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Strange bedfellows

A Republican president offers unexpected relief for activist investors. Activist Insight reports on how the Trump administration may set the stage for regulatory reforms and big deals.

In February 2017, Activist Insight conducted a number of interviews to ascertain what the potential impact of Trump's presidency on activism might be. Some interviewees preferred not to go on the record, citing company policies about commenting on politics, while others heavily caveated their remarks, noting the uncertainty of the political process and the lack of familiarity between the White House and Capitol Hill. Trump was, after all, a very unlikely Republican candidate.

CIRCA 2017

> *"In December 2016, President Trump appointed one of their own, Carl Icahn, as his regulatory advisor."*

In 2016's long and unusual election campaign, the political salience of activist investors was a surprise, to say the least. During Hillary Clinton's campaign against financial short-termism and Donald Trump's at one point scathing criticism of hedge fund managers, activists appeared to have few real defenders. So much so that at one point, Pershing Square Capital Management, Jana Partners, Elliott Management, Carl Icahn and Third Point Partners formed a Washington lobby group, CIRCA – the Council for Investor Rights and Corporate Accountability (Third Point has since quietly withdrawn from the list of sponsoring members and did not respond to requests for comment).

CIRCA today hosts a website with answers to a list of frequently asked questions, such as "What does activism do for the U.S. economy?" and, "Aren't activists really just short-term investors?" The group has been quieter than it expected to be had Clinton won and is, in the words of political strategist Rob Collins, an adviser to the group, "really upbeat."

That's because issues on which it had feared regulation have so far been spared attention from legislators. Although the group's mission is limited to educating policymakers and defending the interests of its members on antitrust policy Schedule 13D rules – the process by which activists are required to disclose stakes and intentions – shareholder rights have not been at the forefront of efforts to roll-back regulation under the new administration. To boot, in December 2016, President Trump appointed one of their own, Carl Icahn, as his regulatory adviser.

A halt for shareholder empowerment

The impact of Trump's opposition to the Dodd-Frank Act, his predecessor's signature reform of financial markets, is unclear as far as shareholder rights go. A February 3 executive order charts a clearer policy on regulating financial advisers than large corporations, and the Securities and Exchange Commission (SEC) has not been formally bound by a cap on the introduction of new regulation. Even so, many in Congress – including House Financial Services Committee Chair Jeb Hensarling – are gunning to remove restrictions on executive compensation, pay ratio disclosures and the mandated regular "say on pay" policy votes.

Some activists are understood to fear that efforts to regulate proxy advisory firms such as Institutional Shareholder Services (ISS) and Glass Lewis are an

Good for gadflies?

Nell Minnow is among those who think governance activism should continue its upward trajectory, regardless of the new administration. "Even if there are regulatory changes, private action will make up for government inaction," she told Activist Insight Monthly in an interview.

Still, Jim McRitchie, a veteran filer of shareholder proposals, fears an attempt to increase the threshold from $2,000 of stock to between 0.15% and 1% of a company's market capitalization may seep from the Business Roundtable, a corporate lobby group, into the priorities of Republican lawmakers. Yet he hopes Icahn's presence as an adviser to Trump will soften those voices, saying in an interview with Activist Insight Monthly, "In the past he has helped small shareholders so him being there is better than him not."

"It's in his own selfish interest," McRitchie expands. "What I do at these companies is weaken their defenses. I'm not trying to do Carl Icahn any favors, but I do want to increase shareholder accountability."

“Changes to tax policy could have unintended consequences on these structures that could drive additional or a different type of activism.”

attempt to make recommendations more pro-management. Proposals to require registration and greater disclosure from proxy advisers, including consulting revenue, are supported by pro-business groups and feature in Hensarling’s Financial CHOICE Act, which remains in limbo. “The threat of regulation of advisers may put proxy advisers on notice to be engagement friendly and error free in their reports,” says Martha Carter, head of Teneo Governance and a former head of ISS Research. “Proxy advisors that support full or partial slates in activist campaigns will need to do the buttoned up due diligence to ensure that they aren’t exposed to criticisms.”

Meanwhile, governance expert Nell Minnow, who used to run ISS, holds little truck with alleged conflicts. Proxy advisers are “doubly advisory,” she says, meaning that their recommendations are just that, on non-binding proposals.

A hot market

Derek Zaba, a former activist now helping companies engage institutional investors with CamberView Partners, spoke to the potential impact on markets of economic and tax policy changes that have already seen markets run up quickly since the November election. “Many activist theses regarding strategy are tax-driven or tax-enabled,” he said in an interview, citing spinoffs, REIT separations, inversions, and Reverse Morris Trusts. “Changes to tax policy could have unintended consequences on these structures that could drive additional or a different type of activism.”

Others put it more simply. A hot market, leading to more M&A activity, will embolden activists to push firms to partner up. And while the same broad antitrust policy that prevented mergers between Halliburton and Baker Hughes or Staples and Office Depot in 2016 will stand, enforcement could gradually shift in a less interventionist direction. In a February 3 speech, acting Federal Trade Commission chair, Maureen Ohlhausen, described her lodestar as “regulatory humility,” and called for harder evidence of harm caused by combinations.

Then there is a proposed corporate tax holiday to encourage firms to return cash held overseas to the U.S. At the moment, a question mark hangs over whether that capital will fund investment, M&A or, as BlackRock’s Larry Fink asks, “Will it be used simply for more share buybacks?” Whatever the answer, activists are likely to want a say over the uses of that capital, should the changes take place.

“Putting the uncertainty of regulatory reform in the context of 2016, where we saw winners and losers in activism, it is likely that we’ll see more tactical activism, as well as size and sector-specific campaigns,” says Carter. “2017 will be a transition year.”

Universal proxy

Yet another ambition of Hensarling is the stopping of SEC progress on mandating a universal proxy, which he says “favors special interests and short-termism rather than benefiting the vast majority of public company shareholders.” That puts him at odds with Icahn, who applauded the SEC for its initiative and said the policy would “eliminate needless voter confusion in contested elections, give shareholders greater freedom of choice, and hopefully end some of the gamesmanship employed by incumbent boards to keep shareholder-nominated directors out of the boardroom.”

Progress is unlikely until the SEC has a permanent chair, and it is unclear whether Icahn discussed the issue with Trump’s nominee, Jay Clayton, as part of the interview process for the job. Yet, as shareholder defense lawyer Keith Gottfried points out, a relatively small change to the proxy rules, which currently require the consent of a nominee to be on a ballot paper, could allow investors to demand the use of a universal proxy without it being mandated by the commission.

That may be a possibility, especially where companies fear greater upheaval if dissatisfied investors are forced to vote for activist nominees over incumbents in order to achieve a measure of change, as currently happens. Yet observers of the impressive private ordering effort that introduced proxy access to many large companies are skeptical that the same could happen for the universal proxy. “As opposed to proxy access, which is viewed by many investors as a fundamental shareholder right, universal ballot would only impact a limited number of companies facing a proxy contest,” says Zaba. “It’s hard to see a similar groundswell of support like we saw for proxy access.”

Something racier

A bad quarter for retail has hit even the biggest brands hard. For an activist willing to get into intimates, L Brands might present an opportunity.

Even before end-of-year earnings were released after the market close on February 22, L Brands looked vulnerable to an activist approach. Compounded by the 16% sell-off when markets re-opened, the worst performing stock in the S&P 500 on the day and a 12-month low, the allure of the Victoria's Secret owners' lingerie is obscured by red flags.

L Brands, Inc.

Industry	*Apparel Stores*
Sector	*Services*
HQ	*Columbus, OH*
Market cap	$15.05 billion*
Exchange	*NYSE*
Ticker	*LB*

** as of February 28, 2017*

> "Many of its issues are macroeconomic – such as currency headwinds and less frequent Chinese, Middle Eastern and Russian air travel impacting airport stores."

Stripped down

Long-running concerns about the state of retailers generally have suddenly hit the company harder than most. One-year trailing total shareholder return is -34%, compared to -8.5% for its peers. At around $50, shares are priced at around 14-times forward earnings, for a well-regarded brand.

Investors in the stock have to weigh a variety of data. Earnings per share crashed from $4.22 in 2015 to $3.98 in 2016, with guidance of $3.05 to $3.35 for 2017. Comparable sales at Victoria's Secret itself were down 20%. Margins also weakened, partly due to heavy year-end discounting.

Given a steady rise in profits leading up to 2016, the hope that this blip will be temporary may inform some daring buyers; Goldman Sachs analysts described the projection as "overly punitive" and maintained its "buy" rating in a February 24 note, despite noting that management's description of February sales – including Valentine's Day – suggested the worst numbers for that month since 2007.

Yet so long as the cash keeps flowing into dividends, with a yield of 4.6% comparing favorably to 1.5% for the company's peer group, L Brands might have one of the better life rafts in the business. Many of its issues are macroeconomic – such as currency headwinds and less frequent Chinese, Middle Eastern and Russian air travel impacting airport stores – while others, such as declining mall traffic, are longer term problems.

The emperor's old clothes

Management has not been standing still during 2016's horror show. After the surprise departure of Victoria's Secret CEO Sharen Turney in February 2016, it reorganized its business divisions, stopped selling swimwear and scrapped its catalog in favor of a renewed focus on digital sales. It also upped its share repurchases.

Yet concerns about oversight and governance at the board level could provide a useful hook for an activist. Les Wexner, the company's founder, CEO and chairman, has been running the show since the 1960s and wife Abigail also sits on the board of directors. The board has an average tenure of 19 years, and no new directors have joined since 2014. Even worse, Wexner appears at 27 on As You Sow's list of the most "overpaid" CEOs, and long-running compensation issues saw an 11% protest against L Brands' "say on pay" vote at last year's meeting and a 9% vote against audit committee member David Kollat, whom some shareholders deemed not to be independent.

That said, management has some handy defense mechanisms to fall back on, in case of a challenge. Insiders own 16.5% of the stock, and the second-largest holder, Primecap Management,

> "That said, management has some handy defense mechanisms to fall back on, in case of a challenge."

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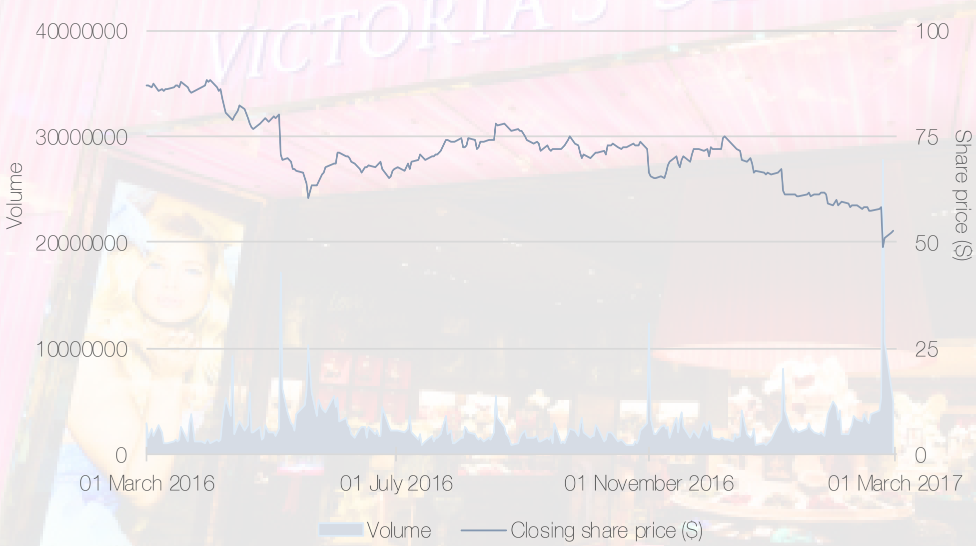
has no history of supporting dissidents in proxy contests, according to Proxy Insight data. One activist described the challenges as "not insurmountable" to winning a proxy contest, but argued that the ownership structure would require support from proxy advisers – necessitating a credible plan for running the company.

Activist options

The elements of that plan might fall into different categories. An operational plan might include reinstating swimwear and apparel, which cost the company two percentage points of comparable sales in 2016 and perhaps as much as six percentage points in 2017, yet with the decision long past, resurrecting the initiative could prove as costly. Alternatively, cutting capex for 2017, already dialed back from a $1 billion forecast to $850-900 million, and accelerating the pace of share repurchases could help to support earnings in a difficult period. That would only make sense if the market were saturated, however, and management is keen to make a success of its international expansion plans.

Alternatively, an activist could push for a breakup of the Victoria's Secret and Bath & Body World businesses, higher franchising rates for overseas stores, or a sale of the entire company. Yet further issues restrict the scope of the change an activist could provoke. L Brands' $15 billion market capitalizations limits the number of both activists and private equity firms that could take on the challenge. A staggered board means only three seats up for grabs in a contest, while a takeover bid or spinoff would require a supermajority of 75%, after a management-sponsored resolution to scrap the provision failed at last year's annual meeting.

L Brands 12 month share price performance.



Fundamentals

52 week high	$88.77 *
52 week low	$47.93 *
Share price	$52.62 *
Total Shareholder Return (12 months)	-34.4% *

** accurate as of February 28, 2017*

Source: Capital IQ, CSI data