JUNE 2017

PUBLIC UTILITIES FORTNIGHTLY

"In the Public Interest"

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David Owens Makes His Mark

First Recipient of PUF's Owen Young Award

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PUBLIC UTILITIES FORTNIGHTLY
"In the Public Interest"

We return to twice monthly. The mid-month digital PUF 2.0 debuts June 12.

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The cover of May's PUF featured the last drawing of Thomas Edison facing left. This cover of June's PUF features another great of our industry, David Owens, facing right. David, executive vice president of the EEI, retires this month and is the first recipient of *PUF's Owen Young Award*.

Leadership Lyceum Podcast

Shareholder Activism: Coming to a Utility Near You?

A Conversation with Chris Young, Managing Director and Head of the Contested Situations Group at Credit Suisse

By Tom Linquist

I spoke about shareholder activism with Chris Young, Managing Director and Head of the Contested Situations Group at Credit Suisse. Chris is a lawyer who moved into investment banking in the technology sector. He spent a little over six years at Institutional Shareholder Services. Chris joined Credit Suisse seven years ago and leads the Contested Situations Group.

Tom Linquist: Chris, you refer to activism as "contested situations." Perhaps it's helpful to define terms upfront. Shareholder activism, in some type of planned and directed form, conjures images of corporate raiders from the 80s – the stuff of *Predators' Ball* and *Barbarians at the Gate*.

The contemporary form of activism seems less hostile. Or perhaps the euphemism sounds a little less hostile if it's described as "contested situations." What is activism, and how has it evolved over time?

Chris Young: I think the current activists are the next generation of what we used to call "corporate raiders." I think the major difference is that back in the 80s, the raiders would make plays to take over a hundred percent of the target company.

I heard a well-known activist state that the genius behind activism is you can take a non-control position, a small stake, not pay a control premium, yet exercise some degree of control over the company. That's why they are willing to take on all the costs and added bandwidth to run campaigns. It's an expensive, time-consuming way to invest rather than to just pick a stock and sit back.

I think that's the biggest difference.

Tom Linquist: What do activists want and how has that changed over time?

Chris Young: I always talk about four buckets of activism. First, mergers and acquisitions. Sell the company or a subset of what would break up the company and get re-rated on different businesses, or sell your non-core businesses and focus on your core. That would be all mergers and acquisitions-related.

Second, balance sheet, is straightforward. Usually the argument is that you have too much cash on the balance sheet. You can return it in various ways, either through a dividend or a share repurchase.

The third area is governance. This is not usually the focal point or the driver for activism. Often there is a request for board representation. Or a request for some changes in compensation practices and other things.

For hedge funds, that's not usually the driver, but it's a means to an end if they can get on the board and have some say from the inside and implement balance sheet and mergers and acquisitions changes.

The current activists are the next generation of what we used call 'corporate raiders.'

The fourth bucket is what I call operational. To me, it's one of the more interesting developments because it's the hardest and therefore, the rarest kind of activism you see. It focuses on the income statement more than the balance sheet.

It's where the activist purports to have ideas on how to run the business better.

Historically, that's been a hard form of activism to deploy, because companies and advisors can say, "Hey, these guys are a bunch of traders, what do they know about running a power producer or a utility?" Or whatever the case may be.

Over time as the asset classes mature, at least in the U.S., the activists have been able to almost morph into a pseudo-private equity sort of structure where they have recruited operators, retired CEOs, COOs in the industry.

They used to have difficulty doing that because of the stigma attached to activism in the early days. But more recently, we have been surprised by what you would consider very conservative individuals who have strong personal brands to protect, who have been willing to say this. "I'm going to have a little fun and agreed to work with an activist on their fight here, and I'm going to add my expertise on operations on how to run a company."

Some will take over leadership of the company.

Tom Linquist: So, you have three areas: mergers and acquisitions, balance sheet and operations performance, where I can't envision influencing events without the governance change. How, in the absence of getting representation on the board, are they able to get control of the three other areas?

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Chris Young: That's a good point. That's why I usually say governance. That bucket is a means to the end and the end is the other three: mergers and acquisitions, balance sheet, and operational.

I would say that you have plenty of examples where the activist does not get on the board, just threatens to run a proxy fight and then the company decides not to fight. Maybe they've gauged investor sentiment and determined that they may lose that vote and therefore, they agree to do a buyback, for example.

Or they agree to sell a non-core business line without any of the governance changes. The activist is able to accomplish one of the other three goals without actually having to change the governance.

Now the threat of changing the governance typically has to be stated overtly. It's the elephant in the room that everybody knows is there. That is the weapon. It's the stick that the activist can use while you are negotiating what we call a settlement.

You either decide to fight because you determine that the activist is wrong, and it's in the best interest of the company and the shareholder to fight. Despite the expense and the bandwidth that you must devote to a fight.

Or in many cases, and the data shows this, there are settlements that you meet halfway and you agree to do part of what the activist is looking for and maybe refuse to do something else. Sometimes the settlements do include board seats. But a lot of times maybe those board seats are not the principals from the hedge fund.

Again, the quality of the board nominees that the activists can recruit has improved over the past decade-plus. Often, the principal of the hedge fund wants to be on the board, too, to have a shareholder watchdog in the board room.

But increasingly, many of them are happy just to have influence on maybe two seats and say, "These are two people that we would like to have on the board. I don't need to go on the board as Mr. Activist. I'm comfortable that if you agree to do this buyback and do one other thing and then put these two individuals, who are independent of me, on paper at least, then we are happy."

That would be a version of the governance change. It doesn't have to be the activist or a principal from the fund itself that goes on the board.

Tom Linquist: Yes, but you must move the chess pieces that are in place to have the powerful influence absent the governance.

Chris Young: Yes, you either have to have that or you have to threaten to force your way on the board and then the company has to determine, "Oh, that's a credible threat and therefore, let's find a way to not go through all of that brain damage."

Sometimes it's the right call for the company to refuse it. It's all going to depend though. Everyone has to remember the activist is an outside investor, meaning they are investing based on publicly-available information, unless they are doing something wrong. They can get it wrong. Some of them are very smart and just by using publicly available information, they can have good ideas.

Other times, they don't have the full picture, because they don't have the access to non-public information. Therefore, their prescription for creating shareholder value is erroneous and therefore, you need to educate them.

Tom Linquist: What drives the timing for an activist?

Chris Young: The activists decide when to go public. With rare exceptions, a company does not want to go public because they know that will change their share registry and then their employees are going to be distracted. The activists can just decide when it wants to go public.

What controls the final escalation typically is the board nominations deadline. We all talk about circling that date on the calendar. The activist has it circled. The company has it circled and they know typically after that date passes the company's leverage increases for another year.

You have examples where the activist does not get on the board, just threatens a proxy fight.

This means typically, unless there is a way to act outside the calendar.

One of our jobs along with outside counsel is to examine a company's charter and bylaws. Is there a right for shareholders to call a special meeting?

At what threshold is their right to act by written consent? At what threshold can they remove directors? Because activists have been willing to use those tools and tactics to act outside the annual meeting calendar.

Tom Linquist: Surprise attacks.

Chris Young: Surprise attacks or just not being bound to that nomination deadline, so it's not that same little date circled on the calendar. They can act three hundred sixty-five days a year.

Tom Linquist: With that single date, is there a "hunting season", is there an "activism season?

Chris Young: There's a hunting season and the pressure, yes, it builds up to that date, I think for both sides.

Tom Linquist: Let's discuss your vulnerability framework. What are those principal areas that you advise a CEO and a board to make sure they are watching?

Chris Young: I think a lot of it is common sense, of course. Shareholder return on a relative basis against the peers, the index. If you are underperforming from a shareholder returns perspective, you are going to have an unhappy shareholder base.

That shareholder base is going to be more open to an activist coming in and presenting what I mentioned before, that free option.

Tom Linquist: You mentioned that you have not seen a lot of activism in the utility space. But you talked about one of the fundamental settings in which you find activism. It was when the industry was ripe for consolidation. There has been a long trend over the last twenty-five years in the utility industry.

Twenty-five years ago, there were in excess of one hundred independent utilities. Now there are less than fifty. Do you have any advice specific to a consolidating industry?

Chris Young: If you are in an industry that is perceived to be ripe for consolidation, then you are vulnerable to being pushed into consolidating.

It's one of the easiest strategies for an activist. It's a home run for them to take a position in a company, whatever sector it is in. But if you are talking utilities, they will take a position in a company they believe will be consolidated, the target company.

They will agitate to make that deal happen and capture the expected takeover premium over a pretty short period of time, often using leverage. When you do all the math, that's a tremendous sort of annual rate of return for that investment.

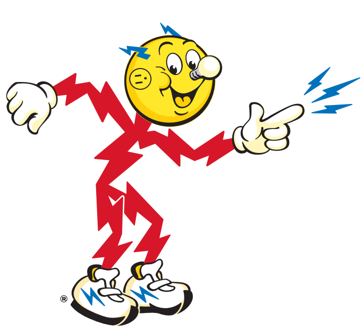
Tom Linquist: What can you do?

Chris Young: The best defense, again, against activism, it's a cliché because it's true – high performance, high multiple. To extent that you are one of the smaller firms in a sector and therefore, by definition, would be considered maybe a target rather than the acquirer.

If you are trading at a high multiple because you are performing on all cylinders and one of your peers is trading at a lower multiple, that peer is going to be more vulnerable than you are because you are more expensive.

It's easy to say, perform better, but that's really it. Among your peer group try not to be the laggard. It's like that old joke with the bear and the two guys, "I don't have to be faster than the bear. I just have to be faster than you." PUF

To hear the full interview, please link to the podcast at Leadership Lyceum: A CEO's Virtual Mentor, available at Apple iTunes. Search iTunes Podcasts, with the keyword Leadership Lyceum.



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Last month, the Commerce Department released detailed data on Americans' consumer expenditures in March. The data is a key component of the first quarter's Gross Domestic Product.

Number-crunching by your PUF team found that electric bills in the first quarter were just 1.25 percent of all consumer expenditures. One and a quarter percent! This percent has never been lower. By a lot. The previous record, 1.34 percent, was set in the first quarter of last year.

The electric bills percent has been below 1.40 percent in just six of the two hundred thirty-three quarters since the first quarter of 1959.

Remarkably, five of these six low electric bill quarters have taken place since the fourth quarter of 2015. And, as remarkably, all but one of the quarters since then have been below 1.40 percent.

Another way to see how low electric bills have become, is to use fractions. 1.25 percent is one-eightieth. So, in the first quarter, electric bills were one-eightieth of consumer expenditures.