The Deal

Engine Capital's Ajdler on Activism EXCLUSIVE

Since 2013, the activist fund manager has taken a "fix it or sell it" approach to investing. He's put a whopping 20 directors onto corporate boards in his quest for share-price improvement. Here's our interview.

By Ronald Orol

Updated on January 23, 2018, 05:24 PM ET

Arnaud Ajdler_Engine Capital LP

Since 2013, **Arnaud Ajdler**, the founder of activist fund Engine Capital LP, has been an insurgent investor with a "fix it or sell it" investment philosophy that has put a whopping 20 directors onto corporate boards. He took some time to speak with The Deal's activist podcast about key targets for share-price improvement: M&A, capital allocation and C-Suite payments. Ajdler also explains why he thinks Procter & Gamble's (PG) **decision** to fight activist **Nelson Peltz** was "silly."

Here's our Q&A, which was **recorded** as an activist podcast for The Deal.

The Deal: *Can you tell me about your activist philosophy?*

Arnaud Ajdler: I would say half of what we do is activist focused, the rest is plain value plus catalyst, special situation investing. On the activist front we are very focused on this idea of fix it or sell it. The idea is to try to find multiple paths to improve shareholder value. Some people try to find paths to push a company into a sale. That's fine, but we like to find multiple ways to win. We first want to find good companies, good assets, strategic assets that someone will want to buy, that's one aspect, the selling part. The other part is "fix it." We want the asset to be underperforming so there are as many levers as possible to optimize.

There is the operational lever - could the company be run better, could the margins be better; could the profitability be improved. There is the capital structure; how is the balance sheet structured. We like to find companies where there is excess cash for example, and talk to them about adding more leverage and reducing cost of capital that should expand the multiple.

Should your target companies have low leverage?

We like to prefer finding situation with little leverage because then we can suggest adding leverage. If we find a company that already has 3x or 4x leveraged, what can we tell them, to go after 5x leverage? There is not much more you can add.

If you go after a company that has excess cash and 1x leverage then you can ask them to increase leverage, conservatively.

There is another lever, capital allocation; let's say they have a history of making poor acquisitions; if we can switch that to buying back stock, that can create shareholder value.

There is a governance lever. We look at the quality of the board. We look at the compensation structure—how is management compensated to run the company? That can also impact shareholder value. We may have some views on how executives should be compensated.

Governance is a big issue. Do you look for overtenured boards? Over boarded directors? What is the focus here? Do these kinds of directors have to go?

We look at situations where directors have been on the board too long. Sometimes we find situations where directors have been on the board for 20 years. That's too long. Sometimes we find directors who don't have any experience relative to the business. That can be a red flag. So we are looking for a situation where we can put a couple people with deep, relevant experience in the space, onto the board. That can add value.

What is an example of a situation where you launched a campaign and how it ended up?

One example is **CST Brands Inc.**, which is a convenience store retailer based in Texas that was spun off from **Valero** Energy (VLO) a few years ago. We liked the industry, which was consolidating. Back to this idea of fix it or sell it. We knew the asset would be attractive to some of the bigger players because of the significant synergies. At the same time it was underperforming peers, margins were below peers, same-store sales were below peers, the company was putting money to work at low return on capital. They had a ton of real estate, so there was a strategic question - should they own the real estate or should they separate the real estate? That is another situation where except for one person no one on the board had relevant experience. Also, management wasn't incentivized the right way.

So what did you do?

We started a dialogue with them and asked for board representation. They declined. We went public with our letter and over the following two weeks we heard from the top shareholders who agreed with our perspective that the company was undervalued, some felt it should be sold; some said it should be improved in the public market. Everyone agreed that the status quo was not working. We ended up nominating a minority slate of four directors; shortly thereafter the company came to us with a proposal to settle. As part of settlement they would announce strategic alternatives and add one of our director candidates. There was some more discussion, we settled, added two new board members, the company announced they were going to look at strategic alternatives and six months later the company was sold to a strategic consolidator.

*Since **Engine Capital** was launched in 2013 it has settled with 11 public companies and put 20 directors on boards. Can you talk about what might make you decide to launch a contest?*

When we find a situation where a company is undervalued, under-managed, when you have a view about what to do to create strategic value. Engine's process is to privately send the board a letter outlining our thoughts. Then, depending on the situation, we may ask for board representation. That could be someone from Engine or not from Engine or a combination of candidates from inside and outside the fund. In some cases we will go public with our views, which is the next step. Typically shareholders tend to agree with our views because we tend to target under performing companies in the first place. If they [board, management] hear from other shareholders that there is discontent, that puts pressure on the company to work with us.

Have you taken a proxy fight to a vote? What about at Crescendo Partners, the activist fund you worked at previously?

At the prior fund I worked for we did that, had to take a contest to the finality of a vote. At Engine Capital we have always been able to settle prior to a vote. There was one situation where we had to file a preliminary proxy but typically we are able to settle early on without having to nominate. Typically we have to nominate and at that point we settle. If we can settle and get most of what we want without having to go all the way to a vote that's my preference.

*Let's talk about a situation where a director fight had to go all the way to a vote and then some, and that is Nelson Peltz's blockbuster proxy fight at **Procter & Gamble**, the largest stock market capitalization company ever to face an activist director election war. You **wrote** an editorial about the battle before it was concluded at a time where they had the preliminary vote out with Peltz up by 0.0016%. Essentially each side had 50% of the vote. Why did you write it?*

I was following the situation. This proxy fight was silly to begin with. You have a sophisticated investor with a lot of operational background who owned north of $3 billion in stock and his ask wasn't very aggressive, just to add himself to an expanded board. Not a very aggressive ask for someone who has a good reputation as a board member. The board spent over $100 million in expenses fighting him. So this all felt silly. The bottom line was that half of the company wanted Peltz, effectively shareholders have spoken, half want Peltz and half don't. It was time to settle this, which is what they ultimately did.

You have been on a number of boards. If you are one person on a 13 person board do you have a lot of influence?

My guess given his [Peltz] background he will add to the boardroom dynamic. Having a professional investor with capital market investment experience helps. Will he have an impact in the boardroom? Absolutely. At the same time, is he going to be disruptive? That was the claim of the company, I very much doubt so. For him to pass anything, any motion, you need someone else to second the motion and for any decision to be made he will need to convince at least six other board members to get something through. Is he going to challenge the status quo? Yes. Is he going to disturb or have a negative impact on the turnaround? I don't think so.

You had suggested in your column that most boards have good intentions but that directors are complacent and they need someone to come in and challenge them. Why?

My experience on boards is that board members like to go along with each other, like a social club and when things go right and the CEO does a good job that's fine. When you have an issue or when the CEO doesn't do a good job, you need the board to challenge the situation. Often boards try to get along and they can have difficulties challenging the status quo. That's where having a shareholder with a significant stake and who very much cares about the outcome of the company can have a positive impact in terms of challenging the situation and bringing forward the tough discussions that needs to happen.

For more coverage like this, **sign up** for the Activist Daily.