

AN FTI CONSULTING REPORT – PUBLISHED 05/27/2020

The Activism Vulnerability Report

Q1 2020



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.

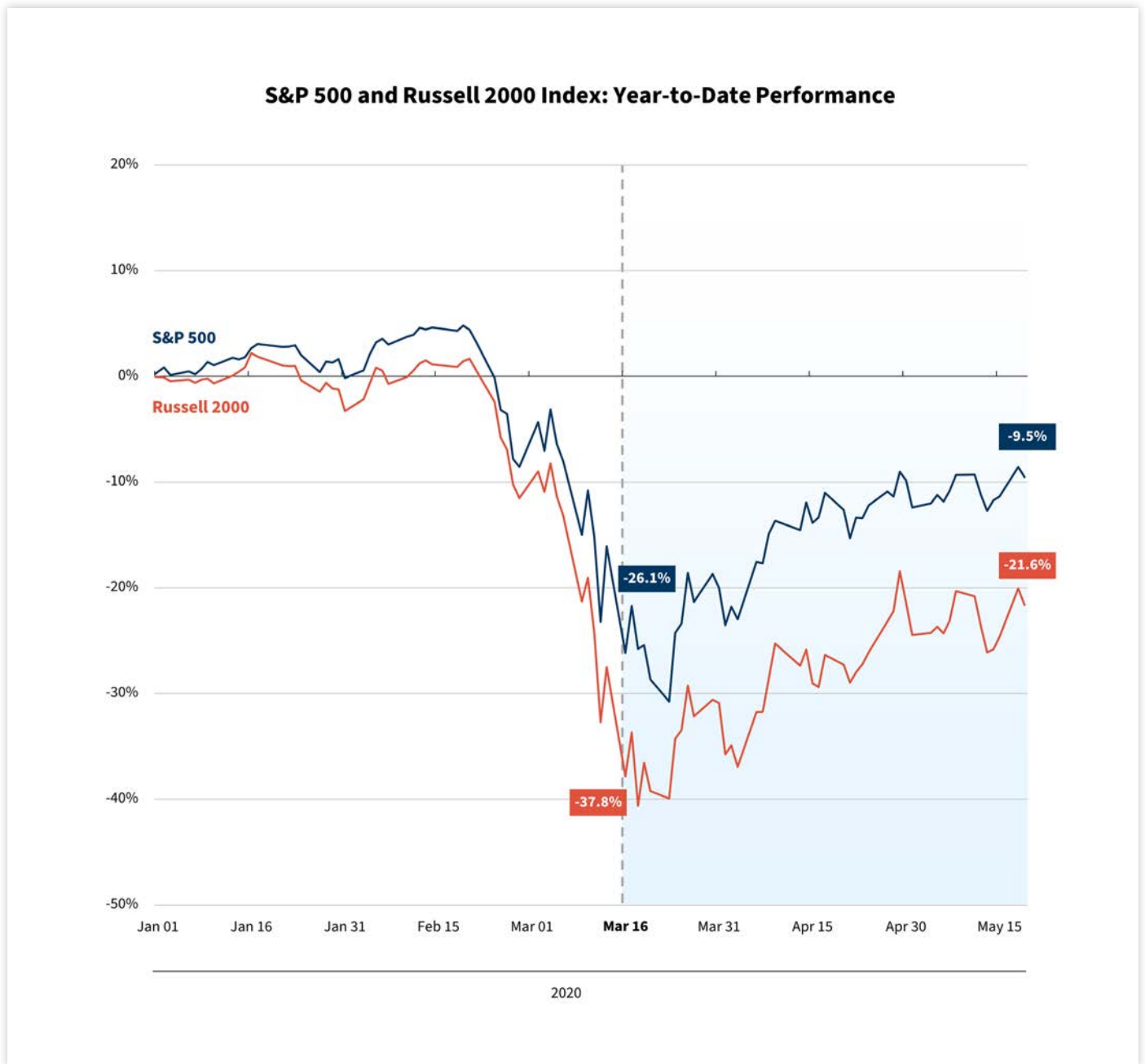
Introduction and Market Update

We hope this finds you all healthy and safe amid these challenging times. Our team, like the rest of the world, is adapting to new realities and environments. We send our sincerest gratitude to the many on the front lines of this crisis, from the healthcare professionals to package delivery workers, who have courageously stepped in the face of unfathomable challenges.

As North America enters what feels like the middle innings of the COVID-19 era, there are societal rays of light and hope that the worst of this pandemic is behind us. No doubt, however, we have a challenging road ahead as we venture back to “normal” life. In the coming weeks and months, as some state and local governments ease lockdown restrictions and businesses slowly reopen, we will begin to see a glimpse of what that road will look like.

While that future may not be entirely clear to us at the moment, what is clear is the economic wreckage this pandemic has left in its wake. In this third quarterly edition of the Activism Vulnerability Report, we get our first view of the initial impacts of COVID-19 on corporate financial statements. Readers of our Q4 2019 Report, issued in March, will recall that the Screener bases its analysis on the most recently available data for the given category score, meaning that financial data is sourced from the most recent company annual or interim report. Thus, for the Balance Sheet and Operating Performance categories, the Q1 2020 results were the first to include these impacts, albeit only the limited impact from the partial month of economic restrictions.









However, despite the impacts on first quarter results and any potential longer-term effects on corporate performance, equity markets have experienced a sizable rebound from the depths of the historic sell-off of March 2020. The S&P 500 and Russell 2000 have both rebounded over 13% since the date of our last publishing, March 26. While still down by ~10% and 22%, respectively, year-to-date, this marks a notable recovery from where they stood in March, a recovery largely based on central bank intervention and increasing hope for a vaccine.



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:

 <p>Governance</p> <ul style="list-style-type: none"> – Proxy voting standard – Board composition – Proxy access 	 <p>Total Shareholder Return</p> <ul style="list-style-type: none"> – Capital gains – Dividend and share repurchase policy – Relative valuation 	 <p>Balance Sheet</p> <ul style="list-style-type: none"> – Capital allocation – Leverage ratios – Liquidity 	 <p>Operating Performance</p> <ul style="list-style-type: none"> – Revenue and earnings growth – Profitability margins – Merger integration
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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.

Q1 2020's Most Vulnerable Industries

The chart below displays the Total Vulnerability Scores for 25 well-known industries as of March 31, 2020:

Rank	▲ Rank QoQ	FTI Industry	Q1 Vulnerability Score	Q4 Vulnerability Score
1	-	Media	60.43	58.16
2	-	Telecommunications	55.57	53.14
3	-	Publishing	54.86	51.09
4	▲ 1	Consumer Durables	51.54	50.92
5	▼ 1	Aerospace and Defense	51.37	50.97
6	▲ 6	Professional Services	50.74	48.61
7	▼ 1	Automotive	50.54	49.37
8	▼ 1	Construction	50.01	49.26
9	▼ 1	Agriculture	49.21	49.23
10	▲ 3	Energy, Power & Products	48.53	48.52
11	-	Hospitality, Gaming & Leisure	48.31	48.65
12	▼ 3	REITs	48.31	49.00
13	▲ 2	Consumer Non-Durables	47.56	47.09
14	▲ 2	Mining	47.44	46.93
15	▼ 1	Healthcare Services	47.19	48.20
16	▼ 6	Real Estate	47.12	48.95
17	-	Regional Banks	46.04	46.70
18	-	Pharmaceuticals	45.42	44.89
19	▲ 1	Technology	44.46	44.65
20	▲ 2	Transportation	44.40	43.77
21	▲ 2	Life Sciences & Biotechnology	43.39	42.21
22	▼ 1	Large Financial Institutions & Fintech	42.94	44.05
23	▼ 4	Business Services	42.85	44.76
24	-	Insurance	40.59	39.10
25	-	Investment Advisory Services	36.16	32.48

Our Q1 data shows a similar top-five most vulnerable industries to last quarter, with consumer durables moving ahead of aerospace and defense, from fifth to fourth. The fastest mover up the rankings in this quarter is professional services, a group that accounts for corporate marketing firms, as well as consulting firms (Disclaimer: this includes our parent company, FTI Consulting).

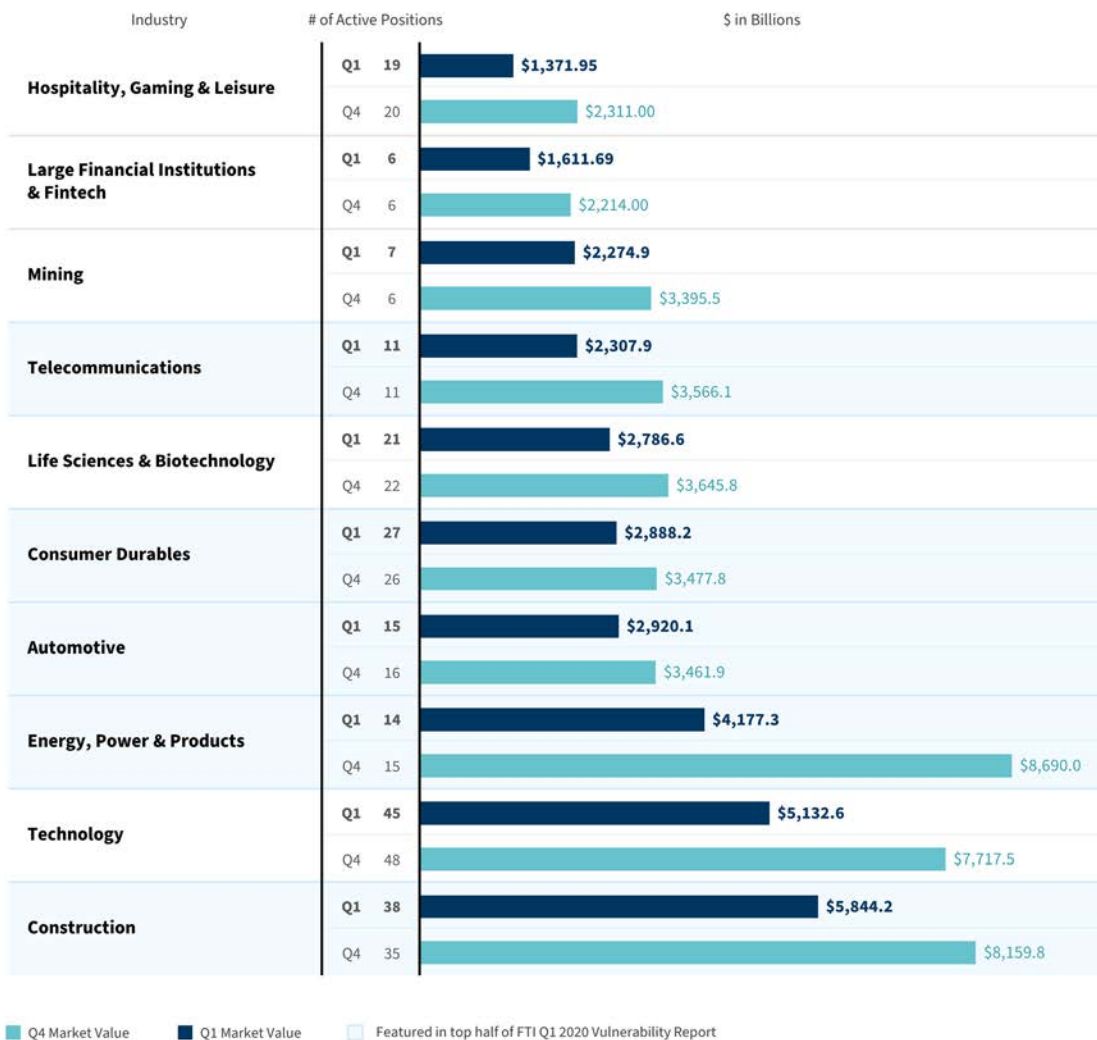
While readers might have expected to see the negative results from Q1 lead to more volatility in the rankings, it is important to remember that Q1 was largely complete by the time the entire country was facing broad economic restrictions, and for that reason, Q1 financial results will not show the entire story. Instead, we would expect that quarterly results from Q2 will help paint a more complete picture.

Overall, it's notable that the top eight industries all increased in total vulnerability since Q4 2019, suggesting that these industries are separating from the rest of the group. Additionally, this quarter saw the highest number of industries (eight) with a total score of 50 or higher, expanding from five in the previous two quarters.

Major Funds’ Holdings by Industry

As in last quarter’s report, FTI analyzed the holdings of major hedge funds whose primary strategy is shareholder activism by industry to compare with the Screener’s findings. For purposes of consistency, FTI uses Activist Insight’s annual Activist Top 10¹ list to determine the funds to include in this analysis. Of the top ten industries making up Activist Insight’s Activist Top 10, six are within the top half of FTI’s most vulnerable industries list.

Top 10 Industries Represented in Activist Insight’s 2020 Activist Top 10



¹ https://www.activistsight.com/research/TheActivistInvesting_AnnualReview_2020.pdf

FTI Observations & Insights



Energy Power & Products

“For the second time in five years, the industry faces tremendous headwinds regarding commodity prices which ripple through the entire energy complex, with downward pressure on crude oil, natural gas liquids, LNG, refined product and power prices. Many survivors from the wave of restructuring and value destroyed by the 2014 through 2017 market price disruption were still in recovery mode when 2020 began. Many E&P companies in the US invested heavily after 2016 in new project and development activities, while oilfield services companies relocated or expanded their service fleets to meet demand. This dramatically increased daily US oil production from 9 million barrels in 2016 to over 12 million barrels in 2019, allowing politicians and the energy industry to tout “American energy independence.” However, many E&P companies generated poor shareholder returns as they grew, leading to activist shareholders running proxy contests to oppose directors and mergers during 2018 and 2019. As we entered 2020, capital providers emphasized the need for E&P companies to operate on existing cash flow and reduce reliance on new or outside capital for development. Many companies issued capital budget guidance for 2020 to operate on internally generated cash flow.

Then came the perfect storm of COVID-inspired shutdowns, resulting in world-wide crude oil demand declining by more than 20%, and oversupply as result of the disagreements between Saudi Arabia and Russia on production levels. The price of crude oil tumbled globally, with US producers experiencing even lower prices and pressure on pipelines, terminals and refineries regarding tankage capacity to store crude oil, refined products and LNG. Many E&P companies began reviews of field operations, preparing to shut-in part or all their production while operating margins declined to negative. Additionally, and not surprising, companies are adjusting capital and G&A budgets as cash flows plummet.

The number of E&P, OFS and midstream restructurings are on the rise as companies and debt holders evaluate how to manage through this tumultuous time, which many old-timers compare to the lean times of the mid-1980s. The industry deployed a tremendous amount of capital during the recent horizontal drilling boom and learned how to extract vast amounts of hydrocarbons. It is yet to be determined if that knowledge will be economically viable in the future.”

**– Albert Conly, Charles Carroll and Bob Medlin,
Senior Managing Directors – FTI Consulting’s
Corporate Finance & Restructuring practice**



Hospitality & Gaming

“The Hospitality and Gaming sector is, in more ways than one, the epicenter of this pandemic. As of the beginning of May, there were approximately 6,000 hotels closed in the United States since the beginning of the year, and the hotel REITs have closed most of their hotels, with much of the world doing the same.

This is not an economic shock, but a crash. An industry that prides itself on personal contact, “pressing the flesh” conventions, and “face to face” meetings is now a social outcast. The scars on the traveling public may not be permanent, but they are not going away anytime soon either.

While hotel owners, brands, investors and the traveling public figured out the new normal, hotel values plummeted taking REITs with them. Some hotel REITs lost 75-90% of their value, although values have somewhat recovered to (say) 50% discounts. But the recovery is uneven – those with urban, fly-to resorts, and group and convention hotels are likely to recover slower.

The industry employs millions of dedicated, hard-working Americans – many of who are proud to serve others. It’s important that governments support the industry financially, and the traveling public, once again, meet and greet, see friends and promote commerce – much as they did after 9-11.”

– Alan Tantleff, Senior Managing Director
and Leader of the Hospitality,
Gaming & Leisure industry practice

Retail

“For those familiar with Cheers, we remember Cliff explaining the water buffalo theory to Norm: ‘Well ya see, Norm, it’s like this... A herd of buffalo can only move as fast as the slowest buffalo. And when the herd is in the wild, it is the slowest and weakest ones at the back that are killed first. This natural selection is good for the herd as a whole, because the general speed and health of the whole group keeps improving.’ Unfortunately, this has become a sad reality for the retail sector as COVID-19 shuttered vast portions of the retail sector for months and closed over 630,000 stores.

The broad disruption to consumer markets as result of COVID-19 crippled the retail sector and placed many retailers in peril. As expected, retailers on the brink of bankruptcy prior to the pandemic have already started to file for bankruptcy protection. More surprisingly, a number of retailers with healthy balance sheets prior to COVID-19 are being pushed towards bankruptcy and will need to make tough decisions over the coming weeks/months to avoid filing.

As we look forward to the rebound of the retail sector, we anticipate a wave of bankruptcies and store closures as the market stabilizes and approaches equilibrium. The over-saturation of the retail landscape has been discussed for years, and COVID-19 will be the driving force to close unprofitable stores and focus on a subset of highly profitable stores. This right-sizing will result in a healthier retail sector over the coming years, but might be a retail sector we don’t recognize...”

– Christa Hart, Senior Managing Director
in the Retail & Consumer Products
industry practice





What This Means

Undoubtedly, the spread of COVID-19 has created a chilling effect on shareholder activism, perhaps amplified by the coincidental overlapping with the 2020 proxy season. For one, the optics of a proxy fight during a global health crisis are not particularly great, as the added time commitment, cost and pressures this places on the target firm may very well be more detrimental to its long-term health in such an environment.

Additionally, the mechanics of running an effective campaign virtually present a major obstacle to gaining support from fellow shareholders and proxy advisors, a challenging enough process with face-to-face meetings. In recent years, we've seen a trend in activists and targets settling without going to shareholder vote. Could COVID-19 accelerate this trend even further?

On the flip side, the uncertainty in financial markets, and the greater economy as a whole, have created historically volatile and significantly reduced valuations. What's more, the broad-based decline in equities has surely created new and

widening instances of value gaps, spreads between intrinsic and market value, compared to the historically high valuations present towards the end of the ten-year bull market.

Lower valuations and mispriced assets have long been considered the perfect investing conditions for the value investors activists claim to be. Seen in that light, could COVID-19 eventually be seen as a tailwind for shareholder activism? The influx of activist funds that are reportedly raising capital seems to suggest so.

A successful reopening of businesses and restarting of economies on the first try, while unquestionably desired, is far from guaranteed. Speaking on CNBC in April, renowned investor Howard Marks highlighted the possible disconnect between market prices and economic realities, saying “[the market] is only down 15% from the all-time high on February 19, but it seems to me the world is more than 15% screwed up.”



While the unknowns are abundant, we believe in two certainties. The first is that at some currently unknown point, we will move past this. The second is that this period represents a major inflection point in history. Like every major economic downturn in the past, strategies implemented here are magnified in importance. Because of this, actions and behavior of senior executives will be carefully evaluated and scrutinized by investors, regulators and the public alike. In short, while the conditions throughout this 2020 proxy season may have kept activist investors largely at bay, it is unlikely this will persist. The reactions and responses made now are the basis for future vulnerability to shareholders, making this period especially critical for boards and management to mitigate this risk.

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