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In early May, Barclays Research published a report entitled FedEx 2.0 suggesting how FedEx could create shareholder value by improving its operations. The report pointed out that as opposed to UPS, FedEx runs its ground and air businesses almost as completely separate companies. UPS has only \$10 billion more revenue than FedEx (\$54B versus \$44B) but an \$88 billion enterprise value compared to \$30 billion for FedEx.

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## \* Young Guns of Activism \*

**Engaged Capital** was founded by Glenn W. Welling, a former Principal and Managing Director at Relational Investors. It received an \$85 million seed investment from Grosvenor Capital Management and commenced operations in the fourth quarter of 2012. They started off strong, despite being only approximately 50% invested. In the fourth quarter of 2012, their long/short fund (\$125M of assets) was up 6.29% on a net basis and the long only fund (\$10M of assets) was up 7.90% on a net basis, versus -0.38% for the S&P500.

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## Under the Threshold Activism Below 5%



On May 16, **Sandell Asset Management** sent a white paper (attached) to Spectra Energy ("SE") outlining their goal to transform Spectra Energy from a Utility to an Infrastructure Player. Sandell estimates that the valuation of SE would be between \$41 and \$48 if the Company were

to take the following steps: (i) Drop-down SE's US Transmission assets into an MLP; (ii) IPO/Sell SE's Canadian operations, a fully-owned subsidiary operating as Westcoast Energy Inc.; and (iii) IPO/Sell SE's 50% stake in DCP Midstream LLC to highlight DCP's MLP-qualifying income. Sandell says that these steps will better align shareholder bases to

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# 10 Questions with Marc Weingarten

Marc Weingarten is chair of the Business Transactions Group at Schulte Roth & Zabel LLP where his practice focuses on mergers & acquisitions, leveraged buyouts, corporate governance, securities law and investment

partnerships. One of the leading lawyers representing activist investors, he has advised on many of the most significant activist campaigns in recent years. Marc was able to make time to sit down with us for this month's edition of 10 Questions.



**13DM:** You represent a great many activists, and have been involved in some of the most significant contests over the years. How did you get involved in the business?

**MW:** It really started in the eighties, representing Asher Edelman in all of his

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## MARC WEINGARTEN (cont'd. from pg. 1)

hostile fights. Many involved proxy contests, and that's where I really learned the trade. Many of today's activists were in the mix back then, as were many of today's proxy solicitors and public relations firms. So I've known all the players for a long time. And my firm has a premier practice in advising hedge funds, so they've naturally turned to us for advice on activism.

**13DM:** What advice do you give your activist clients about approaching management? When should they first approach them and what should the tone of that conversation be?

MW: I generally recommend that they approach management in a constructive way prior to going public with their activism. That way management can give them a hearing without getting defensive in response to a public attack, and the activist may get some valuable insight into the situation at the company which they couldn't know as an outsider. That may enable them to reshape or sharpen their platform, or at least anticipate the company's response. And it increases the likelihood that the company will adopt the activist's proposal, or settle, without looking publicly like they've been pushed to do so. Having private discussions first also gives you more credibility later with institutional shareholders, rather than coming at the company out of the blue with all guns blazing.

**13DM:** You have represented activists in hundreds of campaigns. What is the main factor that distinguishes a winning campaign from a losing campaign?

**MW:** Picking the right target is the most critical factor. If the company is a demonstrably poor performer over a significant term, compared to peers and a relevant index, with a very unhappy shareholder base, you've got a situation primed for success. Where it hasn't done that badly, but the activist just thinks it could do better, you've got an uphill battle. If you've picked the right target, then it's all about execution-winning the hearts and minds of the other shareholders with a clear, consistent, well-articulated message.

**13DM:** Are there any new trends in shareholder activism you've seen in this most recent season?

**MW:** One trend clearly is activists going after larger-cap targets. There's no mystery as to why-they're doing it because they can. The sector has seen enormous capital inflows in recent years, reflecting the excellent returns. A number of new activist funds have started up, spun out of places like lcahn and Pershing Square, and launched with over a billion in capital. And if you can get institutional investors to support you, you can win even if you only own a percent or two of the outstanding. No company is immune.

Another trend this year was for more majority board fights than ever before, with greater success than in the past. They're much harder fights to win than where you're just looking for minority board representation-ISS requires that you prove you have a superior business plan, and the companies scare the

other shareholders with fears about "disruption" and harp on the failure of the activist to pay a premium for its supposed acquisition of control. But particularly where the activist is seeking management change, often the only practical way to achieve it is with majority board change. There have been several majority board contests this year, which may also be partly attributable to the decline in staggered boards. And many more have been successful than historically.

**13DM:** Activism is certainly evolving and becoming a widely accepted strategy. Even Marty Lipton recently called it an "asset class." Do you see more hedge funds adopting an activist strategy? It seems like many hedge funds who historically never filed 13Ds are starting to be 13D filers and alleging that they will utilize activism as a strategy from time to time

**MW:** Yes, we're seeing many more hedge funds which would never call themselves activists trying out the strategy now when they're stuck in a position where they think they can unlock value. We call them "occasional activists". Earlier this year we represented TPG-Axon in its campaign for Sandridge Energy. They're not an activist fund, but they'd been invested in Sandridge for a long time and were incredibly frustrated by what they saw as mismanagement by an imperial CEO who stood in the way of value realization on some really terrific assets. And right now we're in the middle of the fight for control at Vivus. We're advising First Manhattan, which again is not an activist fund, and

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"Picking the right target is the most critical factor. If the company is a demonstrably poor performer over a significant term, compared to peers and a relevant index, with a very unhappy shareholder base, you've got a situation primed for success."

## MARC WEINGARTEN (cont'd. from pg. 2)

has been invested in Vivus since 2008. Vivus has an FDA-approved anti-obesity drug called Qsymia, the most effective drug in the sector and which should be a blockbuster billion-dollar plus seller, but First Manhattan thinks they've badly fumbled the launch of the drug and is looking to replace the entire board with candidates with much more drug commercialization experience. I think these "occasional activists" in some ways have more credibility with other investor/shareholders than activist only funds-they're long-term investors who have suffered alongside their fellow shareholders and are putting their money where their mouths are to try to improve things for everyone. They really can't be accused of short-termism,

and they go active not because "it's what they do" but, to the contrary, it's not what they do but they're incensed at corporate mismanagement that has destroyed value.

**13DM:** There have been a recent spate of activist situations where large shareholders ignored, at least in part, ISS's recommendation for the incumbent Board (i.e., Tessera, DSP Group, Morgans Hotel). This is not the first time that shareholders have gone against ISS, but it is the first time that I can remember where they have gone against the recommendation for management – and three times in a couple of weeks. Are shareholders becoming more independent in their voting decisions?

**MW:** Many of the largest institutional investors are becoming more independent. Several of them-BlackRock, Vanguard, State Street and Fidelity, for example-have developed highly sophisticated in-house capabilities to make proxy voting decisions, with their own detailed policies and guidelines. They still use ISS, but mainly for

informational purposes. These investors are now another stop on the campaign trail-they'll listen to both the activist and management, and then make their own voting decision. They don't automatically follow ISS recommendations-they have their own agendas.

**13DM:** There has been much discussion about changing the 13D rules as allowed by the Dodd-Frank Act, particularly in shortening the 10 day filing period. What are your thoughts on this?

**MW:** The Wachtell proposal to shorten the 10-day window has nothing to do getting earlier notice to issuers and the market-the Hart Scott rules, advance notification bylaws and poison pills already do a perfectly fine job at that.

"The [activist] sector has seen enormous capital inflows in recent years, reflecting the excellent returns."

It's simply an attempt to further tilt the playing field in favor of corporates by reducing the potential profit of an activist and so disincentivizing them from undertaking a campaign at their own expense and risk for the benefit of all investors. The Williams Act 13D rules were intended to provide early disclosure of potential hostile acquisitions of control, not appeals to shareholders to exercise their voting franchise to maximize value, and ought not to be tightened to deter activism. But I think the pressure from corporates to shorten the 10-day window, particularly by comparison to the shorter windows in other countries, will be overwhelming. If that happens, it should really be coupled with an increase in the threshold for reporting-to at least 10%-as the ownership of just 5% of a company's stock is really not a threat to control, let alone a level at which an activist should

be stopped out.

**13DM:** If you could add or change one corporate governance rule, what would it be?

**MW:** The one change which I believe would be most meaningful would be to permit shareholders to amend the corporate charter without the necessity of the board having to first be in favor of doing so. The charter is the fundamental corporate document which governs shareholder rights, and I don't believe that the private owners of a company should be able to impose their will, and their entrenching rules, on the public owners in perpetuity. It should be a cost of going public that the charter can be changed by the public shareholders. If

the private owners want to insure their continuing control, they should keep the company private.

**13DM:** Are there any proxy rule changes on your wish list?

MW: I believe the proxy rules should be changed to permit the use of universal proxies. When a shareholder attends the meeting in person, they can vote on a ballot which lists all of the director candidates from both sides, and can pick and choose whatever combination of candidates they prefer. But if they vote by proxy, they can only vote on the card supplied by either the activist or the company, and can't freely split their votes for the particular nominees they prefer. That's a serious limitation on the shareholder franchise, and really should be remedied. ISS and Glass Lewis frequently recommend split voting, but there's no way to really split your votes when voting by proxy. A simple modification to the bona fide nominee proxy rule would fix this problem and facilitate universal proxies.

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## IN THE CROSS HAIRS (cont'd. from pg. 1)

Pershing Square Capital Management LP is raising money in the next 10 days for a special purpose vehicle to buy the stock of a large U.S. company, according to a letter sent to investors, and the rumor is that FedEx is the target. According to the letter, the target is a large-capitalization (✓), investment-grade (✓) U.S. corporation (✓) that principally operates in one business segment (✓) and serves a diversified global customer base (✓). The letter goes on to say that the business is simple, predictable, free-cash-flow-generative, and enjoys high barriers to entry, high customer switching costs, and substantial pricing power. The company benefits from long-term secular demand for its

products and services. In addition to in-place growth from existing assets, the company has the opportunity to deploy growth capital in its core business at attractive rates of return. The company has for many years underperformed its peers with regard to business productivity, operating margins, and return on capital employed. As a result, the

company trades at a substantially lower multiple of earnings than its most comparable competitor. However, there are some parts of Pershing's description of its target that are not consistent with FedEx. Many would say that FedEx does not have a simple business, does not have high customer switching costs and does not have the opportunity to deploy growth capital in its core business at attractive rates of return.

Southeastern Asset Management is a large Fedex shareholder and at their recent annual meeting used similar language to describe FedEx: "it enjoys pricing power" "it is extremely stable" and "has a terrific moat." Southeastern went on to say at its annual meeting that the most valuable part of FedEx is FedEx Ground, the time definite, small package ground delivery segment which com-

petes with UPS. It grows units at healthy rates, thanks to web commerce and by steadily gaining market share from UPS as a lower cost alternative. Returns on assets and therefore implicitly returns on capital are incredibly high. The stock market treats FedEx in total as cyclical and capital intensive due to its second most valuable division, which is far better known than its most valuable division. This is as powerful an association as Dell and the PC. Southeastern says that they can't find any way that this Ground segment should be worth a fraction of a multiple point less than UPS, since it should always outgrow UPS. Such multiples make FedEx Ground worth around 24 billion dollars compared



to FedEx's total market cap of 30 billion. FedEx Freight is worth another few billion and net debt is about a billion. So you pay close to zero for the legacy Express division which, despite it cyclicality and volatility and current low margins will grow long-term with world trade.

Pershing Square says in its letter that they believe the company offers substantial opportunities for improvement, which if achieved, will lead to dramatically improved profitability and a substantial increase in value. Based on their analysis, they believe the downside risk is modest in light of the price they are paying, the stability of the company's underlying business model, and the company's strong balance sheet. Pershing Square intends to acquire a greater than 5% stake in the company which will require them to disclose their investment in a Schedule

13D filing. They intend to engage with the company's management and board regarding the company's business, management, governance, operations, assets, capitalization, financial condition, strategy and future plans.

The activist fund Pershing Square is raising will be capped at \$1 billion and will invest alongside the New York-based firm's main hedge funds, which plan to invest about 15% of their capital in the same stock. Pershing Square manages about \$12 billion, meaning the total investment could approach \$3 billion. The firm, which already has a position in the stock, plans to buy more than 5% of the company and will talk to the board and management to

bring about change.

It is worth noting that FedEx was not the only company rumored to be the target for this activist investment fund. There was also speculation about Walgreens and ADT. However, Walgreens certainly does not have high customer switching costs. ADT is definitely not the

target as it is way too small for such an investment vehicle, and I would highly doubt that Pershing Square would choose a target that already has an activist on the Board. If the target is FedEx it would certainly benefit Pershing Square to have activist friendly shareholders such as Southeastern Asset Management (5.24%) and T. Rowe Price (3.43%), but they would have little hope of getting the support of infamous activist opponents Dodge & Cox (5.48%) and Wellington Management (4.36%). Moreover, not unlike Carl Icahn going after Dell, Pershing would potentially be facing off against an iconic Founder/CEO in Fred Smith and his 6.23% ownership.

Regardless of whether or not FedEx is Pershing's next target, the dialogue has certainly started about it being a potential activist investment.

## ENGAGED CAPITAL (cont'd. from pg. 1)

Engaged makes concentrated investments in undervalued public companies and through a constructive engagement process serves as the catalyst for strategic change and shareholder value creation. Engaged focuses on small and mid-cap companies (\$500M to \$3B market cap). They see a void in that market due to the fact that the most successful activists are now managing \$6 to 12B in assets and can't focus on that market. There is some truth to that statement. While activist fund Starboard Value has seen tremendous success in the small and mid-cap market, funds like MMI, Shamrock and ValueAct SmallCap have left that market in recent years. They also like the small and mid-cap market because they believe that many of these companies are under covered by both analysts and investors and lack the business advisors and management experience of larger cap companies, creating a variety of market opportunities that allow an activist to come in and provide real value, advising these companies on ways to enhance value for all shareholders.

Engaged's style will be constructive engagement with a two to five year investment horizon. They will not be making a lot of public statements about their investments, but will be holding managements and boards accountable behind closed doors. They focus their investments in three categories: (i) companies they had invested in previously that currently have another activist in the shareholder base sympathetic to their agenda; (ii) companies where they already had a strong relationship with the management team, and thus the size of their investment was uncorrelated to the impact that they could have on decisions; and (iii) companies with smaller market capitalizations (\$500 million - \$750 million) and compelling agendas where they were able to gain "warm" introductions to management to assist in influencing the

company's decisions.

Engaged has a four part investment process. The first part of the process is idea generation - to identify companies that are performing well in the product/service markets where they compete yet are not receiving a commensurate valuation in the capital markets. Prospects are typically defined by their leading brands or franchises, their high return on capital, their stable cash flow generation and their low financial leverage. They screen for companies with one or more of the following challenges: bad business mix (good business/bad business), capital allocation miscues (think bad acquisitions), capital structure inefficiency (potentially too much cash on the balance sheet), lack of transparency and disclosure (investors cannot value the company appropriately), or misaligned incentive compensation (management not paid to create value for shareholders).

The next step is research. They have a six-step bottom-up research process: (i) Company Review – understanding the business model; (ii) Industry Analysis – industry economics, peer comparison, and competitive position; (iii) Trading Dynamics – drivers of share price historically, ownership history, shareholder base; (iv) Financial Model – historical analysis, forecast, and valuation; (v) Governance – board structure, defense profile, and compensation and (vi) Engaged Capital Opportunity – impediments to value creation, engagement plan, and process for unlocking value.

The third step is engagement, which centers on how best to communicate with a portfolio company and all of its relevant constituents. They will try to develop relationships with major stakeholders to better understand the opportunity and to apply pressure on management and the board to change. They strongly believe in transparency and are willing to share

their work and insights with relevant parties (advisors, shareholders, directors, sell-side analysts, etc.) to help them build the consensus needed for change. They believe that the more influence they are able to exert, the lower the risk of the investment and the greater potential for upside once their agenda is complete.

The final step to their process is portfolio construction/risk management. The most important part of this step is something they call "conviction indexing" - as they gain conviction that management is going to execute on the agenda they have been suggesting, they add significant capital to the investment. Their portfolio will consist of 10 - 15 positions, comprised of "core" and "on-deck" positions. Core positions have a capital commitment greater than 5% of the portfolio and they actively communicate with each. On-deck positions each take 1%-4% of their capital. These are investments where they believe the risk/reward profile is exceptional but they have yet to gain conviction that they can be part of the solution to improve the company's valuation discount. If they do reach that conviction, these investments become core positions. The portfolio is diversified using a robust top-down risk management process to ensure that the overall portfolio provides an attractive risk/return profile. They diversify across industries, geographies, engagement life-cycles, and various macro-economic situations. In the long/short fund, for each core investment, they identify a set of companies that possess similar exposures such as industry, size, commodity, volatility, common factors, and macro-economic risks to name a few. From this universe, they screen down to a list of companies that they want to short, based on valuation, company quality, and correlation to their core, long investment. They then establish a hedge ratio based on the life cycle of their engagement and the headwinds/

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## ENGAGED CAPITAL (cont'd. from pg. 5)

tailwinds that are being faced in that industry/sector.

As of December 31, there were nine companies in Engaged's portfolio. Six of the companies were "core" positions and three were "on-deck" positions. Below is a description of two of their largest positions.

Abercrombie & Fitch Co. ("ANF"). They have been following this company for

years, during which time the company has been underperforming its peers, despite the strength of its brands. They believed that management was spendthrift, lacking discipline in their capital deployment and overall spending. At the end of 2011 and beginning of 2012, a series of negative announcements sent the stock from \$75 to \$40 and by the summer of 2012, it was trading below \$30 per share. This led to Relational Investors getting involved, which was the impetus for Abercrombie to reform their capital spending and begin to produce significant free cash flow for deployment to shareholders. Engaged estimates that ANF is now in a position to repurchase 25% of its stock by the end of 2014. Moreover, management announced that after they hired an outside consulting firm to help achieve the maximum benefit from a cost cutting initiative, something Engaged had been urging them to do. Management stated that an operating margin in the low teens (an approximate 50% increase from current levels) is an attainable goal, which is consistent with Engaged's analysis that a cost reduction plan could add several hundred basis points to the bottom line.

Rentech, Inc. ("RTK"). In September, Engaged was introduced to Rentech, a company that owned 60% of a \$1.5 billion publicly traded master limited partnership (MLP) but only had a market value of \$500 million. RTK had a long, unflattering track record as an alternative energy com-

pany but had "struck gold" in 2006 when it paid \$70 million for a nitrogen fertilizer plant in the middle of the corn belt in Illinois. In 2011, management put the fertilizer plant into a newly created MLP called Rentech Nitrogen Partners ("RNF") and sold 40% to the public through an IPO. RTK retained 60% ownership of RNF along with its legacy alternative energy assets. So, why does RTK trade at approxi-

Abercrombie & Fitch TRADEMARK SINCE 1892



mately \$500 million when it owns an approximately \$900 million stake in RNF? First, the alternative energy business had never made any money, and actually it did not even generate revenue. Second, shareholders were suffering from a disastrous capital allocation plan as management had been investing cash flows from the highly profitable fertilizer asset in the energy business to the tune of over \$400 million since 2006. Third, at least a portion of the discount was attributable to potential tax leakage from the RNF stake. Engaged began to engage management in late October and recommended the company immediately exit the alternative energy business, sell a portion of its RNF holdings, and distribute its large cash balance prior to year-end tax changes. On

December 10, management committed to find the highest value option for the alternative energy business by the end of the first quarter of 2013 and announced a \$42 million special dividend. On February 28, 2013, RTK announced the closure of the alternative energy business and the elimination of approximately \$20 million of R&D spending tied to those operations. With this announcement, RTK has become a holding company with a 60% ownership interest in RNF. How-

ever, while management has shut down the money-losing alternative energy business, they have not eliminated \$25 million of associated corporate costs. As such, the valuation gap has not been closed yet. Engaged believes that management is considering various near-term options to address the valuation issue, and has been communicating with management on a regular basis - sharing financial analysis, providing objective shareholder feedback and suggestions, and dimensioning what type of performance is required to create value for shareholders. In

May, Rentech announced a series of

transactions that resulted in them

entering the wood processing and wood pellet business. After reviewing the transaction and discussing it in depth with management and experts in the industry, Engaged is comfortable management has made what appears to be a good decision in pursuing this business. The Company now owns pieces of two business (RNF and the wood fabrication/ pellet business) both of which have their own management teams, yet RTK still has a corporate infrastructure of 65 people with a cost of \$30M. Engaged estimates that reducing corporate costs to peer levels would add 15% to 20% to the company's market value and they are currently engaged with the company pressing them to address this issue immediately.

## MARC WEINGARTEN (cont'd. from pg. 3)

**13DM:** There have been recent high profile proxy fights where the activist agreed to personally compensate its nominees if they were elected to the Board. These arrangements have been criticized by some. Do you see more of this in the future and how do you structure these arrangements to placate some of the more outspoken critics?

**MW:** I do think we'll see additional attempts at this in the future, coupled with educational campaigns to explain to shareholders why these arrangements are justified and beneficial. Activists are not on equal footing with corporates to attract board nominees-they're asking distinguished corporate executives to get involved in fight for board seats, risk the mud-slinging that can happen in a campaign that can damage their reputation, and all without any assurance of success. And the activists are trying to recruit the absolute best board candidates available-industry "rock-stars". It's natural and appropriate that they need to pay these candidates more than the company would. The argument that this would result in different classes of directors with different economic incentives is silly. We have that now, where different directors have very different levels of options with differing expiration dates, or differing levels of stock ownership, and some directors who represent majority or private equity owners and whose compensation in their day jobs will vary based on company performance. But the special incentives to the activist nominees will need to be tied to value creation over a longer term, like three years, rather than when the activist decides to exit. I've got to believe that pay for performance in the board room can be made to work.

## UNDER THE THRESHOLD (cont'd. from pg. 1)

assets, reducing SE's conglomerate discount thereby lowering cost of capital and tie management incentives more directly to operational performance of assets and strategy.

Sandell points out that over the past year, SE has traded down 5% versus comps which were up 21% - a 26% underperformance and over a 3 year period, SE's underperformance has been much more dramatic – 72% below comps. Sandell estimates that dropping down SE's US Transmission assets yields SE value of \$20-\$21/share and uses as a case study Williams Companies dropping down all of its midstream and pipeline assets into Williams Partners in January 2010. Sandell estimates that the IPO of Westcoast Energy will highlight its \$14 to \$16/share value based on trading multiples for comparable Canadian infrastructure companies. Finally, Sandell estimates that the IPO/Sale of DCP Midstream yields \$7/share, plus an additional \$4/share from normalization of natural gas and NGL prices.

On June 11, the Company announced that it will be dropping down all of its US Transmission and Storage Assets into an MLP. As far as Sandell is concerned, this is a great start but there is a lot more that can be done, which they conveyed to management on June 12. Then, on June 17, Sandell sent a public letter to the Company applauding their decision to drop the assets into an MLP, but urged them to pursue the additional steps that Sandell outlined in its white paper and to imple-

ment operational cost cuts across SE's entities that will reduce inefficiencies and boost profitability as management teams are more aligned with underlying operating asset performance and their related publicly-traded shares. Sandell further points out that the Company's CEO compensation has been consistently ranked at the top amongst CEOs of the same peer group despite a significant underperformance to the peer group, demonstrating a complete lack of alignment between executive compensation and shareholder returns. Sandell speculates that it is both this lack of alignment and the CEO's beneficial ownership of only 0.04% of shares outstanding that explains why SE has not engaged in all the actions its peers have already taken – the glaring absence of financial motivation for the CEO to do so.

Sandell ends the letter by informing the Company that they have formed a shareholder group and are now one of the Company's largest shareholders. The Group intends to continue to promote change at SE for the benefit of all of its shareholders. They would like to work collaboratively with the Company but should the Company fail to promptly take all the steps to maximize shareholder value as Sandell has outlined in its white paper, they intend to pursue a change to the composition of the Board at the next annual meeting. The deadline to nominate directors is January 30, 2014.

## New Filings for June

Company Name	Investor	Mkt. Cap.	Filing Date	%	Cost	Item 4 Action
Health Management Assoc.(HMA)	Glenview	\$3.6B	6/11/13	14.6%	n/a	replace board
Smithfield Foods (SFD)	Starboard	\$4.6B	6/17/13	5.7%	\$32.5	sum-of-the-parts transaction
Famous Daves American (DAVE)	Farnam	\$113.0M	6/24/13	5.2%	\$10.7	share buyback/reduce expenses
Parkervision (PRKR)	Gem	\$362.1M	6/25/13	7.7%	\$3.3	opposes shareholder proposals
Tim Hortons (THI)	Scout	\$8.4B	6/25/13	5.5%	\$53.3	increase shareholder value

### One to Watch

Company
Tim Hortons Inc. (THI)

Market Cap.: \$8.4B (\$54.6/share)

Enterprise Value: \$8.7B

Cash: \$180.7M Debt: \$531.9M EBITDA: \$746.6M Investor

**Scout Capital Management, LLC** 

13F Holdings: \$7.8B # of 13F Positions: 48 Largest Position: \$1.6B Avg. Return on 13Ds: n/a Versus S&P500 avg: n/a Investment
Date of 13D/A: 6/25/13
Beneficial Ownership: 5.5%
Average Cost: \$53.3

Amount Invested: \$447.7M Highest price paid: n/a # of larger shareholders: 1

On June 25, 2013, Scout sent a letter to the Board expressing its opinion that with an appropriate capital structure and more judicious allocation of capital spending, the Company could double free cash flow per share to C\$4.50/share by 2015, which based on peer multiples, should result in a stock price of C\$90-\$112. Scout urges the Board to increase leverage to the moderate level of 3x Debt/EBITDA and 4.4x Adjusted Debt/EBITDAR, which would provide incremental capital to fund accelerated share repurchases. Scout believes at this recommended leverage level, the Company can maintain credit statistics that support the long term health of the business, compare favorably to its highly franchised peers, and generate dramatically better shareholder returns. Next, Scout urges the Board to curtail the use of the Company's cash flow to fund real estate investments or new store capex in the U.S. Scout believes if new stores make sense, well-capitalized franchisees will be happy to invest their own capital. Scout believes multi-unit operators will be brought into the system, who have more experience in the local markets and the capital intensity of the business would be reduced. Finally, Scout recommends the following metrics to its management compensation targets: (i) per share metrics such as free cash flow per share and/or EPS, (ii) capital efficiency metrics such as incremental returns on invested capital, and (iii) total shareholder returns vs. peers. At present, Scout notes, the singular metric used by the Company is the EBIT target, which Scout believes is inappropriate, along with leading proxy advisory firms, ISS and Glass Lewis & Co. Scout ends its letter by stating that it looks forward to a dialogue with management, the Board, and its fellow investors. Scout is not an activist investor. This is only their third 13D filing in their history, their second one being five weeks ago and their first one coming in 2004. They did not take any significant activist measures in the May 2013 filing and in the 2004 filing on EFunds Corp. they also made recommendations to return cash to shareholders and better align management's incentives with shareholders. The recommendations they make in this letter are similar to the recommendations that Highfields Capital made to Tim Hortons management in May of 2013, except that Highfields also advocated for the Company to spin off or sell its distribution business, create a real estate investment trust to house its property assets and bring in some new directors who have more financial experience. This is a very steep uphill battle for Scout. As evidenced by the fact that management did not respond to Scout's overtures or act on Highfields' recommendations, the Company will likely ignore both shareholders. This would mean that Scout or Highfields would have to escalate to a proxy fight, something that I am not sure Scout is prepared to do based on their history. As we recently saw with JANA's proxy fight at Agrium, even for an extremely experienced and competent activist, winning a proxy fight in Canada is a tough task, and even more so against an iconic company such as Tim Hortons. Moreover, while Scout points out that Tim Hortons has significantly underperformed their peers, they have created significant value for their shareholders over the past five years. Agrium also inderperformed its peers, but the shareholders were reluctant to restructure a board that has been delivering significant stock price performance. The two things that Scout has in their favor is that between them and Highfields, they own 9.5% of the Company versus management owning less than 1% and that another large shareholder is T. Rowe Price (5.5%), who is significantly more likely than the average mutual fund to support an activist.

#### **Activist/Activist Defense Directory**

#### **Investment Banks**

	Contact	Phone Number	E-mail
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## Sandell Group

Unlocking Shareholder Value at Spectra Energy Corp (SE)

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#### Goal: Transform Spectra Energy Corp (SE) from 'Utility' to Energy Infrastructure Player

- SE is one of the largest North American energy infrastructure companies with \$25bn+ of prospective investment projects, operated and perceived as a utility company
  - SE has underperformed peers by 70%+, trading at a meaningful discount due to its tax-inefficient, conglomerate structure, unnecessarily elevating its cost of capital versus an industry on the cusp of explosive organic growth
  - There are clear steps to unlocking and maximizing shareholder value through strategic/financial actions already undertaken by industry peers; in our analysis, the current FinCo + OpCo financing structure at SE does not prevent any of these steps

We estimate that an appropriate valuation for SE would be \$41 to \$48 per share (+32% to +55% upside) if it were to take the following steps

- Step 1: Drop-down SE's US Transmission (UST) assets into Spectra Energy Partners, LP (SEP), an MLP
  - Dropping UST into SEP would <u>lower its overall cost of capital and be 20%+ accretive to both SE's dividend and SEP's distribution</u>, vaulting SEP to the highest class of large MLPs (e.g., WPZ and KMP) that are widely followed and trade at premium multiples / yields to other MLPs
  - Through this step, SE would clearly <u>target the separate MLP & 'GP HoldCo' shareholder bases</u>, reducing the current conglomerate discount. Furthermore, SE's slate of organic growth projects would provide consistent growth for both SE/SEP's dividend/distribution
  - As shown by industry peers, the long term benefits of a lower cost of capital and the <u>fast growing incentive distribution right (IDR) cash flow</u> will directly accrue to the pro forma SE 'GP HoldCo' shareholders over time
- Step 2: IPO/Sell SE's Canadian operations, a fully-owned subsidiary operating as Westcoast Energy Inc. (WE)
  - By IPO'ing WE in Canada, SE can <u>access the lower cost of capital afforded to Canadian infrastructure assets</u> that trade at premiums given global interest in Canadian energy resources (oil sands, shale, LNG, NGLs), competitively low corporate tax rates (15%-20%) and yield-driven investors
  - We believe that an IPO of Westcoast would be oversubscribed as Canadian pension funds, mutual funds and traditional energy infrastructure investors would be attracted to <u>its asset base</u>, <u>upside potential and significant market cap (~\$10bn)</u>
  - Comparable Canadian companies trade at 13x to 14x 2013 EBITDA vs. SE trading at less than 11x 2013 EBITDA
- Step 3: IPO/Sell SE's 50% stake in DCP Midstream LLC (DCP) to highlight DCP's MLP-qualifying income
  - In its current structure (where DCP is owned by tax-paying C-corps), its potential MLP-type valuation is obscured; an IPO of DCP would remove this veil
  - DCP's assets would be a <u>natural target for other MLPs (including DPM or SEP)</u>, a transaction that would highlight the strategic value of DCP

These steps will 1) better align shareholder bases to assets, reducing SE's conglomerate discount thereby lowering cost of capital and 2) tie management incentives more directly to operational performance of assets and strategy





#### Spectra Energy (SE): Transformation from 'Utility' to Energy Infrastructure Player

#### UST / Liquids

Gulf coast to Northeast US Pipeline Infrastructure

Owns 61% of SEP (MLP)

Long term, take or pay, fee based reservation revenue (95%)

#### Distribution

Regulated, retail natural gas distribution in Ontario

2<sup>nd</sup> largest distributor in Canada; Dawn Storage is largest underground storage facility in North America

M&NLP (Canadian Portion)

#### Western Canada

Canadian pipeline & midstream operations in BC/Alberta located in most productive shale gas fields; LNG upside

Empress NGL system exposed to NGL prices

#### Field Services

50% of DCP, largest US NGL producer and nat gas processor (with EPD & WMB); PSX is co-owner

40% POP, 10% KW contracts exposed to natural gas & NGL prices

#### SEP (MLP)

Drop-down all assets into SEP, pushing significant future capex to lowest cost of capital entity

Increased market cap and growth trajectory will yield premium multiple

#### Westcoast Energy

IPO/Sell to garner premium multiple afforded to Canadian infrastructure assets due to global interest in Canadian energy, lower tax rates and yield-driven investors

#### **DCP**

IPO/Sell to garner premium multiple afforded to taxefficient MLP which is lost in current structure with SE & PSX as tax-payers or

Merge with DPM/SEP or another large MLP



- SE's Sum of the Parts (SOTP) Valuation Range is \$41 to \$48/share (+32% to +55% upside)
- SE drop-down has successful case study
  - Williams Companies (WMB) dropped down its pipeline assets to Williams Partners (WPZ) in January 2010 with WMB owning 80% of WPZ; currently at 67% ownership
  - Given subsidiary financing structure at SE, no new debt will need to be raised and no cash to be transferred (avoiding capital gains treatment)
- WE IPO is efficient and easy to pursue
  - WE was acquired in 2002 by Duke Energy (DUK)
  - SE was spun out of DUK in 2006 with WE as a subsidiary
  - WE's debt (under Westcoast Energy Inc. and Union Gas Limited) is already at the subsidiary level
- DCP to be IPO'ed or sold
  - Crystallizes value for investors specifically DCP's tax advantaged structure which is lost as DCP pays SE significant tax distributions
  - Motivates DCP management to operate more efficiently, grow more aggressively and better manage transition from commodity-exposed contracts to fee-based contracts

Spectra Energy Corp. SOTP Valu	uation*	Base	\$ / %	High	\$ / %
		Case	Uplift	Case	Uplift
Spectra Energy Partners, LP (SI	EP) LP Div / Share (1)	\$2.48		\$2.48	
(Full drop down of US Transmission	Yield (2)	5.4%		4.9%	
assets from SE, SEP assumes	SEP Price	\$45.72		\$50.35	
TET, SEC + Comml Paper,	SE shares owned (3)	187		187	
Other debt less \$500m WE note)	Value of LP shares	8,565		9,433	
	IDR payment	169		169	
	GP Yield (4)	3.7%		3.7%	
	Value of IDR	4,561		4,561	
	Equity value to SE	13,126		13,994	
	per share	\$20.00	\$5/50%	\$21.00	\$6/40%
Westcoast Energy Inc. (WE)	EBITDA (5)	1,195		1,195	
(100% Canadian business;	Multiple (6)	12.6x		14.2x	
Distribution and Western Canada	Enterprise value	15,066		16,924	
segments + M&NLP)	Debt (7)	6,171		6,171	
	Equity value to SE	8,895		10,753	
	per share	\$14.00	\$4/40%	\$16.00	\$6/40%
DCP Midstream LLC (DCP)	EBITDA (8)	580		710	
(100% Field Services business,	less: interest & D+A (9)	(270)		(270)	
comprising 50% ownership	Distributable cash flow	310		440	
of DCP)	Coverage ratio	1.10		1.10	
	Dividend	282		400	
	Yield (10)	6.1%		5.6%	
	Equity value to SE	4,588		7,186	
	per share	\$7.00	\$1/10%	\$11.00	\$5/20%
NAV / Sha	re	\$41.00		\$48.00	
% upside from o		32%		55%	
<ol><li>Assumes dropdown of SE US Transmission assets,</li></ol>	current IDR waterfall structure				

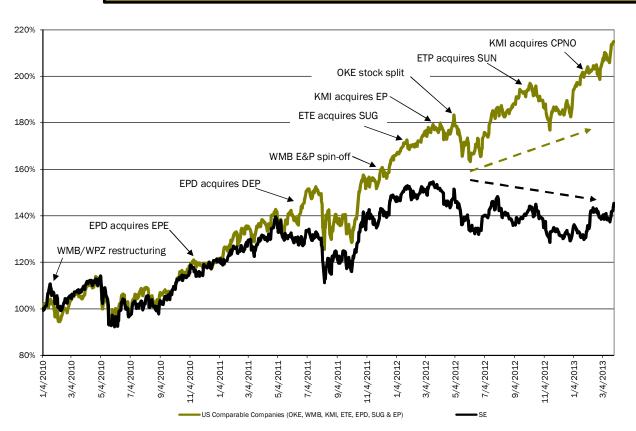
- (2) Base: SEP yield; High: assumes SEP current yield less 50bps for size premium
- (3) Total PF LP shares out of 224m, SE owns 82% of the LP + 4m GP shares
- (4) C-corp owned GPIDRs: Base & High: WMB div yield
- (5) Distribution + Western Canada 2013 EBITDA estimates from SE, not considering M &NLP (incl in US Transmission)
- (6) Base Case using 2013 TRP trading multiples; High Case using avg of TRP + ENB + KEY multiples
- (7) Westcoast + Union Gas subsidiary debt + \$500m SE debt + \$459m pfds + CP less: M &NLP debt (cash collateralized) (8) Base: Field Services EBITDA estimate for 2013 (NGL/bbl of 80c); High: assumes higher NGL and Nat Gas prices
- (9) 2013 estimates from SE
- (10) Base case: avg div yield of comps & High Case: DPM Yield
- \* excl Express-Platte, Sand Hills & Southern Hills, \$85m/yr of corp costs + pens underfunding of \$430m in US/Can, s/o of 658m, Dec 2012 debt figures





- SE stock returns have been poor compared to comparable energy infrastructure companies with similar growth profiles
  - Stock underperformance acute over past several years as <u>industry peers have engaged in several value-enhancing strategic actions</u>, acquisitions, splits and spin-offs driven by low interest rate environment, strong credit conditions, desire to be tax-efficient and the targeting of specific investor criteria

Over the past year, SE has traded down 5% versus comps which were up 21% - a 26% underperformance Over a 3 year period, SE's underperformance has been much more dramatic – 72% below comps



#### Absolute Price Performance

	Comps	SE	Diff
1 YR	21%	-5%	-26%
2 YR	57%	12%	-46%
3 YR	106%	34%	-72%



#### Step 1: Drop down SE's US Transmission assets to Spectra Energy Partners, LP (SEP), an MLP

- Dropping US Transmission assets into SEP yields SE value of \$20-\$21/share
  - Drop down of SE US Transmission assets into SEP would allow SE to benefit from SEP's lower cost of capital; SEP would also be able to fund capex and growth directly with debt and public equity raises, while leaving SE as a 'GP HoldCo', a nimble, highly-strategic entity reserved for overall capital allocation decisions
  - After the completion of the drop-down, SEP would become one of the largest MLPs (comparable to WPZ and KMP), thus benefiting from a premium valuation and a well-defined organic growth trajectory over time, SEP's liquidity would increase through new equity issuances, reducing SE's 82% ownership
- We believe this transaction would be significantly accretive to SEP and simultaneously increase SEP's IDR payout by almost 6x
  - SEP's distribution would increase from \$1.98/share to \$2.48/share (25%+), based on elimination of cash taxes paid on SE's UST assets
  - Assuming current IDR structure, the IDR cash flow to SE shareholders would increase from an estimated \$29m annually to approximately \$169m annually given SEP's organic growth prospects, this IDR payment should increase exponentially as SEP continues to grow with initial accretion to SE's dividend of 20%+
  - This transaction leaves SEP conservatively capitalized and given SE's subsidiary level financing for most of its debt (i.e., current debt will travel with assets) and SEP stock consideration, eliminates any capital gains tax
  - We estimate this process will take 2-3 months with SEP assuming all subsidiary level debt and tendering for SE's FinCo unsecured debt

Ke	y Valuation Me	trics	
Metric	SEP	PF SEP	Change
Adjusted EBITDA	305	1,397	
EBIT	109	945	
Distributable Cash Flow	239	775	
Annual dividend to LPs	\$1.98	\$2.48	25%
IDR Cash Flow for SE (1)	29	169	5.8x
SE ownership of SEP	61%	82%	
EV / EBITDA	16.3x	12.6x	
Debt / EBITDA	3.5x	5.2x	
(4) 4			

(1	L)	Assume	no c	hange	in	IDR	struc	ture
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<sup>(2)</sup> Base: SEP current dividend; High: SEP yield less 50bps

Valuation for SE						
	Base	High				
Appropriate dividend yield (2)	5.4%	4.9%				
Implied share price for SEP	\$45.72	\$50.35				
Units owned by SE	187	187				
Value to SE shareholders: SEP	8,565	9,433				
IDR cash flow	169	169				
IDR dividend yield (3)	3.7%	3.7%				
Value to SE shareholders: IDR	4,561	4,561				
Total value to SE shareholders	13,126	13,994				
per share	\$20.00	\$21.00				

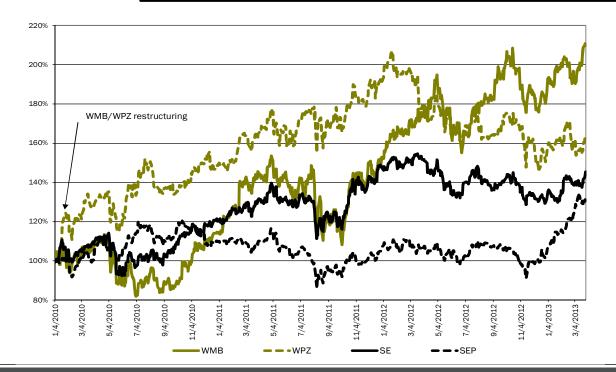
<sup>(3)</sup> Base/High: WMB div yield



#### Step 1: WPZ/WMB transaction provides a successful case study

- Williams Companies (WMB) dropped down all of its midstream and pipeline assets into Williams Partners (WPZ) in January 2010
  - The \$12bn in asset drop downs increased WPZ's EV 5x+ from approximately \$2.6bn to \$14.2bn, increasing its capacity for growth and reducing its cost of capital
  - The transaction was financed through WPZ stock (50%, taking WMB ownership to 80% from 24%), new debt (25%) and assumed debt at the asset level (25%), minimizing any capital gains tax consequences for WMB and was completed in under 1 month (announced January 19<sup>th</sup>, closed February 17<sup>th</sup>)
  - Transaction successfully targeted MLP and 'GP HoldCo' shareholder bases and unlocked significant value for WMB shareholders

WMB has considerably outperformed SE in the relevant time frame with sell-side valuing WMB's GP IDR at 25x+ Cash Flow



#### Absolute Price Performance

	WMB	SE	Diff
1 YR	19%	-5%	-25%
2 YR	46%	12%	-34%
3 YR	99%	34%	-65%



#### Step 2: IPO/Sell Westcoast Energy Inc. (WE)

- The IPO of WE will highlight its \$14 to \$16/share value based on trading multiples for comparable Canadian infrastructure companies
  - WE was purchased in 2002 by Duke Energy (DUK), former parent of SE, for \$8.5bn and was primarily comprised of Canadian natural gas pipeline, storage, processing and retail distribution (Union Gas) business
  - DUK enhanced the WE acquisition in 2005 through an asset swap with ConocoPhillips (COP), whereby DUK swapped 19.7% of DCP (giving COP an equal 50% stake in DCP) for the Empress NGL system in Canada (among other asset exchanges); DUK spun out SE in 2006 with WE as a fully-owned subsidiary
  - Canadian infrastructure companies currently trade at a premium due to global interest in Canadian energy (shale, oil sands, LNG export, NGLs), competitively low corporate tax rates (15%-20%) and large, yield-driven institutional investors
  - IPO will result a re-rating of the valuation of WE as Canadian investors highly value consistency and dividends; proceeds can be used to pay-off interco loans or preferreds
- Since debt is at the subsidiary level and the subsidiary publicly files financials, an IPO of WE should be quick and efficient
  - We estimate this process will take 3-6 months
  - With a <u>management team in place to operate assets and a compensation scheme more closely tied to WE stock performance, WE should operationally outperform,</u>
     providing upside for shareholders; WE currently reimburses SE for all centralized corporate functions and files with SEDAR i.e., we expect no significant dis-synergies
  - Given size / scale of WE (and its ability to raise debt and equity capital directly from investors), WE should be able to finance growth projects in the Horn River, Montney and North Montney, as well as other long term LNG projects (e.g., Prince Rupert with BG Group) at a cheaper cost of capital

Large Cap Canadian Infrastructure Comparables							
Name		Mkt cap	EV	Rating	EV/EBITDA	P/E	Div yield
ENBRIDGE INC		39,261	68,644	A-	16.2x	22.8x	2.69
TRANSCANADA CORP		34,951	60,177	A-	(12.6x)	19.7x	3.79
KEYERA CORP		4,863	5,681	N/A	13.7x	26.3x	3.5%
					(14.2x)	22.9x	
Westcoast Energy Inc. Valuation							
	per share	Mkt cap	EV	Rating	EV/EBITDA	P/E	Div yield
se: TRP EBITDA x	\$14.00	8,895	15,066	BBB+	▼ 12.6x	26.9x	3.49
e: Avg EBITDA x	\$16.00	10,753	16,924	BBB+	14.2x ♥	32.5x	2.89
	ENBRIDGE INC TRANSCANADA CORP KEYERA CORP	Name ENBRIDGE INC TRANSCANADA CORP KEYERA CORP  Westco per share e: TRP EBITDA x \$14.00	Name         Mkt cap           ENBRIDGE INC         39,261           TRANSCANADA CORP         34,951           KEYERA CORP         4,863           Westcoast Energy In per share           per share         Mkt cap           e: TRP EBITDA x         \$14.00         8,895	Name         Mkt cap         EV           ENBRIDGE INC         39,261         68,644           TRANSCANADA CORP         34,951         60,177           KEYERA CORP         4,863         5,681           Westcoast Energy Inc. Valuation           per share         Mkt cap         EV           e: TRP EBITDA x         \$14.00         8,895         15,066	Name         Mkt cap         EV         Rating           ENBRIDGE INC         39,261         68,644         A-           TRANSCANADA CORP         34,951         60,177         A-           KEYERA CORP         4,863         5,681         N/A           Westcoast Energy Inc. Valuation           per share         Mkt cap         EV         Rating           e: TRP EBITDA x         \$14.00         8,895         15,066         BBB+	Name         Mkt cap         EV         Rating         EV/EBITDA           ENBRIDGE INC         39,261         68,644         A-         16.2x           TRANSCANADA CORP         34,951         60,177         A-         12.6x           KEYERA CORP         4,863         5,681         N/A         13.7x           Westcoast Energy Inc. Valuation           per share         Mkt cap         EV         Rating         EV/EBITDA           e: TRP EBITDA X         \$14.00         8,895         15,066         BBB+         12.6x	Name         Mkt cap         EV         Rating         EV/EBITDA         P/E           ENBRIDGE INC         39,261         68,644         A-         16.2x         22.8x           TRANSCANADA CORP         34,951         60,177         A-         12.6x         19.7x           KEYERA CORP         4,863         5,681         N/A         13.7x         26.3x           Westcoast Energy Inc. Valuation           per share         Mkt cap         EV         Rating         EV/EBITDA         P/E           e: TRP EBITDA x         \$14.00         8,895         15,066         BBB+         12.6x         26.9x

Assumes 2013 guidance from SE for Distribution + Western Canada, 20% tax rate, 11x coverage ratio M&NLP debt not included in analysis given cash collateralization of debt

SANDELL 5 ASSET MANAGEMENT



#### Step 3: IPO/Sell DCP Midstream LLC (DCP)

- IPO/Sale of DCP Midstream yields \$7/share, plus an additional \$4/share from normalization of natural gas and NGL prices
  - Highlights tax-efficient nature of DCP and its value to public shareholders or other potential tax-efficient acquirers; current structure hides DCP's cash tax distribution payments made, approximately 50% of which goes to SE to pay taxes on DCP's pass-thru income (remaining goes to co-owner, PSX)
  - IPO'ing DCP would allow a) the market to value those tax distributions as part of DCP and/or b) an MLP acquirer to value those tax-efficient cash flows
  - As a separate entity, DCP management could engage in value-enhancing strategies either through operational actions (e.g., hedge NGL prices, grow more aggressively) or strategic actions (e.g., partnering with adjacent operators to maximize value)
  - We estimate this process will take 3-6 months, as DCP is currently audited and files financials with the SEC and will require negotiations/discussions with co-owner PSX
- Over the last decade, DCP has been forced to dividend cash generated to its JV owners allowing competitors to gain market share and competitive advantage in its basins, as shale discoveries have revolutionized the gathering and processing business
  - DCP has dividended more than its net income to cover JV owners' operating/growth cash needs and tax payments in some years dividending 125%-130% of its net income (note: given that DCP is an LLC, it does not pay taxes and therefore its net income is EBT)
  - Going forward, DCP should be encouraged to invest cash generated as opposed to distributing it to take advantage of the many growth opportunities

Valuation for SE's 50% ownership of DCP					
	Base	High			
	Case	Case			
EBITDA (1)	580	710			
Interest expense & D&A (2)	(270)	(270)			
Distributable cash flow	310	440			
Coverage ratio	1.10	1.10			
Dividend	282	400			
DPM dividend yield	6.1%	5.6%			
Total value to SE shareholders	4,588	7,186			
per share	\$7.00	\$11.00			
,					

<sup>(1)</sup> B ase case uses 2013 guidance, High case assumes higher NGL and Nat Gas prices (2) SE estimates

NGL Midstream Comparables / Valuation							
				2013	Div		
Name	Mkt Cap	EV	Ratings	EBDA x	Yield		
MARKWEST ENERGY	10,005	13,081	BB	13.4x	4.9%		
TARGA RESOURCES	5,047	7,551	BB	12.0x	5.7%		
COPANO ENERGY-UN	3,323	4,555	B+	13.6x	5.7%		
ATLAS PIPELINE P	3,001	4,379	B+	9.7x	6.0%		
CROSSTEX ENERGY	1,614	2,757	B+	8.8x	6.5%		
PVR PARTNERS LP	3,328	4,915	B+	11.6x	8.5%		
DCP MIDSTREAM PA	3,863	5,767	BBB-	11.6x	5.6%		
Averages				11.5x	6.1%		
DCP - Spectra Base	9,176	14,976	BBB	12.9x	6.1%		
DCP - Spectra High	14,371	20,171	BBB	14.2x	5.6%		



#### None of management comments on MLP opportunities are correct

- Management comment #1: Assets with a low tax basis may not be efficient for MLP drop down
  - If SE takes partnership units in exchange of cash or employs a LevPar structure (below), there is no tax impact to MLP drop down
  - The tax impact on an asset sale from a 'GP HoldCo' to an MLP can be minimized by utilizing the leveraged partnership (LevPar) structure. This structure enables the C-corp to avoid upfront tax payments so long as it guarantees the debt issued by the MLP in conjunction with the asset acquisition and as part of the consideration, accepting some amount of LP equity issued by the MLP; a LevPar structure was employed in Energy Transfer's acquisition of Southern Union
  - Additionally, in SE's case, since the majority of the debt is funded at the subsidiary level, most of the financing of the asset can travel with the assets
- Management comment #2: MLP value incrementally unclear given commodity exposure and significant Canadian presence
  - Management had made these comments in Q1-12 when questioned about whether they would be at a competitive disadvantage if they did not utilize the MLP structure. Implementing Step 2 and Step 3 removes this concern as these steps will isolate the inherent value of SEP and the asset drop down strategy (Step 1)
    - Step 1 of our value maximization plan would clearly target MLP and 'GP HoldCo' shareholders, lowering cost of capital
    - Step 2 of our value maximization plan includes IPO'ing Westcoast Energy, which would include all of SE's Canadian businesses
    - Step 3 of our value maximization plan states that SE should IPO/Sell DCP as it would highlight its MLP-qualifying income
- Management comment #3: Path towards U.S. tax reform remains unclear
  - While this has been an understandable concern given the lack of clarity on a fiscal cliff resolution in the past year, lawmakers ultimately reached an agreement and
    enacted legislation, which did not include any tax reform impacting MLPs
  - <u>Given that US lawmakers have proposed several recent initiatives to expand the MLP structure to help lower the cost of capital for alternative energy projects, we believe there is very little significant risk to the MLP structure</u>



#### Management compensation has limited alignment to shareholder returns

Despite the underperformance of SE shares, CEO compensation ranks as one of the highest among comparable company CEOs

- Surprisingly, in 2012, after missing expectations and stock underperformance, SE CEO's compensation increased from 2011
  - Other than John Gibson at Oneok, Greg Ebel out-earned all other CEOs for 2012 and for the 3 years ending 2012
  - SE also has <u>duplicative management teams at each of its subsidiary operations</u> (SEP, WE and DCP) with a <u>CEO at its MLP (note: no other comparable company has a</u> separate CEO for their 'GP HoldCo' and MLP entity) and full executive teams at WE and DCP
  - Lastly, <u>SE routinely compares itself from a performance standpoint to regulated US utilities (e.g., PEG, ED, PCG, XEL)</u> we do not believe these are the right comps for SE and neither do any of the other energy infrastructure companies listed below





#### Management compensation has limited alignment to shareholder returns

- Insiders only own less than 1% of SE US shares
  - Directors + management own 1.3m shares out of 658m shares o/s
    - Management alone own ~0.8m shares
  - In addition, directors + management own ~29k units of SEP US
- Management compensation is a mixture of both short and long-term remuneration
  - Total compensation: ~1/3 base salary (19% for CEO); ~20% short-term incentives; remainder as long-term incentives (split between time-based and performance-based)
    - Short-term incentive pay is based on a mixture of measures (incl. EPS, EBIT and ROCE)
    - Long-term incentive program consists of performance share unit awards that vest on achievement of performance goals in combination with phantom units that
      vest over a 3-year period
  - Over the past 3 years (2010-12), CEO Gregory L. Ebel has received compensation of ~\$22.9m; the other named executives have received a combined \$26.6m

Management Compensation						
Name	Title					
		2010	2011	2012	2010-12	
Gregory L. Ebel	President and CEO	6,864,886	7,782,334	8,225,957	22,873,177	
J. Patrick Reddy	CFO	2,482,225	2,513,081	2,391,525	7,386,831	
Alan N. Harris	Chief Development and Operations Officer	2,540,124	2,547,879	2,361,008	7,449,011	
Reginald D. Hedgebeth	General Counsel	2,202,875	2,171,154	2,216,586	6,590,615	
Dorothy M. Ables	Chief Administrative Officer	1,753,904	1,767,974	1,691,852	5,213,730	

Top executives paid almost \$50m over past 3 years despite 70%+ underperformance of SE share price versus comparables



— Castlerigg Master Investments ———