The Activism Vulnerability Report
Q2 2020
Introduction and Market Update

We hope this report finds you and your families healthy and safe amid these uncertain times. After enduring more than eight months of a global pandemic, there is lots to reflect on, lots to improve upon and lots to be thankful for. Abnormalities, such as social distancing, remote work and virtual happy hours, have become the new norm for the foreseeable, and the unforeseeable, future. We raise our glass to those who are adapting and evolving.

Across the United States and Canada, and the rest of the globe for that matter, some industries have remarkably thrived throughout the pandemic, while others struggle to hold on. We admire those businesses and executives who have opened new doors, and also those who have made difficult decisions to close others. And through it all, front line workers have bravely faced the pandemic-related fears head-on, risking their own well-being for that of the general public and the care of their families and communities. We are especially thankful to those individuals and will continue to be.

The later months of the second quarter reflected a notable, and surprising, uptick in economic activity, as compared to the free-fall that began here in North America during the end of the first quarter. Consumer sentiment slowly began to improve off first quarter lows as the U.S. and global economies began to re-open. Moreover, Congress approved stimulus checks to those in need and raised weekly unemployment benefits considerably. Massive monetary policy action from the Federal Reserve provided much needed support for the U.S. equity and credit markets. Europe and Japan also increased their Quantitative Easing programs in an effort to bolster their respective economies.

FTI Consulting welcomes our clients and friends to the latest edition of the Activism Vulnerability Report, presenting findings from FTI’s Activism Screener. Each calendar quarter, the FTI Activism Screener assesses the vulnerability of approximately 3,400 U.S. and Canadian companies with market capitalizations of at least $100 million using publicly available information.
The second quarter also represented the best quarter from a quantitative performance perspective for U.S. equity markets in the last twenty years.\(^1\) As of the date of publication, all three major US indices, the S&P 500, Dow Jones Industrial Average and the Nasdaq have rebounded to positive performance on the year, up 1%, 8% and 28%, respectively. The statistics can be somewhat misleading when taken at face value, as they do not fully capture the growing bifurcation of equity markets between winners and losers. Growth stocks have performed significantly better in 2020, on a YTD basis, than Value stocks, with technology stocks thriving. As of the date of publication, the S&P 500 Growth Index was up 23%, while the S&P 500 Value Index was down (10%).

In the same vein, without the FAAMG (Facebook, Amazon, Apple, Microsoft and Google (Alphabet)) stocks, the S&P 500’s performance would be less a cause for celebration and more a cause for concern. The FAAMG stocks now represent 20% of the S&P 500 Index (by market capitalization), a level not seen from a single industry in at least 70 years.\(^2\) The FAAMG stocks, which are the S&P 500’s five largest components, are up by an average of 39% so far this year, while the median change for all 500 stocks is (4%).

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Per FactSet’s Earnings Insight report, earnings declined by 34% year-over-year in Q2 2020. While this beat the estimated decline of 45%, it is the largest year-over-year decline since Q1 2009. Some corporate balance sheets remain stretched thin, as executives and board members consider overhauled capital structures, possible restructuring and capital allocation policies. Federal Reserve Chairman Jerome Powell went as far to say that, “the current economic downturn is the most severe in our lifetimes.”

That is saying something. Combining this reality with the broader equity market recovery presents the highest valued S&P 500 since 2001 on a forward Price-to-Earnings basis, suggesting stocks are running ahead of the economic recovery. The U.S. is still far from containing the coronavirus, and volatility will likely remain elevated in the current market environment.

Despite the continued uncertainty, the climate for shareholder activism was notably more active than in prior months. Although total new campaigns in the United States were down 7% from the first half of 2019, the total board seats won by activist investors were up slightly (+3%) over the same period. The uptick was driven by a significant increase in board seats won through contested votes. Board seats won through settlements were slightly down over the same period. Elliott Management, ValueAct and Starboard Value were the three most active funds in the activism asset class for the first half of 2020, as defined by capital invested. Each invested over $500 million in activism-related investments, with Elliott investing $1.8 billion.

Those who have been observing the convergence of activist investing and private equity need look no further than the influx of SPACs for confirmation. Traditional activists including Pershing Square Capital Management, Starboard Value and Hudson Executive Capital have listed, or plan to list, vehicles of their own with the intent of finding attractive private companies to bring to public markets. Following the recently successful listings of a number of SPACs, Ackman told reporters he was looking to find a unicorn. He raised $4 billion should he comes across one.

Separately, ValueAct Capital co-founder Jeff Ubben announced in late June that he would leave his post at the fund to launch a new environmental and social impact investment fund, Inclusive Capital Partners. In 2018, Ubben launched the Spring Fund, a similar ESG-focused fund underneath the ValueAct umbrella. According to a June interview with the Financial Times, he questioned whether the two strategies could not coexist. Ubben’s move is a significant one, as the trend toward sustainable investing continues to accelerate; funds claiming to abide by ESG criteria recently surpassed $1 trillion under management for the first time, according to Morningstar.

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5 https://www.ft.com/content/eaa28471-e295-44a9-a138-dda047dbd61c
Finally, recent months have seen several major developments in the regulatory landscape surrounding shareholder activism and investor engagement. Most notably, in late July, the SEC approved new restrictions on proxy advisors, which will require the advisors to share voting recommendations with companies concurrently with their investor clients, as well as making the proxy advisors liable for material errors and omissions. In a news release, the SEC stated that the rule was designed to ensure shareholders have “reasonable and timely access to more transparent, accurate and complete information on which to make voting decisions.” However, critics of the rule change claim it will suppress the full exercise of shareholder voting rights. The SEC also proposed a new rule in July to raise the threshold above which institutional investors are required to file quarterly Form 13-F’s disclosing equity positions from $100 million to $3.5 billion.\(^9\)\(^10\)

FTI Activism Screener Methodology

— The Activism Screener is a model that aggregates and analyses over 25 criteria that are relevant to activist investors. They are sorted into four broader categories, scored 0.0-25.0, (1) Governance; (2) Total Shareholder Return; (3) Balance Sheet; and (4) Operating Performance, which are aggregated to a final Total Vulnerability Score. The Screener determines a score for each category by applying weightings to each criterion based on its significance.

— By classifying the relevant attributes and metrics into broader categories, FTI is able to uncover precisely where potential vulnerabilities are found, which allows for a more targeted response.

— FTI’s Activism and M&A Solutions team determined these attributes and metrics, along with their respective weightings, through careful research of historical activist campaigns in order to locate themes and characteristics frequently targeted by activist investors. The following is a selection of themes that are included for each category:

<table>
<thead>
<tr>
<th>Governance</th>
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<tbody>
<tr>
<td>— Proxy voting standard</td>
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<td>— Board composition</td>
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<tr>
<td>— Proxy access</td>
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<table>
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<tr>
<th>Total Shareholder Return</th>
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<tbody>
<tr>
<td>— Capital gains</td>
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<td>— Dividend and share repurchase policy</td>
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<td>— Relative valuation</td>
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<table>
<thead>
<tr>
<th>Balance Sheet</th>
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<tbody>
<tr>
<td>— Capital allocation</td>
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<tr>
<td>— Leverage ratios</td>
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<tr>
<td>— Liquidity</td>
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<tr>
<th>Operating Performance</th>
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</thead>
<tbody>
<tr>
<td>— Revenue and earnings growth</td>
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<tr>
<td>— Profitability margins</td>
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<tr>
<td>— Merger integration</td>
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</tbody>
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— As specialists in the field, the Activism and M&A Solutions team is constantly following the latest trends and developments in shareholder activism. Because of the constantly evolving activism landscape, and with a desire to keep the Activism Screener in-line with these changing market dynamics, the attributes and metrics and/or their respective weightings may be updated in future quarters.
Q2 2020’s Most Vulnerable Industries

The chart below displays the Total Vulnerability Scores for 25 well-known industries as of August 11, 2020:

<table>
<thead>
<tr>
<th>Rank</th>
<th>▲ Rank QoQ</th>
<th>FTI Industry</th>
<th>Q2 Vulnerability Score</th>
<th>Q1 Vulnerability Score</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td>Media</td>
<td>61.30</td>
<td>60.43</td>
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<tr>
<td>2</td>
<td></td>
<td>Telecommunications</td>
<td>55.75</td>
<td>55.57</td>
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<tr>
<td>3</td>
<td></td>
<td>Publishing</td>
<td>54.48</td>
<td>54.86</td>
</tr>
<tr>
<td>4</td>
<td>▲ 9</td>
<td>Consumer Non-Durables</td>
<td>51.45</td>
<td>47.56</td>
</tr>
<tr>
<td>5</td>
<td>▲ 7</td>
<td>REITs</td>
<td>50.89</td>
<td>48.31</td>
</tr>
<tr>
<td>6</td>
<td>▲ 1</td>
<td>Automotive</td>
<td>50.01</td>
<td>50.54</td>
</tr>
<tr>
<td>7</td>
<td>▼ 2</td>
<td>Aerospace and Defense</td>
<td>49.94</td>
<td>51.37</td>
</tr>
<tr>
<td>8</td>
<td>▼ 2</td>
<td>Professional Services</td>
<td>49.26</td>
<td>50.74</td>
</tr>
<tr>
<td>9</td>
<td>▼ 1</td>
<td>Construction</td>
<td>49.04</td>
<td>50.01</td>
</tr>
<tr>
<td>10</td>
<td>▲ 1</td>
<td>Hospitality, Gaming &amp; Leisure</td>
<td>48.46</td>
<td>48.31</td>
</tr>
<tr>
<td>11</td>
<td>▼ 1</td>
<td>Energy, Power &amp; Products</td>
<td>48.29</td>
<td>48.53</td>
</tr>
<tr>
<td>12</td>
<td>▼ 3</td>
<td>Agriculture</td>
<td>48.28</td>
<td>49.21</td>
</tr>
<tr>
<td>13</td>
<td>▲ 5</td>
<td>Pharmaceuticals</td>
<td>46.87</td>
<td>45.42</td>
</tr>
<tr>
<td>14</td>
<td>▲ 2</td>
<td>Real Estate</td>
<td>46.38</td>
<td>47.12</td>
</tr>
<tr>
<td>15</td>
<td>▼ 1</td>
<td>Mining</td>
<td>46.34</td>
<td>47.44</td>
</tr>
<tr>
<td>16</td>
<td>▼ 12</td>
<td>Consumer Durables</td>
<td>45.58</td>
<td>51.54</td>
</tr>
<tr>
<td>17</td>
<td>▲ 3</td>
<td>Transportation</td>
<td>45.45</td>
<td>44.40</td>
</tr>
<tr>
<td>18</td>
<td>▼ 3</td>
<td>Healthcare Services</td>
<td>44.81</td>
<td>47.19</td>
</tr>
<tr>
<td>19</td>
<td></td>
<td>Technology</td>
<td>43.74</td>
<td>44.46</td>
</tr>
<tr>
<td>20</td>
<td>▲ 3</td>
<td>Business Services</td>
<td>43.74</td>
<td>42.85</td>
</tr>
<tr>
<td>21</td>
<td></td>
<td>Life Sciences &amp; Biotechnology</td>
<td>42.99</td>
<td>43.39</td>
</tr>
<tr>
<td>22</td>
<td>▼ 5</td>
<td>Regional Banks</td>
<td>42.93</td>
<td>46.04</td>
</tr>
<tr>
<td>23</td>
<td>▼ 1</td>
<td>Large Financial Institutions &amp; Fintech</td>
<td>41.37</td>
<td>42.94</td>
</tr>
<tr>
<td>24</td>
<td></td>
<td>Insurance</td>
<td>37.35</td>
<td>40.59</td>
</tr>
<tr>
<td>25</td>
<td></td>
<td>Investment Advisory Services</td>
<td>33.68</td>
<td>36.16</td>
</tr>
</tbody>
</table>

Our Q2 data shows a similar top-three most vulnerable industries to last quarter, though there were large moves for the fourth and fifth most vulnerable industries, Consumer Non-Durables and REITS, respectively. Consumer Non-Durables experienced the largest move up the chart for the quarter, up nine spots, while Consumer Durables was the largest mover down the chart for the quarter, down 12 spots.

When compared to the previous quarter, fewer industries received a total vulnerability score of 50 or higher, decreasing from eight to six industries.
FTI Observations & Insights

Publishing + Digital Media

“COVID-19 has and will continue to change everything. If you are in the tech sector, you keep watching your stock go up. If you are in publishing and digital media with significant advertising-related revenue, the impact can be essentially framed as two points: 1) legacy print and digital advertising have experienced declines; up to and over 50% year-over-year for print and over 20% for digital advertising and 2) the migration from legacy to digital accelerated 18 to 24 months, which puts even more pressure on digital transformation for newspapers, magazines, digital natives or print media. For newspapers and magazines that have both advertising customers and consumers, moving as quickly as possible to a consumer-led model is essential. Print media – printers and direct mail – where linked to advertising and in some cases changes in consumer habits have seen significant impacts. Digital natives like newspapers and magazines have increased digital audiences but lower digital advertising revenue. In-person events are basically gone. Label printers and transactional mailers have seen much less impact, but digital migration just accelerated. Whatever the path of transformation the sector was on, COVID has accelerated the need to transform and financial challenges just increased.”

– Ken Harding, Head of FTI Consulting’s Publishing + Digital Media Industry Group

Media + Entertainment

“In the last six months, the COVID-19 crisis has upended the media landscape, leaving even the most successful companies facing unprecedented challenges. From Disney to where its theme parks, cruise ships and studios are closed, to the entire theatrical exhibition industry being shut, the dislocations have been material and with probable lasting effects. On the flip side, digital companies that cater to in home and socially distanced activities have seen tremendous growth despite (or perhaps because of the crisis). Coming out of the pandemic, we expect to see these changes, both good and bad, to continue and likely accelerate.”

– Philip Schuman, Head of FTI Consulting’s Media + Entertainment Industry Group
SEC Regulatory Update: Form 13-F

On July 10, 2020, the SEC announced a proposal to amend and increase the threshold needed for investors to file Form 13-F. Form 13-F is a quarterly filing with the SEC required to be filed by all investors with equity investment discretion of at least $100 million. In its recent proposal, the SEC suggested amending the threshold to $3.5 billion. SEC Chairman Jay Clayton noted “Today’s proposal will update, for the first time in over 40 years, the 13-F reporting threshold to a level that furthers the statutory goal of enabling the SEC to monitor holdings of larger investment managers while reducing unnecessary burdens on smaller managers.”

The release for the proposed amendment went further to note that since 1978, when the threshold was set at $100 million, the overall value of the public corporate equities has grown over 30 times from $1.1 trillion to $35.6 trillion. It also went on to mention that the “new threshold would retain disclosure of over 90% of the dollar value of the holdings data currently reported while eliminating the Form 13-F filing requirement and its attendant costs for the nearly 90% of filers that are smaller managers.”

Investor relations professionals, stock exchanges and retail investors have been championing greater transparency on behalf of investment managers for years. The recent proposal by the SEC is a notable step back from these initiatives. While larger mutual fund managers and hedge funds will still be required to file a quarterly Form 13-F with the SEC, it suddenly creates a large gap in the reported holdings of the publicly traded entities.

Many well-known shareholder activists do not manage $3.5 billion in equity assets. Less than 100 hedge funds would have to file a quarterly Form 13-F, while the remaining funds will no longer experience the “unnecessary burden,” as the SEC noted. If the SEC’s proposal comes to fruition, a shareholder activist can build a position, whether it be through equity or an alternative type of investment, and the corporate entity may never know the full extent of their holdings. This proposal is a major benefit to the activist investor as it gets to fly under the radar, while the corporate entity could be blindsided.

If 90% of the investment managers no longer have to file a quarterly Form 13-F with the SEC, a stock surveillance offering can help fill in those gaps. The retention of stock surveillance becomes at utmost value to assist in filling in those gaps created by this new proposal, as well as monitoring a potential shareholder activist building a position.

– David Farkas, Managing Director in the Activism & M&A Solutions practice
What This Means

As we continue to adapt to our new realities, so too must companies as they reposition themselves to survive and thrive for an uncertain duration of COVID-19 business conditions. The current environment heightens the need for strong and innovative management teams, and flexible boards of directors. The timing of the 2020 proxy season unquestionably protected some companies from activist criticism and changes. However, as market participants benefit from increased clarity on the near- and medium-term outlook, investors will likely be more active than ever, behind-the-scenes and publicly, in assuring that their portfolio companies are headed the direction they envision will generate the greatest shareholder return.

The next round of shareholder activism campaigns may be more driven by corporate strategy and performance focused theses, rather than capital allocation preferences. Returning capital to shareholders, through increased dividends or share repurchases, has recently been a popular tactic for activist investors; however, many companies spent the first half of the year preparing balance sheets and liquidity positions to weather a long storm of uncertainty, making it unlikely that campaigns advocating for higher shareholder payouts would garner much support from other shareholders. Instead, we think it is more likely that activist investors will be more interested in finding opportunities to add shareholder value through shaping corporate strategies and examining cost structures and supply chains.
While balance sheet and capital allocation campaigns may remain restrained in 2020, we expect the recent rebound in the M&A market may embolden activists to push companies to seek strategic alternatives, as larger peers look to add scale. Amidst the uncertainty of the first half, well-positioned corporations began to stockpile cash and increase liquidity to weather the storm. At the close of the second quarter, “cash holdings of U.S. public companies amounted to $2.54 trillion during the latest reported quarter, up from $1.96 trillion at the end of 2019”.

Further, several deals that were put on hold in March and April that featured an activist dimension have reappeared, while new takeover campaigns have also sprung up.

While we believe that M&A and corporate strategy will remain key tenets of the activist playbook in this environment, this may be the year that ESG activism gains further momentum. As executives continue to make real-time changes to their corporate and social policies, all while under the media’s magnifying glass, investors increasingly see these decisions as long-term drivers of value-creation. Key governance issues, such as board tenure and executive compensation, have long been at the forefront of activism, but environmental and social issues particularly have seen an uptick this year. According to Nuveen, two out of every three proposals from shareholders submitted for annual meetings this year addressed environmental or social matters representing a continued uptick over the past five years. Although the recent surge in focus on how executives approach corporate governance and the treatment of both employees and customers was in part driven by the COVID-19 pandemic, we expect it will remain at the forefront long after the pandemic wanes.

As the United States and Canada hopefully approach the end of what will be a highly unusual summer, we envision the changing of seasons as an inflection point. Executives and corporate boards have had over six months to work through the feedback cycle of analysis and action. While the economic future is still uncertain and corporations must contend with two, large near-term variables in COVID-19 and the United States presidential elections, activist investors and traditional long-only shareholders alike will expect results and will not hesitate to voice their concerns. And they will likely make those expectations vocal as we approach the 2021 proxy season.

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11 https://www.wsj.com/articles/after-stockpiling-cash-some-companies-are-looking-to-spend-11596706202

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