# Shareholders Activism: recent trends and strategies

**Whitbread plc (LON:WTB) – market cap as of 04/05/2018: £7.84bn**

## *Introduction*

Conflicts of interest between shareholders and managers represent an old phenomenon and an inherent element of capitalistic governance systems. It stems from the fact that managers tend to profit from simply because their companies are getting bigger (through higher salaries, increased social standing, etc.) and not necessarily when shareholders' value increase. Management might be therefore incentivised to enter or invest in riskier projects of questionable profitability. On the other hand, payout of larger dividends or buybacks programmes, both of which are means to increase profit attributable entirely to shareholders, might be disregarded.

Under failures in monitoring managers, the temptation for excessive compensation and perks as well as tendencies for building corporate empires are even higher. Those activities are highly detrimental to shareholders because they squander the free cash flows of a company. For this reason, shareholders may undertake a variety of activities in order to improve the return on their investments and better control the management.

## *Overview of shareholders activism*

Shareholders activism is a fairly broad concept, which relates to a range of actions and can affect a company on multiple levels. It can take many forms: from aggressive, short-term oriented corporate raiding on one side of the spectrum, to passive engagement management on the flipside. In the following paragraph, we will discuss its main characteristics, the different types of activism, typical strategies related to it and the characteristics of the most common targets.

In the U.S, the majority of block-holders (owners of a large block of company's shares) are institutional investors (mutual funds, investment companies and pension funds). Nevertheless, they are rarely actively engaged in corporate governance. Very often they cannot get involved due to excessive regulations. Moreover, since most of the mutual funds track stock indexes, their superior returns can only come from lower costs, so that they are left with little money to pursue active monitoring. Still, institutional investors might get involved in "activism" (active monitoring) indirectly, by cooperating with activist hedge funds, an issue which we will discuss in more detail in the subsequent part of the article.

Activism falls typically under the scope of hedge funds, but it can also be done by private equity firms or wealthy individuals. Hedge fund activists differ from their traditional institutional counterparts by having more concentrated portfolios, enhanced performance incentives and less regulatory constraints. Such a combination makes them more likely to succeed in bringing a change to the organization.

As already mentioned, the most aggressive form of activism is corporate raiding. It refers to hedge funds trying to make a quick profit by forcing the acquisition of a company (typically hedge funds are on the sell side). Usually, the strategy of an activist would be to identify an undervalued company and buy a significant portion of its shares. By using the voting powers acquired, the hedge fund would gain seats on the board of directors in order to remove any opposing party to the takeover and foster the success of the transaction. Corporate raiding was especially prevalent in 1980s, when countless hostile takeovers took place.

As a result, activist hedge funds gained the bad reputation of short-term opportunists, which might harm the long-term value of the company. Involvements in the strategic or operational decisions with the aim to improve the company's value in the longer-term was rather a non-existent strategy for hedge funds at the time. Nowadays, however, hedge fund activism often entails positive changes to the strategy and governance of the company and focuses on long-term value building.

On the opposite side of the spectrum is "engage management", which refers to the situation in which shareholders make general statements on the condition of the company, but do not try to enforce any specific action plan. This is the least invasive form of activism and usually not the most effective one.

### *Activists` strategies*

The most typical areas in which activists focus in order to unlock shareholders value are the following: Capital Structure, Corporate Governance, Business Strategy, Mergers and Financing.

With regard to Capital Structure, activists may opt for dividend pay-outs, stocks buybacks or target recapitalization. This is the strategy of activists with short-term investment horizon but, however, these strategies may also be employed by longer term activists too).

Under Corporate Governance, activists tackle the issues of executive compensation, lack of transparency, corporate fraud, replacement of the management or – in extreme cases – replacement of the CEO. It often results in the so called 'proxy battles': unfriendly contests for the control over an organization, where many companies subject to activism are reluctant to settle. Activists would rather opt for a proxy battle – although it can heavily exploit corporate resources and may be very disruptive to the ongoing business of the company – if they believe that short-term disruption costs are lower than the long-term value creation/benefits coming from better corporate governance. Recently, a proxy fight that received a lot of media's attention was the one between Procter & Gamble and famous activist investor Nelson Peltz (founder of Trade Fund Management). It is estimated that collectively they spent more than $100 million dollars on the contest.

With respect to the Business Strategy issues, activists usually attempt to spin-off unprofitable business lines or sell "non-core" assets. Spin-offs refer to situations where a particular business unit is rendered as a separate business and legal entity. By doing so, the parent company can focus more on the divisions with better growth potential in the long-term and/or specialize on its core operating business, which is tantamount to channelling more resources to the most promising businesses. Activists can also push for the sale of assets: very often the activists themselves will also be the buyers of those assets. Moreover, an investor can also decide to block particular takeover offers if perceived as inadequate or not maximizing shareholders' value. Typically, hedge funds with short investment horizons decide to get involved in these strategic issues implying a quick sale of the company's assets in order to obtain a quick return on their investment, whereas, longer term activists are more involved in the fundamental strategic issues of a company that determine its long term success.

The last means of activism represent the provision of financing for a company in distress or with restructuring issues.

### *Targets of activists' investments*

In general, the approach of hedge funds when choosing the targets is discretionary. Still, there are a few characteristics which make certain companies more vulnerable to shareholder's activism than others.

First of all, activists look for companies with low market to book value which at the same time are profitable and have solid operating cash-flows. Alternatively, they might get interested in companies with diverse business portfolios in order to push potential sale of units or attack the companies with an above than average excess cash available.

Besides, an attractive target would be a company which doesn't follow today's "best practices" of corporate governance. It especially concerns the companies with lavish spending or extravagant benefits and perks such as first class travel, excessive meal expenses or costly corporate events and parties. It is usually a distinctive feature of well-established, mature companies, where management and employees tend to become complacent over the years and are used to getting generous pay checks and bonuses, which from a shareholders' perspective may be inadequate compared to the performance of company. In such a case, activist investors usually leap into action and execute lean management and more efficient organizational forms, or even try to replace the management. Unsurprisingly, this type of strategy often triggers strong objection and resistance from the management and, again, may lead to great tensions with investors.

The last group of potential targets are the companies which have experienced some serious obstacles. For instance, they might have lost a significant portion of their market share or overlooked a strategic opportunity. As a result, the stock price can sharply fall, over a particularly short period of time. In this case, current shareholders might be particularly prompt to exit the company. This is a great opportunity for the activists, as they can purchase stocks at a cheap price and possibly also obtain board seats.

Finally, a company with any easily identifiable and fixable problems or a company with any combination of the above mentioned conditions would also be an attractive target for activists.

### *Current trends*

Activist investing is a very prosperous business and it doesn't seem like it will disappear any time soon. Quite the contrary, nowadays activist hedge funds are targeting more and ever bigger companies.

Historically, the main focus was on smaller cap companies, which was related to the limited amount of capital at activist hedge funds' disposal. It is important to remember that in order to be able to push changes effectively, activist ought to purchase at least 5% stake in a company.

Throughout the years, however, activists achieved impressive rates of return, especially when compared with predominant passive investing approaches. Moreover, with a shift from short-term to long-term activist strategies, they captured the attention of institutional investors, who recognized the benefits of active engagement in corporate performance or operational issues of companies and thus were willing to lend support to hedge fund activists.

The close cooperation with institutional investors is beneficial for hedge funds not only in terms of additional source of financing but also in case of strong opposition from the management. Hedge funds may want to side with institutional block-holders in order to gain a board seat. Such a strategy may be crucial, especially when activists hold only a small share of ownership in the company. As long as the activists' goal is to improve the company's performance over time, it is the institutional shareholder's best interest to accept the activist on the company's board.

One of the implication of it is that nowadays many activists attempt to distinguish themselves from "bad actors" known from the times of hostile takeovers. They try to portray themselves as keenly concerned in governance, social or environmental issues and emphasize the long-term consequences of their involvement rather than short-term returns.

Having been able to attract new partnerships, activists' assets under management grew at a higher rate than the overall hedge fund industry. As of January 2017, AUM of activist hedge funds amounted to $97.9bn. For the time being, therefore, activists have enough capital and leverage to shift towards large cap companies. For instance, in 2014 only 8% of the total number of targets were large cap companies. Since then, it has steadily grown and as of 2017 it constituted 21% of total number of targets

One last important trend, which cannot be passed over in this context, is the rise of shareholders' activism outside US, particularly in Europe. An apparent reason for this is a bullish stock market paired with higher than ever valuations in US. Taking into account that for activists the most promising investments are still the companies valued between $1 and $10bn, current market forces imply difficulties in winning such targets and finding potentially undervalued companies in US.

Lower valuations in Europe and favourable economic conditions signal further inflows of activist investors' cash to Continental Europe in the near future. The political situation is also supportive, as in 2017 the European Union implemented the shareholders' rights directive, which has the primary purpose of encouraging a long-term shareholders' engagement.

### *Assessment of the practicalities and dynamics of shareholders activism on target companies*

Empirical evidence has shown that the investment horizon of institutional investors is an important determinant of hedge fund activism. Firms that have a greater percentage of long term horizon institutional investors in their ownership structure receive more interest from hedge fund activists, as both types of investors demand an improved corporate governance structure. In fact, what tends to happen is that activist shareholders are more likely to monitor firms side by side with other long-term shareholders. Moreover, this cooperation increases the probability of hedge fund activists to receive board seats and initiate proxy fights, suggesting an alignment of these with long-term activists to reduce agency problems with the management team. On the other hand, firms predominantly owned by short-term investors, are more likely to have de-listings, spinoffs, and divestitures, as shareholders are mainly concerned about obtaining a good return on their investments (as they are not truly concerned about the long term viability of the company). Empirically (based on a historical sample) it has been illustrated that the operating performance of firms with short-term institutional investors does not improve as compared with peers characterized by a greater concentration of long-term investors, which see significant improvements in firm performance following hedge funds' activism. Therefore, the investment horizon of institutional investors in companies is a crucial determinant in understanding the targeting and campaigning effort of hedge funds in addition to the potential impact of activist on the long-term profitability and performance of the target company.

This supports the idea that institutional investors may value activists' ownership, as it is an indicator of security given the involvement of activists is a cost-free oversight of management for institutions. Activist investments may also signal to institutional investors that the company is not being fully recognized and valued correctly by the market and hedge funds, by getting involved in the target company, strive to converge the current valuation of the company to its "real" valuation (thus, obtaining a positive ROI). To this extent, previous literature has demonstrated that activist investments have a positive effect on the returns of a company, where companies with long term horizon investors experience a higher return than firms with short term horizon investors. However, this assertion has to be weighed against the potential detrimental effect that activist investors involvement may have on the corporate governance of a firm due to the defensive moves initiated by the management team to stave off the attempts of activist, who are striving for a change in management. In fact, previous studies have shown that activists are attracted to firms with weak governance structures.

### Whitbread and Costa Coffee case study

*Brief overview of Whitbread and its performance*

At Premier Inn, it has been renovating its UK properties and continuing with steady expansion internationally, particularly targeting Germany. Whitbread said total Sales growth at Premier Inn was 4.7% in the third quarter and 5.9% in the year to date, slower than the chain reported for the same periods in 2016.

*Brief overview of Costa Coffee and its performance*

Costa Coffee is UK`s biggest coffee chain, with more outlets than Starbuck and Caffè Nero combined (Starbucks, Caffè Nero and Costa Coffee represent the three UK`s biggest coffee chains). The company has pursued an aggressive expansionary strategy in recent years targeting more than 3,000 shops in the UK by 2020, despite its aggressive business plan Sales growth have slowed in recent quarters (8.3% YTD but lower compared with last year). According to Costa Coffee`s chief executive, Alison Brittain; "well-publicised weak retail market footfall is negatively impacting our high street stores' like-for-like performance and we expect this to continue for some time". One of the major explanations of growth stalling has been the struggling of retail and leisure businesses across the UK, as UK consumer spending fell for the fourth consecutive month, rounding off the weakest annual performance since 2012.

*Rationale of Shareholders Activism in the Deal*

Elliott Management Corporation become the major shareholder of Whitbread when it acquired 6% of the company's shares mostly via contracts for difference. Once major shareholder, it presented a business plan to spin off Costa Coffee from the Premier Inn chain, the company`s other main business segment. Furthermore, the emergence of another activist hedge fund, Sachem Head, that acquired 3.4% of the company`s shares in December 2017, also fostered the separation of the two business units.

It is worth noticing that Whitbread`s share price surged by 7.5% on the news that Sachem Head Capital Management bought 3.4% of voting rights, and the increase in the stock price was the highest among the last 8 years (until December 2018). The reason for such a change in Whitbread`s stock price was mainly attributed to the fact that already in December 2017, activists were proposing the disposal of Costa Coffee and a sale and leaseback of other assets. More specifically, Costa Coffee was trading at just 9x P/E, whereas recent deal values in the coffee shop sector had been transacted at a minimum of 10x P/E, thus signalling how Costa Coffee was trading below the sector average and median (actually trading in the low quartiles). Therefore, the spin-off of the company was perceived positively by the market as it created value and boosted valuations. More importantly, it would have solved the main question Whitbread investors were asking themselves: "Why is our coffee shop segment trading at (lower) multiples that do not correspond to the industry in which it belongs?" Moreover, according to Sachem head, with the disposal of Costa and the sale and leaseback of the property portfolio, Whitbread would have been able to achieve an EV (enterprise value) of 15x EBITDA (earnings before interest tax depreciation and amortization) leading to a share price of £44-49.

Therefore, the emergence of Elliott Management Corporation as a major shareholder backed by another hedge fund activist Sachem Head increased the likelihood that the coffee to hotels group would have been broken up leading to a wider change of strategy. In fact, Whitbread shares closed at £42.18 at the news, more than 7% higher showing a similar gain to that seen in December 2017 from the disclosure of Sachem Head`s involvement. Nonetheless, Whitbread`s share price remains cheap when compared to the FTSE 250, an index of mostly UK exposed companies, as its share price trades at a lower P/E multiple than the index.

Nonetheless, some analysts disagree with the prevailing market sentiments regarding the spinoff, as they argue that Costa Coffee will not achieve the same multiple valuation as the coffee industry benchmark, unless it does achieve a more stable and secure growth acceleration. Whitbread itself always insisted to keep the two different segments together, as so to exploit savings and an efficient internal capital management (namely, the cross subsidy of cash flows from more mature industries to fast growing ones). In fact, Costa was a fast growing business with a high return on capital, thus generating a high cash balance which was then used to finance Premier`s Inn growth. Therefore, without Costa`s free cash flows, Premier Inn might have to slow down expansion, make more use of leaseholds, or borrow more in order to sustain its growth targets.

On top of Costa`s spin off recommendation, hedge fund activists have proposed Whitbread to gear up its balance sheet in order to provide cash returns to its shareholders as an additional way to spur stock price appreciation. This proposal, which has been rejected by Alison Brittain (chief executive), comes at a time in which Whitbread is experiencing a change in its corporate governance structure, whereby Alison Brittain will be replaced by Adam Crozier (currently Whitbread`s senior independent board director) in February 2019. Therefore, there might a chance for the proposal to be backed by the new chief executive due to his softer stance.

Overall, Costa`s spin-off represents another victory for Elliott`s long established London outpost (as opposed to Sachem who failed to convince the firm to pursue the disposal of Costa Coffee in December 2017). As of today, by separating the two businesses, Whitbread could create value for a nominal amount of £1bn, thus achieving an Enterprise Value of approximately £10bn. Assuming that Costa could command a premium approximately similar to Greggs (main competitor of Costa), the spin off would value Costa at an EV of £2.4bn, at a multiple of 10x forward one year P/E. On the flipside, Premium Inn would be valued at £7.2bn, a 12x P/E. However, the main issue for investors – and creditors – is that by demerging the firm, its cash flows will become more uncertain as there is no guarantee from either of the two businesses to repay each other's debt. This, in turn, puts pressure on covenants compliance, which could lead to a capital injection potentially reducing the value of the company. (Note: most demergers are characterized by a joint liability agreement whereby all the previously existing debt prior to the demerger are still cross-guaranteed, whereas, all new debt is covered exclusively by the issue.)