High impact dialog

An interview with Glenn Welling of Engaged Capital

Few of the companies in which Engaged Capital has taken a significant stake would disagree that its founder, Glenn Welling, is a straight talker. He practices a distinct form of activism, often referred to as the "constructivist" school, and with strong similarities to the style employed by private equity. Indeed, Engaged's website describes its approach in just those terms, with "high impact dialog" its major selling point. "I can't fix a bad business," he explains. "I can only fix a bad valuation of a good company."

That approach comes naturally to Welling after a career spent largely as a "trusted adviser" on Wall Street. He started out at consultancy firm Marakon Associates, which he says "pioneered the idea that management could have a clear understanding of how strategic choices can affect a company's stock price." Advising corporates on how to boost shareholder returns is something that followed him in moves to AT Kearney, modelling-software developer HOLT Value Associates and Credit Suisse, and provided a base for the eventual leap into activism. "When you think about what an activist does, that's it, isn't it?" he says.

Of course, there were a host of skills to acquire along the way. The part of HOLT's business that advised investors' decision making provided an introduction to the buy-side. Credit Suisse involved a more thorough introduction to M&A through the firm's suite of activism defense services. But the decisive influence came from his time at Relational Investors, which brought Welling on board in 2008.

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The Godfather of Governance

While at Relational, Welling managed mid- and large-cap healthcare and consumer investments and began the transition from adviser to changemaker. "I learned a tremendous amount from Ralph and David," Welling says of the Relational's founders, Ralph Whitworth, who recently stood down for health reasons as Chairman of Hewlett Packard, and David Batchelder. Chief among those lessons was the importance of corporate governance. "Ralph is the godfather of governance investing, and I'm a firm believer that it is crucial to sustaining long-term value," Welling says. "Lots of people pay lip-service to good corporate governance, but we really believe in it."

Reforming executive remuneration to align it more closely to the interests of shareholders has become a regular feature of the Engaged Capital playbook, and no-one has felt the brunt of that more forcefully than Abercrombie & Fitch CEO Mike Jeffries. After Engaged first criticized the company in December, matters rapidly escalated until the activist announced it would run a proxy contest.

Yet, despite holding just 0.5% of the stock, Engaged forced significant changes including seven new directors, an independent Chairman, the termination of the company's shareholder rights plan and a large share repurchase. Oh, and Jeffries' bonus was linked exclusively to shareholder return, return on equity and the firm's EBIT margin improvements. According to Welling, it could take between one and five years for the company to capitalize on all the reforms it has put in place, but there is still an upside of 50%.

Downsizing

With a market cap of under $3 billion and a strong brand, Abercrombie was right in the center of Engaged's target. According to Welling, it was a desire to exploit the value gaps in the small- and mid-cap space that led him to leave Relational, which was rapidly accumulating capital and, like

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7
public campaigns since 2012

28%
net return of Engaged’s flagship fund since inception (Oct 2012)

many activists, focusing on larger targets. Although it wasn’t easy, Engaged now has several hundred million dollars under management and is working its way towards its target and cap of $2 billion.

“If anyone had told me what the odds of us raising capital were, I’m not sure I would have left Relational,” Welling laughs, referring to the nine months he spent with his team of breakaway activists going through seeding processes. Eventually, $22 billion alternative investments manager Grosvenor Capital made a commitment, and UK-based GO Investment Partners offered a bridge to European, Asian and Middle Eastern investors with an interest in expanding their exposure to US activism. When Welling joined Relational in the immediate aftermath of the financial crisis, there was frustration that activism didn’t fit into well-defined categories for potential backers. Now, he says, activism has become an asset class of its own.

Engaging

Since launching in October 2012, Engaged has had at least a couple of hits. A little over a year ago, it disclosed a 5% stake in AeroVironment, the largest supplier of drones to the US military. After highlighting cash hoarded on the company’s balance sheet and threatening to fight a proxy contest when the company refused to consider Welling for a seat on its board, Engaged was surprised at the speed with which the stock rallied. It sold out between December and April when the company began to dominate its portfolio, but with an average buy-in price of $20.75 and a peak of over $41, is likely to have harvested substantial returns.

More recently, it teamed up with Lone Star Value Management to fight a proxy contest at Rentech—ultimately settled—and Voce Capital Management at Oplink Communications. “We’re not averse to working with other shareholders,” says Welling. The latter is an especially typical Engaged target, with plentiful cash reserves, a strong, sustainable business and satisfied customers. It’s too early to say how Oplink will play out, but Welling says it can be “more impactful” to work with other shareholders—in contrast to recent suggestions that activists are more likely to clash than cooperate in the same stock.

Case Study – Jamba Juice

Engaged’s latest campaign is at Jamba Juice, a smoothie retailer with franchises and directly-owned stores across the US. “We’re really excited,” he told Activist Insight last month. “It’s a phenomenal brand with strong headwinds,” but barely profitable on a corporate-wide basis.

Welling’s plan is to get the company to take one of two strategic options, both of which he believes lead to the same place. On the one hand, it could right-size its cost structure by reducing expenses to a similar level to its peers, potentially doubling its EBITDA. Alternatively, it could move to a full franchise system, allowing unprofitable stores such as those Engaged has identified in New York to sink or swim, and in-store profits to be reflected on a corporate level. Shares closed at $11.78 the day before Engaged filed its Schedule 13D, but Welling thinks it could go as high as $20.