

Tecumseh's Proxy Battle Nears a Showdown

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Shares of **Tecumseh Products** (TECUA) have been off to the races lately, up more than 240% from the March low of \$3.00.

You may recall that Tecumseh is one of the largest manufacturers and distributors of hermetically sealed compressors. The company's products, which are sold worldwide, are used in commercial and residential freezers, refrigerators, dehumidifiers, air conditioning units, commercial central air conditioners and heat pumps. But, I as noted in my [Feb. 3 column](#), there's a fight brewing.

On Feb. 20, the Herrick Foundation, one of the largest charitable foundations in Michigan, announced its intention to run a slate of four candidates for election to Tecumseh's seven-person board. The company recently announced that May 8 will be the record date for the stockholders entitled to vote at its upcoming 2009 annual meeting. We anticipate that the company will hold its annual meeting in early June. If elected, the Herrick candidates, who will then control a majority of the board, intend to pay shareholders a substantial cash dividend and examine a sale to possible strategic and financial buyers. Our current shareholder analysis suggests it is more than likely the Herrick Foundation's candidates will obtain the necessary support needed to be elected.

Background to the Proxy Campaign

In early 2007, the board of directors replaced Todd Herrick as president and CEO and removed Kent Herrick (Todd's son) from his senior management position with the company. Shortly after the Herricks' removal, the Herrick family commenced litigation against the company. The litigation was ultimately settled with Todd Herrick leaving and Kent Herrick joining the board. In addition, the foundation appointed one other director on the seven-person board.

In June 2008, Herrick demanded that Tecumseh call a special meeting of shareholders for the purpose of replacing two additional directors. If elected, Herrick's nominees announced their intention to:

1. Implement an exchange offer to collapse the dual class share structure (see comments about the share recapitalization proposal below).
2. Pursue using excess cash to pay dividends to all shareholders.
3. Explore whether a sale of Tecumseh as a whole or in parts is desirable to enhance shareholder value.

In addition, the Herrick family members announced that they would not reassume officer positions with the company and have no intentions of replacing the CEO or his new management team.

In November, with more than 91% of the Class B shareholders participating in the special meeting (Class A shareholders do not have voting rights), Herrick narrowly failed to get the votes necessary to remove and replace the two directors.

(Note: At the special meeting, Herrick needed to obtain 50.1% of the company's shares outstanding in order to remove the two directors, e.g., $5,077,746 \times 50.1\% = 2,543,951$ votes needed. Of the shares voted, 2,423,769 voted for the removal of one director, and 2,108,961 shares voted for the removal of the second. At the upcoming annual meeting, Herrick will only need 50.1% of the *votes cast*, e.g., assuming 91% of the Class B shares are voted again: $5,077,746 \times 91\% \times 50.1\% = 2,314,995$ votes needed to replace each director.)

On Feb. 20, the Herrick Foundation nominated four individuals to replace four of the seven directors who are up for election at the next annual meeting. During the past several weeks Tecumseh and Herrick have

been engaged in various settlement discussions. However, according to our understanding of these deliberations, it seems that both parties are at an impasse and that a settlement is unlikely.

Value Analysis

Tecumseh is perhaps most well-known for its engine business, although the company sold that unit in 2007 for \$51 million, following the sale of much its electrical components business earlier in the year for \$220 million. Tecumseh now concentrates on its compressor business, which generated \$968.9 million in sales during 2008.

Still, given the difficult economic environment, 2008 sales were down more than 13% from 2007, and the company lost \$50.5 million (\$79.9 million from continuing operations), vs. a loss of \$178.1 million (\$6.0 million from continuing operations) in 2007. The fourth quarter was especially challenging as the recession deepened; during the quarter, sales fell 35.1 % to \$163.7 million. Not surprisingly given the market environment, Tecumseh's shares have suffered as well and are currently down 73% from their 52-week high.

Yet, the company has maintained a very solid balance sheet. As of fiscal year-end 2008 (December), Tecumseh had \$113.1 million in cash, or \$6.12 per share. With just \$30.8 million in debt (\$30.4 million short-term) the company has \$4.45 in net cash per share, representing 59% of current market cap. On the asset side, it has another \$12.5 million in restricted cash, \$4.8 million in long-term investments, \$81.0 million in prepaid pension expense and \$37.0 million in recoverable income taxes. With a current book value per share of \$25.83, Tecumseh trades at just 0.4 times book.

Besides the terrible economic climate, a number of other factors have been an overhang on Tecumseh's share price, including ongoing board representation issues relating to the Herrick Foundation's ownership stake in class B shares and the February announcement by the U.S. Department of Justice that Tecumseh is one of several companies in the compressor industry being investigated for possible anticompetitive practices. Here, the company was granted conditional amnesty by the DOJ, and it will not be the subject of criminal prosecution (in the event there was wrongdoing) as long as Tecumseh offers full cooperation in the investigation. This, however, does not apply to civil lawsuits.

With a current enterprise value of \$106 million, Tecumseh is trading at just 0.11 times EV to sales. Theoretically, for the current price of \$10.21, buyers are getting \$4.45 in net cash, and getting the rest of the company's assets, with a book value of \$21.38, plus a call option on the future of the company, for \$5.76.

About the Share Proposal

Tecumseh currently has a dual class share structure consisting of Class A common stock, which does not have voting rights, and Class B common stock, which has one vote per share in the election of directors and other corporate matters requiring a shareholder vote. The company has included a shareholder proposal in this year's proxy statement requesting shareholders to collapse the dual class structure so that all shareholders have equal economic interest and voting power in the company.

If shareholders approve the recapitalization, each share of Class A stock would be reclassified and converted into one common share, and each share of Class B stock would be converted into 1.1 common shares. The additional 0.1 share realized from the conversion of Class B common stock would result in an additional 507,775 shares (about 3.0%) of common stock being issued.

There would be no change in the overall amount of shareholder's equity, but the higher number of common shares would increase the outstanding shares and the weighted average shares outstanding used in the calculation of basic and fully diluted earnings per share. The increased number of common shares would also lower the book value per share, and basic and fully diluted earnings per share would be reduced.

Know What You Own: Other companies in the building materials sector include **Fastenal** (FAST) , **Vulcan Materials** (VMC) , **Martin Marietta Materials** (MLM) , **MDU Resources** (MDU) and **Valspar** (VAL) .

At the time of publication, Jonathan Heller was long TECUA, and Damien Park held no positions.