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Crestwood Highlights Potential For Activism Without Leverage

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It was, in many ways, a common activist situation. Crestwood Equity Partners, a midstream energy company, experienced a steep decline in the value of its equity, with the limited partnership interests having declined more than 80 percent over the course of 2015. In December 2015, an activist, Raging Capital Management, which had acquired an almost 5 percent equity stake in Crestwood, approached the Crestwood board with recommendations for improving the value of the company's partnership units. After discussions with Raging Capital, Crestwood took steps to address most of the activist's recommendations.

Specifically, in response to the recommendation to improve the EBITDA (earnings before interest, taxes, depreciation, and amortization) distribution coverage ratio and to reduce leverage over time, Crestwood reduced the partnership distributions (to an even greater extent than Raging Capital had recommended); in response to the recommendation to reduce leverage, Crestwood effected a tender offer for $250 million of three classes of outstanding debt; and, in response to the recommendation to explore asset sales and other strategic alternatives, Crestwood entered into a significant third-party joint venture, with its asset contributions creating an implied market value for its interest in the venture of almost $1 billion. (The one recommendation made that Crestwood did not implement was a direct partnership unit buyback program.)

The program was well-received by the market and Crestwood has achieved a substantially higher unit market price.

What was unusual, however, was that the activist was successful despite having had no source of leverage with which to seek to induce the board to engage with it and to consider and implement its recommendations.

As is typical in the master limited partnership context, the Crestwood partnership agreement vested management of the partnership in its general partner, and provided no viable path to removal of the general partner or voice in management by the limited partners. In addition, as permitted under Delaware law — and underscored by a number of recent Delaware Court of Chancery decisions, including Brinckerhoff v. Enbridge Energy (April 29, 2016), Dieckman v. Regency (Mar. 29, 2016) and El Paso Pipeline Partners LP Derivative Litigation (Apr. 20, 2015) — the partnership agreement eliminated all fiduciary duties of the general partner to the limited partners. Thus, there was no judicial or equityholder check on actions by the general partner, including with respect to interested transactions or other actions that might not be supported by the equity holders. As a result, there was no credible explicit or implicit threat of Raging Capital, as a limited partner, commencing a proxy contest to require action by, or the removal of, the general partner.

What are the special circumstances under which activism without leverage may be effective?

Importantly, the Crestwood general partner had a reputation as being a strong sponsor and had a history of strong support for Crestwood. The general partner had undertaken numerous initiatives to create value that would be recognizable by the market — such as consummating a roll-up merger that eliminated incentive distribution rights of the general partner; a 10-for-1 reverse stock split; a joint venture between Crestwood and an affiliate of the general partner, that was favorable to the partnership, to expand the business in a highly productive oil basin; and exploration of a sale of the company.

In 2015, the general partner and its affiliates had commenced a program to buy a significant amount of the Crestwood limited partnership units — evidencing their belief that the units were undervalued due to market dislocation and aligning their interests with the limited partners. In addition, the Crestwood senior management team was well-respected, and the CEO had purchased a significant number of limited partnership units, adding to his already meaningful stake.

In the Crestwood situation, the steep decline in the value of the limited partnership units had arisen due to selling pressure following what appeared to be a failed process in selling the company (with no transaction consummated at a time that the company was selling at a much higher value and despite multiple potential partners emerging). There was also selling pressure due to energy industry concerns (i.e., low oil prices) and collapse in MLP stock prices generally, increased risk relating to certain Crestwood properties, and selling to capture the significant tax losses.

However, in Raging Capital's view, Crestwood had:

- numerous scarce and/or strategically advantaged assets;
- despite high leverage, a strong financial position; and
- a sponsor with a history of good management of and strong commitment to the partnership, whose interests were aligned with the other equity holders.

Importantly, Raging Capital had a well-considered, comprehensive "Crestwood Comeback" plan that focused on long-term value creation. Notably, the recommendations were business-oriented rather than control-oriented, were measured and did not call for dramatic changes, and were focused on perceived needs in the context of a significantly changed macroeconomic environment for the company. We note, further, that the letter Raging Capital sent to the Crestwood board, outlining its recommendations, opened by complimenting the Crestwood board and management for "executing on important initiatives" and closed with thanks to the board for its "consideration and ongoing stewardship."

The Crestwood situation highlights that an activist may determine that there is a potential for activism without leverage to be effective when:

- The target company has highly valuable assets, but considerable, irrational market dislocation, so that the shares or units are significantly undervalued;

- The target company directors and/or senior management are competent, capable of considering and making changes, and have evidenced an interest in shareholder value creation;
- The target company directors and/or senior management have been actively buying company equity, evidencing a belief in and commitment to the company, and aligning their interests with the other equity holders; and
- The activist has concrete, long-term oriented, business-focused (rather than control-focused) recommendations, and adopts a tone of constructive engagement.

It bears emphasis that the core of activism is the pressure that an activist can bring to bear on a company — and, in most cases, activism without leverage is not likely to be effective notwithstanding the “wisdom” of the activist’s agenda.

However, in the ever-expanding world of activism, with even the largest and best-performing companies vulnerable to activist approaches, the Crestwood situation indicates that activists may, under certain circumstances, invest in and recommend changes at MLPs, controlled companies, or other companies where the corporate structure and governance preclude or limit traditional routes to leverage by the activist. Those decisions will be based on the activist’s view of the attractiveness of the investment opportunity, balanced against (1) the degree to which the activist’s business recommendations are compelling, (2) the likelihood that the controllers will be open to consider the recommendations, and (3) the degree of leverage, if any, that the activist may be able to bring to bear on the company. Leverage in controlled situations will range on a continuum from — in an MLP situation — little or none, to — in companies with a controlling stockholder — potentially effective leverage, including the ability to run a proxy contest for a precatory vote of equity holders, to make recommendations public, and/or, perhaps most importantly, to communicate and engage with creditors, rating agencies, and other company constituencies about the activist’s recommendations.

Crestwood highlights the potential effectiveness of longer-term thinking and constructive, nonself-interest-focused recommendations by activists, as well as the possibility of openness to new ideas and constructive engagement with activists by companies — both of which have become more prevalent as activism has matured and company attitudes about shareholder engagement have evolved.

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