The IRR of "No"

Statistically speaking, one of the worst strategies for buying a company is to push your hostile bid all the way to a vote of your target's shareholders.

In the past five years, only one hostile bidder which has gone all the way to a shareholder vote—CF Industries—walked away with the prize. In each of the other six contests—including the other one where, like CF, the bidder's nominees were elected by shareholders—the target remained independent.

But this much is already widely known. What is less well-known is how all this has worked out for the potential sellers—not the executives and directors who lead the "Just Say No" defense, but the shareholders themselves who, in five of these six cases, voted to continue saying No.

Measured on an absolute basis, the median cumulative Total Shareholder Return (TSR) for targets which remained independent through Oct. 20, 2014 following an M&A proxy contest was 50.4%. But absolute return is a naïve view of the issue: the real question is what return shareholders might have had by redeploying their capital into the next best alterative to keeping the target standalone.

Relative to those next best alternatives, it turns out, the median return to shareholders of saying No is profoundly negative.

Had shareholders in these six firms sold at the closing price the day before the contested meeting and reinvested in:

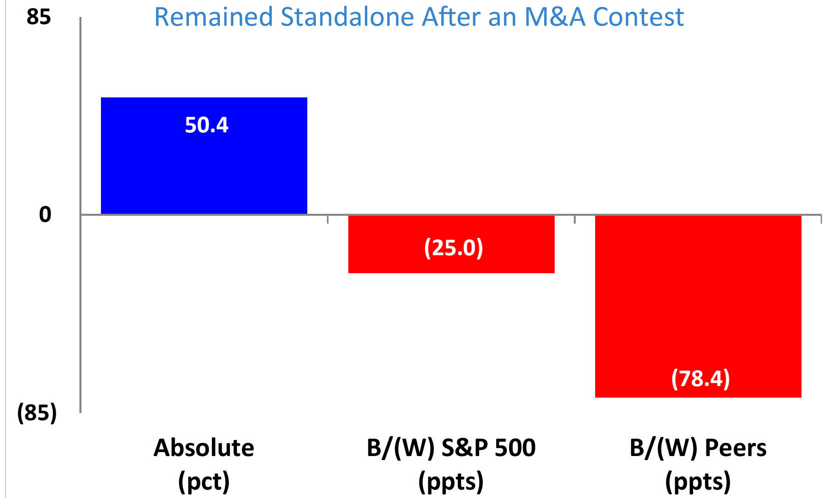
- the broader market, as through an S&P 500 Index fund, they would have earned at the median an additional 25.0 percentage points through Oct. 20, 2014;
- the sector, through a group of close peers, they would have realized at the median an additional 78.4 percentage points through the same date.

In the case of all six of these targets, the underperformance relative to investors' next-best alternatives began immediately after the show-me moment of the M&A proxy contest, and was generally sustained throughout the first 1, 3, 6 and 12 months after the contested election. At the median, the six firms underperformed the broader market by 2.0, 7.1, 21.5, and 10.6 percentage points over these periods, respectively. Despite mitigating measures like post-contest buybacks, moreover, these firms generally posted negative absolute performance over most of those four measurement periods.

COMPANIES DISCUSSED IN THIS NOTE:

- **AGN** **Allergan**
- **ILMN** **Illumina**
- **ARG** **AirGas**
- **PULS** **Pulse Electronics**
- **NRG** **NRG Energy**
- **CASY** **Caseys Gen. Stores**
- **ONVI** **Onvia**
- **TRA** **Terra Industries**

CHART FOCUS Median TSR Performance of Targets Which Remained Standalone After an M&A Contest



From date of contested election rough Oct. 20, 2014. Sources: Bloomberg Finance LP (TSR), ISS (peers).

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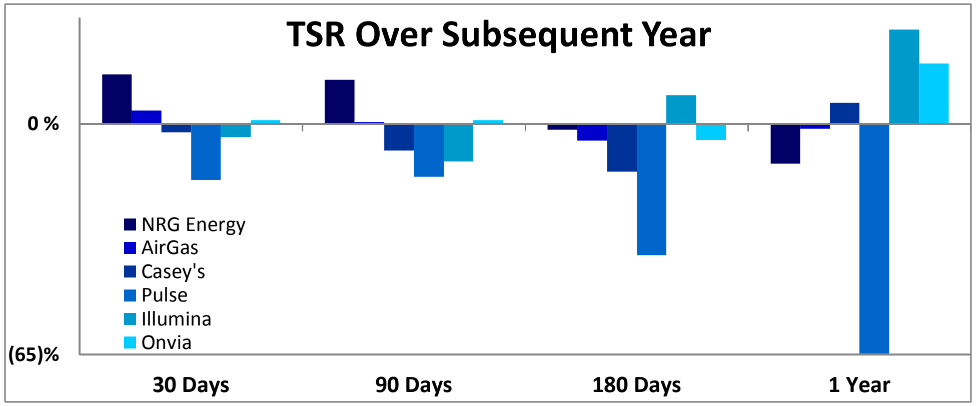
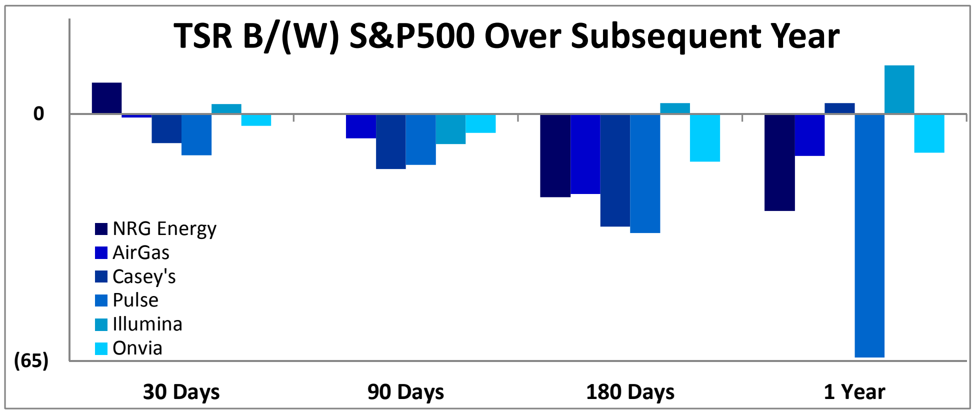
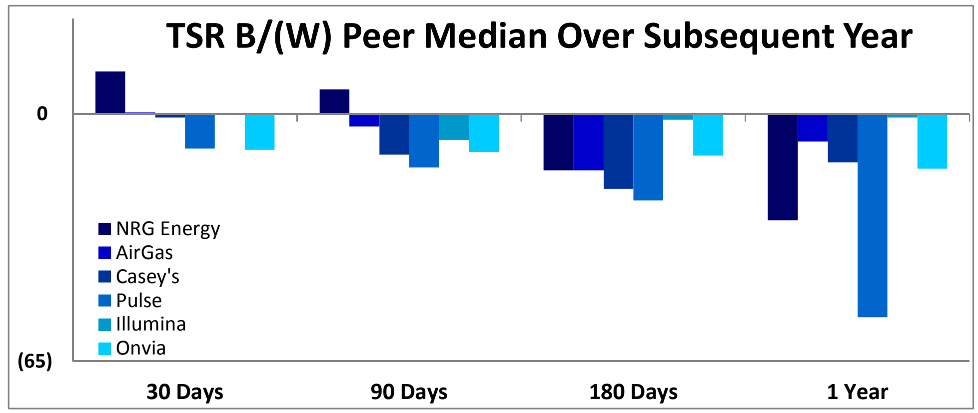


Only a small amount of this underperformance appears to have been due to the sector in which they operated. The six targets underperformed the median of their peers, over the same four time periods, by 0.5, 8.4. 14.9, and 13.6 percentage points, respectively.

For the full period from the contested election through Oct. 20, 2014 (which ranged from 2.4 to 5.3 years), three of the six eventually recovered some ground versus the broader market performance. Only two of them—Illumina and AirGas—reversed the negative trend relative to the median of their peers.





How Saying "No" Compared to S&P500 Index Performance

	Contested	TSR B/(W) S&P500 Index After:				TSR B/(W)	
	Meeting	30 Days	90 Days	180 Days	1 Year	Index to date*	
		(ppts)	(ppts)	(ppts)	(ppts)	(ppts)	(years)
NRG Energy	7/21/2009	8.2	0.1	(21.9)	(25.5)	(107.4)	5.3
AirGas	9/15/2010	(0.9)	(6.4)	(21.1)	(11.0)	(5.2)	4.1
Casey's	9/23/2010	(7.7)	(14.4)	(29.6)	2.8	1.4	4.1
Pulse	5/18/2011	(10.8)	(13.4)	(31.3)	(64.1)	(153.5)	3.4
Illumina	4/18/2012	2.6	(7.9)	2.9	12.7	257.2	2.5
Onvia	5/31/2012	(3.1)	(5.0)	(12.5)	(10.2)	(44.8)	2.4
Median		(2.0)	(7.1)	(21.5)	(10.6)	(25.0)	3.8
Mean		(2.0)	(7.9)	(18.9)	(15.9)	(8.7)	3.6

**Data as of: 10/21/2014*

How Saying "No" Compared to Peer Median Performance

	Contested	TSR B/(W) Peer Median After:				TSR B/(W)	
	Meeting	30 Days	90 Days	180 Days	1 Year	Peers to date*	
		(ppts)	(ppts)	(ppts)	(ppts)	(ppts)	(years)
NRG Energy	7/21/2009	11.2	6.5	(14.8)	(28.0)	(99.1)	5.3
AirGas	9/15/2010	0.4	(3.3)	(14.9)	(7.2)	20.8	4.1
Casey's	9/23/2010	(0.9)	(10.7)	(19.7)	(12.7)	(91.8)	4.1
Pulse	5/18/2011	(9.1)	(14.1)	(22.7)	(53.5)	(153.0)	3.4
Illumina	4/18/2012	(0.0)	(6.8)	(1.5)	(0.9)	246.9	2.5
Onvia	5/31/2012	(9.5)	(10.0)	(11.0)	(14.4)	(65.1)	2.4
Median		(0.5)	(8.4)	(14.9)	(13.6)	(78.4)	3.8
Mean		(1.3)	(6.4)	(14.1)	(19.5)	(23.6)	3.6

**Data as of: 10/21/2014*

What Differentiates Good Bets from Bad?

The conventional wisdom is that giving additional time to a board facing a hostile bid improves the outcome for shareholders. This makes some intuitive sense, if the board uses that time to better inform the market about sources of hidden value: ideally, the target board convincingly demonstrates higher intrinsic value to investors, or wins a more compelling offer after initially saying No, or both, without ever going to a contested vote.

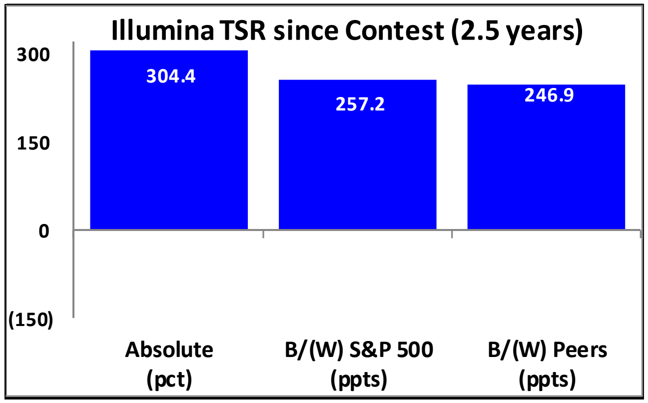
For those which do go all the way to a vote yet remain independent, however, the abysmal subsequent returns relative to shareholders' next best alternatives suggest something in the process has gone awry.

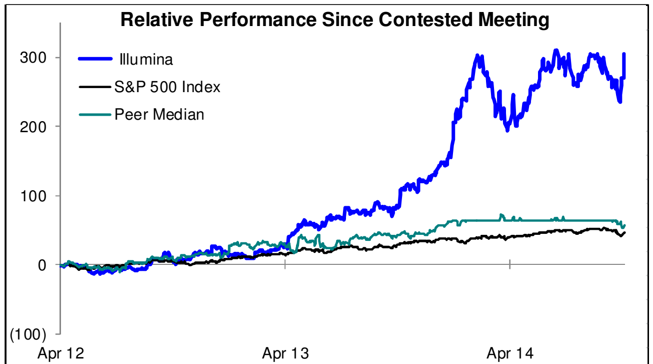
The real question for shareholders looking at this data—or considering their voting strategies in upcoming M&A contests, such as the expected Dec. 18 special meeting at Allergan—is what differentiates the good bets from the bad?

Verifiable Scarcity Value Matters

In only one of the six cases was leaving the company standalone a clear homerun—though in the heat of the contested election, that may not have been so obvious from outside the boardroom.

In 2012, **Illumina**, a leading equipment maker in the nascent DNA sequencing market, faced a hostile tender offer from Roche Holding Ltd. Approximately one-third of Illumina's revenues came from the National Institutes of Health, but in the wake of the 2011 government shutdown, the ongoing uncertainty about the nature and extent of forthcoming federal budget cuts drove a steep decline in Illumina's stock price. At the point of the shareholder vote, the $51.00 in cash per share which the hostile bidder was offering represented an 88% premium to the undisturbed price from six months earlier. It also appeared to represent a significant premium when measured by traditional M&A metrics, such as LTM EV/EBTIDA multiples.





Source: Bloomberg Finance LP. Peers: Myriad Genetics Inc, Life Technologies Corp, Thermo Fisher Scientific Inc, Perkinelmer Inc, Bruker Corp

Illumina argued, however, that its true value was intimately tied to the development of the broader genetic sequencing market, which it contended was much closer to viability than Roche had argued. As much as the stand-alone strategy held risk for Illumina shareholders, moreover, the risk for Roche of not having Illumina—a market leader already on its way to ubiquity in the first sequencing market, and with all the beneficial network effects that implies—was likely still larger, and should thus drive a much headier valuation. Completely aside from its stand-alone prospects and valuation, Illumina argued, it had significant scarcity value for a strategic bidder—and for this bidder in particular.

The arguments about the potential addressable market, and particularly about the scarcity value of the asset, resonated with shareholders, who overwhelmingly rejected the bidder's nominees.

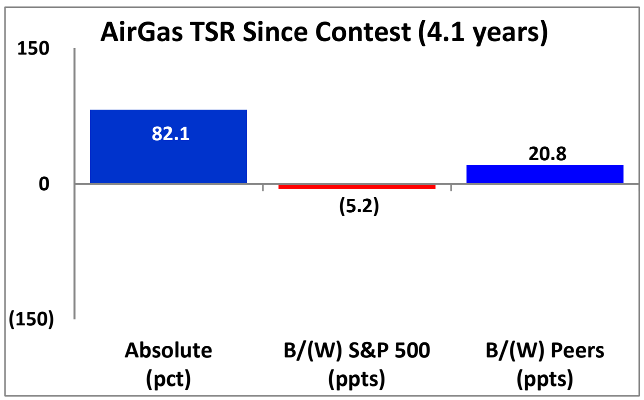
And though Illumina's shares did not begin to outperform the next best alternatives—the S&P 500 and the median of its peers—for as much as a year, both arguments have since been borne out in the company's operating results.

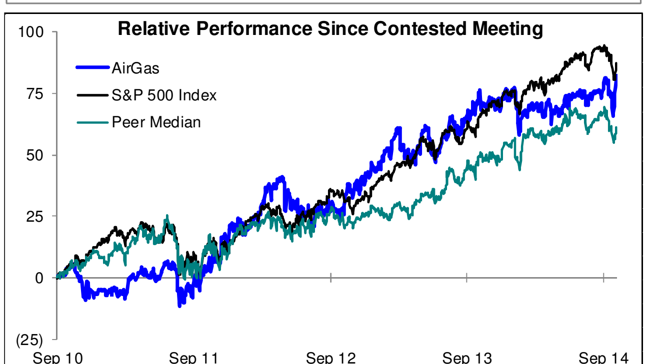
As a consequence, saying No—and remaining invested in Illumina as a standalone entity over the subsequent two-and-a-half years—has delivered TSR of 304%, significantly outperforming the next best alternatives of the broader market (by 257 percentage points) and sector peers (by 247 percentage points).

Credibility on Business Dynamics Matters

Two years before Illumina, the board at **AirGas**, the largest U.S. distributor of industrial, medical, and specialty packaged gases, made a similar argument about scarcity value in resisting a $65.50 all-cash bid from Air Products, which was looking for a "highly efficient re-entry into the U.S. packaged gas market."

AirGas, its board argued, had a singular, and not easily replicated, position atop a fragmented U.S. packaged gas market. Through approximately 400 acquisitions over the previous quarter century–including the acquisition of Air Product's packaged gas business eight years earlier—AirGas had accumulated a 25% share of the $12.5 billion U.S. packaged gas and welding hardgoods market, approximately equal to the combined market share of the four major producers still competing in that market. For any major producer to enter the market, the choices were to roll up the best of the approximately 900 small independents, or to buy AirGas.





Source: Bloomberg Finance LP. Peers: Praxair Inc, Air Liquide SA, Linde AG, Air Products & Chemicals Inc

But "scarcity value" is not something that drives higher standalone value unless, as with Illumina, there is also considerable market opportunity on the horizon from which the target company is unusually well-positioned to benefit. At AirGas, the board also argued that the retail business was just emerging from a cyclical trough, in which operating performance would grow rapidly.

EBITDA margins had climbed above 18% in its most recent quarter, and the board was projecting substantial EPS growth over the opening few years of the cycle. For CY 2012 the board projected EPS of $4.20. Analyst consensus , immediately before the emergence of the Air Products offer, was just $3.69 for FY 2012, and $4.16 for FY 2013 (three quarters of which were in CY 2012).

At the contested meeting in September, shareholders elected the bidders' three nominees but did not approve the bidder's proposal to pull ahead the next annual meeting—at which it could have nominated enough additional candidates to change control of the board—to the following January. While two companies sparred over that and other tactical issues in the Delaware courts, the new directors dug in—and ultimately declared they also believed, based on the evidence from inside the boardroom, that the Air Products offer undervalued the company.

Though AirGas has not enjoyed the runaway success of Illumina, it has posted a cumulative TSR of 82% over the four years since the contested meeting. This was marginally below the S&P 500 Index (5.2 percentage points) by Oct. 20, 2014, but for much of those 4.1 years AirGas shares had performed in line with, or above, the broader market index. AirGas also significantly outperformed (21 percentage points) the median of peers through Oct. 20, 2014.

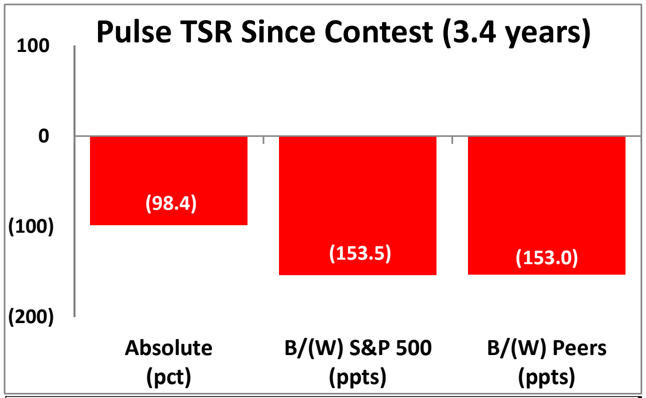
Moreover, shareholders retain the full rights of ownership—bearing out the board's point in 2010 that the Air Products offer at the time of the vote carried no meaningful premium for the change in control.

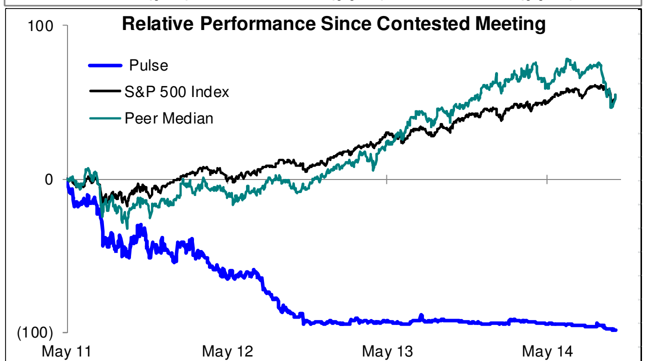
"Self-Help" Strategies Don't Help

By contrast with both Illumina and AirGas, the board of **Pulse Electronics** fell back on the argument that, having just revamped its management team, it simply needed enough time to demonstrate what it could do.

It was likely helped in this argument by the fact that shares had been falling for some time, but the $6 unsolicited offer from Bel Fuse which resulted in an M&A contest at the 2011 annual meeting still represented only a meager premium to trading prices—and that the bidder itself hadn't made any definitive offer directly to shareholders, or even specified the final form. The bidder, moreover, nominated two candidates on a platform of operating and governance reform—not, as in the case of every other hostile bidder in the sample, on the platform of getting a fair hearing for its offer.

Though shareholders rejected the bidder's nominees, the performance since then has been spectacularly poor—a loss of 98% of value on an absolute basis, and a 153 percentage point underperformance of both the broader market and the median of peers over the ensuing 3.4 years.





Source: Bloomberg Finance LP. Peers: Littelfuse Inc, Espey Mfg & Electronics Corp, Cognex Corp, Chase Corp, General Cable Corp, Coleman Cable Inc, TE Connectivity Ltd, Bel Fuse Inc

For shareholders looking for lessons to apply in the future, Pulse stands out for two reasons:

1. Its performance since the contested election, which is the mirror image of Illumina's, suggests shareholders should be particularly wary of any "defense" built around a board which has only recently begun to see the light, changing executives or strategic plan or both.

   Much of this post-contest performance appears to be due to the dire financial straits into which Pulse had slid: by January 2013, shareholders were being asked to approve a massively-dilutive recapitalization with Oaktree Capital, which now controls the company with 70% of outstanding shares.

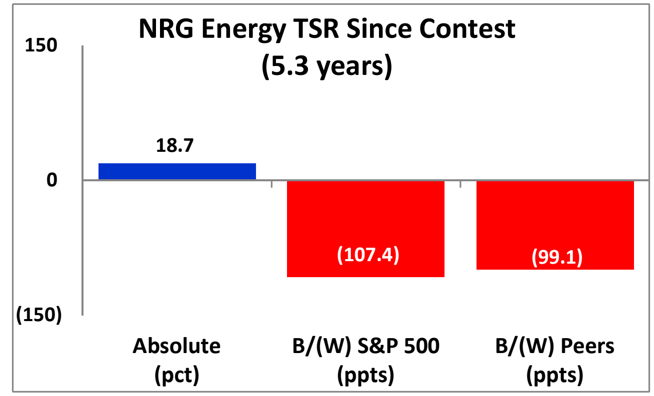
2. It is not clear shareholders had a truly viable alternative from a bidder that refused to make a firm offer, in cash or in stock, and presented itself in the proxy contest—despite being a competitor—as interested primarily in improving the business and corporate governance.

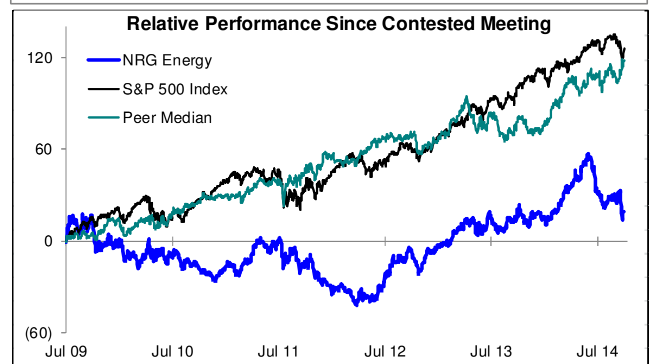
As a special bonus for those with an interest in karma, Pulse is also interesting for having appointed a new CEO just weeks before the hostile bid who had himself been a nominee in another M&A contest, at **NRG Energy**, two years before.

By NRG's July 2009 contested meeting, Exelon Corp's all-stock bid offered a premium of 44% to the undisturbed price of the previous October.

In the interim, however, NRG had taken a number of self-help initiatives, to demonstrate it could achieve higher value while remaining independent. These included an accretive opportunistic acquisition of Reliant Energy, whose retail operations gave it countercyclical earnings power; R&D initiatives in nuclear, wind and solar energy which hadn't yet blossomed; and launching significant cost and operating performance improvements which, the board projected, had it on track to post a six-year EBITDA CAGR of 21% and a free cash flow yield of 23%.

At the annual meeting, shareholders rejected the bidder's nominees, putting their faith in the self-help narrative.



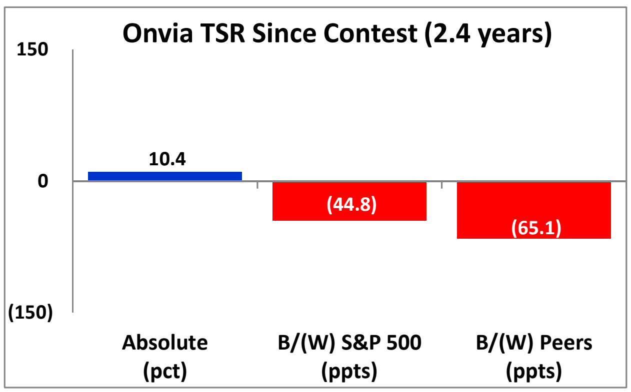


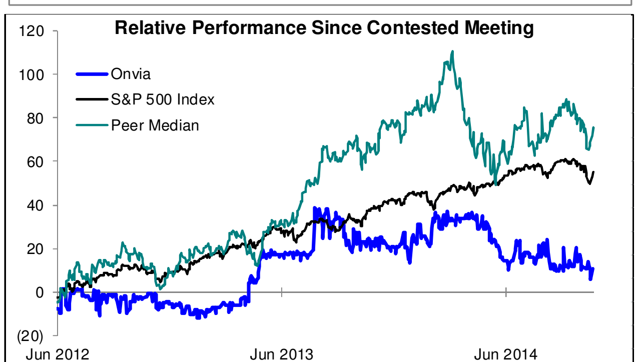
Source: Bloomberg Finance LP. Peers: American Electric Power, Calpine Corp, The Southern Co, Edison International, Xcel Energy Inc, NV Energy Inc, Alliant Energy Corp, Exelon Corp

Over the subsequent 5.3 years, they saw a cumulative TSR of just 18.7%. This was 107 percentage points worse than the next best alternative of reinvesting in the broader market, and 99 percentage points worse than reinvesting in peers. Though performance was positive on an absolute basis, the lesson from an investor's perspective– based on the perspective of return relative to the next best alternative—is similar to Pulse: a board's own self-help plan, particularly if launched in response to or amid a hostile bid, is unlikely to return strong value over a sustained period.

When **Onvia** received an unsolicited offer cash offer from 14.6% shareholder Symphony Technology Group in early 2011, the board—which had just hired a new CEO for its turnaround plan a year earlier—rejected the offer as undervaluing the company's potential. When the same shareholder made another, lower offer a year later, the board also rejected that offer—and the bidder launched a proxy contest for the three seats up for election in May.

The bidder did not make a public tender offer, but its last offer to the board did appear to undervalue the company on key M&A valuation multiples. The bidder emphasized that its offer represented a premium of 41% to the 30-day average trading price before its offer became known—but the company was so thinly traded (on 27% of trading days over the previous year, no shares were traded at all) that premium to market appeared to be less relevant than valuation multiples.





Source: Bloomberg Finance LP. Peers: Ultimate Software Group Inc, Ptc Inc, Dealertrack Technologies Inc, Netsuite Inc

The board emphasized, in its defense, that it was not against selling the company, it merely believed pursuing a sale before the turnaround plan was completed was unwise. The hostile offer, it believed, did not account for the additional value to be created under that strategic plan. Shareholders generally agreed, rejecting the bidder's nominees at the annual meeting.

Over the subsequent 2.4 years through Oct. 20, 2014, as it executed on its strategic plan the company posted a cumulative TSR of just 10.4% - worse than the next best alternatives of reinvesting in the S&P 500 Index or in peers by 45 and 65 percentage points, respectively.

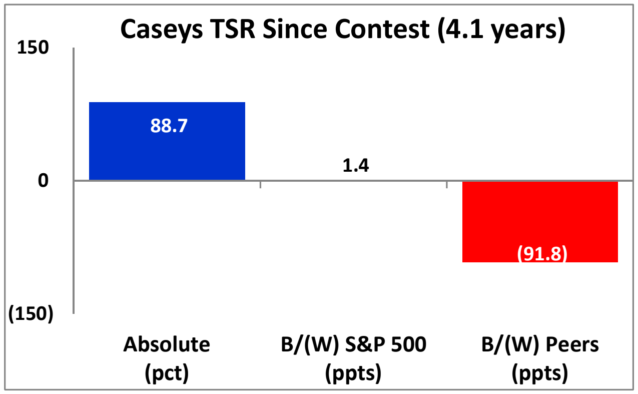
Defensive Tactics May Signal Greater Issues

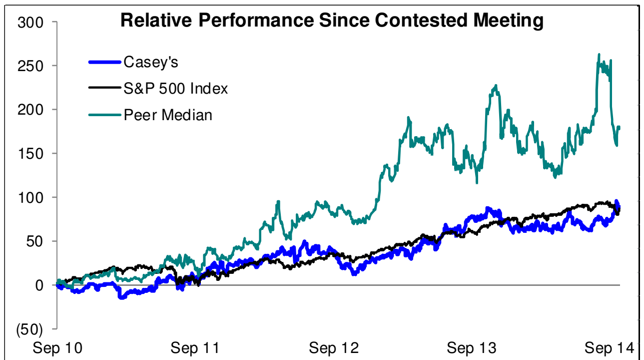
When Canadian issuer Alimentation Couche-Tard made its initial $36.00 per share offer for **Caseys General Stores** in 2010, it explained its interest as the ability to leverage Caseys operational expertise in rural locations and food service, which would better position the combined company to compete. But Couche-Tard made its initial offer without any committed financing—and then took the opportunity of the subsequent run-up in the target's stock to sell its 3.9% toehold for $38.43 per share, a peculiar move for any bidder trying to convey commitment to the marketplace. Compared to precedent transactions, its offer appeared undervalued both on EV/EBITDA and PE multiples, and was below the historical average premium of hostile deals generally.

Against this backdrop, the Caseys board demonstrated its conviction that the Couche-Tard offer significantly undervalued the company by completing a Dutch self-tender at $38 per share, with 53% of shares tendered by mid-August. In one mutually-agreeable transaction, this handily removed from the shareholder base any shareholders who might have felt the Couche-Tard offer a compelling starting point for negotiations.

Those who remained, however, discovered that the debt agreements which funded the buyback contained a "poison put" provision which, in the event of a sale in the near term, would transfer a significant portion of the firm's value—more than 16% of par value, or greater than $2 per share after accounting for the self-tender—from equity holders to debt holders through a "make-whole" payment. Make-whole provisions are not uncommon in debt agreements, but they are generally in the range of 1-3% of par. Offering such a significant make-whole in the midst of an M&A contest, with the company already in play and the probability of payout significantly higher, is also uncommon. A few weeks later, when 7-Eleven made a preliminary indication of interest at around $40, the wisdom of that poison put began to seem even more questionable.

Ultimately shareholders rejected the bidder's nominees, and the potential bidder in the shadows faded away, as potential bidders, their usefulness at an end, are sometimes wont to do. Over the





Source: Bloomberg Finance LP. Peers: Susser Holdings Corp, Pantry Inc, Travelcenters Of America LLC, Alimentation Couche-Tard

subsequent 4.1 years through Oct. 20, 2014, Caseys posted a TSR of 89%, 1.4 percentage points above the next-best alternative of the S&P 500 Index. But it also underperformed peers by 92 percentage points, underscoring the point that defensive tactics beget of one's own balance sheet, or the evanescent hint of a better deal in the offing (despite new hurdles introduced by other defensive tactics), may speak volumes about a board's focus.

Other Notable Factors

On average—and including CF's ultimately successful pursuit of **Terra Industries** in this data set—hostile bids took about six months between first public announcement and the contested shareholder vote.

Over that period some boards won significant increases through a number of successive "bumps" and valuation increases. Terra, with four bumps and a total increase in offer value (fueled by a rising CF share price)—of 117% over the more than 10 months prior to the shareholder vote, was the most notable of these. At the median, however, shareholders saw only 1 bump, for an increase of just 9.2%, prior to the proxy contest itself. If the purpose of saying No is to win the target board more time, it does not often, apparently, win the target shareholders a much richer bid to consider when the matter finally comes to a shareholder vote.

Among the six firms which remained independent after the M&A contest, four had classified and two had declassified boards. Only one of the declassi-

Structural Challenge (US M&A Contests, 2009-14)

Target	Voted	Bidder	Shares Held: Bidder [a] (%O/S)	Shares Held: Board (%O/S)	Shares Held: CEO (%O/S)	GICS Sector	Public Campaign (months)	Control Slate?	Target's Board
Terra Industries	11/20/09	CF Industries	7.0%	0.9%	0.6%	Agricultural Chemicals	10.3	No	Classified
NRG Energy	7/21/09	Exelon Corp	0.0%	0.8%	0.6%	Independent Power Prod.	8.4	Yes [b]	Classified
Airgas Inc.	9/15/10	Air Products	0.0%	11.0%	10.2%	Industrial Gases	7.4	No	Classified
Casey's Gen. Stores	9/23/10	Alimentation Couche Tard	3.9%	0.4%	0.1%	Food & Staples Retailing	5.6	Yes	Declassified
Pulse Electronics	5/18/11	Bel Fuse	0.8%	0.3%	0.0%	Electronic MFG Svcs	2.6	No	Declassified
Illumina, Inc.	4/18/12	Roche Holding Ltd	0.0%	3.3%	1.8%	Life Sciences Tools & Svcs	2.8	Yes [b]	Classified
Onvia	5/31/12	Symphony Technology Grp	14.6%	11.4%	0.7%	Internet Software & Svcs	4.1	No	Classified
		mean	3.8%	4.0%	2.0%		5.9		
		median	0.8%	0.9%	0.6%		5.6		

Sources: SEC filings, ISS data

Notes:
[a] Exelon: 500 NRG shares; Air Products: no ARG shares; Roche: 100 Illumina shares.
[b] Other ballot proposals would have expanded board and elected additional bidder nominees, enabling a change in control of the board despite the classified structure.

Offer and Outcome (US M&A Contests, 2009-14)

Target	Voted	Bidder	Offer on Date of Shareholder Vote: Market Value (per share)	Market Value (mils)	Form	Bumps	Dissidents Elected?	Ultimate Resolution
Terra Industries	11/20/09	CF Industries	$ 40.64	$ 4,057	Cash/Stock	Four (117%)	Yes	Sweetened & sold
NRG Energy	7/21/09	Exelon Corp	$ 28.37	$ 7,915	All Stock	One (10.2%)	No	Remained standalone
Airgas Inc.	9/15/10	Air Products	$ 65.50	$ 5,478	All Cash	Two (9.2%)	Yes	Remained standalone
Casey's Gen. Stores	9/23/10	Alimentation Couche Tard	$ 38.50	$ 1,962	All Cash	Two (6.9%)	No	Remained standalone
Pulse Electronics	5/18/11	Bel Fuse	$ 6.00	$ 250	TBD [a]	None	No	Remained standalone
Illumina, Inc.	4/18/12	Roche Holding Ltd	$ 51.00	$ 6,286	All Cash	One (14.6%)	No	Remained standalone
Onvia	5/31/12	Symphony Technology Grp	$ 4.25	$ 36	All Cash	None	No	Remained standalone
		mean		$ 3,712		1.4 (22.6%)		
		median		$ 4,057		1.0 (9.2%)		

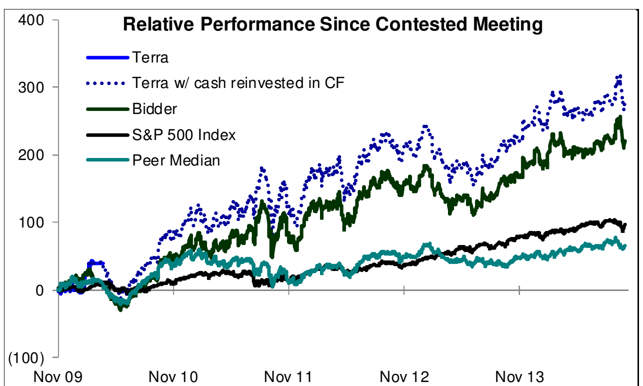
Sources: SEC filings, ISS data

Notes:
[a] No formal tender offer at time of contest; public statements indicated offer would be in cash, non-voting shares of bidder, or both.

fied boards faced a control slate contest, however— while two of the four classified board faced a change in control through other ballot proposals which would have completed an end-run around the structure.

The two firms which remained independent, and whose post-contest performance validated that outcome, were the only firms with significant shareholdings by the CEO. At AirGas, the founder/CEO held 10.4% of shares. At Illumina, the CEO held 1.8% of shares. At the remaining target firms, however, the CEO held only a fraction of a percent of shares: at the median, CEOs of the targeted companies held just 0.6% of outstanding shares.

It is tempting to highlight the fact that the two firms which proved to be better investments relative to shareholders' next best alternatives were both firms whose CEOs had significantly larger economics at risk. The fly in that ointment, however, is Terra—whose CEO held just 0.6% of shares, but which delivered significant shareholder value by garnering a higher bid from a third party, then forcing the initial bidder to top it with a cash-and-stock offer. If all pre-tax cash proceeds had been reinvested in shares of the bidder, shareholders would have seen a total return of 271% through Oct. 20, 2014, significantly beating the S&P 500 Index and the median of peers by 181 and 211 percentage points, respectively.



Source: Bloomberg Finance LP. Peers: Agrium Inc, The Mosaic Co, Yara International ASA, CF Industries Holdings Inc

Even including shares held by CEOs, the median shareholding of the target boards was just 0.9%. Only at Onvia did the independent directors have significant shareholdings, at 10.7% of outstanding shares. Yet even with significant economics at risk, that board's faith in the turnaround and strategic plan has not been borne out after more than 2 years.

Bidder toeholds, on the other hand, varied significantly, from 14.6% at microcap Onvia to a nominal few hundred shares at the three largest target firms (NRG Energy, AirGas, and Illumina). At the fourth largest—Terra—the bidder took a toehold of 7%, however, bucking the trend for multibillion dollar hostile bids.

* * *

We will continue to monitor this situation and market trends, speak with interested parties and, where relevant, issue additional *M&A Edge* notes to provide further information and guidance for clients.

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