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The Activist Investor

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# Case Study: InfuSystem Holdings, Inc.

This situation features some distinctive attributes of an activist situation:

- shows how one works from start to finish
- illustrates how a special meeting can compel action
- what an investor does after it prevails over incumbent management.

Even better, the portfolio manager for this case wrote this account. Ryan Morris leads Meson Capital Partners, a small investment fund with big ambitions. He has kindly allowed us to feature his experience with the company, which he wrote as part of his periodic letters to his clients.

InfuSystem Holdings, Inc. (INFU) has an enterprise value of approximately $70mm. Meson Capital Partners, the investor, has total AUM of $3.5 million. Meson's portfolio manager, Ryan Morris, is 27 years old and has become Executive Chairman of the Board, with bright prospects for a turn-around. How did this happen?

**Michael R. Levin**
847.830.1479
m.levin@theactivistinvestor.com

# A highly recurring, economically insensitive, cash cow

We first heard about InfuSystem last fall when a friend called to ask for help because the stock had plummeted 70% and the board and CEO did not appear aligned with shareholders. Indeed, the insiders had granted themselves roughly 18% of the stock as compensation over the previous four years while the stock had declined continuously. We had just finished with another activist situation, HearUSA, in which we served on the equity committee of a bankrupt company. There, we had to fix a problem we didn't see coming, With InfuSystem, we went in with our eyes open about what was coming. (We have already disclosed all of this account in securities filings.)

Initially, the investment looked interesting because the company clearly had high margins and a recurring revenue stream, with essentially no economic sensitivity. Its low-cost solution for cancer treatment is about as far from discretionary spending as you can get. There had been a lot of noise around the profitability figures over the prior two years, but the revenue was steadily increasing.

The company had $15mm annual EBITDA back when it was private in 2006. Since then revenues grew over 50%, and customers seemed as happy as ever. What's more, asset depreciation seemed overstated: the company depreciated their infusion pumps over 5 years for accounting purposes, even though pumps last 10 or more years in the field, and can be easily refurbished. With a price of $1 per share and an EV of about $50 million it seemed far too conservative to assign a low single-digit multiple to such a high quality income stream. As my friend pointed out though, unless something was done at the top, the value would never accrue to shareholders. The company could ultimately end up over-leveraged and in bankruptcy.

# The Moons Align

The best position to occupy is the one that nobody else can occupy. We came pretty close to meeting this definition with our InfuSystem strategy. First: the share ownership was reasonably concentrated, with 13 institutional investors owning about 50% of the outstanding shares. Even better, they are all value-investors with similar philosophies as ours.

Second, these funds all manage much more money than their InfuSystem investment represented. Even though these funds each owned 5-10% of the company, that holding represented a very small percentage of their AUM (a sub-1% position to them). When investors each don't have enough upside to wage an activist campaign themselves, and yet can't exit easily because they own too much of the company's outstanding share, each investor is effectively stuck. In the end, though, no one was stuck here.

Third, InfuSystem is a recurring revenue business with a diverse customer base and very little key-man risk. This confluence of rare and favorable structural factors, in addition to the very low share price, is why we made it our largest position. By way of contrast, attempting to wage a fight against a founder who views the business as his baby can be about as pleasant as getting between a bear and her cubs. Similarly, an asset-light consulting business with key relationships could have customers follow the deposed leader to a new company, resulting in a Pyrrhic victory.

# "Settling" for the Whole Enchilada

The essential first step was finding a large shareholder to partner with. Absent that, it would be impossible to act, given the small size of our partnership. (As with launching a start-up, it is an indirect vote of no confidence if you can't get at least one other person to line up with you.) In December, after purchasing 2% of the company, we formed a 13D group with Kleinheinz Capital Partners of Fort Worth, Tex., as well as another investor (someone we collaborate with and who persuaded me to try living in California).

We scheduled a meeting with the CEO shortly after filing the 13D, optimistic about gaining his cooperation in changing the company. We didn't prepare a specific business plan with a 100-page PowerPoint presentation, because we knew things would look different once we got inside. We did know that the high executive compensation threw interests out of alignment. Factors like that are never isolated; they always give clues to other issues, like employee resentment that leads to ineffective job performance. Considering how upset the shareholders were, we thought management would, perhaps grudgingly, give us a few board seats. We would win them over once inside.

Unfortunately, they responded much more negatively than we expected. We needed to proceed with steps that did not require their cooperation.

Typically, shareholders would nominate director candidates for the next annual meeting, and wait a few months. But we knew of too many cases where the top people delayed the annual meeting to protect their position, or sold the company to a friendly buyer who continued to employ them.

Instead, we followed a course that would counter such evasive actions and provide the conditions we needed if it came to a fight. We filed a proxy to call a special meeting to remove the entire board of directors. Calling a special meeting required approval from 50% of the total outstanding shares, a very high hurdle considering insiders owned 18% and our group had only 11%. But this gave us the maximum number of options: even if we failed to get 50%, we could still nominate a slate for the annual meeting, with a much lower vote standard to prevail. We needed only a majority of voting shares, so since only about 70% of shares usually vote, effectively we just need 35% of the outstanding shares to win.

It took longer than expected to round up the votes, but after a month or so – even though management kept trying to get people to change their position – we had 55%, easily satisfying the goal to request a special meeting. We took an understated approach, and would not sling mud at anyone. We thought handling it in a civil manner would leave the door open to an amicable agreement later. Once information about an ugly incident gets out, it is on Google forever.

Unlike some other activist investors, we get no psychic benefit from beating up other parties; we only care about a positive outcome for our investors. Ultimately, we pursued a strategy of informing all sides about how bad it would look if the matter escalated, and how it would work if we succeeded with our project. In this way we reached a better agreement for all parties sides.

This democratic shareholder process prompted changes at the board of directors. What counted most was our alignment with our investors and other INFU shareholders. By conducting ourselves as we did rather than leaving behind scorched earth, we have both a company with a turnaround ahead, and the possibility of making similar activist investments in the future.

# When the dog catches the car

The dog does not normally catch the car – and what does he think will happen if he does? Fortunately we prepared better when we "caught" InfuSystem. The key was recruiting a new CEO with the experience and know-how to figure out what the company needs. I have some experience of my own at VideoNote in an operating role, and it served us well in evaluating the quality of the company management. So, we brought Dilip Singh into InfuSystem as CEO. He has proved his worth as a fantastic teammate and all-star turnaround manager. Previously, he served as CEO of MRV Communications, which had a divided board of directors, and was much larger and complicated than InfuSystem, with divisions all over the world. Compared with that situation, InfuSystem is a breeze.

Dilip and I us spent the first two weeks visiting employees at the Detroit, New York and Kansas offices. We received a very warm welcome. Famously, Steve Jobs was celebrated for his dictatorial approach to management, but Jobs is the exception. Dilip and I believe in a bottom-up, inclusive approach. In the case of InfuSystem, without the distress that Apple suffered in 1996, we need to learn quickly from the employees. We certainly have ideas on how to improve the business, but none of them will come to fruition unless we obtain is buy-in from the team.

We are just getting started inside the company. The most exciting part is that the new board of directors has no bias or allegiance to the past, and no barriers to shareholder-friendly actions that boards often use to preserve the status quo. As our new CEO, Dilip Singh is fond of saying, "We are not here for a job. We are here to get a job done!"

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For further information, or to discuss a specific turnaround situation, please contact:

Michael R. Levin
m.levin@theactivistinvestor.com
847.830.1479
www.theactivistinvestor.com