Engaged looks for a path to resolve a company's valuation issues - Activist Profiler
by Ed Mullane
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Engaged Capital splits the world into product markets and capital markets, looking to find companies with dominant products successful at competing for customers, but where shareholders do not share customer enthusiasm, founder and Chief Investment Officer Glenn Welling told *Activistmonitor*.

"When we do our [target] customer interviews, customers love these businesses and love their products and services," said Welling. "But when we look at the second element -- competing in the capital markets for shareholders, and we go talk to shareholders -- they've been disappointed for years," he explained.

This tends to be due to a company's management and board doing something identifiable that is constraining its valuation, Welling said.

The firm looks for good businesses with high returns on capital, high cash flow generation, low financial leverage, and strong competitive positions that are trading at significant discounts to their intrinsic value.
"Once we know we have an asset that is undervalued, and we can see why because we identified the key drivers of value -- what's not being done or what's being done wrong -- we than have to figure out, is there a path to get the issues resolved?"

Looking through Engaged's portfolio and 13 exits, there is no one type of activism, or only one type of change the firm has driven. Every company is different and strategies need to be tailored to each situation, Welling says.
See *Activistmonitor's* dedicated Engaged Capital activist page here, including the types of demands it has made through its campaigns.

The Engaged founder has a simple philosophy: He knows he can't fix a bad business, but he can fix a good business with a bad valuation. This harkens back to 25 years of trying to help executives and boards fix these issues.

Small and mid-cap activism vacuum

Engaged Capital was formed in 2012 to take advantage of what Welling saw as a vacuum in small and mid-cap activism.

Larger, more experienced activists left this space as they attracted too much capital to invest in companies with market caps between USD 500m and USD 5bn, forcing them to scope out larger targets, Welling said.
"Companies of this size do not have the same quality of advisors, they don't have the buyside or sellside coverage and as a result, these companies tend to be significantly under-followed."

Small and mid-caps offer opportunities to create significant value over shorter time periods due to being less complex than large-cap companies, Welling said. Management teams and boards also typically have less experience – Engaged works with many first-time public company CEOs and CFOs in this space, he added.

The approach: private equity investor for public equities

Engaged looks at companies valued between USD 500m and USD 8bn, although a majority of its investments are in a USD 500m-USD 2bn market cap range, Welling said. The firm targets four major sectors: consumer discretionary and staples, healthcare, industrials, and IT.

This gives Engaged a universe of 1,300 to 1,400 potential targets to look at, compared to the roughly 300 names available in the large-cap space. It is a much larger pool to profit from, Welling said.

The fund's portfolio has a concentration of eight to 10 core investments at any given time, each making up anywhere between 5% and 15% of its portfolio. It typically has another four to eight smaller positions on top of

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that.

Its average holding period is two to three years, meaning Engaged only needs three or four investment ideas per year. At any given point in time, the fund has a watch list of about 20 to 30 potential investments, said Welling.

For a typical investment, Engaged will have researched a company for anywhere from six months to two years, with much of that consisting a lot of questions. “We want to validate or invalidate our [investment] hypothesis but also develop a rapport and relationship with management and the board,” said Welling.

Engaged then moves to 'transmit mode', moving from primarily asking questions to delivering messages: “Here are the things a company needs to do to close the valuation gap over the long run.” It enters transmit mode only after contacting customers, suppliers, other shareholders, former employees and other experts in the space.

Welling said he very much prefers to work with management teams and boards behind the scenes, having them take credit for the changes they execute. This approach stems from Welling’s years as a consultant, investment banker, and advisor before starting the fund.

Roughly two-thirds of Engaged’s ideas are sourced internally. A proprietary screening methodology Welling developed earlier in his career identifies companies with low market expectations relative to historical performance.

The remaining third comes from outside calls from other investors, former portfolio company management teams, directors, bankers, sellside analysts, or larger activists who have been pitched a name that is too small for them.

When it does make the decision to invest, Welling considers Engaged as a private equity investor for public equities.
Its activism tends to focus on the key economic drivers of a business: sales growth, margin improvement, and asset utilization, Welling said. “If you look at our investments they tend to focus on the real operational drivers of a business, because Engaged does not believe in financial engineering.

Investments are approached with two goals: first, to generate extraordinary returns for its investors and, second, to leave the targets in better shape than when it initially invested. Welling noted that Engaged has delivered over 35% median returns on the 13 exits it has made.

The firm measures "The Engaged Effect", which is the impact of its activism on a company's performance during an investment and after it exits. Engaged holdings have delivered a 24% average relative return during their holding period and the research shows that companies continue to perform above the index, for one, two and three-year look-backs after exit, Welling said.

This is an important data point highlighting the private equity-like perspective Engaged takes, said Welling. “We don't consider ourselves short-term investors. We do not consider any of the recommendations that we make to be considered financial engineering or a short-term fix to a business."

Background and formation of Engaged

Welling began his career in strategy consulting 25 years ago, and has spent his time helping companies figuring out on how to improve their valuations. In the 1990s, he built a company called ValuAd US, a financial software and training platform. It was sold to HOLT Value Associates in 1999.

With ValuAd US, Welling developed software to show executives and corporate boards how the decisions they make will impact their company’s valuation.

Valuation tends to be affected by key areas that Welling labels as "buckets": corporate strategy, capital allocation, cost structure, product portfolio, communications with investors, and corporate governance.

HOLT Value was sold to Credit Suisse in 2002, where Welling remained as a managing director and ultimately became the head of its investment banking department advisory business until being recruited to join Relational Investors in 2008.

To help revamp Relational's investment process, Welling brought over five colleagues from Credit Suisse and helped re-structure Relational into industry verticals where he ran the consumer and healthcare investments. At Relational, Wellings' investments included large cap companies like **PepsiCo** (NYSE: PEP), **CVS** (NYSE: CVS), **Genzyme** (NASDAQ: GENZ), **Medtronic** (NYSE:MDT), and **Gilead Sciences** (NASDAQ: GILD), and smaller cap companies such as **Harmon International** (NYSE: HAR), **Par Pharmaceuticals** (NYSE: PRX) and **Charles River Laboratories** (NYSE: CRL).

With the tremendous inflow of capital into Relational and other activist peers earlier in the decade, Welling noticed that capital was gravitating to the large-cap market, becoming a crowded space for activists formerly focused on smaller companies and creating a vacuum in this space.

Welling left Relational at the end of 2011 to form Engaged. A team of former colleagues joined the firm in 3Q12, when Engaged received USD 85m in seed funding from Grosvenor Capital Management. Engaged has between USD 300m and USD 400m in assets under management, he said.

A portfolio look: Jamba and Outerwall

Engaged filed a 13D on **Jamba** (NASDAQ: JMBA), the maker of smoothies, squeezed juices and energy bowls, in July 2014. In January 2015, Jamba announced it agreed to appoint two new independent members to the board, Welling and James Pappas, a managing member of **JCP Management**.

Going by the name of Jamba Juice, the retail chain was a hybrid franchise and company-owned model, providing the opportunity to move to a fully franchisee organization. This freed up a tremendous amount of cash and allowed the company to cut its cost structure in half, noted Welling.

The second part of the agenda was to help create value by driving growth in the top line through better product innovation and marketing, he said. This entailed new management team members and new marketing hires to implement a combination of strategy changes and cost reductions, he said.

See *Activistmonitor's* dedicated Jamba Juice campaign page here.

Outerwall (NASDAQ: OUTR) is another Engaged holding. This is a company that generates a high amount of free cash flow, but has historically done a poor job allocating the cash flow, said Welling.

The Bellevue, Washington-based company is made up of two businesses, Redbox and Coinstar, where together they have one of the largest retail footprints in the country with over 60,000 locations, he said.

When Engaged invested in Outerwall it had a 40% free cash flow yield, said Welling. Over the years, the company spent USD 650m on failed growth projects and another USD 1bn buying back stock at around 2x its value when Engaged invested, he noted. OuterWall shares, which traded at more than USD 80 in July 2015, are currently trading in the mid-USD 40s.

Since Engaged initiated its investment, shares have rallied from the high-USD 20s, the company has doubled its dividend, it hired Morgan Stanley to run a strategic review process, added one of Engaged's nominees to the board, and, on 1 August, two more Engaged directors were slated to join the board, noted Welling.

The company needs a major strategic shift or substantial change on how it allocates capital and an awareness that it may be better off as a private company since it has a business that is in secular decline, Welling said. Outerwall would be more highly valued as a private company, where the cash flows can be optimized and monetized by one owner, he argued.

See *Activistmonitor's* dedicated Outerwall campaign page here.