

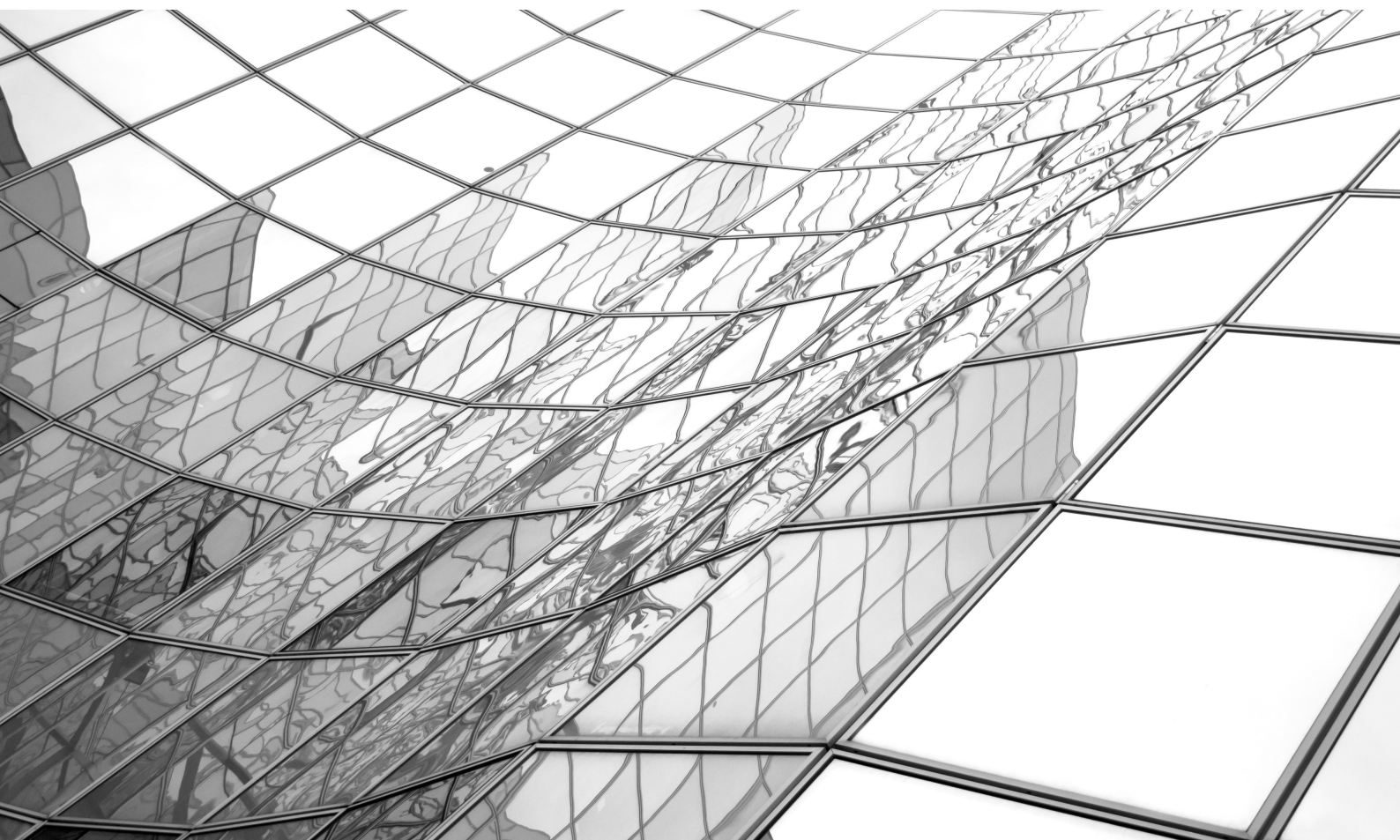


2017

Activist Insight

M&A ACTIVISM:

A SPECIAL REPORT

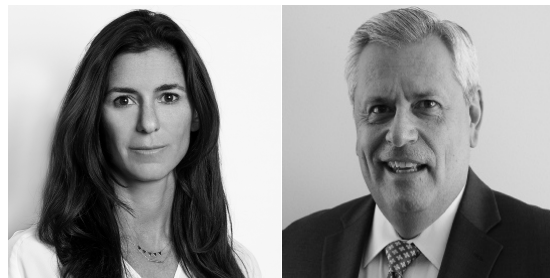


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KINGSDALE Advisors

Get the deal done



In M&A, a friendly deal can no longer be counted on as a “sure thing,” says Kingsdale Advisors.

At Kingsdale Advisors we pride ourselves on being ahead of the curve. We commit ourselves to constantly learning, innovating, and overcoming unforeseen challenges. Over the past few years, as the activist landscape has continued to evolve, we have found ourselves fighting more battles across the deal table, not just the boardroom table. Sometimes we see the usual faces, sometimes a new face and sometimes the unexpected face of a shareholder our client thought they knew. Whoever it is, the level of sophistication and effort going into matchmaking and deal-breaking by shareholders is clearly increasing.

While shareholder activism is now discussed broadly and frequently, there is little content and study on activism within the context of M&A. How often and why is the deal, not the company, becoming the target?

In this special report we quantify, clarify and shed necessary light on this phenomenon, which is too often lumped in with general activism and yet clearly operates by its own playbook. The fact is a friendly deal can no longer be counted on as a “sure thing.” By our estimates, only one-third of activist scenarios become public; it’s a good bet that almost all M&A activity has at least some activist connection.

When you consider the time, money, and effort that goes into just getting to the announcement of a transaction, it makes sense to understand, consider, and prepare for the risk that an activist can quickly derail your deal. Since 2003, Kingsdale has assisted companies around the world in successfully completing their transactions no matter the challenge.

In the pages that follow, backed up by data from our partners at Activist Insight, we will discuss M&A activism from all angles. Whether it’s the board perspective, managing the deal, pursuing alternatives, reacting to calls for spinoffs or break-ups, or knowing when to walk away – we will leave you with the knowledge that while you should be very concerned about M&A activism, there are steps you can take, both to protect your company in advance and to increase your chances of success once a deal is in motion.

To provide a depth of commentary not generally available, we have asked the co-heads of Kingsdale’s governance team, Victor Guo and Victor Li – former Institutional Shareholder Services (ISS) executives who provided vote recommendations on over 150 proxy contests and 2,000 M&A transactions – to contribute their expertise to this report.

We hope you find this report useful in planning for the future and we hope you think of us when you need support in overcoming any obstacles between you and your deal. At Kingsdale, that’s not just what we do, it’s who we are. ■

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Activist Insight Introduction



Activist Insight

The influence of activists in M&A has grown significantly since the financial crisis, says Activist Insight.

Shareholders were once a pliant bunch. With the rise of activists, spurred for years by rising assets under management, growing institutional investor support and more sophisticated analytical and tactical capabilities, there is now no area of business in which the influence of shareholders is not growing.

Nowhere is that more true or important than in M&A. Since the financial crisis, activists have caused previously unthinkable combinations, broken up conglomerates and halted some deals dead in their tracks. Moreover, as this report details, the number of M&A-related demands made over the past seven years has steadily increased, more companies have been acquired after facing an activist demand, and more large companies have been affected.

Today, companies that are under-scale, cash-strapped, or struggling in consolidating industries are under more pressure than ever from activists. A continued hot streak in U.S. markets after a pause during the U.S. Presidential election appears to suggest deal volume will be sustained, and activists are poised to benefit.

To do so, the activists no longer need to make hostile offers of their own. Today, they can count on plentiful acquirers waiting to be alerted by an activist's public letter or regulatory filing. In some cases, activists work in tandem with buyers, in others with fellow shareholders. "Activists can help start the conversation about where the value of a company really sits," Kingsdale Advisors' CEO Amy Freedman told Activist Insight for this report.

Meanwhile, driven by the impact activists have had, large asset managers and previously passive hedge funds have become increasingly willing to opine on deals, even if the default preference is still to hide in the shadows. The verdicts of proxy voting advisors, meanwhile, have become more important.

"The lines between activist investors and traditional investors are becoming more blurred by the minute," says Kai Liekefett, a Partner at law firm Vinson & Elkins and Head of its Shareholder Activism Response Team. "You cannot be sure an unhappy shareholder won't launch their first campaign against you."

This report draws on interviews and Activist Insight's extensive database of activist campaigns to help sketch out developments in M&A activism in North America. We outline activist tactics, examine the kinds of considerations boards are likely to face and suggest how companies should prepare for the onslaught.

We would like to extend our thanks to Kingsdale Advisors for their support in this project and all those who contributed to this report. We hope you enjoy its findings. ■■

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The Board Perspective

Pre-announcement preparations for shareholder approvals have become an increasingly onerous process, putting new strains on independent directors and management teams alike. Today, boards prepare early, knowing the robustness of the process will be closely monitored. Responses for various eventualities in which an activist emerges are tested. A smooth rollout, including the official announcement and conference calls, is underpinned by management selling the deal to key shareholders from the get-go.

“Understand that your process will be scrutinized,” says Joe Spedale, President, Kingsdale Advisors, U.S. “While your legal team will be able to tell you what is required and your bankers will tell you if the valuation makes sense, boards need to understand they will be held to a higher standard and the optics of the process are important, especially if the deal was done relatively fast or will appear unexpected to shareholders.”

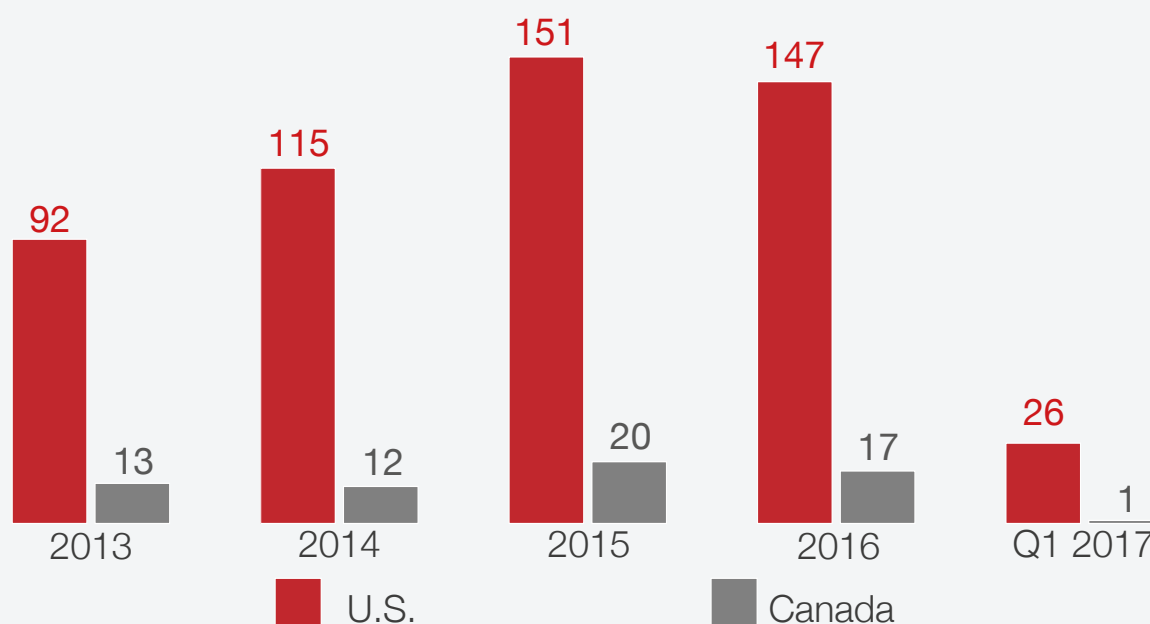
In recent years, activists have run proxy contests to prevent deals, pursued appraisal rights, and made

their own takeover bids – or in the case of computer pioneer Dell, all three. Carl Icahn’s rival bid and attempt to remove directors forced a mere \$150 million extra from the management buyout team (all currency amounts in this report US \$ unless otherwise stated), but years later a Delaware judge awarded some shareholders that had sought appraisal rights an extra 21% on top of the deal price, plus interest.

Since that 2013 campaign, M&A-related demands from shareholders have soared (see below). Some result in companies being sold that otherwise would not be in play, while in other cases deals are scrapped.

Fortunately, a number of steps can be taken to ensure deals are more resilient. Voting lock-ups are one possible step, Spedale says. If not, talk to the shareholders most likely to have reservations early and often, he says, especially if their opinions are influential. Planning a merger with Dow Chemical, DuPont did just that, inviting Trian Partners to comment on the structure of the deal privately.

Number of M&A-related public activist demands by country



Demands include: Push for merger, push for sale, push for acquisition, oppose acquisition, oppose merger/takeover, oppose terms of merger/takeover, push for company division, push for spinoff, takeover company.

Demands taken from regulatory filings, press releases, public letters, and interviews.

Source: Activist Insight Online

ISS typically ignores fairness opinions without detailed financial analysis, which are commissioned by the seller.

Above all, proxy voting agencies play a key role in determining the ultimate level of shareholder support – or opposition. ISS typically ignores fairness opinions without detailed financial analysis, which are commissioned by the seller, adds Victor Li, Executive Vice President, Governance Advisory at Kingsdale Advisors and formerly a Senior M&A Analyst at ISS. Often, ISS will take the pulse from clients and sell-side analysts to understand whether there are already doubts, he explains. If there are, they will question management on everything from the discounted cash flow analysis to the peer group used in multiple-based valuations.

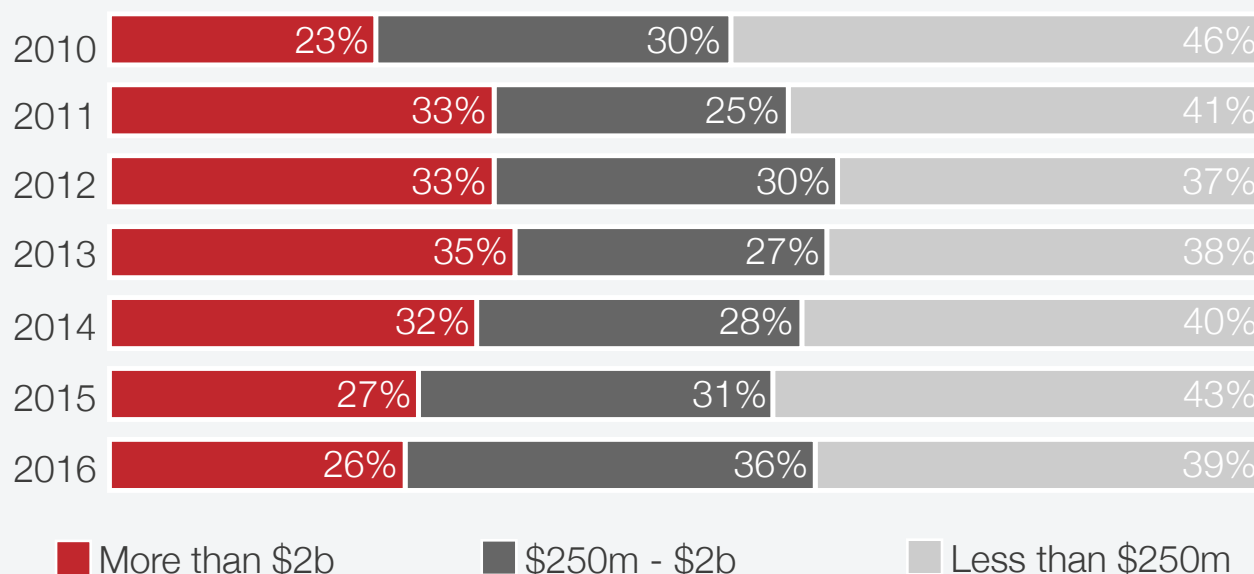
“What issuers need to be aware of is that instead of cherry-picking peer companies that are in management’s favor, it is very important to provide support and educate ISS on how the company’s peer group is generated and on what basis,” Li told Activist Insight. “If equity analysts consider other companies in the peer group, management needs a solid explanation for the difference.” ■

Who's at risk?

Outside of basic materials, services and technology companies were the most frequently targeted by M&A demands in the U.S. and Canada, testifying to the competitive nature of those industries. Software and semiconductor companies have proven particularly vulnerable, given consolidatory pressures, while retailers and restaurant chains with significant real estate can be pressured to maximize the value of those assets.

Much M&A activism takes place at companies with a market cap of below \$2 billion, as the chart below highlights. Nonetheless, the number of large deals under scrutiny has risen. Since 2014, an average of 15 issuers with a market cap of more than \$10 billion have been targeted each year in North America, although most were U.S. companies.

Market cap breakdown of M&A activism in North America since 2010



The data above refer to companies publicly subjected to M&A-related activist demands, as detailed opposite.

Source: Activist Insight Online

Managing Your Deal



An interview with Victor Guo, Executive Vice President, Governance Special Situations at Kingsdale Advisors.

How should boards approach the shareholder approval leg of M&A transactions?

Before announcing a transaction, companies need to complete a risk assessment of how shareholders will react and the resulting vote impact. If boards have been engaging shareholders they should have a good sense of what issues they might be vulnerable on and what they will need to prove to shareholders to get the deal done.

Boards should also consider how they will deal with the emergence of an activist. One thing they can do is to try and set up a lock-up agreement with shareholders.

How should boards respond to an activist?

Once an activist emerges, the board should immediately activate its already developed contingency plan as well as a communication plan. Consideration of next steps should be focused on the activists' critiques and expected traction they will find with shareholders. To mitigate this, management needs to show publicly that it has done enough homework before the announcement of the transaction. Taking too long to respond to the activist can be perceived negatively.

In advance, there should be an assessment of the shareholder base and whether it is primarily institutional or retail. Management should have a list of the top 20-30 shareholders in hand, and begin preparations to engage.

Do you think the greater concern is activist investors, or the broader shareholder base becoming more activist?

The willingness to accept activism and go activist are both increasing. What management should consider is what that willingness is predicated on and the

impact it will have. It is important to understand the activist's agenda and how it might align with other shareholders. If there is only one activist, management needs to assess whether the activist is acting alone or if there are a group of shareholders behind it. The company should consider what engagement (if any) is appropriate depending on their agenda. The really big players still don't like to be public. Even if the activist acts alone, if there is a long-term, credible institution who happens to agree, its impact cannot be ignored. Strength comes from numbers. An activist won't be showing up unless they have some degree of confidence that they will be able to sell their point of view to shareholders and, chances are, they have already talked to them.

Here is the challenge we see with the broader shareholder base in deal situations and a point that is often overlooked. These are investors who have bought into your company based on the long-term strategy and story you have been selling. You are now flipping that position on them and telling them to sell.

As such, boards need to remember they aren't just making the case for why this is the best deal they can get, but more importantly why this is a better deal than remaining as a standalone company. It's a fine line boards struggle with especially when a deal faces opposition. If there is a worry the deal could fail, management is often concerned they don't want to have said anything that will weaken or hamstring the company in the future.

Are proxy voting advisors becoming more interventionist?

Yes, and there's a general trend of shareholders applying more scrutiny to M&A. The number of "friendly negotiated" M&A transactions that were voted against by ISS has been increasing steadily over the most recent years. According to ISS' Voting

It is invaluable having Kingsdale as a strategic shareholder advisor to help review the transaction.

Analytics, in 2016 over 6% of M&A deals that were reviewed by ISS in the U.S. received an “against” vote recommendation, more than double the 2014 rate. Moreover, boards should be aware that ISS can support one side of a transaction while in fact voting against the other side if the benefits seem unfairly weighted. It is also important to note that an increasing number of institutional shareholders now do their own added level of analysis when it comes down to special resolutions.

If there is a public activist, ISS will apply more scrutiny. What companies sometimes don’t appreciate is that an ISS client might call or email feedback on a deal, and that will be sufficient for ISS to take a deeper look. Some credible retail shareholders can also have their concerns considered as part of the process. Hence, it is invaluable having Kingsdale as a strategic shareholder advisor to help review the transaction as early as possible through the lens of proxy advisors.

How important is the proxy statement in these situations?

The background is the main opportunity for the board to make its case. It’s the only section of the proxy statement that can show how hard management worked. Every single significant event should be documented, covering the entire process: what was involved, how many parties were spoken to, how negotiations went. Disclosure can have a positive

impact, and can increase the comfort level of ISS. Minimal disclosure and a take-it-or-leave-it approach can be costly.

How should companies approach demands for a “bump” in the sale price?

First, companies must realize that as soon as their deal is announced, third-parties are prepared to criticize the terms faster than ever before.

Management then has to consider the expectations of the activist, for instance if the premium is 30% and the activist wants a 45% premium. One of the things management can show is the process: the time taken, the number of financial advisors retained, potential buyers spoken to. If management only spoke to one party, and the strategic review only took three months, then you have a problem. That’s harder to defend.

Activists might also press for a standalone process. Management might have its reasons for wanting to accept an offer. If a business is in the midst of a difficult turnaround, show the activist the facts, ask their advice on how to approach the turnaround. Perception is often different from the reality, but people tend to be greedy. Explaining the downside risk and liquidity advantages of staying public might help. Then again, the activist could be right if they are really thoughtful. It’s situational. ■

Tips for boards

- 1 Prepare for an activist by viewing the deal through shareholders’ eyes, looking for weaknesses
- 2 Monitor trading activity prior to the deal, considering how the deal impacts on the goals of buyers
- 3 Take the temperature of your shareholders as soon as a deal is announced
- 4 If an activist does emerge, understand how their objective will resonate with other shareholders
- 5 Consider a settlement or confidentiality agreement, but be prepared to say no
- 6 Emphasize the robustness of the strategic review process in your proxy statement
- 7 Explain the strategy and downside risk to other courses of action
- 8 Prepare to engage with proxy advisors, provide solid backup for valuation assumptions
- 9 Equity analysts carry more weight than your financial advisor
- 10 No deal is safe – be able to “show and tell” how and why it is a good deal

Pursuing Strategic Alternatives

A persistent criticism of “hit-and-run” activism has activists interested primarily in forcing companies to sell themselves, allowing the investor to earn a quick buck but denying management and long-term shareholders the opportunity to enjoy the benefits of a longer standalone strategy. Certainly, activists have increasingly sought the sale of their targets in recent years. Activist Insight data shows demands for M&A doubling between 2011 and 2012 in North America rising by another third in 2014. On average, 47% of M&A-related activist demands since 2010 have been for targets to either sell themselves or merge with another company – reflecting the ease with which an investor can publish a letter or act on speculation in the market and a growing number of buyers.

Arnaud Ajdler, Managing Partner at Engine Capital, who regularly calls for companies to consider “strategic alternatives,” explained the process thus: “What we try to do is find a good quality business that is also undermanaged,” he says. “We then approach the board and say, ‘fix yourself in the public markets or sell yourself.’ Either is fine with us.”

Increases in valuations and M&A volume can boost the chances of management being open to these entreaties. “Most boards are very mindful of their

fiduciary duties,” says Morgan Stanley Managing Director David Rosewater, who advises companies on dealing with activists. “If the value that can be obtained at that time through a sale is compelling enough, directors are not going to resist just to keep their jobs.”

As the volume of demands has increased, so too has the inventiveness and influence of M&A activism. In 2014, for instance, activists pushed retailer PetSmart into that year’s largest leveraged buyout and partnered with a strategic acquirer to wage a hostile takeover at Allergan. Now, both strategic and private equity buyers are interested in activist targets, as the chart below highlights. Notwithstanding Ackman’s Pershing Square Capital Management being sued over the latter deal, Vinson & Elkins’ Liekefett says strategic acquirers are still working with activists – albeit more covertly.

Another strategy growing in popularity is that of taking stakes on both sides of a potential strategic combination and seeking a “marriage” of the two firms. Such moves can incur antitrust issues: a deal between Staples and Office Depot was deemed bad for competition, while ValueAct Capital Partners was forced to settle a charge of not disclosing attempts to influence a change of control a few months later when it backed the merger of Baker Hughes and Halliburton. ■



Deal Or No Deal

Activists don't just create M&A – they can often set out to wreck it. According to Activist Insight data, an average of 21% of U.S. and 45% of Canadian M&A activism between 2010 and the end of 2016 was aimed at preventing deals. In 2016, both markets saw record levels of activism opposing M&A.

Some of these demands may relate to stopping overly acquisitive companies from initiating more deals, but most are focused narrowly on the terms of previously announced transactions – about two-thirds in the U.S., and 84% in Canada. As Liekefett explains, “Activists typically don't want to kill the deal, just to reprice it.”

“Bumpitraging” – so-called because activists seek a “bump” in the share price, is getting easier and more common. Of 68 opposed mergers since 2013, 18 ended up with shareholders enjoying a higher consideration, Activist Insight found, with the average increase just under 21%.

But those cases were a minority. Several deals with equity components worsened, and most deals continued on the same terms. The problem with fighting an announced transaction, Ajdler says, is that “you work very hard and at the end, either the buyer walks away and the stock goes down significantly, or there is a small increase in price and most investors, especially arbitrageurs, cave.”

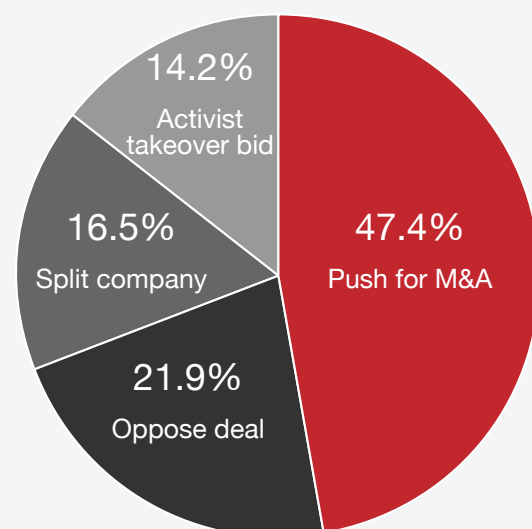
Still, certain circumstances can encourage an outbreak of shareholder opposition. Longstanding shareholders, including pension funds and value investors, can be stirred if they believe a stock they own is being sold at a low price or less-than-advantageous time. If the deal is likely to offer synergies, the pressure can be more intense. AMC Entertainment ended up paying more than 10% extra and offering a cash-stock mix option to acquire Carmike Cinemas in 2016, following vocal opposition from two investors. Bumpitraging is also an easier game to play with tender offers, which can be amended and extended and don't require a shareholder meeting.

“Failed votes rarely come back on improved terms,” Spedale warns.

At other times, an activist might argue that a company has neglected potential avenues for value creation. “Now, if a company hasn't been shopped, then it's a different story, because you can flush out other bidders,” Ajdler explains. “But most companies tend to shop themselves these days.”

Such was the case in Carl Icahn's unsuccessful attempt to push Family Dollar to merge with Dollar General in 2015. Family Dollar had already held secret talks with Dollar Tree and discounted Dollar General on antitrust grounds. After warning that Icahn had nearly disrupted an achievable deal, the Dollar Tree transaction sailed through. Having beaten the announcement, Icahn still elicited a profit from the trade, unlike those that followed him. ■

Breakdown of M&A-related activist demands at North American companies since 2010



Breakdown of M&A action type by objective.

Source: Activist Insight Online



The Breakup Shakeup

Approximately 17% of M&A activism in North America seeks the breakup of companies through the sale or distribution of business divisions, running as hot as a quarter of demands in some years. Public letters, proxy contests and non-binding shareholder proposals are all common tactics for activists with this in mind, as with Carl Icahn at eBay or Relational Investors and the California State Teacher's Retirement System (CalSTRS) at Timken.

Often proactive by nature when the company is intent on remaining a conglomerate, these campaigns have on occasion been more reactive, as with Darden Restaurants' sale of its Red Lobster restaurant chain. Starboard Value believed management was making a mistake, hoping instead to spin all of Darden's property into a real estate investment trust (REIT). Unwilling to criticize Red Lobster's business and therefore unable to explain why it was selling it to private equity firm Golden Gate Capital, Darden was routed in a proxy contest later that year.

Some demands turn on a dime. In 2014, Sandell Asset Management ran a proxy contest at Bob Evans Food, narrowly missing out on a majority of the board, which would have allowed it to separate a frozen foods business run by the restaurant chain. More than a year later, the company changed its CEO and began engaging anew with the activist. In January 2017, it sold its restaurant business to a private equity firm, creating the pure-play frozen food division the activist sought.

Deal structure matters

How a deal is structured can play a critical role in its eventual success. Mergers requiring a shareholder vote can be risky, especially if the consideration is wholly or partly stock-based and can be buffeted by choppy markets, as with the AB InBev-SABMiller deal after Britain voted to leave the European Union. Dead votes, when shareholders of record sell before voting or before a revised bid is made, can also be an issue.

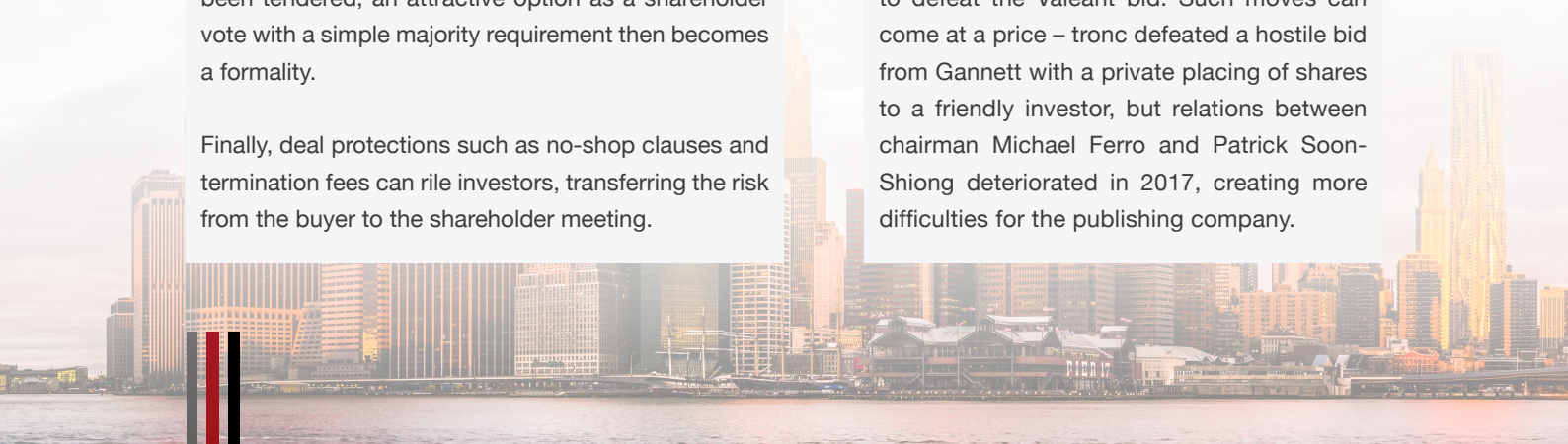
Tender offers, which can be easily amended and extended, are often more susceptible to arbitrageurs playing holdout, as with Carl Icahn's recent acquisition of Federal-Mogul. ISS and Glass Lewis are less likely to opine on tenders – another bonus. In certain conditions, Delaware companies have been able to move to a merger after the majority of shares have been tendered, an attractive option as a shareholder vote with a simple majority requirement then becomes a formality.

Finally, deal protections such as no-shop clauses and termination fees can rile investors, transferring the risk from the buyer to the shareholder meeting.

Hostile M&A

Special meeting requests, proxy contests, and poison pills increasingly help to blur the lines between activism and hostile M&A. In 2016, French pharmaceutical company Sanofi launched a consent solicitation to remove directors of its target Medivation, requiring only majority support under the latter's by-laws, although it was later trumped by a bid from Pfizer.

The year before, Allergan had seen its case against a takeover by Valeant weaken as it sought to deny activist Pershing Square a requested special meeting where directors would have been up for removal. Again, it needed a white knight in the form of Actavis to defeat the Valeant bid. Such moves can come at a price – tronc defeated a hostile bid from Gannett with a private placing of shares to a friendly investor, but relations between chairman Michael Ferro and Patrick Soon-Shiong deteriorated in 2017, creating more difficulties for the publishing company.





What Lies Ahead?

Whatever the precise form, M&A activism looks likely to persist. It can be relatively cheap, using public letters to draw attention to opportunities, and lucrative; of 68 opposition campaigns, only a minority succeeded but the overall average increase in consideration was 5%. Yet it can also be toothless if most shareholders back management.

The experience of 2016 suggests volatile markets and a lull in deal volume can make investors restive – that year, demands opposing M&A doubled in the U.S., while attempts to promote M&A activism fell by one-quarter. In booming markets, activists are more willing to attack boards and management teams and run proxy contests on almost the sole issue of whether a company should be sold.

the transaction. It now has a fully functional team, California-based Evergreen Coast Capital, providing private equity to the tech industry.

Some see private equity trending the other way – becoming more activist. Several private equity firms have taken large positions in publicly listed stocks in order to drive change. At NRG Energy, in what may be the first case of its kind, Bluescape Resources formed a group with Elliott to push for board changes. While New York City Comptroller Scott Stringer called the settlement “hasty and deeply flawed,” Bluescape’s director was re-elected. With competition for buyout firms increasing, some reason that bids by private equity firms could become more hostile, or indeed activist.

“With competition for buyout firms increasing, some reason that bids by private equity firms could become more hostile, or indeed activist.”

In the immediate future, it seems unlikely that activists will be any less important to the functioning of M&A than they currently are. Instead, many expect to see the partnership invented by Pershing Square and Valeant Pharmaceuticals replicated in a slightly different form, despite its current legal troubles and the dismal subsequent performance of Valeant. So far, the tactic has only been replicated by Lone Star Value Management, at much smaller companies.

Other recent episodes show activists flirting with the idea of pursuing strategies closer to private equity. Elliott Management, which helped broker the largest-ever leveraged buyout in the technology space – Dell’s acquisition of EMC – partnered with Francisco Partners to acquire Dell Software Group as part of

Pressure for traditional investors to take an active role overseeing portfolio companies will undoubtedly require more engagement from boards looking to pilot through M&A. Tougher standards from proxy voting advisors and deeper analysis by shareholders could make the post-announcement process more important and time-consuming. In this environment, there will be plenty of fuel for dedicated activists.

“Whether running a vote no campaign or pushing a company toward a particular transaction, the sheer number of activists, their assets under management, and the fact they are targeting small and mid-size companies in recent years makes it clear we will see much more in the coming years,” concludes Spedale. “M&A is cyclical but activism is not.” ■■





KINGSDALE Advisors

WINNING IS EVERYTHING.

When every move matters you need North America's most trusted advisor to management, boards and the leading activists who target them.

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Since 2003, public companies have looked to the expertise of Kingsdale Advisors on all shareholder, governance, and transaction related matters.

We leverage the strengths of our multi-disciplinary team to design breakthrough strategies for the most complex challenges, providing superior execution and hands-on shareholder interaction.

Our specialized services set us apart: Strategic & defensive advisory; governance advisory & proxy analytics; strategic communications; and voting analytics.

- In-house proxy advisor style analysis conducted by industry leading governance team co-headed by former ISS executives who provided vote recommendations on over 150 proxy contests, 2000 M&A transactions, and over 1000 shareholder rights plans.
- Analysis to determine the composition and distribution of the shareholder base to project support.
- Profiling significant investors and determining their propensity for joining in activist activity.
- By-law and corporate defense review.
- Director profiling and vulnerability analysis.