The Ultimate Poison Pill: Closing the Value Gap

James M. McTaggart, Chairman & Chief Executive Officer

Seldom in the history of U.S. business has a structural change hit with the same force. Ten years ago, large-scale LBOs, raiders, and forced restructuring were virtually unknown. Today, they are commonplace and are rapidly changing the economic landscape. At the source of this structural change is a growing belief that many large diversified companies are not being managed to create the maximum value possible for their shareholders. It is also important to note that the gap between actual and potential market values, the "value gap," is so large for some companies that substantial profits can be made even after premiums of 30- 50% are paid to acquire control. This perception, combined with a flood of institutional money into junk bonds and LBO funds, has produced the takeover entrepreneur, who can now entice or threaten all but the very largest corporations.

Can it be true? Is the value gap of sufficient size to make a large number of diversified companies attractive takeover candidates? In general, the answer is yes, although the number of candidates has been declining recently due to the spread of value-based strategic management. More important, however, are the sources of the gap. There are three management shortcomings that we believe account for most of the gap between actual and potential market values:

1) A tendency to invest far too much capital in unprofitable businesses

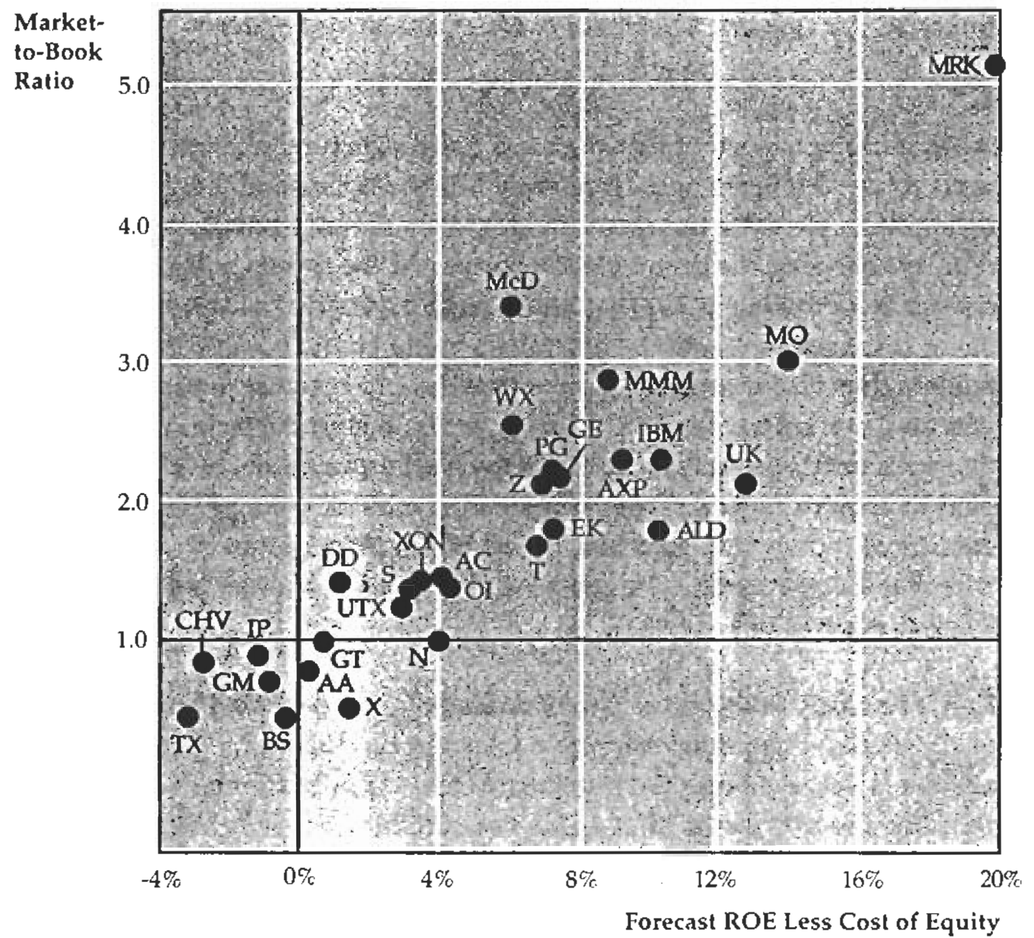
2) Poor balance sheet management, and

3) Tolerance of noneconomic overhead.

The Determinants of Value

In order to describe clearly the three sources of the value gap, it is necessary to first examine the factors that determine the market value of any business or company.

Exhibit 1: Profitability of Dow Jones Industrials - June 1986



ALD	Allied Corp.	IP	Int'l. Paper
AA	Aluminum Co. of Am.	McD	McDonald's Corp.
AC	American Can	MRK	Merck & Co.
AXP	American Express	MMM	Minnesota Mining
T	American Telephone	MO	Philip Morris
BX	Bethlehem Steel	OI	Owens-Illinois
CHV	Chevron	PG	Proctor & Gamble
DD	DuPont	S	Sears, Roebuck
EK	Eastman Kodak	TX	Texaco, Inc.
XON	Exxon Corp.	UK	Union Carbide
GE	General Electric	X	U.S. Steel
GM	General Motors	UTX	United Technologies
GT	Goodyear Tire	WX	Westinghouse
IBM	Int'l. Business Machines	ZZ	Woolworth (F.W.)
N	Inco Limited		

Fundamentally, the value of a company is determined by the cash flow it generates over time for its owners and the minimum acceptable rate of return required by investors to supply equity capital. This "cost of equity capital" is used to discount the expected equity cash flow, converting it to a present value. The cash flow is, in turn, produced by the interaction of a company's return on equity and the annual rate of equity growth. High-ROE companies in low-growth markets, such as Kellogg, are prodigious generators of cash flow, while low-ROE companies in high-growth markets, such as Texas Instruments, barely generate enough cash flow to finance growth.

A company's ROE over time relative to its cost of equity also determines whether it is worth more or less than its book value. If ROE is consistently greater than the cost of equity capital (the investor's minimum acceptable return), the business is economically profitable and its market value will exceed book value. If, however, the business earns an ROE consistently less than its cost of equity, it is economically unprofitable and its market value will be less than book value. These basic principles can be seen at work in **Exhibit I**, which plots the profitability of the Dow Jones Industrials, based on Value Line forecasts of ROE and Marakon estimates of the cost of equity capital.

Growth acts as a magnifier. If ROE remains constant and the growth rate of a profitable business increases, its market-to-book ratio rises. For an unprofitable business, increasing growth actually drives the market-to-book lower (unless growth causes ROE to rise). And in the case where ROE is just equal to the cost of equity, growth has no impact on the market-to-book ratio. The primary reason for the scattering of the observations in **Exhibit I** is differential growth rates.

The profitability of a company is determined primarily by the profitability of its businesses. The profitability of a business is, in turn, determined by economic forces affecting supply and demand in its product markets, its competitive position, and the effectiveness of its strategy. The interaction of constantly changing economic forces and competitive strategies produces a wide variation in both industry and company profitability, as can be seen in **Exhibits II** and **III**. Understanding how industry economics and competitive position determine profitability for a given business is the first step toward developing strategies to increase shareholder returns.

Exhibit II: Profitability of 14 U.S. Industries – Spring 1986

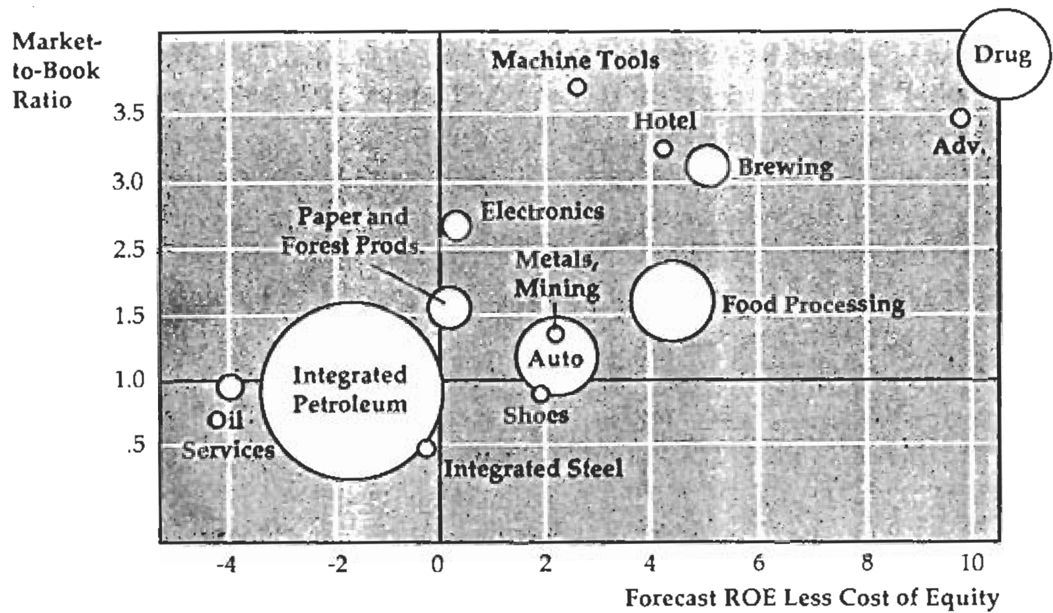
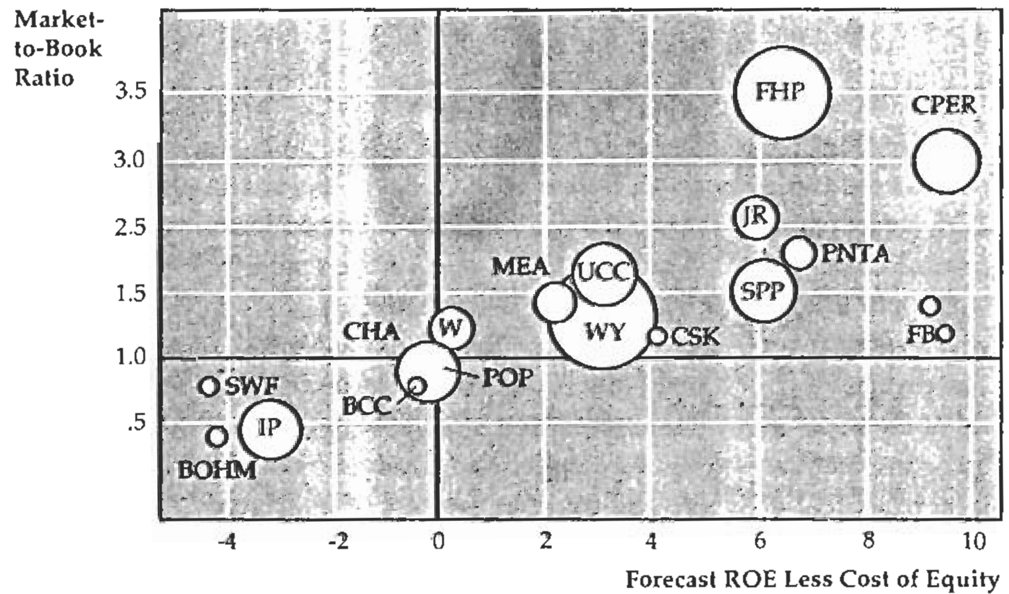


Exhibit III: Profitability of Paper and Forest Products Companies – Spring 1986



BOHM	Bohemia	FHP	Fort Howard Paper	SPP	Scott Paper
BCC	Boise Cascade	IP	International Paper	SWF	Southwest Forest
CHA	Champion International	JR	James River	UCC	Union Camp
CSK	Chesapeake	MEA	Mead	W	Westvaco
CPER	Consolidated Paper	PNTA	Pentair	WY	Weyerhaeuser
FBO	Federal Paper Board	POP	Pope & Talbot		

Sources of the Value Gap

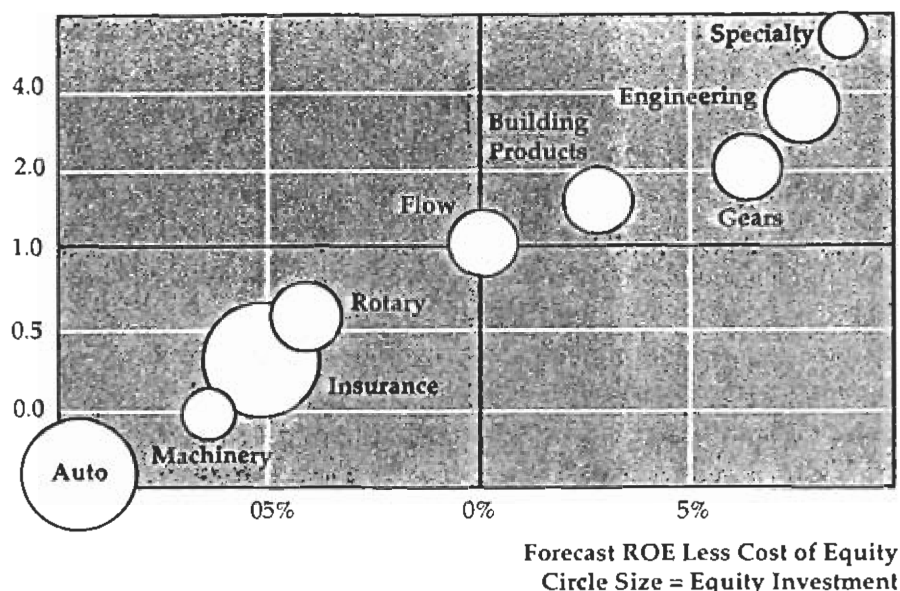
The wide variation in industry and company profitability also occurs within a typical diversified company's portfolio of businesses. Within a company, however, the capital allocation discipline provided by creditors and investors is replaced by management policies and strategies, which can significantly magnify the variation, particularly on the downside. The magnification can occur in either of two ways. The first is when management allows low-return businesses to invest too much capital, a process that can actually produce businesses with negative market values. The second is when management allows or causes high-return businesses to underinvest, which if prolonged usually results in a loss of competitive position and declining returns. In both instances, the business unit market values are significantly lower than they otherwise would be. This tendency to misallocate capital by allowing or causing businesses to pursue inappropriate strategies is the first of the three major sources of the gap between actual and potential market value.

The business portfolio shown in **Exhibit IV**, based on a recent engagement, illustrates the magnitude of the gap that can be produced by pursuing inappropriate business strategies. This company's sales were roughly $750 million, and its common stock was trading at about 80% of book value. Its portfolio contained five profitable and four unprofitable businesses. The operating value of each unprofitable business, based on the prevailing strategies, was less than 50% of its book value. All told, the four operating values summed to $115 million, versus a combined book value exceeding $300 million.

The most unprofitable business, machinery, was actually worth a negative $12 million; that is, the present value of its planned cash flow was negative $12 million. This was produced by an operating strategy whose primary objective was growth. The key element of the plan was a massive capital spending program designed to boost capacity and eliminate a competitive cost disadvantage. And while the program, if successful, would have significantly enhanced the unit's ROI (from 8% to 12%), the long-term positive impact on value was more than offset by the near-term negative cash flow.

Based on a thorough assessment of market economics and profitability relative to competitors, we concluded that by changing strategy at each

Exhibit IV: Profitability of Company Portfolio



of the four businesses to emphasize profitability rather than growth, their combined market values could be increased by at least $150 million within two years. In other words, the current value gap caused by over-investing in four unprofitable businesses was $120 million, or 40% of the company's market value.*

As a general rule, strategy changes at the business unit level emanating from improved capital allocation can enhance market values by anywhere from 20-100% within a few years. While this alone can provide impetus to takeover entrepreneurs, the value gap can, in fact, be further magnified by poor balance sheet management and tolerance of noneconomic overhead.

With respect to balance sheet management, substantial value can often be created by redeploying underperforming assets and reducing the cost of capital used to fund investments. On the asset side, two of the more prominent targets are excess cash and underutilized real estate. The source of value creation in the cash account is the low after-tax return it earns. To the extent that excess cash is held for long periods of time in

*The machinery business was subsequently sold in a leveraged buyout for book value and has since prospered.

taxable securities, it is worth less than its face value. Redeploying excess cash by repurchasing shares, for example, generates a capital gain equal to the present value of the tax savings. Excess pension fund reserves are also a source of funds that can be worth more if returned to shareholders. The source of value creation with corporate real estate is land or buildings that are not being put to their highest and best use. The capital tied up in undeveloped land, vacant office space, underutilized plants, or unprofitable retail outlets nearly always earns a return well below the cost of capital. To the extent that it can be redeployed into profitable businesses or, again, used to buy back stock, a substantial capital will occur.

On the liability side, value can be created for equity holders by increasing financial leverage up to a point. This, of course, is one of the sources of value that LBOs have utilized to recapture purchase price premiums. The source of the value creation is the tax saving due to the deductibility of interest. As a rule of thumb, each dollar of new debt should increase the firm's equity value by 20-25 cents until the firm's financial risk becomes excessive. At this point, the benefits from futher borrowing are offset by the restrictions placed on the firm, which limit its capital availability and increase the probability that the interest expense will not be tax deductible. This point, however, is significantly beyond the current leverage position of most U.S. companies.

The magnitude of the opportunity to increase returns through improved balance sheet management will, of course, depend on the amount of nonproductive assets on the company's books and its capacity to borrow. In the case of Gulf Oil, we estimated that redeployment of over $1 billion of excess cash and full utilization of the company's debt capacity would have produced a 20-25% increase in the market value of Gulf's stock. Focused efforts to reduce underperforming assets and improve liability management can result in increases to shareholder value of up to 50%.

With respect to overhead, our experience suggests that most large companies are overburdened and do not appreciate the magnitude of the overhead drag on equity values. The accumulation of overhead throughout most companies occurs for a variety of reasons. As companies grow, they face the continuing problem of how to decentralize operating re-

sponsibility while maintaining some centralized control. In many instances, the result is duplication of support functions at corporate, group, and business unit levels, such as accounting, personnel, and planning. In addition, the overriding objective of most people managing the support functions is to maximize the quality of their services, and their compensation is often closely correlated to the number of people under their stewardship. The result is excess staff and a service "quality-to-cost" ratio that is much lower than it should be.

The impact of noneconomic overhead on value can be staggering. For example, the overhead at Beatrice Corp. was estimated at roughly $150 million annually, or 1.3% of its $12 billion in sales. By contrast, Esmark, at roughly $6 billion in sales, was spending only $25 million on overhead functions, less than 0.5%. If Beatrice could have managed down its overhead to $50 million, the resulting $100 million in pretax earnings would have created roughly $1 billion of shareholder value. This represents nearly 30% of Beatrice's preacquisition market value and 70% of the premium paid to acquire control of the company. This means that if the new owners can manage down Beatrice's overhead to Esmark's level, they will be two thirds of the way to recovering the acquisition premium, with potential divestments, strategy changes, and the impact of leverage and taxes yet to be considered.

Closing the Value Gap

In the current environment, with takeover financing readily available, no company can run for long with a large perceived gap between actual and potential market values. To close the gap, we recommend a five-step process:

First, develop accurate estimates of the operating and divestment values of each business in the portfolio. Few companies have this information, and yet it is the foundation of managing for shareholder value.

Second, incorporate profitability and operating values into both the strategic planning process and incentive compensation. The planning process should stress the relationships among market economics, competitive position, and profitability. Business unit managers cannot be expected to

develop value-creating strategies if they don't know how much their units are worth or why they are either profitable or unprofitable. To ensure effective implementation, a significant portion of key executive compensation must be tied directly or indirectly to shareholder value.

Third, don't hoard cash or carry nonproductive assets on the books. At least once a year, a thorough analysis of asset productivity should be conducted.

Fourth, put in place an aggressive financial policy. The level of borrowing should be matched to the ability of business units to bear interest rate risk. Excess cash flow should be dedicated to profitable diversification, dividends, and repurchasing shares.

Fifth, don't tolerate noneconomic overhead. Support functions should be viewed as service businesses and where possible, subjected to both performance measurement and outside competition.

If managed well, a diversified company could be worth more than just the sum of its business unit values, owing to economies of scale and scope in support functions and to the increase in debt capacity produced by diversification. Those companies that can accomplish this feat will not only enrich shareholders but will also put in place the best possible poison pill.