CAPflash
CAP Compensation Advisory Partners NEWSLETTER | ISSUE #78 | FEBRUARY 1, 2016

2015 – Activist Investors and Executive Pay

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Shareholders can voice their support for, or concerns with, a company's executive compensation program through a non-binding advisory vote on executive compensation, commonly referred to as "Say on Pay". One shortcoming of Say on Pay is it does not allow shareholders to provide specific input on pay program design and pay practices. Since executive pay programs are a management tool to support business strategy, where there is not agreement on business strategy there may be a fundamental disagreement between a company and certain investors regarding incentive plan performance metrics, goals, etc.

In our experience, "activist investors" were more vocal and influential in boardrooms during 2015 than during other recent years. As a result, Compensation Advisory Partners ("CAP") analyzed circumstances at nine companies that had proxy contests in 2015[1] where in each case, one area of activist focus was executive compensation. We found that executive compensation issues were often supportive and complimentary to other, larger internal issues at the target companies. While these activists may have targeted executive compensation, this was not the main driver in engaging with the company. Activist complaints tend be more focused on strategic/financial issues and they use compensation as a point of discussion to identify where their views differ. For example, if return on capital is not a utilized metric in incentive plans and the company has completed several low return acquisitions, the activist may use this as support that strategy is flawed and that compensation reinforces that flaw.

"Activist investors" are individuals (i.e. hedge fund managers) or groups (i.e. alternative investment companies) who purchase a stake in a target company's outstanding equity shares with the end-goal of influencing company decision making by acquiring seats on the Board of Directors. Once on the Board, activists will try to effect changes (i.e., by divesting or acquiring a business segment, cutting expenses, increasing distributions to shareholders, etc.) that ultimately increase the company's value and the value of the activist's investment.

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WHAT WE FOUND

Compared to prior years, 2015 saw an increase in proxy contests. Among companies in the Russell 3000 Index, there were 20 proxy contests initiated by activist investors during 2015. This compares to 14 proxy contests in 2014 and 16 in 2013.

Of the 20 proxy contests initiated by activist investors in 2015, nine (45 percent) specifically took issue with the executive compensation program at the target company. In each case, "issues" with executive compensation were a part of the supporting statements for the dissident slate of directors. This is a stark contrast to 2014 and 2013, where 4 (29 percent) and 1 (6 percent) proxy contests took issue with executive compensation, respectively.

1 CAP reviewed all proxy contests that were initiated during the entirety of calendar 2015 (n=20).

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Specific compensation practices highlighted in 2015 include:

EXECUTIVE COMPENSATION ISSUE	NUMBER OF COMPANIES (N=9)	PERCENTAGE OF COMPANIES
Pay for Performance Misalignment	7	78%
High CEO Compensation	4	44%
Choice of / Adjustments to Performance Metrics	4	44%
Weak Corporate Governance Structure	3	33%
High / Increase to Board of Director Compensation	3	33%
Awards of Special Grants to Executives	2	22%
Outsized Peers	1	11%

Ultimately, we found that activist investors frequently use executive compensation and pay for performance disconnect as levers to bolster their argument for receiving seats on the target company's Board of Directors.

TARGET COMPANIES

Of the nine activist campaigns which specifically took issue with executive compensation practices, the companies that were being targeted generally had lagging TSR performance, both in absolute terms and relative to competitors. Further, low Say on Pay results in 2014 also provided activists with an additional reason for targeting certain companies.

As the below table demonstrates, where activists were successful in securing Board seats, the most recent Say on Pay support was generally low and either the company's 1-year TSR, 3-year TSR, or both were relatively low.

SUCCESSFUL ACTIVIST CAMPAIGNS

Of the nine proxy contests that specifically targeted aspects of executive compensation, four ultimately resulted in the activist investor gaining Board seats at the target company. The four companies, which are noted in the chart below, include: Myers Industries, Imation Corp., The Children's Place[2] and Shutterfly, Inc.

The main common denominator, from a compensation perspective, among the successful activist campaigns was a perceived disconnect between executive pay and financial performance at the target company. More specifically, at Myers, Imation and The Children's Place, the activists were able to show that, despite poor TSR (in both absolute and relative terms), the executives at these companies were still being rewarded either through salary increases, above target annual incentive payouts or equity grants.

Further, with regard to Shutterfly's executive compensation program, activists made the case that executives were being rewarded for performance

2 The Children's Place settled with the activist for one Board seat prior to the vote.

COMPANY NAME	SAY ON PAY RESULTS			TOTAL SHAREHOLDER RETURN	
	2013	2014	2015 (YEAR OF PROXY CONTEST)	1 YEAR *	3 YEAR CAGR *
Activist Gained Board Seat (n=4)					
Myers Industries Inc.	75%	75%	60%	-17.8%	12.6%
Imation Corp.	95%	50%	34%	-17.8%	-12.9%
The Children's Place, Inc.	17%	61%	94%	13.8%	6.3%
Shutterfly, Inc.	55%	50%	22%	-18.3%	22.4%
Activist Did Not Gain Board Seat (n=5)					
Hill International, Inc.	n/a (triennial)	54%	n/a (triennial)	-0.3%	-9.3%
Ethan Allen Interiors Inc.	86%	92%	80%	-14.1%	5.1%
E. I. du Pont de Nemours and Company	95%	98%	96%	14.4%	17.3%
Biglari Holdings Inc.	33%	31%	50%	-21.7%	2.8%
Select Comfort Corporation	98%	93%	96%	26.9%	6.7%

* As of Fiscal Year End

against metrics that were not "shareholder friendly" (i.e. metrics focusing on top line growth as opposed to earnings growth). In response to the activist criticism, Shutterfly's Compensation Committee established several changes to their 2015 and 2016 executive compensation program performance targets to "further reflect shareholders views". However, the lead activist investor (Marathon Partners) ultimately deemed these changes inadequate and requested further, more fundamental, adjustments to the entirety of the compensation program, namely, to begin prioritizing profit over scale.

It is not surprising that activist investors are most successful at winning Board seats at their target companies when they can tie executive compensation to the poor financial performance of the company. If shareholders are not realizing a desired return on their investment in any given company, it is reasonable to expect that they would show more support for an activist investor hoping to gain access to the target's Board if it could potentially lead to financial improvement. When executive compensation can be tied to poor financial results, it simply provides activists, and shareholders alike, with another reason as to why a shift in leadership could be desirable or change in strategy could be advisable (e.g. CEO change).

ISS also tends to influence the outcome of these proxy contests. ISS supported at least one of the nominees on the dissident slate of directors at each of the four companies that lost at least one Board seat to the activist investor.

Ultimately, of the four companies who lost Board seats to activist investors, three companies (Imation Corp., Myers Industry and Shutterfly) have made changes to their executive leadership teams as these CEOs have stepped down. Further, while DuPont was able to win its proxy contest and keep dissident nominees off of its Board, five months after the Annual Meeting, the CEO announced her retirement.

CONCLUSION

We are seeing increased activity where activist investors are accumulating stakes in companies with the intention of agitating for change. Their hope is to make changes that will enhance the company's value. While our analysis reflected proxy contests specifically focusing on executive pay (e.g. pay for performance misalignment), there are a number of circumstances where companies settle with the activist investors, avoiding a contentious public battle, and allow the activist a seat or multiple seats on the Board. Some examples include Baxter International settling with Third Point LLC, Freeport McMoRan settling with Icahn Enterprises and Citrix Systems settling with Elliott Management.

In order to be well positioned, Boards and Compensation Committees should be proactive:

- Ensure the Company and Board have a clear strategic focus and stick to it
- Make sure the metrics used in incentive plans align with the company's strategic vision
- Confirm the Board has a game plan for shareholder and activist engagement
- Encourage the Company and Board to use external advisors to provide guidance
- Highlight company performance against goals
- Emphasize pay for performance relationship through the validation of relative performance and pay positioning
- Proactively seek feedback from shareholders throughout the year
- Assess program features which may not have a lot of value to executives but are viewed as problematic pay practices (i.e., eliminate excise tax gross-up, eliminate / reduce perquisites, move from single to double trigger equity vesting in the event of a change in control)

It is critical for the Board to work with management to ensure pay practices are defensible and supportable in light of company performance and good governance standards.

APPENDIX

Summary of Activist Campaigns

COMPANY	ACTIVIST	EXECUTIVE COMPENSATION ISSUE HIGHLIGHTED BY ACTIVIST	CONTEST RESULT
Hill International, Inc. *Program and project management company*	Bulldog Investors, LLC *ISS supported both dissident director nominees*	• Felt that executive officer compensation is not truly aligned with the interests of shareholders • Between June 2010 and May 2015 the company stock had decreased by 8%. Over this time period the two top executives "received a total of $25 million in compensation or about 50 cents per share"; further, between 2007 and 2014, "Board of director compensation has increased by 183%" • Concerned that executives are being too generously compensated while shareholder value is declining	No dissident nominees elected to the Board
Ethan Allen Interiors *International interior design and manufacturing company*	Sandell Asset Management Corp *ISS supported 3 of 6 dissident director nominees*	• Concerned with the length of the CEO's most recent employment contract given that he has been in the position for 27 years • Concerned with "narrow" performance metrics; adjusted operating income and adjusted operating income per share • CEO's compensation is not tied to total shareholder return ▪ Company's stock price has "underperformed its peers by 119% over a 10 year timeframe" ▪ Felt that CEO compensation should be tied to TSR and not operating income metrics	No dissident nominees elected to the Board
E.I. Du Pont *International science and technology company*	Trian Fund Management *ISS supported 2 of 4 dissident director nominees*	• Compensation program does not properly align management compensation with stockholder value creation • "Despite bottom quartile relative TSR performance against peers, 2013 performance share unit payout (PSUs) was 113% of target" due to top quartile relative revenue performance • "Prioritizing revenue growth without regard to return on capital incentivizes management to grow revenue recklessly and often results in long-term value destruction" • High annual Incentive payouts despite poor performance • "Revenue and EPS fell short of long-term targets but short-term incentive payouts have been 86-87%" in 2012 and 2013, respectively • Trian sought to end "crony" compensation • "In 2014, the Board acknowledged poor operating performance and gave management a 0% payout factor for corporate performance under DuPont's short-term incentive. However, individual performance ratings ranged from 80% to 100%"	No dissident nominees elected to the Board CEO stepped down 5 months after the conclusion of the contest
Biglari Holdings *Owns and operates Steak N' Shake*	Groveland Capital *ISS did not support dissident director nominees*	• CEO received "outsized compensation in 2014 despite poor performance" • Flaws with company's corporate governance practices ▪ CEO would be entitled to a "golden parachute" of approximately $100M as part of a naming rights deal if the CEO were forced out of the company • From 2009 to 2014 "Biglari underperformed the S&P 500 Index by 40.2%, the S&P 500 Restaurant Index by 57.6%, the Russell 3000 Restaurants by 77.6%, and its ISS Peer Group by 214.5%"	No dissident nominees elected to the Board
Myers Industries *International manufacturing and distribution company*	GAMCO Asset Management *ISS supported 1 of 3 dissident director nominees*	• Management pay rose in 2014 despite poor operating performance ▪ CEO and CFO base salaries increased 3% and 8%, respectively • Proxy statement indicates that bonuses and long-term compensation are based on a variety of factors that do not take into account the effectiveness of acquisitions and divestitures as well as capital allocation • "Concerned about the integrity of the Company's Financial Controls and Reporting". GAMCO took issue with the apparent adjustments being made to performance metrics • Board approved increases to the cash retainer and stock grants of 31% and 25%, respectively, in 2015 ▪ "Concerned with minimal board ownership levels (<4%)" • Poor financial performance ▪ 1-year total shareholder return (-14.2%) lagged the market ▪ Revenue grew mainly due to an acquisition	Three dissident nominees elected to the Board CEO stepped down

COMPANY	ACTIVIST	EXECUTIVE COMPENSATION ISSUE HIGHLIGHTED BY ACTIVIST	CONTEST RESULT
Imation Corp. *Data storage and information security company*	Clinton Group *ISS supported all dissident director nominees*	• Since 2010, "Named Executive Officers and directors have collected $48M in compensation compared to a market value decline of -$301M during the same period" ▪ "Company paid bonuses of 126% of target to the top three executives in 2014, a year in which the Company suffered a cash flow decline of -$38M" ▪ "At 2014 Annual Meeting, company received a 50% voting approval on say on pay and responded by increasing executive compensation from $6.2M in 2013 to $11.2M in 2014" ▪ "Company executives have single trigger golden parachute payments" ▪ "Directors earned an average of $316K in 2014, far excess of their peers" • During CEO's tenure, company has "underperformed" and has "destroyed shareholder value" ▪ "Stock price is down 70% during CEO's tenure" ▪ "Net revenue is down 44% from 2010-2014" ▪ "Deployed $174M in four acquisitions during CEO's tenure, with poor results"	Three dissident nominees elected to the Board CEO stepped down
Select Comfort Corporation *Designer, manufacturer, retailer and services of a Sleep Number beds*	Blue Clay Capital *ISS did not support dissident director nominees*	• Board has "rewarded executives" for sagging stock price and failure to meet goals ▪ Special stock awards: "Despite the fact that company's stock has lagged major indices and its peers, the Board granted special performance awards to the CEO and other executives" » Special awards had "a grant price of $17.77 and was fully earned at $23.10, providing an additional $2.9M in compensation. Grant date and target prices were 35.1% and 15.6%, respectively, below the $27.36 price" when CEO was promoted to current position ▪ Changing performance metrics: Company did not grow operating margins as forecasted and changed 2014 annual incentive plan metric from net operating profit, which has been a metric since 2001, to EBITDA, "resulting in aggregate cash incentive payments of $2.1M to the company's executives" • Company has a classified Board and the activist felt that the Board "had grown stale and is entrenched"	Activist dropped proxy contest before it went to shareholder vote
The Children's Place (settled proxy fights prior to Annual Meeting) *Children's specialty apparel retailer*	Macellum Advisors GP and Barington Capital Group *ISS supported 1 of 2 dissident director nominees*	• "Company's executives have received generous compensation despite poor results, reflecting a lack of alignment of pay with performance" ▪ "CEO has been richly compensated despite poor operating performance; compensation has been egregious" ▪ CEO total compensation the last 3 years has been $35.1M, which was "50% greater than the CEO of Carter's"; Carter's has a market cap 4x The Children's Place and its stock price has "outperformed the company by 130% over a 3 year period" (2011-2013) ▪ CEO compensation is "2x the median target compensation" of peers (or the 100th percentile) ▪ Company uses a peer group that has a median market cap of greater than $2B, or double the company ▪ CEO was "awarded $6.8M in 2013 despite missing the company's original target for adjusted operating income by 9.5%" • "The Company's stock price has significantly underperformed its peers and the market as a whole over the past 1-, 3- and 5-years as well as during the CEO's tenure"	Settled prior to contest – activist received one Board seat
Shutterfly, Inc. *Manufacturer and retailer of photo-based products*	Marathon Partners *ISS supported 2 of 3 dissident director nominees*	• Company has "a compensation scheme that had run amok" • Activist felt that compensation should focus on shareholder-friendly metrics such as EPS and free cash flow rather than revenue and EBITDA growth • Cited excerpts from ISS and Glass Lewis reports on executive compensation issues • CEO received a special RS award of approximately $7M • Sought improvements to executive compensation. Board proposed the following changes, which were ultimately rejected by Marathon ▪ Increase 2015 EBITDA trigger goal ▪ Increase 2015 target revenue goal for 100% funding of the performance-based restricted stock units ▪ Increase the minimum target for free cash flow per share in 2017 for executive compensation purposes to a minimum of 50% over free cash flow in 2015	Two dissident nominees elected to the Board CEO stepped down

Note: The comments in the above chart are paraphrased or direct quotes from activist investors' proxy contest materials/filings and do not reflect the view of CAP.

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Please contact us at (212) 921-9350 if you have any questions about the issues discussed above or would like to discuss your own executive compensation issues. You can access our website at www.capartners.com for more information on executive compensation.