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The Activism Vulnerability Report

Q4 2021

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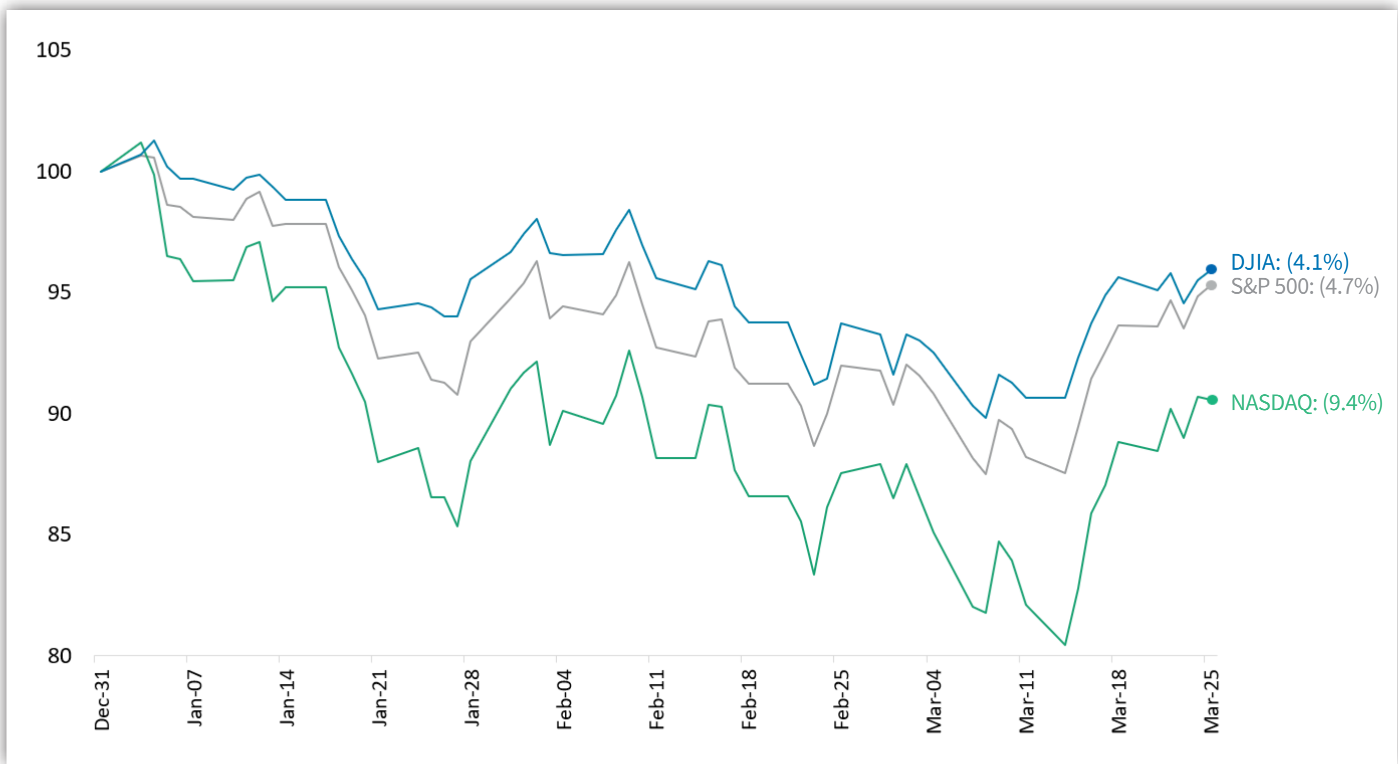
Intro and Market Update

With the cold air subsiding and milder temperatures arriving, we welcome friends, clients and readers back to FTI Consulting's ninth quarterly Activism Vulnerability Report, which will present findings from our Activism Vulnerability Screener for the fourth quarter of 2021 and discuss other trends and happenings in shareholder activism and engagement.

During the final quarter of 2021, investors experienced heightened volatility as strong consumer demand and pressure from continued supply chain headaches powered the rapid rise of inflation. Despite this headwind and the beginnings of the Omicron variant COVID surge, major indices finished the year up handsomely.[1]

In January 2022, however, major indices came under increased pressure, with the S&P 500 suffering its worst monthly performance since March 2020, as valuations on certain high-profile names came down meaningfully. Russia began military operations which eventually became an invasion of Ukraine, leading many nations to impose heavy economic sanctions on Russia.[2] With so much uncertainty surrounding US economic policy and challenging geopolitical tensions abroad, markets dropped precipitously and continue to trend toward the downside with considerable volatility. Year-to-date through March 25th, the Dow Jones Industrial Average is down 4.1%, the S&P 500 is down 4.7%, and the Nasdaq is down 9.4%. Over the same period, the VIX is up over 19%.[3]

Year-to-Date Performance (2022)



[1] FactSet, market data from October 1, 2021 to December 31, 2021

[2] https://www.nytimes.com/2022/02/21/business/economy/ukraine-russia-economy.html

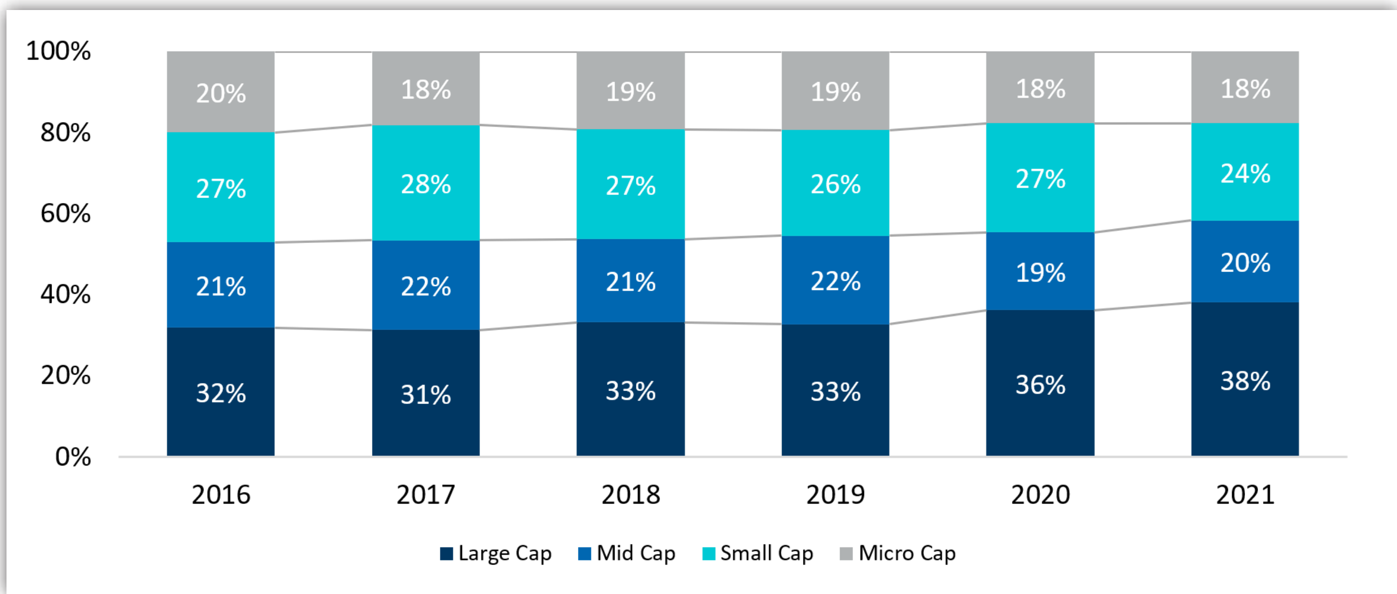
[3] FactSet, market data as of March 25, 2022

Activism Update

U.S. shareholder activism decreased by volume in 2021, with publicly disclosed U.S. activist targets down 9% from 2020 levels (456 U.S.-based companies were subjected to activist demands in 2021 compared to 503 in 2020).[4] The Technology and Consumer Cyclical sectors were the most targeted sectors in the U.S. during 2021, followed closely by the Industrial sector. Within the Consumer Cyclical sector, the Retail industry has seen particularly heightened activist activity in 2021, with insurgent shareholders launching high-profile campaigns at Saks, Inc., Macy's, Inc. and Kohl's Corporation. When compared to 2020 activity, the Consumer Defensive sector experienced the largest increase in activist attention, while the Funds sector saw the strongest decrease, as determined by new targets.[5]

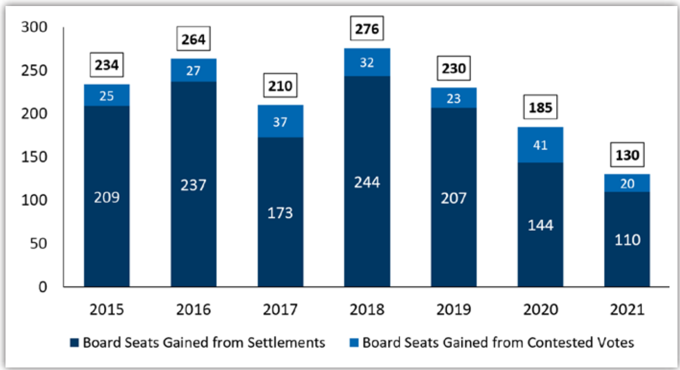
2021 also witnessed the continuation of a five-year trend of increased focus within the U.S. on large-cap companies (> $10 billion market-cap). Large-cap corporations represented 38% of all new U.S. activist targets with at least $50 million in market-cap in 2021. This compares with 36% of all targets in 2020 and 33% of all targets in 2019. The small-cap ($250 million – $2 billion market-cap) segment experienced the largest decrease within U.S. activism targets in 2021. The uptick in large- and mega-cap activism in 2021 may be due to the greater stability offered by larger and more established companies during the COVID-driven uncertainty of the last two years.[6]

U.S. Activist Targets by Market Cap



Total board seats gained by activists within the U.S. finished 2021 at the lowest level since 2015 by a significant margin (when Insightia, formerly known as Activist Insight began tracking the data), down nearly 30% vs. 2020's already low level. Interestingly, board seats gained from contested votes also dropped significantly in 2021, finishing the year down 51% from 2020's record high.[7] These data points suggest the optics surrounding the pandemic and lingering inflation concerns exacerbated activists' willingness to settle.

[4] https://www.activistinsight.com/download/5340/
[5] Ibid
[6] Ibid
[7] Ibid



However, it would not be fully accurate to interpret these voting results as a full-throated endorsement of companies and their boards. For instance, when including the many uncontested director elections, the number of directors at U.S.-listed companies who received less than 50% shareholder support was at the highest level since 2017. In another measure of shareholder sentiment, results on say-on-pay votes were largely in line with 2020 and other recent years.

Moving to individual activists, brand-name activists continued to deploy the most capital in 2021 for new campaigns. Third Point finished as this year's most active fund with $4.6 billion invested in new campaigns, followed by Elliott Management and Starboard Value, with $2.6 billion and $2.0 billion, respectively.[8]

Among campaigns launched, one recent trend has been activists launching full slate director nominations in several cases. Mantle Ridge nominated a full slate against retailer Dollar Tree.[9] The contest settled with the company agreeing to add six of the activist's eleven nominees, along with a mutually agreed upon seventh director; it has been rare historically for a company to agree to a controlling slate in a settlement agreement. A separate theme of the 2022 proxy season has been several high-profile campaigns focused on encouraging companies to spin-off or sell segments of their businesses, in order to achieve full valuation of the assets and streamline operations.

On the regulatory side, the SEC recently proposed changes to 13D and 13G filing requirements that may have a large impact on how activists build their positions in potential targets. Currently, a 13D must be filed within 10 days of acquiring beneficial ownership of more than 5% of a covered class. The proposed rule would shorten the deadline to just five days after acquiring beneficial ownership of 5% or more. As for 13G filings, the deadline changes are identical for Passive Investors (shortened deadline from 10 to five days after beneficial ownership of 5% or more), but much more dramatic for Qualified Institutional Investors ("QIIs") and Exempt Investors ("EIs"). The current deadline for QIIs and EIs is 45 days after the calendar year-end in which beneficial ownership exceeds 5% or more, while the proposed rule would be just five business days after the month-end in which beneficial ownership exceeds 5%.[10]

The proposed rule changes would also deem the owner of a cash-settled derivative security, other than security-based swaps, a beneficial owner of the reference equity securities if the owner intends to effect change or exert influence on the issuer. Currently, only holders of derivatives that were settled "in-kind," or otherwise convey a right to acquire the covered security within 60 days, are considered beneficial owners. Under the proposed changes, holders of such derivatives would be required to disclose their positions in combination with their equity exposure to demonstrate their total legal interest in the issuer.[11]

Further, the SEC proposed an amendment to Rule 13d-5 to "clarify that forming a group does not require an agreement," which had been the differentiating factor between those acting together and those who were acting in parallel without disclosed communication.[12]

The first mover advantage is crucial in many activist campaigns, and these rule changes will force activists and "wolf packs" to adjust their current strategies for covertly acquiring large stakes in potential targets. If the SEC were to implement these changes, activists would have to get creative to stay under the radar in order to maximize the effect of their campaign launch.

[8] Ibid

[9] https://www.reuters.com/business/activist-investor-pushes-dollar-tree-board-refresh-2021-12-10/

[10] https://corpgov.law.harvard.edu/2022/03/06/sec-proposes-amendments-to-schedules-13d-and-13g/

[11] https://corpgov.law.harvard.edu/2022/03/06/sec-proposes-amendments-to-schedules-13d-and-13g/

[12] Ibid

In Focus: Consumer Retail Activism

Remember the early days of the pandemic, when few people were comfortable leaving their homes or apartments to venture out to work, shop or socialize? The fear and uncertainty stemming from the illness forced these everyday activities online and tremendously accelerated the digitalization of the world economy. Zoom and Microsoft Teams became the new office, Amazon, UberEats or other delivery apps transformed into the new grocery stores, and the e-commerce arms of retail stores created the only form of shopping available. And now, this rapid transformation of how we work, shop, and interact with those around us seems to have culminated in the advent of the "Metaverse."

The excitement, and necessity, surrounding the push to digitalize the global economy was not lost on retailers who worked to bolster their position in the ever-growing digital space, and it was certainly top-of-mind for many financial professionals who sought to seize the lucrative opportunity. As we worked through the pandemic era, a new trend seemed to have emerged in the activism arena. Activists started to analyze retail data that demonstrated rapid increases in online sales and, naturally, a noticeable drop of in-store activity, and recently began targeting some of the biggest names in retail.

While not necessarily an activist campaign, in early March 2021, Hudson's Bay, the parent company of Saks Fifth Avenue, spun off Saks' online business and sold a minority holding to Insight Partners at a valuation of $2 billion.[13] The $2 billion dollar valuation of the online entity was about 30% higher than the valuation at which Hudson's Bay was taken private only about a year earlier. Then, in October 2021, the Saks online business announced its intention to IPO at a valuation of $6 billion, three times the valuation it received just seven months prior.[14] Clearly, investors are currently willing to pay a hefty premium for major players in the new digital regime.

The success that Saks' online business experienced in such a short time was likely the catalyst for activist investors to jump into the fray, targeting peers of similar size and stature. The first such campaign was initiated in October 2021 by Jana Partners, who called on Macy's to separate its e-commerce business, claiming the move could double its valuation at the time to $14 billion.[15] More recently, in December of 2021, Engine Capital sent a letter to the board of Kohl's urging the review of strategic alternatives, one of which being the divestiture of its online operations. Engine emphasized that the valuation of the e-commerce business could be worth as much as $12.4 billion on its own, close to double the entire company's market valuation of about $7 billion at the time the letter was sent.[16] In both cases, the suggestions of the activists were turned down, but as of this writing the campaign remains ongoing, with Macellum Advisors now leading the Kohl's campaign.

We will be watching closely to see how these campaigns progress, and whether new campaigns working off similar ideas will be launched, especially now that COVID restrictions are beginning to ease worldwide. People are going back to work in the office, traveling and socializing as they were before, and shopping in-store once again. As life returns to normal, the explosive growth of online business seems likely to decelerate. In such an environment, the idea of splitting large retailers may not be as attractive as it once was, but time, and results, will tell.

[13] https://www.wsj.com/articles/saks-e-commerce-unit-begins-ipo-preparations-11634508756?page=1

[14] Ibid

[15] https://www.bloomberg.com/news/articles/2021-10-06/activist-jana-calls-for-macy-s-to-spin-off-e-commerce-unit?sref=p5QwRxCz

[16] https://www.wsj.com/articles/engine-capital-urges-kohl-s-to-consider-e-commerce-separation-11638745345

Screener Results

Rank	▲ Rank QoQ	FTI Industry	Q4 2021 Vulnerability Score	Q3 2021 Vulnerability Score
1	▲ 6	Biotechnology	59.9	56.2
2	▲ 8	Telecommunications	58.6	55.7
3	▼ 2	Utilities	57.7	63.5
4	▲ 12	Automotive	57.7	54.2
5	▼ 3	Aviation & Airlines	57.1	59.5
6	▲ 3	Healthcare Services	56.5	55.7
7	▼ 4	Media & Publishing	56.3	58.8
8	▼ 4	Savings Banks	56.2	58.1
9	▲ 5	Agriculture & Chemical Products	54.9	54.5
10	▼ 5	Aerospace and Defense	54.6	57.5
11	▼ 5	Insurance	54.4	56.9
12	▲ 9	Consumer Finance	54.0	50.6
13	▲ 9	Business Services	53.9	50.5
14	▲ 4	Consumer Non-Durables	53.8	52.1
15	▼ 4	Pharmaceuticals	53.6	54.9
16	▲ 15	Technology-Software	53.6	46.8
17	▲ 10	Consumer Durables	53.5	48.4
18	▼ 10	Regional Banks	52.9	56.0
19	▼ 7	Restaurants	52.8	54.8
20	▼ 1	Financial Conglomerates	52.7	51.8
21	▲ 3	Construction	52.6	50.0
22	▼ 5	Hospitality & Gaming	52.3	52.6
23	▼ 8	REITs	51.0	54.3
24	▲ 6	Industrial Equipment	50.9	47.7
25	▲ 8	Life Sciences	50.9	45.7
26	▼ 6	Real Estate	50.0	51.0
27	▲ 2	Industrial Distributors	49.3	47.8
28	▼ 5	Banks	49.2	50.3
29	▼ 1	Professional Services	49.1	47.9
30	▼ 5	Chemicals	48.7	49.1
31	▼ 5	Transportation	48.6	49.0
32	▼ 19	Power	48.3	54.6
33	▲ 1	Investment Managers	46.0	44.7
34	▲ 2	Technology-Hardware	45.7	41.4
35	-	Mining	39.9	42.9
36	▼ 4	Energy	37.9	45.9

In the fourth quarter of 2021, Biotechnology jumped six spots to claim the title of the most vulnerable industry from Utilities, according to FTI's Activism Vulnerability Screener. The reason for the top rank was a rapid rise in the industry's aggregate Total Shareholder Return (TSR) score. Using SPDR S&P Biotech ETF as a proxy for returns, the biotech industry tumbled 11.3% in the fourth quarter,[17] driving the sector's TSR score higher. The Telecommunications industry also followed close behind, moving up eight spots due to a combination of weaker Governance, TSR and Operating performance scores.

Other notable movers include the Automobile industry, which climbed 12 spots and entered the top five. Technology-Software jumped 15 spots, and Power dropped a record 19 spots to round out the five least vulnerable industries.

Observations & Insights

"The SEC's proposed amendment to Rule 13d-5 to "clarify that forming a group does not require an agreement" could have a major impact in how hedge funds communicate their intentions with their inner circles. An investor wolf-pack can be explained as a group of shareholders who have been known to caucus with shareholder activists. In unison, these investors will likely vote along the lines of the aggressor in a proxy contest.

During a contentious proxy contest, a wolf-pack analysis is a commonly used tool to help identify investors that have historically held equity positions in proxy fights, activist campaigns, and other investments alongside the primary dissident to provide a more accurate base of suspected votes for the dissident director nominees. Analyzing historical Form 13F filings where the aggressor waged prior campaigns could provide insights into investors that have relationships with the primary dissident. This activity gets tracked and noted as a likely detractor vote.

The SEC's proposed amendment could prevent the primary dissident from discussing its intentions with other shareholders out of fear that these other investors will soon become part of the dissident team. This unplanned and unwanted scrutiny on its investing practices and personal backgrounds of its founders and principals could provide fodder for the targeted companies for its shareholder letters and fight decks."

David Farkas – Managing Director,
Activism and M&A Solutions

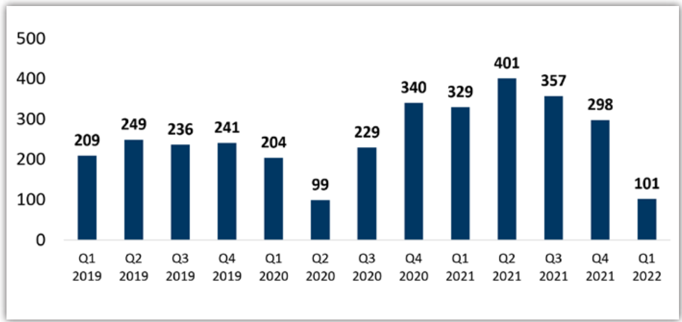
[17] FactSet, market data from October 1, 2021 to December 31, 2021

What This Means/Conclusion

Based upon the continued increase in shareholder activism campaigns to start 2022, it does not appear that the recent market volatility will have as major an impact on the behavior of activist investors as it did at the outset of the pandemic in the United States. In fact, the recent sell-off, particularly in the tech space, may provide attractive entry points for funds looking to shareholder engagement as a source of alpha without having to worry about the potential public image impacts that came with running proxy contests in 2020, and to a lesser extent, 2021. For companies, these dynamics highlight the importance of recognizing the changes in their shareholder base and understanding how to approach messaging key elements of corporate strategy.

What remains to be seen is to what level the previously robust M&A market will rebound, as the first quarter of the year is on pace for the lowest transaction total since the second quarter of 2020. While the rebound from the depths of the pandemic was fueled in part by reduced interest rate policy, providing cheap capital for financial and strategic buyers alike, any rebound from the current dip in transaction volume will likely have to power through a period of rising rates. That said, a rebound will be aided by near record-high dry powder levels from private equity buyers and a heightening competitive environment across industries.

Quarterly M&A Deals



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JASON FRANKL
Senior Managing Director
+1 202 312 9216
jason.frankl@fticonsulting.com

BRIAN KUSHNER
Senior Managing Director
+1 214 397 1764
brian.kushner@fticonsulting.com

GLENN TYRANSKI
Managing Director
+1 212 651 7120
glenn.tyranski@fticonsulting.com

CARL JENKINS
Managing Director
+1 303 689 8877
carl.jenkins@fticonsulting.com

DAVID FARKAS
Managing Director
+1 646 453 1293
david.farkas@fticonsulting.com

KURT MOELLER
Managing Director
+1 202 312 9143
kurt.moeller@fticonsulting.com

ROBERT KUEPPERS
Senior Advisor
+1 203 856 4457
robert.kueppers@fticonsulting.com

WALKER SPIER
Director
+1 202 728 8728
walker.spier@fticonsulting.com

WYATT FRIEDMAN
Director
+1 410 804 9701
wyatt.friedman@fticonsulting.com

LAURA VOLKMANN
Senior Consultant
+1 224 434 6245
laura.volkman@fticonsulting.com

GRIFFIN MIDDLETON
Consultant
+1 646 671 0325
griffin.middleton@fticonsulting.com

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