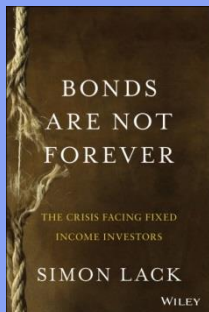




In Pursuit of Value

February, 2014

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Two-Edged Activists

Activist hedge funds draw increasing media attention nowadays. There are good reasons for this; the successful ones invariably carry out deep research on their targets and often lobby for the company to buy back shares, divest an underperforming business or exploit today's low interest rates by increasing leverage. This is all done with the intention of driving up the stock price, and while such effects may be transitory and not always in the company's long term interests, it's worth following what some of these managers do.

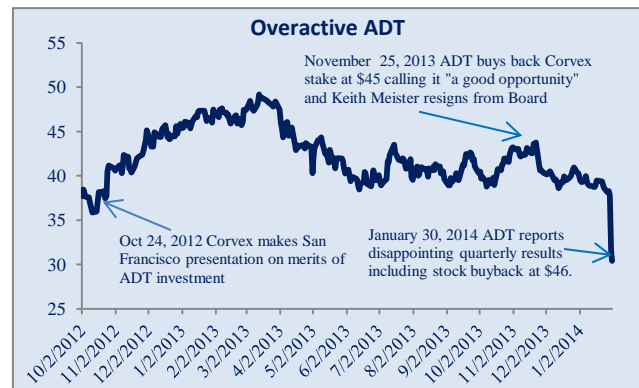
Investors need to choose carefully which ideas to consider. Take Eddie Lampert, who runs ESL Investments. He's enjoyed enormous personal financial success, and yet as with so many hedge fund managers it would have been far better to own shares in "Eddie Lampert Inc." (if such was possible) rather than invest alongside him. He is increasingly identified with Sears Holdings (SHLD), and while few can doubt the strength of his conviction about SHLD's long term prospects since he and his fund own two thirds of the company, its stock has followed a volatile and relentlessly downward path for years. It seems as if every quarter the company's operating results show sequential deterioration, and invariably Eddie and his fund buy more shares. Although his public comments remain upbeat, examining the financials can also lead one to conclude he's running the company into the ground so he can scoop up the shares he doesn't yet own from disillusioned investors and then unlock the enormous value that he says remains. It may yet turn out to be a huge winner, but if you can't buy Eddie Lampert Inc. it might be hard to show much of a return.

We have no interest in SHLD, but we follow other activist-linked stocks and one of current interest is ADT. Formerly a division of Tyco, they were spun off as an independent entity in 2012. ADT is the biggest provider of alarm systems in the U.S. with about a 25% residential market share and 90% recurring revenues. There are opportunities for them to grow through acquisitions of smaller competitors as well as through providing more value added and sophisticated equipment. Switching costs are high – their typical customer stays with them for seven years – and Keith Meister of

Corvex Capital made a persuasive case for the company's stock shortly after their IPO. As with any activist, he already owned what he was talking about. Meister lobbied for increased leverage and more share buybacks, reasoning that the stable nature of the company's cashflows could support an Enterprise Value/EBITDA ratio above its then-current 6.5. Corvex owned 5% of the company's shares and Meister took a seat on the board.

Warren Buffett is a great source of brief yet memorable quotes on many issues. One of my personal favorites is his secret to a happy marriage: "Marry someone with low expectations." I use this at home tirelessly by warning my wife that her expectations are too high, to which she breezily retorts that in fact they couldn't be any lower. Another Buffett quote comes from Andrew Liveris, CEO of Dow Chemical, who recently noted that Buffett (a shareholder) had advised him to care about those investors who, "...will stay versus investors who will leave." This was in reference to a holding by Third Point (another activist). In other words, pay attention when a CEO is dancing with an activist.

ADT's CEO Naren Gursahaney may be competent, but after stumbling through a dance with Keith Meister it's pretty clear that if you ever hear that Gursahaney is playing cards your most profitable move is to run, not walk, to grab that last seat at the table. Although in late 2012 Meister had extolled ADT's business prospects and believed the stock could rise 50% to \$63, a year later in November 2013 he abruptly resigned his board seat less than a year after joining and sold his shareholdings back to ADT over the weekend at \$44. Since ADT was still



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following Meister's script to buy back shares, management deemed it reasonable to pay the previous day's closing price for Corvex's block of shares without insisting on any discount for size. Had Corvex sought to sell their shares publicly the market would probably have demanded a steep price concession due to an insider abruptly resigning and unloading their stake at once, and indeed when the news was absorbed ADT's stock price slumped 9%. The sudden about face of the company's hitherto most vocal supporter as well as the extreme gullibility of the CEO both weighed on sentiment. Just recently the company defended this transaction as enabling ADT, "...to retire the shares without incurring transaction costs." Humiliated and still in denial.

We were also owners of ADT because we liked the story, but we concluded that Keith Meister's actions were of greater import than management's and so immediately sold our position (although not at the same price as Corvex, but nonetheless close to our purchase price). CEO Gursahaney affirmed his credentials for most naïve CEO by commenting that purchasing Corvex's block of shares without a price discount represented a good opportunity for ADT given their buyback program – missing the irony that the original buyback proponent was now all too eager to exit his investment as fast as possible. Rather like Groucho Marx observing that he wouldn't belong to any club that would have him, Meister must have concluded that he wouldn't invest with a CEO stupid enough to buy back stock under such circumstances.

We thought perhaps Meister had some private insight on the company's prospects not available to non-board members. The upcoming investor day was likely to reveal any issues of concern, but in fact it came and went with little news and later Corvex announced it was invested in Williams Companies (WMB), of which more later. Little of note happened with ADT until late January when they announced quarterly earnings that showed deterioration in operating margins, customer acquisition costs and customer retention. The company revealed that its buyback during the quarter had resulted in spending \$1.2 billion to buy stock at an average price over \$46 per share, and following earnings it traded below \$30. What's truly amazing is that Meister and Gursahaney both presumably had access to the same internal management reports during the quarter, and yet arrived at starkly different places in terms of the true worth of the company. The CEO's exposure as financially unsophisticated or agnostic to his shareholders' returns is complete. Seats to play poker at the same table as Gursahaney no doubt trade at a premium.

Although activist investors are popularly believed to be promoting value for all shareholders, their interests are quite obviously narrowly commercial and not nearly as high-minded as casual observers may believe. In fact, given a few more episodes such as this one it wouldn't be unreasonable for the target of an activist hedge fund to drop in price once the interest becomes known, reflecting the very real possibility that the company will take steps to satisfy a single vocal shareholder at the expense of others. Perhaps a Corvex Discount will be applied to the next unwitting victim, sharply reducing the profitability of such a strategy. ADT and its shareholders would unquestionably have been better off if Corvex had never taken an interest in them.

For our part, at current pricing we like the ADT story again. Their operating results were disappointing along several metrics but home security is a business that is attracting interest from cable and telco companies. Google's recent acquisition of Nest (an internet-linked home thermostat) reflects the interest in an "internet of things," and at a free cashflow yield of 14% (assuming no growth at all) we think we can wait for ADT's current management to improve recent performance or be acquired by a bigger firm. We had a small position before their earnings and added afterwards. To quote Buffett again, "...invest in a business that can be run by an idiot, because one day it will be."

To return to WMB, this company owns the GP of Williams Partners (WPZ), and represents an attractive way to invest in the growth of domestic energy infrastructure since basically WPZ owns and finances the assets while remitting half the distributable cashflows back to WMB. WMB is to WPZ as a hedge fund manager is to his fund; increased assets at the fund (read WPZ) may or may not be good for the fund overall, but will most assuredly be good for the manager (read WMB). WMB's "Incentive Distribution Rights" give it a chunk of the distributable cashflow (DCF) generated by WPZ, just as a hedge fund manager keeps a percentage of the profits of his fund. As WPZ develops and operates new energy infrastructure assets, funded by the issuance of new WPZ debt and equity, WMB will oversee the process and garner its share of the increasing DCF without having to put up any capital.

We wrote about this theme in more detail last month, and WMB is a holding of ours. One might expect a hedge fund manager to quickly recognize the similarities between the two business models. Corvex recently announced an investment in WMB, which provided a nice lift to our investment (the Corvex Discount remains a theoretical concept for now). Activist interest in a stock can be good, but nobody should confuse a relationship with an activist hedge fund manager as friendship.