PUBLISHED IN fei | Daily
daily.financialexecutives.org
March 31, 2014

Your Balance Sheet is a Sitting Duck

By Christopher Westfall

The numbers speak for themselves, with a key metric of activist investor influence -- gaining a board seat on a target company — reaching a five-year high, according to data compiled by *FactSet's SharkRepellent.net*. According to that survey, activist investors were granted one or more board seats at 16 U.S. companies just in the first two months of 2014. That is the most since 2009, where 22 campaigns at 21 distinct companies resulted in board seats, according to the survey.

And today's activist investors are not looking for a quick profit — they'll wait out a company for a long period of time.

Activist investors are becoming more prevalent and are achieving success more often than ever. Financial executives that ignore their rise can put their company's balance sheet and future in peril.

"Activists can be motivated by either short-term or long-term gains," says Henri Leveque, leader of PwC's U.S. Capital Markets and Accounting Advisory Services. "They take a look at their means, the risk profile and the opportunity, and will adjust their strategy accordingly. If a short-term strategy delivers the required return, the likelihood is that they will certainly choose that path, however, we see no shortage of activists or traditional institutional investors who are beginning to act like activists (e.g. large pension funds) and roll up their sleeves and take a more active, long-term hands-on approach to drive shareholder value."

The current environment is also not a passing fad, says Ron Chopoorian, a PwC partner and leader of the firm's U.S. Divestitures practice in New York. PwC is holding a webinar at 1 p.m., March 31, entitled "*Embracing Shareholder Activism: Strategy through Tactical Execution.*"

"The last three years have seen a significant increase in the shareholder movement, and that's going to continue," says Chopoorian."There is a significant amount of cash flowing into these funds driven by their success in significantly outperforming the market in recent years."

While today's headlines are filled with the success of big name activists — like Carl Icahn and Nelson Peltz -- there are numerous smaller activist firms fueled by hedge fund assets that are targeting small and mid-cap public companies. They are also being fueled by real success, generating a 48 percent average gain for shareholders over the last five years, according to an analysis by *Bloomberg News*.

How does a financial executive know if they are in an activist investor's crosshairs?

For one professional in the world of activist investing, CFOs and other leaders that put their companies at risk are becoming common and can be spotted more easily than ever.

"You are building up capital not for acquisitions, but because you don't want any leverage. By doing so, you have made the risk/return decision for your shareholders, but that isn't your decision -- it's the shareholders,'" explains Jeffrey Lazar Kochian, a partner with the law firm Akin Gump in New York, when describing the perfect activist target. "At that point, you should not be surprised when the activist investor calls."

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Kochian says there are two common activist investor targets in the market today: Mid-cap companies that have grown, but have a CEO with a "cozy" relationship with board members, and companies where earnings go to management outside the usual corporate structure, such as REITs.

As for returning capital through buybacks and dividends to placate activist inventors, Kochian said that is quickly becoming a worthless defensive tactic. "That is often what activists are after, but in some ways, it's like cheating. If you couldn't think of anything to do with your cash, why weren't you returning it to shareholders in the first place?"

PwC's Leveque also lists five key indicators for financial executives that can catch the attention of activist investors:

A suboptimal capital structure, including a significant amount of cash sitting on the balance sheet;
Ongoing poor market or financial performance;
A lack of new products or innovation;
And a lack of transparency in investor communications, especially when communicating the execution of a business plan.

"As a whole, financial executives need to be less reactive," says Chopoorian. "They need to closely align strategy, and they need to be very proactive about the performance and optimization of all assets as part of their normal business processes."

At the end of the day, financial executives need to think like a activist investors if they want to understand their exposure.

"Are they looking at their assets? Is it generating ROE above their target. What assets are and are not, and what are they doing about it," Kochian says. "These questions should become a standard part of the quarterly board deck that that a CFO prepares."

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