the Board of Advisors for the University of Maryland School of Medicine's Institute of Human Virology and has served on several public company Boards of Directors. Mr. Berardino earned a bachelor's degree from Fairfield University, where he served as a member of the Board of Trustees for 18 years, and has chaired the Advancement and Finance Committees.

13DM: It is relatively clear what the roles of lawyers, proxy solicitors and public relations executives are in a proxy fight or activist engagement. A&M takes a more operational focus. Explain to us your role in an activist engagement.

JB: Our role can vary from situation to situation depending on what is needed. In some cases, we can provide the board an unvarnished outside-in view of a company and its management – highlighting dysfunctions in strategy, governance, capital allocation, leadership and business execution which have resulted in value destruction. In other cases, we can create a detailed transformation road map that will drive value creation for shareholders and we can work with the company to implement that transformation program. In other cases, we can sit side by side with management helping orchestrate every aspect of a proxy battle (decision tree planning, managing agency conflicts, vendor alignment, mapping out strategic responses, scripting management teams, prepping the board for Glass Lewis and ISS meetings, advising on settlement negotiations and assisting with shareholder outreach)

13DM: Often companies undergo enterprise transformations, either as a result of being engaged by an activist or to prevent it. What are the keys to successful enterprise transformation?

JB: We have a 'lessons learned' presentation that highlights the top 10 factors which are necessary to drive a successful transformation. Of those items, the single most important critical element is having the CEO lead the transformation. Delegating is not an option. There has to be an evangelical buy-in from the very top of the organization for a transformation to be successful. Second, there needs to be a maniacal focus on the customer. The transformation must be anchored in clearly articulated strategic priorities and the Enterprise's customer value proposition. This is not solely a cost cutting initiative. Achieving significant financial improvement and cash generation will be uncomfortable for management teams but we promote focusing on the "hard stuff" early rather than simply cherry picking the easy stuff.

13DM: What are agency conflicts with respect to advisors and how is A&M different?

JB: Agency conflicts deal with how various parties get paid and whether or not

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those economic incentives are aligned with shareholders' desire for value creation. For instance, if an entity gets paid by the hour, there may be an incentive to drag out the process in order to maximize one's fees. In other cases, certain parties get paid handsomely if the conflict culminates in a transaction that generates banking fees, so the temptation for a quick transaction that leaves money on the table may not be in the best interests of long term shareholders.

A&M sits on the side of value creation and frequently structures its compensation with success fees, meaning we have true skin-in-the-game to drive value creation.

13DM: Very often activist targets have a very large short interest as the reason investors are shorting it (i.e., bad management for example) is the opportunity activists see (i.e., replace bad management). Why is it important to track short interest as it relates to activism?

JB: It is not uncommon for activists to be involved in situations that are heavily shorted. For the most part it is safe to say that the overwhelming majority of activist targets are "not on a winning streak".

Short interest can act like a booster rocket because ultimately it represents future buyers of the stock. Remember, it is not a question of whether a short will buy back its position, it's a question of when. If the short interest rises to a significant portion of the float (think greater than 20%) and the stock has a relatively low float, a massive short squeeze can occur. Inside baseball on hedge funds: Hedge Fund Prime Brokers charge their hedge fund clients for borrowing the stock that is shorted. When a larger portion of the float is shorted, the stock becomes "hard-to-borrow" and the Prime Brokers' Stock Loan departments charge their customers way more (making it harder to be profitable on the short). In addition, shorts by their very nature tend to have a dour/skeptical view on a company's prospects. If a company is successful in driving transformational change, the upside surprise in revenues, earnings, cash flows and capital structure can make things very uncomfortable for shorts, causing them to cover (buying back their short positions) .

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13DM: Likewise, you also track how debt is trading and option volatility around earnings. Can these be signals for potential shareholder activism?

JB: There's an old Wall Street adage that the debt markets are the "smart money". For the most part, if a company is doing well, a company's stock and debt will both perform well, trading in tandem. At certain times however, debt markets can signal a future problem in the price of the equity. If free cash flow or leverage metrics deteriorate, debt investors may signal a concern about the health of a company well before the equity market participants get the memo. Activists can use this divergence to ambush the equity when it falters and agitate for operational and cap structure improvements.

Options are a different indicator. Frequently around earnings season option markets can signal a greater hesitancy about the prospects of a company and its management team's credibility in the form of the implied move statistic that is embedded in the volatility assumptions of at-the-money near term expiring puts and calls. Essentially, the higher the implied move, the less equity and option investors trust in a management team's ability to deliver on the promised performance baked into their outlook or guidance.

13DM: How do you think passive index funds and the rise of passive investing has fundamentally reshaped the activist playbook?

JB: More than anything, the massive herdlike move to passive investing has the potential to introduce unintended

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consequences. While the governance and concentration of voting control issues can and will be debated, nobody is asking whether passive investing is introducing new unexpected inefficiencies into the equity investment environment. While an index committee can determine whether a company is included in an index basket and what its weighting is to be (think how many shares will be purchased), it doesn't contemplate the strategic value of that company could be to another company. Another way of saying it is if an index fund doesn't buy your company, that doesn't mean another company won't buy your company. Therein lies an arbitrage opportunity that activists can exploit and act to catalyze. Passive investing by its very nature doesn't anticipate change. If you unpack it philosophically, passive investing has an embedded assumption that capital markets are efficient and therefore change is always properly anticipated and discounted in current valuations. As fewer fundamental investors survive the tectonic shift in allocation of assets to indexed approaches, that core efficient markets assumption may become much less valid.

We have also seen a significant turnover in the top ten activist shops over the past 10 years. Given the juggernaut performance of the S&P 500 over the past decade, activists have been under intense scrutiny to perform. The investor community has become more unforgiving with respect to bouts of underperformance by all types of investment strategies. Activist funds are not immune to this trend.

13DM: Why is it important to not only know who is buying your stock, but to also know who is selling it?

JB: The information content embedded in the shareholder base and shareholder moves points to the expectations of investors. Reading the tea leaves of the shareholder base can signal a great deal about where a company is in its lifecycle and potentially how successful a management team is in creating value for shareholders. It is one thing if a stock is held by stalwart, long-only blue chip growth fund and trust fund managers. The company is probably viewed as a well-managed, reliable performer. It is another thing if a stock is predominantly held in dividend/income oriented strategies. There, the cash flow sustainability and the visibility of income streams are of paramount importance. It is an entirely different thing if a stock is held primarily by value-momentum-quality factor biased quant funds. Any change in their delicate quant scores or optimization algorithms could trigger seemingly indiscriminate selling. It also says a lot when a company's long term stalwart shareholders throw in the towel in disgust and sell their stock to special situation and contrarian biased hedge funds. That's a company that may have a high probability of a 13D filing in the very near future.

13DM: Over the past several years large cap and mega cap proxy fights have become possible, while they were hardly even considered many years ago? What are the differences from an operational perspective of mega cap campaigns versus small or mid cap campaigns?

JB: Some activists are getting bigger and need to deploy greater amounts of capital to move the needle for their LPs. They can't afford to trifle with small and midcap companies because there isn't enough economic uplift in those situations to justify the efforts. While more complex and tricky, large cap and mega cap companies tend to feature more value creation levers to pull. Often there can be noncore assets that should be divested or monetized, there can be deferred merger integration and unrealized synergies, there can be massive opportunities in working capital efficiencies which positively impact the cap structure, or tax structure optimizations available across multiple international tax regimes. In addition, there could be an opportunity to liberate savings from cultural 'sacred cows' in terms of spend pools (think R&D, distribution and marketing). Companies can also deliver more to shareholders if they are at the top of their game in terms of efficiencies in sourcing, logistics, IT, customer analytics, and HR functions. The bigger

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you get, the more you see behaviors becoming complacent and silos becoming ossified, structures become too bureaucratic and organizations become sclerotic. In these situations, governance, leadership, decision rights and change management are super important considerations. The absolute need for well-articulated vision, agreement/ alignment, permission and accountability cannot be understated.

13DM: When an activist shows up at a Company, the Boards tend to get very defensive and become even more reluctant to admit past mistakes. On the other end the activists often come with a plan that they strongly believe in. Is there something that can be done differently on either end to make the process less antagonistic?

JB: Can't we all just get along? The question presupposes a change in the character and emotional makeup of the parties involved. Maybe in a perfect world, but I don't think that either side will magically become enlightened and self-aware. Perhaps, the challenge also lies in the media driven narrative around activist situations – framing the issues in terms of good and evil. In many cases, activists are portrayed as bullies or apex predators – preying on the weak. There is another way to look at it. I think that activist situations in many regards resemble substance abuse situations. Activists are the ones conducting an intervention and employing the "tough love", no excuses, accountability mandate. With dysfunctional management teams and boards, there is a basic human tendency to be in denial ("we don't have a problem") or to indulge in minimization ("it's not that bad…we can handle this"). Against that backdrop, you have intermediaries voting proxies that haven't run a company and may not be the best equipped to opine on a strategy's probably of success. In such situations, we can come in and be the independent arbiter, the truth teller – evaluating the roadmap to likeliest probability of positive change and implementing the initiatives that lead to value creation.

13DM: Do you see the level of shareholder activism increasing or decreasing over the next five to ten years? Any trends you see?

JB: If the past five years is any indicator, the recent data suggests an up-and-down sideways trend in the absolute number of campaigns, but underneath that there are a lot more first-time activists (including fundamental buy-and hold asset managers), there are more international campaigns, the sectors of interest are rotating to include more financials, technology and energy companies than a few years ago.

Valuations have gotten stretched and there is a lot of dry powder in private equity coffers today. That appears to be driving more M&A-related activist campaigns than in years past. The lines between activism and PE are blurring as well.

We have been in an extended bull phase since 2009. The markets can't keep rising forever. It is important to remember that most activist managers by their very nature tend to be value-oriented. They need to protect the downside risk for their LPs and rely upon a margin-of-safety valuation discipline in the names they chose to prosecute. If the market breaks and valuations reset materially lower, activists will have a bigger pool of opportunities to select from and you could see the number of campaigns spike higher.

In the final analysis, activism is a relative ranking game (how well do you compare to your peers). In that framework, there will always be a bottom 10%. While activists may come and go, there will always be somebody throwing down the gauntlet and challenging that bottom 10% of companies to get better.

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