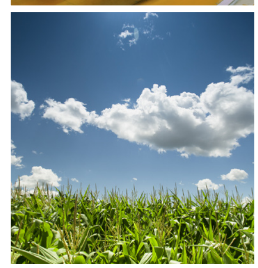
SHAREHOLDER ACTIVISM IN THE INDUSTRIALS SECTOR: THE NEW NORMAL

October 2013

Thanks to the industrials sector's long-standing reputation as a source of solid, steady returns, investors have often given management teams wide latitude to pursue long-term growth strategies.

Not anymore.

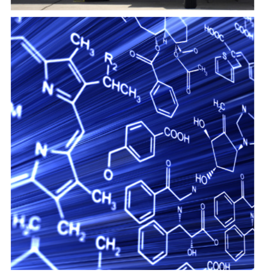


Shareholder activism is continuing its recent rise, as weaker macro-economic growth, vague strategic plans, stagnant margins, complex business models and under-utilized balance sheets have emboldened shareholder activists and even traditional long-term investors.

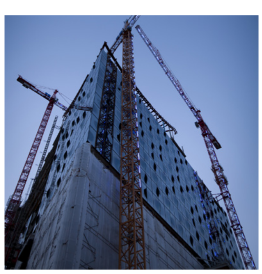
Today's activists often want less growth spending, aggressive cost cutting, monetizing of non-core assets, high-level personnel shakeups and greater short-term returns for shareholders.

This trend is not going away, and few industrial companies are immune from increasing activist demands — even if the organization is thriving. These investors have both the capital and the willingness to challenge even the largest and most well-established industrial companies.

In response, industrial companies need a proactive strategy to head off activism well before it happens. Management must recognize the structural and financial factors that attract activists, and make it a priority to strengthen relationships during the proxy offseason with key investors, proxy advisers and the media.

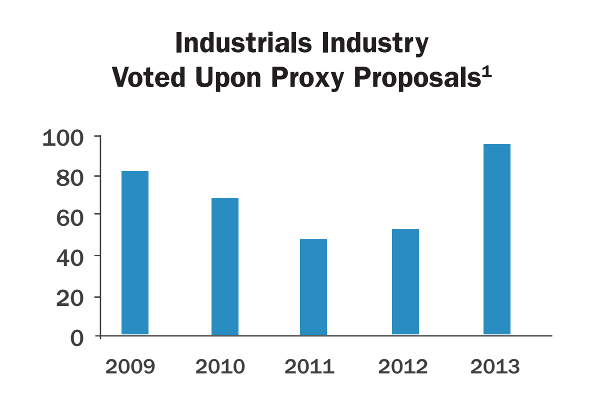


Being a target of activism is no accident and neither is avoiding it. Understanding why and how industrial companies have been targeted by activist shareholders is critical to ensuring a company is not next on the target list.

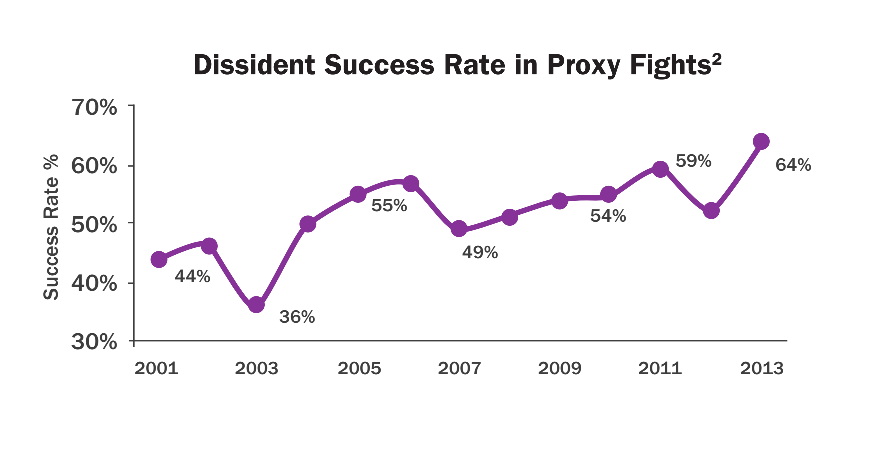


SHAREHOLDER ACTIVISM SHOWS NO SIGNS OF ABATING

The annual proxy season battle between activist shareholders and corporations in the industrials sector has surged in 2013, and it shows no signs of abating.



Following a three-year dip, the number of shareholder proposals making it onto the proxies of industrial companies has risen by 79 percent.[1] These proposals are increasingly being adopted too. Across all industries, the dissident success rate in proxy fights has reached 64 percent, its highest level in recorded history.[2]



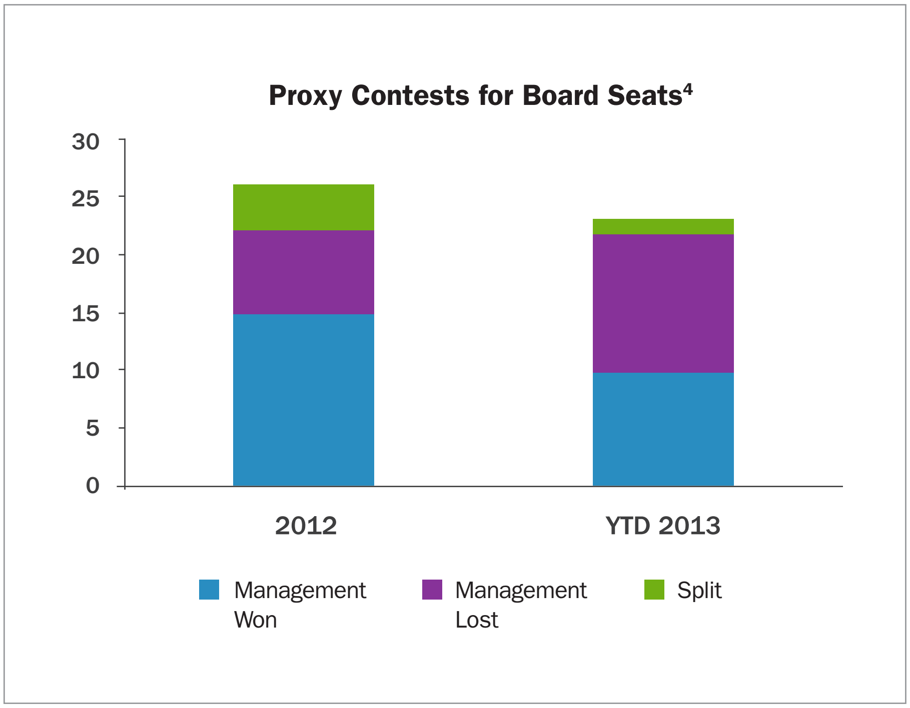
Public activist campaigns and formal proxy fights against industrial companies have become front-page news, and even fodder for discussion at investment conferences. Notable targets have included Agrium, Air Products, Ferro Corporation, Terex, Timken, and even bellwethers such as E. I. du Pont de Nemours.

The scale of shareholder activism across industries is even greater than many realize. A significant number of shareholder proposals are excluded by companies – with the permission of the Securities and Exchange Commission (SEC) – or are withdrawn after negotiations between corporate management and proposal sponsors. Shareholder proposals submitted to companies are 77 percent higher than those that actually show up on proxy statements.[3]

Although both public companies and activists alike prefer the less costly option of a non-public negotiation, this is no panacea, as activists frequently push for more extensive change than a board may be willing to accept. As of Sept. 18, 2013, there were 23 proxy contests for board seats that had gone to a vote this year; 34 settled; 16 were withdrawn; and 13 were still pending. These numbers already surpass the total contests that took place in 2012.[4]

Consider This:

Many activist funds now have enough resources to take on even the largest industrial companies. In addition to the traditional activists such as Bill Ackman (Pershing Square Capital Management), Carl Icahn and Nelson Peltz (Trian Partners), smaller activists such as Clinton Group, JANA Partners and Starboard Value are now pursuing activist strategies against companies that have historically been too large for them to directly engage. Even traditionally non-active funds such as First Manhattan and Glenview Capital Management have conducted full-scale proxy fights for control this year.



Further fueling the success of activism is the increasing involvement of large, formerly passive institutions. As these institutions have invested in more sophisticated corporate governance teams, they have been more willing to vote against management even when it goes against the recommendation of a proxy advisory firm.

The growing power of activist investors combined with the increasing participation of formerly passive institutions helps explain why activists have won more full proxy votes than management this year for the first time since 2009.

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>
> **- Steven Balet, FTI Consulting**

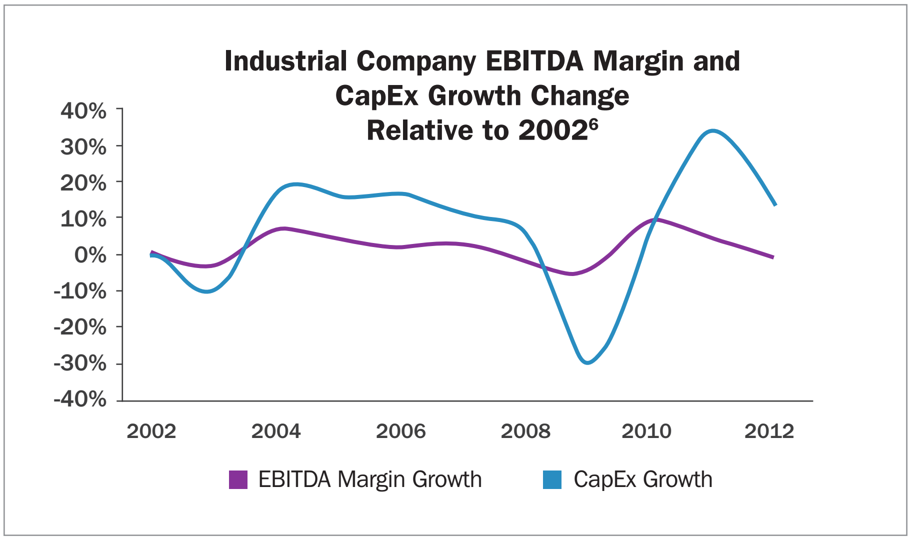
CAPITAL ALLOCATION AND STRATEGIC GROWTH EMERGE AS ACTIVIST DRIVERS

Investors expect industrial companies to experience the second-highest level of activist challenges to management — behind only financial services.[5] *This is a marked change for an industry with steady long-term returns and large capitalizations that traditionally insulated it from shareholder activism.*

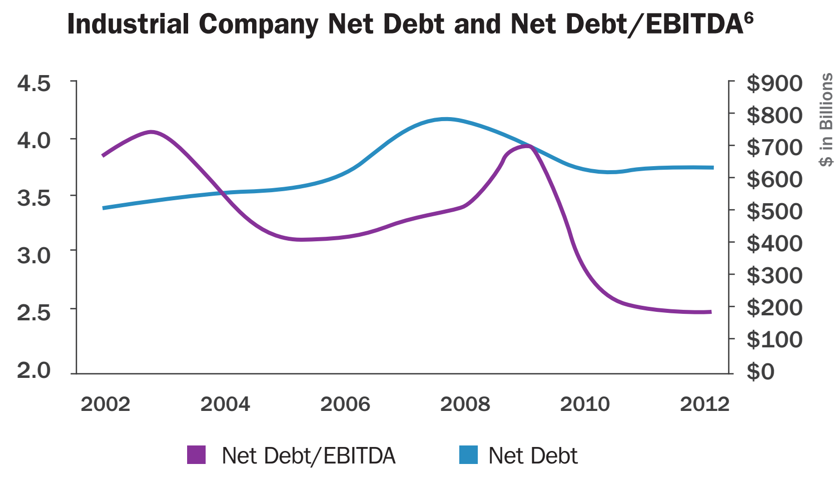
So what changed?

First, lagging demand fundamentals. The rebound from the 2008 financial crisis and continued growth in emerging markets masked what some investors believe to be a more fundamental weakness in the industrials sector. With demand slowing, investors are no longer willing to overlook flawed capital allocation, sub-optimal capital structures, and acquisitions based on poor strategic rationale, or unrealistic expectations about future commodity or product prices.

Other activist investors are dissatisfied with the shareholder returns from the industrial sector's significant capital spending in the last few years. Capital spending unsurprisingly plummeted nearly 30 percent in 2009 during the depths of the recession, while "EBITDA" (earnings before interest, taxes, depreciation and amortization) margins also hit a low point.[6] But as capital spending subsequently increased, EBITDA margins did not expand significantly. Industrial companies have been spending to create long-term growth, but investors aren't willing to wait that long. With EBITDA margins essentially flat to slightly down, activists see an opening to redirect company resources to more immediate shareholder remuneration.



Even as growth has slowed, the industrials sector has maintained healthy, free cash flows and low leverage, with net debt levels down significantly from the acquisitions and "CapEx" (capital expenditure) induced peak of 2007.[6] Leverage ratios have also improved significantly as EBITDA has rebounded to 2006 / 2007 levels, leaving the sector with the lowest net debt to EBITDA level in a decade. If the sector were merely to return to average



leverage, and EBITDA levels of about 3.3x — which is still below the 4x peak in 2008 — it would free up about $200 billion for dividends, buybacks or acquisitions. That represents 8 percent of the industrial sector's total market capitalization.

WHO ARE THE NEXT ACTIVISM TARGETS?

Here are a few key themes specific to shareholder activism targets.

- Size does not matter anymore as activists now manage more than $73 billion, allowing them to target companies of all market capitalizations.[7]
- Companies with investments that have not resulted in strong earnings growth and those that have underperformed their peers are potential targets of activism.
- Activists are increasingly willing to challenge well-performing companies with the means to make a shareholder distribution through cash-on-hand, leverage or spinoff.
- Long-serving boards and ("entrenched") management teams are particularly vulnerable if other factors are also present.
- Activists, like never before, are making stronger strategic arguments to win loyalists among historically long-term and passive investors.

> **"Activists have a seemingly compelling story to tell. Industrials have lots of cash-on-hand and little debt, and yet they're not managing robust top-line profit growth. So why not reduce capital outlays and costs, and deliver more near-term returns to shareholders? In this environment, it is more important than ever for industrial companies to have a strong counter-narrative to explain their investments and long-term growth strategy."**
>
> **- Mateo Millet, FTI Consulting**

CRITICAL QUESTIONS FOR PUBLIC COMPANIES

Industrial companies — indeed all public companies — need to have an activist defense plan in place. This is just as essential as preparations for an operational or environmental crisis, and forward thinking companies should be able to answer the following questions with an affirmative "yes" to ensure readiness for a potential activist fight.

1. Communicate Internally and Be Prepared

Is there a robust monitoring system in place to identify potential activists buying the stock, track activist activity within the company's industry and monitor commentary in the media signaling potential threats?

Does the company have an established online presence that would allow it to quickly and easily deploy a digital/social media strategy to combat an activist?

Does the company have a proxy expert that can provide ongoing advice prior to and throughout a fight?

Is a "Rapid Response" team in place with a developed protocol to respond to an activist filing a 13D, publishing a Board letter, tweets about the stock or commentary in the media about driving company change?

Is the Board well-briefed on the ongoing risks of shareholder activism?

Is the company making a compelling argument to investors about its capital allocation strategy?

2. Improve Shareholder Engagement and the Message

Does the management team have a thorough understanding of vulnerabilities within the shareholder base (not just among top investors)?

Has the company (not the sell-side) targeted new potential shareholders to support management and the Board in a proxy fight?

Has the company developed relationships with the voting decision makers at among the key institutional shareholders?

Does the company understand the voting processes among these institutional shareholders, who their key influencers are, and how to communicate with them?

Does the company know who the retail shareholders are and what influences them?

Has the company articulated its plan to create shareholder value – including progress made against this plan – and clearly explained how and why the company is allocating its cash?

3. Build Relationships with Key Influencers

Does the company have "go-to" relationships in the media that understand and support the management team's growth strategy?

Does the CEO have a favorable profile and credibility in the media that would enable favorable influence on the outcome of a proxy fight?

Does the company have a presence or allies in Washington, D.C. that can advocate on behalf of the company if there are regulatory dimensions to the proxy fight?

ENGAGE INVESTORS IN THE PROXY OFFSEASON

If a company waits until the middle of a proxy fight to vigorously engage its key influencers and institutional investors, it's asking for trouble. The proxy offseason offers a golden opportunity for proactive companies to reach out to an increasingly engaged investment community, with the time and desire to listen.

Many companies maintain an ongoing dialogue with their investors throughout the year, speaking to portfolio managers and analysts via conferences, earnings calls and one-on-one meetings. These are important relationships to maintain. However, the portfolio manager is not always the primary decision-maker on proxy voting issues.

A growing number of large institutions have developed a proxy voting committee or corporate governance team that will accept input from the portfolio manager or analyst, while retaining the ultimate voting decision. That is why industrial companies must know who the voting decision-makers are at their major institutional holding firms, and how they can be favorably influenced. Ultimately, company outreach must go beyond the usual suspects well in advance of a proxy fight to best position a company for success.

The same outreach and engagement imperatives apply to proxy advisers, as activists owe part of their success to firms such as Glass, Lewis & Company and Institutional Shareholder Services (ISS). ISS, in particular, is consulted by many mutual funds and other institutional investors, and studies have found that such proxy advisers can sway a significant percentage of the vote. For example, ISS has been siding with dissidents 73 percent of the time during the recent proxy season, which is up by more than half in 2012.[8] Although many large institutions follow the proxy advisory firms, they no longer vote in lock step with them. Nevertheless, these advisers do retain significant influence, and industrial companies would be well served to proactively engage them.

THE BEST DEFENSE IS A GOOD OFFENSE

Shareholder activist uprisings don't come out of nowhere. There are certain financial, macro-economic and structural factors that make a growing number of industrial companies a ripe target for proxy fights. Management teams and the board need to understand these risk factors and take steps to mitigate them.

But a good defense is not enough.

Industrial companies need to go on the offense by strengthening relationships with key investors, proxy advisers and the media during the proxy offseason. They need a compelling story to tell about how and why they are allocating resources; and how they have the ideal strategy to build shareholder value in both the short- and long-term. The activism landscape is rapidly evolving, and industrial companies that don't evolve with it risk putting their destiny in someone else's hands.

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[1] Data sourced from FactSet.

[2] Data sourced from FactSet. Represents number of outright victories, partial victories or settlements by the dissident as a percentage of all proxy fights where an outcome has been reached; and is based upon scheduled or anticipated meeting dates.

[3] Based on a 2012 survey completed for the Manhattan Institute by the Society of Corporate Secretaries and Governance Professionals.

[4] Data sourced from FactSet.

[5] Based on data from "Shareholder Activism Insight," a Schulte Roth & Zabel report in association with Mergermarket completed in 2012.

[6] Data sourced from CapitalIQ.

[7] Data sourced from Hedge Fund Research.

[8] Data sourced from FactSet through mid-April 2013.