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ARE CONSUMER AND RETAIL COMPANIES MORE VULNERABLE TO ACTIVISM?

BY MELISSA SAWYER

Consumer and retail (C&R) companies have been frequent targets of shareholder activism in the past year. Notable recent situations involved Abercrombie, Darden, Family Dollar, Jos. A. Bank and PetSmart. In fact, so far in calendar year 2014, 16 out of approximately 78 announced proxy fights involved C&R companies (which amounts to approximately 20.5% of all proxy fights, even though C&R companies represent only about 10% of all public companies).

It may be too soon to label this observation "statistically significant." Anecdotally, however, C&R companies do seem to share some characteristics that make them more vulnerable to activism than non-C&R companies, on average. These characteristics fall chiefly into two areas: legal/structural characteristics and economic/performance-related characteristics.

Legal/Structural Characteristics

1. C&R is Not a Highly Regulated Industry: Unlike takeovers of insurance companies, financial institutions and utility companies, among others, significant investments in C&R companies are not usually subject to pre-approval by regulators in the U.S., other than the routine Hart-Scott-Rodino antitrust notification requirement. An activist in a C&R company can acquire up to approximately $70 million without restriction and without notifying the target until 10 days after crossing the 5 percent level (triggering a Schedule 13D disclosure). For small- and mid-cap C&R companies whose stock prices may be trading at the lower end of their 52-week range, $70 million may represent a sizeable and influential stake. Even above the $70 million level, the HSR filing requirements may not prove to be much of a barrier if the investor is able to obtain early termination of the waiting period or to fit its acquisition into the HSR Act's passive investment exemption.

2. Historic Family Ownership: Many C&R companies have their roots as family-owned businesses. Some C&R companies, even after their IPOs, continue to have family members in senior management or on the board. Some companies even have dual-class capital structures that confer greater voting rights on family-related shareholders or estate planning vehicles. These vestiges of family-ownership are easy targets for governance activists, who tend to be keen to eliminate the appearance of nepotism and related party transactions.

3. Weakening of Structural Defenses: Like many S&P 500 companies, C&R companies have substantially weakened their takeover defenses over the past 15 years. For example, fewer C&R companies have shareholder rights plans and classified boards, and more C&R companies allow shareholders to call special meetings. This weakening of takeover defenses not only opens the door to hostile acquisition activity, but also makes these C&R companies vulnerable to threats from activists agitating for changes to strategic plans (because the activists now more readily have the power to replace directors, and hence to replace management).

4. Seasonality of Operations in Relation to Proxy Season Timing: Many C&R companies remain on a typical spring annual meeting schedule, even though this results in their proxy season falling in the midst of when they announce holiday season and first quarter results — announcements that, in recent years, have followed anemic holiday seasons during periods of broader economic malaise. Having director elections at C&R companies' most vulnerable time in the year may not be optimal.

Economic/Performance-Related Characteristics

1. The "Conglomerate Discount Effect." Brand performance can vary widely from year to year depending on changes in trends and consumer preferences, as well as other factors like advertising and promotion allocations in the portfolio, category competition, supply costs and margin erosion. As a result, at any given time, multi-brand C&R companies are likely to have some brands in their portfolio that are performing better than others. Management may have good operational rationales for brand-by-brand performance variations, and may even deliberately plan for certain brands to act as "hedges" against other brands. However, when viewed through a short-term lens, this variability in brand performance can make C&R companies vulnerable to activists' arguments that the companies should spin-off or divest underperforming brands, streamlining their operations to focus only on the companies' most profitable segments.

2. Perception that C&R "is not Rocket Science": Many C&R companies do not have significant long-term R&D pipelines. This is certainly true for retail companies, and may even be true for many food and household products companies that are not subject to the same lengthy regulatory approval processes for new products as, for example, pharmaceutical companies. As a result, there may be an unstated assumption on the part of many

activists that management of C&R companies does not need a lot of time (or company-specific expertise) to unlock the value of C&R brands. This perception that C&R "is not rocket science" may open up the field of potential activists to funds that have not developed any special expertise in the C&R industry or even been involved with a C&R company before.

3. Parts of the Retail Sector are Struggling: It is no secret that the retail sector is struggling, both domestically and internationally. Many retail companies posted poor results following the 2013 holiday season, attributing their performance issues to deep discounting and competition from e-commerce, among other factors. The fundamental shift away from traditional storefront retail into e-commerce and other technological developments may be causing activists to push C&R companies to explore new business models.

What Can C&R Companies do to Prepare Themselves for Activists and Unsolicited Proposals?

The steps C&R companies can take to prepare themselves for activists and unsolicited proposals are not unlike those for companies in other industries. They include:

1. Having thoughtful and regular engagement with investors. Not only will regular investor dialog serve as an early warning system for potential sources of investor discontent, but maintaining regular contact with investors may also enhance management's credibility in the event that management has to ask for the investors' support against a dissident.

2. Pursuing a rigorous strategic planning process, and being particularly attentive to messaging about that strategy in earnings announcements, investor conferences and other public statements. The messaging may include providing preemptive commentary regarding the kinds of topics likely to get air-time in an activist white paper, such as the distinctions between high margin and high volume strategies or top-line and bottom-line growth.

3. Developing and articulating a proactive capital allocation strategy. While capital allocation is not as much a hot topic for activists as it once was, management still needs to be prepared to address whether the company should be doing more share buy-backs or paying higher dividends.

4. Performing a dispassionate governance self-evaluation, including reviewing related party transactions and the role of any founders/family members in management or the board. This sensitive but necessary function is probably most appropriately allocated to the governance committee of the board in the first instance, but the general counsel should also be alert to this topic and should monitor reports from proxy advisory and other services that provide governance scorecards.

5. Being aware of best practices in executive compensation and tracking compensation-related benchmarks. Outliers on executive compensation matters make for easy targets for activists and proxy advisory firms alike.

6. Monitoring activism involving competitors or companies in related sectors to identify trends and key players. Management should consider proactively tackling the key issues that seem to draw the activists' ire to competitors before the spotlight turns to focus on them.

7. Implementing a stock watch to track unusual trading activity and volumes. Stock watches, although imperfect, can provide the board with advance warning several days before an activist would otherwise be required to file a Schedule 13D. Stock watches can be conducted by proxy solicitation firms, among others, and are usually based on observations about trading within certain custodians that are traditionally associated with particular activist funds.

8. Putting a shareholder rights plan "on the shelf." It is not sufficient just to have documentation drafted and available in the general counsel's file cabinet. Directors should also spend some time with outside counsel, actively discussing how and when a rights plan works.

9. Identifying a "rapid response team" (including financial, PR and legal advisers) that can react on short notice to an activist or unsolicited acquisition. Many external advisors are happy to be part of the team and even to do some background work at little or no additional cost initially in the hope that they will ultimately be first in line to get the assignment if and when an activist emerges.

Conclusion

Time will tell if the data support the hypothesis that C&R companies are more frequent targets of activists than companies in other industries. Regardless, there are things that C&R companies can and should do today to prepare themselves for attacks, whether by shoring up their businesses, their governance or their defenses.

Melissa Sawyer is a Partner in the Mergers & Acquisitions Group of Sullivan & Cromwell LLP's New York Office.

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