What Is It You Still Don't Understand?

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After more than thirty years plying my trade, it never ceases to amaze me that so many CEOs can be so inept when it comes to creating shareholder wealth. The same applies to the managers of income trusts, though most of these have only been around for the past two decades or so. Unfortunately, I do not think it is something in the water, as during dry spells in the capital markets very little ever changes for the better. More likely it is about listening to the wrong people or reading the wrong stuff.

I thought it might be interesting to ask the obvious questions and provide the not so usual answers. In doing so, I hope to improve the batting average of CEOs struggling to get things right, and be a worthwhile reminder for those currently on cruise control. Though the order may be random, the thought process is not.

KEEP IT SIMPLE, STRAIGHTFORWARD AND HONEST

As if the fall from grace of CEOs bent on pumping up stock prices with fraudulent earning reports was not proof enough, recent studies show that straightforward and honest accounting practices are the only way to the top of the stock market charts. Investors, still suspicious of management, as well as the auditing and investment banking firms, are not likely to fall for the shenanigans of the past for a long time to come. A clean balance sheet is also a real plus in today's equity market. The simpler the better they say. No one is at all interested in trying to figure their way through convoluted financial statements. Those who cling to such an out-of-vogue way of financing an enterprise, its growth and acquisitions, will gain little in the way of a research analyst following, and have to suffer the consequences of lower-than-peer-group multiples of cash flow and earnings.

Which brings to mind the plight of an old corporate client. In our time it was called Abitibi Inc. It later became Abitibi-Price Inc., and eventually Abitibi-Consolidated Inc. Today it is the world's largest newsprint producer, one of the few commodities seemingly immune to the price rally of the past number of years. Low product prices, however, do not fully explain its woes. An ill-timed and costly acquisition in 2000, right at the top of the cycle, and a 15.8 percent drop in newspaper advertising, in part due to the inroads made by the Internet, have certainly added to its difficulties.

Apart from losing money, it now has a dollar of debt for almost every dollar of sales. Debt costs are rising as interest rates go up. The rating agencies are nervous about the company's ability to repay its bondholders. As such, it has no choice but to strengthen its balance sheet. Tapping the U.S. high-yield market would only complicate matters. While asset sales are a possibility, the chances of obtaining an attractive price are limited. An equity issue is the only answer. Yet management and the directors do little more than twiddle their thumbs on the off chance that a miracle might happen. All the while, shareholders are left to watch the stock price top the new fifty-two-week low list, week after week.

The best possible course of action would be for all those in charge to swallow their pride, admit to themselves and the investors that mistakes have been made, and promise never to be so foolhardy in the future. A commitment to do a rights issue would allow the long-suffering shareholders the first crack at buying more shares at a substantially discounted price. If the company fails to do so in quick order it could trip into bankruptcy court, and nobody but the lawyers and accountants stand to gain if that happens.

Whatever the final outcome, be it a lesson to all up-and-comers that a strong and uncluttered balance sheet is the right way to position a company to take advantage of opportunities and guard against the trials and tribulations of unforeseen setbacks. It is unfortunate that so many corporate executives take so long to learn such a valuable lesson. Once back on track, Abitibi-Consolidated Inc. would also be well advised to launch a proactive investor relations programme making sure that the right information reaches the investors and others. It is the only way to regain research analyst sponsorship and better multiples of cash flow and earnings.

As to using hedging techniques to reduce an outfit's exposure to risk, may I offer that raising additional equity is the better route to follow. It is also less expensive in terms of share, royalty or income trust unit price performance. Nothing is more discouraging to investors than earnings gutted by hedging losses. Furthermore, every time an attempt is made to explain that such is the right course of action, which it is not, doubt is cast on the credibility of the CEO, senior management and the directors.

DIVIDENDS ARE IMPORTANT

Dividends have always been important to longer-term investors. It was only as recently as the mid-1980s that investment bankers were able to convince many a CEO to forego such payments, and instead use the funds to grow and diversify the business. The aim was to try and jack up earnings and the value of management's stock options. Many outfits went into debt attempting to do so. All failed to keep in step with the ones who stuck to maintaining a strong balance sheet and increased the dividend over time. Those able to boost the payout ratio did even better.

Today, there are very few investors willing to allow management to maintain cash balances beyond the enterprise's immediate needs. This helps to explain why royalty and income trusts have become so popular, and why so many companies have initiated the payment of dividends in the past few years. A number have even taken to paying an extra. While never as positive an influence on the stock price as an increase in the dividend or the payout ratio, it is regarded as an indication that management and the directors have the investors' best interests clearly in mind. Furthermore, U.S. studies indicate that two-thirds of the companies that bought back shares in 2002 outperformed the S&P 500 in the next twelve months. Of note, index companies alone purchased a record U.S.$197 billion of their own stock in 2004, 50 percent more than in the prior year.

While many offer that buybacks can increase earnings per share and offset the dilution caused by the exercise of employee stock options, the real effect is more psychological. Shareholders tend to believe that if the stock looks good enough for the company to buy, it is probably no time to sell. Rather, it is likely a good time to add to positions and that, in due course, is what has been happening almost across the board. The exception to the rule kicks in when the issuer has to borrow money to finance the buyback. In which case it may be time to bid the stock adieu.

OPPOSITE ENDS OF THE SCHTICK

Many moons ago I was a TSX seatholder. It still dumbfounds me that so many CEOs turn to underwriters in search of sound capital formation and investor relations advice. That is not where they are ever likely to get it, except right in the back of the neck! Bay Street's reading of who are the best investors is diametrically opposed to what the CEO should be looking for. That is not to say that the investment dealers are all cheats. However, it does suggest that they see the world through differently coloured glasses. Whereas they are looking for fees and commissions, investors are searching for safety of capital, growth and income. They regard the stockbrokers' take as an expense, not a gain.

Three examples of their different way of thinking come to mind. The first has to do with the TSX going public. The other two concern a successful institutional investor and a recent underwriting of a highly touted new issue.

The TSX Group Inc., came public in early November 2002, for the princely sum of $341,608,284 – being 18,978,238 shares priced at $18 each. In the intervening three and a half years the stock has never looked back. Adjusting for a subsequent two-for-one stock split, its all-time high was $36.00. Having paid a $2.50 extra along the way, the current annual dividend rate is $0.80 per share, paid quarterly. In other words, it has been one of the best performing issues on the TSX, and the investment dealers thought they were selling out when the getting out was good. If that were not bad enough, a number of the firms have subsequently been called to task for trying to take advantage of investors by front running orders and other transgressions. Hardly the types to be entrusted with the care of your hard-earned savings. Even so, if the NYSE and Nasdaq eventually come public, their shares could also do very well.

On the other hand, a recent study by the University of Michigan covering the years 1975 through 2000, discovered that companies recruiting investment bankers to their boards of directors may not be doing the CEO a favour. Open-market transactions by insiders in 509 issuers showed average gains of only 1 percent, down from 5 percent when without such a director. Once the executive of the investment banking firm left the board, insider returns bounced back to 4 percent a year, in part because the company executives regained their exclusivity to material company information. All of which is counterintuitive, in as much as many shareholder activists have long claimed that any such director is a negative, when in practice they may help to create a more level playing field for all investors.

The second example has to do with Catherine "Kiki" Delaney, whom I first met in 1972 when she worked at Guardian Capital Investment Counsel with Jim Cole, an older friend of mine. Today she is president of Delaney Capital Management Ltd., taking good care of more than $1-billion of investor money. What is particularly impressive is that she and her associates have handily beaten the S&P/TSX Composite total return index on an annualized basis over the past twelve years – 15.0 versus 11.3 percent. As you will understand, this makes a huge difference to the bottom line over time, and very few of her competitors have come close.

Now that the gilded age of falling interest rates is over, and the next five to seven years may be more challenging, the "value" team at Delaney is going to get a real workout. Which means that they will be even fussier when it comes to selecting stocks to buy, or sell for that matter. At the moment the average time they hold a portfolio position is about two and a half to three years, some for more than a decade. Hardly in keeping with the investment dealer darlings, the short-fused mutual and hedge funds, with a much higher turnover rate and a far less distinguished record of performance as far as investors are concerned.

The final example I would like to cite is the recent Highpine Oil & Gas Ltd. initial public offering of four million shares at $18, for gross proceeds of $72 million. Headed by my good friend Gordon Stollery, this was a highly touted new issue. At one point I was told that the institutional book exceeded $350 million. Sure enough the stock opened at $20 per share on the TSX. It rose to $20.25, and subsequently dropped back to its issue price. Of note, fully 62 percent of the IPO, or 2,484,700 shares changed hands in the first two days of trading. The following week's total was just 660,200 shares. Indicating that most of the underwriting syndicate's favourite clients have sold out, and the stock has moved from very weak to much stronger hands.

Even so, do the investment bankers really care? After all, they got their cake in underwriting fees and ate it too in aftermarket trading commissions. It would seem, however, that they made little effort to place the stock with wise institutional investors like Kiki Delaney. In addition, the new wave of buyers would appear to be mostly individuals looking to the longer term, knowing of Gordon's success in guiding Morrison Petroleums Ltd. through the 1970s and 1980s, before selling out in 1997. His task is to continue to run the company to the advantage of all the shareholders, not just the insiders as Conrad Black and other seedy types have allegedly done in the recent past. To be convincing, he, like Abitibi-Consolidated Inc., will have to institute a comprehensive investor relations programme in order to keep the shareholders onside.

As you now know, there is little merit in believing that the underwriters are prepared to go looking for, or spend much time cultivating, longer-term investors, even though these are the very ones whose actions allow for premium multiples of cash flow and earnings during both buoyant and troubled times in the stock market. Simply put, it is not the underwriters' role in life. It never has been and never will be. No matter what their schtick, investment dealers are but agents. Most would not recognize an astute investor if they saw one. However, to get them to admit to their limitations is like being in the meat business. It is awfully hard to get a hog to butcher itself!

ALL INVESTOR RELATIONS ADVISORS ARE DIFFERENT

While I am proud to say that Rapport is the first ever independent firm of investor relation advisors in the world, we are not, and have never claimed to be, all things to all people. Having spent time building a research-based, institutional-investor clientele as a stockbroker in the late 1960s and early 1970s, there was no way I was ever going to side with the underwriters. Given what you have just read, they are not likely to ever hire or recommend a firm like ours to head up a typical new issue road show. Fortunately, there are plenty of others who are equipped and willing to do so. I must warn, however, that the reputation of such firms is questionable, and that too is unlikely to change.

As is the case with most mutual and all hedge funds, it is the fees and commissions that drive the investment dealers' sales effort, not the merits of an IPO or new issue. The thrust of the road show is to create demand and, whether or not there are buyers from coast-to-coast in Canada, the U.S. and overseas, the underwriting syndicates' best institutional investor clients are typically allocated more than their fair share, particularly if it is a really hot issue, as was the case for Highpine Oil & Gas Ltd. Individual investors seldom get more than a very small slice of the pie. The aftermarket is another matter all together.

That is where the true merits of buying or selling a stock or an income trust unit comes into play. If a CEO ever hopes to attract the likes of Kiki Delaney to the table, care must be taken to develop a broad base of investment dealer research analyst support. Just meeting one-on-one with portfolio managers from time to time will never carry the day. As experience has proven, the best buys must have passed the test of a number of inquisitive research analysts' minds, not just one. Furthermore, if the investor plans to hold an investment position for several years to come, to reduce trading costs and minimize tax liabilities, what is the rush? Would not one be wiser to check things out thoroughly rather than jump the gun? All of which runs counter to the idea that if an investment dealer could somehow get the CEO in front of a number of their firm's better clients, the portfolio managers would scramble to buy the stock and drive the price up through the roof. No folks, that is not how it happens. If anything, they may negotiate to buy an available block of stock through the dealer representing the seller, and reward the initiator with a block order for another their firm may have for sale, or simply say thank you very much and do nothing until another few of their favourite sell-side research analysts happen to concur. Making a sound investment decision is a process. Seldom a quick trick!

That is where RAPPORT can play a vital role. Not only have we been in business longer than anyone else in the field and advised more than 500 corporate clients along our way, we have also been successful investors in our own right. We know what it is like to be sold a bill of goods; what it is like to be right and to be wrong. The research analysts, the institutional investors and stock brokers dealing with individual investors trust us and our corporate clients to tell it as it really is, far more than they would ever expect an underwriter to do. This store of credibility, earned over the past many years, is our strength. It is yours for the asking, or should I say at a modest fee. It cannot be had anywhere else. We are not just another of the many pretty faces about town these days. RAPPORT's reputation is exceptional!

So, if you are looking to build a solid base of ongoing research analyst sponsorship and longer-term investor support, give us a call. We are prepared to respond in a very constructive way on very short notice. None of our competitors can do that. While you are at it, why not order a copy of the first two volumes of *Reflections of a Bay Street Cowboy*, and get the third volume free when it is published later this year. These books offer the best way I know to learn all about how to build investor wealth and gain an understanding of what needs to be done in a political sense to re-establish Canada's position on the world stage. I can absolutely assure you that no other firm in our field can hold a candle to what we have accomplished in the past and will succeed in doing in the future. That is enough of blowing our own horn. Now it is time for us to help you blow yours!