Rapport

Failure Breeds Success

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Failure Breeds Success

Perhaps because Canada was a British colony for many more years than our neighbors to the south, and subsequently little more than a branch-plant economy, we have never been very venturesome. Apart from our vast reserves of natural resources, we are seldom considered to be world beaters in terms of value-added products and services. Whereas the Americans celebrate success and failure, we tend to fear both. It is our nature to be cautious; there's to be brash!

NOTHING VENTURED, LITTLE GAINED

Americans see bankruptcy protection as a way to stop the bleeding, to reorganize and reposition a company by selling off or closing the non-profitable businesses in order to concentrate on its strengths. We, on the other hand, look for government help to keep doing as we have always done. Management's time often becomes totally consumed by the problems, at the expense of the more successful operations and, in the end, the whole shebang gets shut down, at an even greater cost to the investors, employees and taxpayers. Rather than go from failure to success, more often than not, we go from one disappointment to the next!

The fight for control of Inco Ltd. and Falconbridge Ltd. illustrates my point. If there are, in fact, more than $200 million in annual savings available by combining the two Sudbury, Ontario, nickel operations, why did it take a bid from Phelps Dodge Corp. of Phoenix, Arizona, to get the juices flowing? Why did the Canadian companies' CEOs and directors not trigger a joint venture years ago? Where were the Bay Street underwriters when it came to offering sound advice? Why was the research analysts' coverage so superficial as never to have uncovered these potential gains to the benefit of the investors of both entities? And why, for heaven's sake, should the shareholders have had to pay outrageously large break fees if the various and sundry deals fell apart? Were not the true owners of these two major S&P/TSX composite index companies being tied up in knots, powerless to unravel the tangle to their advantage? On top of which the competing chartered and investment bankers are now screaming blue murder for fear their gravy train may leave the station and move on to New York or London, never again to pay outlandish fees and commissions in Canada. Is it not high time we all smartened up? It was never the Canadian government's responsibility to step in, and try to save these two outfits from falling into foreign hands. For all we know, the U.S. hedge funds and the arbitrageurs long

held effective control of both, and could care less about what Ottawa or the Ontario provincial government may have had to say, and with good reason. Given as Canadian National Railway and Canadian Pacific Railway had previously seen fit to use each other's underutilized tracks, rather than invest many hundreds of millions of dollars building more of their own, you might have thought other major company CEOs might have seen the light of day. Obviously few have. Which is a sad commentary in and of itself.

LOOKING BACKWARDS TO GET AHEAD

Doing things the same old way flies in the face of innovation. The money game requires leaders to overcome all sorts of business and human dynamics. If nothing else, we must encourage and support CEOs advancing the cause of capital formation. After all, the more successful an enterprise becomes, the better paying the jobs that are created, and the greater the taxes paid by everyone playing by the rules.

In today's globally competitive marketplace, product cycles are shorter than ever before. Breakthrough innovation is imperative for survival. Most companies do not spend enough time looking backwards in their haste to get ahead. They fail to learn all they might from past shortcomings. As such, errors are bound to be repeated. While not all mistakes are praiseworthy, those which happen early on and inexpensively, and which contribute insights about the customer's needs, should be celebrated as they breed success. Every CEO worth their salt should have a favourite misstep worth telling about to prove they are as human as everyone else searching for the promised land.

SHORT FUSES AND LONG MEMORIES

When I first crossed the Bay Street threshold in 1965 there were many national firms and very few boutiques. The underwriters concerned themselves with being the fiscal agent, or at least a member of the banking group of syndicates comprised of twenty-five to fifty firms. The typical new issue fee ranged from 4 to 8 percent. All investors were charged a trading commission of somewhere between 25 to 55 cents per share. The smaller shops did the in-depth research, the base reports often twenty-five to fifty pages in length. Many of the major issuers paid hard dollars to gain access to industry studies, the small- and mid-caps left to fend for themselves. Things began to change with the advent of discounted underwriting fees and trading commissions in the mid-1970s. Research became less objective and more self-serving and everyone, or so it seemed, got into the bought-deal underwriting game. New issue distribution to individual investors was relegated to the dustbin.

As instant as underwritings became, the longer the memories of those who got shafted. Now it is difficult to find a portfolio manager or an individual investor who does not have a half-dozen or so stories to tell as to how they got sucked into buying a new issue offering lacking proper due diligence, much less savvy research analyst coverage. As CEOs must come to understand, once burned, it becomes very difficult to get such a person back onside, no matter how well the issuer may eventually do. It is one of the key reasons why boards of directors are always on the lookout for a replacement CEO with a sterling reputation when the financial results fail to live up to the stock market's expectations, and why unbiased research comment is so vital to issuers and investors alike. So rather than blow a fuse when a less-than-flattering analyst's report surfaces CEOs and senior executives would be well-advised to track down the critic in question, as all can learn a

great deal by understanding how others perceive a company or an income trust's track record and prospects to be. They should never just throw their arms up in disgust, as short fuses and long memories are to be avoided whenever possible.

OPTIONS DO NOT REPRESENT TRUE OWNERSHIP

Ownership no longer represents privilege. Rather it is the investment bankers, hedge fund managers, and those with options who are the favoured few, at the expense of investors. Whereas the S&P/TSX dividend growers did twice as well as the composite index over the past ten years, up 17.2 versus 8.6 percent compounded, proving beyond doubt that the discipline of having to pay a dividend and the reinvestment thereof makes a substantial difference longer term, the new boys on the block have a tendency to play the stock market searching for immediate gains. Instead of granting the existing investors the right to buy additional shares at a discount, as they once did, special warrant financings and most bought deals are nowadays sold to first-timers, those only too willing to mark to the market the moment the deal is done. Individual investors usually hear about the capital raising after the fact, or get but a partial fill at best. Instead of a payout ratio ranging from 25 to 50 percent of reported earning, most of the cash generated is now earmarked for acquisitions, many of which fail to live up to the dealmaker's promises and management's pro forma expectations. Or, alternatively, the hedge funds will insist on a special dividend, coupled with a substantial buyback commitment, hoping for a quick increase in the price to allow them to sell out at more than what they paid for the stock just a short time ago. Meanwhile the investment bankers continue to make money hand-over-fist. Lest we forget, money does not grow on trees. Nor does it come out of the pockets of those with options.

In fact, options do not represent ownership at all. They are but a risk-free way to play the game. Backdating is an extension of that opportunity, one which is never afforded the average common shareholder. They are like renting a Lincoln from Budget for the weekend at a discount. The only thing a CEO may ever have to do is fill it up before it is returned. They never have to buy the car. Never have to arrange for financing, insuring or licensing the beast. Nor do they and their better half ever have to consider or agree upon the upgrades available, and servicing is never a problem. If the stock price fails to make the grade before the expiry date, the terms are almost always rewritten in the executive's favour. At no point is his or her capital at risk. While it may be argued that optionees will never earn a dividend, their compensation is assured, their expense account and right to use the corporate jet seldom questioned. To say the least, it is a pretty comfortable pew. Far more so than that of the shareholder of 40-plus percent of the companies listed on the TSE whose share price has not improved in recent times and, apart from the income trusts, have never paid a dividend.

Now comes word that even the income trust market is running into headwinds. Whereas the IPO market in Canada was up by an impressive 33 percent in the first six months of 2006, follow-on financings fell. In the case of income trusts, the tally was off by 43.7 percent, bruised by the amount of money flowing out of such mutual funds, and tempered by a decline in related merger and acquisition activity. Why even a few new issues were pulled for lack of investor interest. Not unexpectedly, the oilpatch Explore Co. spinoff structure, which allowed those lucky enough to participate to double their money without so much as lifting a finger, is now on life support. The difference between what the management team members paid for their shares and what the stock market was willing

to bear, was dilutive to existing shareholders as the new shares were being issued at a discount to what they were really worth. This is also a blow to the investment bankers who saw the rip-off as a stepping stone to more financings in the future.

What about the conflicts when senior executives join forces with investment bankers and private-equity firms to effect a buyout of a publicly traded entity? Whereas the shareholders wish to realize the highest possible price, management *et al* try to pay as little as possible. History tells us that an outside buyer would be willing to pay 30 percent more on average. Even more troubling is the very idea that MBO executives have an incentive to minimize values, rather than restructure the outfit and make it leaner and more profitable. Sometimes they use accounting gimmicks to make the performance look worse than it really is: delaying booking of revenues, reporting lower than expected accounts receivable, and accelerating recognition of expenses. All of which stands to have a negative impact on reported earnings, and likely the share price. Furthermore, if there are compelling virtues of private ownership, you might expect the buyout to stay private. The reality is that, with most high-profile deals, this is rarely the case. Once straightened out, buffed, and shined, they are generally taken public again for fantastic sums. Though many CEOs have performance-related pay packages, why be satisfied with tens of millions of dollars attending to the public shareholders' best interests first, when they can make hundreds of millions by putting them last. Is it not time the target companies be sold to the highest bidder? I think so. Don't you?

GOVERNMENTS MUST STAY OUT OF THE WAY

Many have suggested Ottawa should have taken more time to review the terms of the bids for Inco Ltd. and Falconbridge Ltd. Losing two major head offices means fewer high-paying careers, lower tax receipts, and is a blow to local and national prestige. Then again, what about the persistent barriers to interprovincial trade, and the myriad of rules and regulations that hinder the mobility of Canadian labour, discouraging businesses from ever coming here in the first place? You have to wonder if our politicians really have a clue as to what is best for Canada.

For example, raising the price of dairy products to offset the decline in sales and cuts in quota will never spur on demand. Supply management by governments is not the cure to what ails the industry. Only market pricing will get things turned around, as it has in Australia. Though cutting arcane farm subsidies is one of the pressing subjects for the World Trade Organization to address, most of the wealthy members continue to prefer to encourage domestic production, dumping the surplus in foreign markets while protecting their own by levying tariffs. Is it not time the more influential of the 143 WTO countries did what is right for the majority of their citizens? Let us hope the standoff by the Canadian government is not because most of these farmers are concentrated in Quebec and Ontario, key provinces for anyone wishing to gain a majority in the House of Commons!

Globalization, with its huge investment deals, is a fact of life these days. Preventing the Canadian chartered banks from merging is a long-standing and petty mistake which needs correcting. If our financial institutions had had a bigger footprint, and been more *au courant*, they might have promoted the merger of the two forenamed nickel producers. However, if we remain small-minded, Canada will never be competitive in terms of productivity and technological development, and as a source of risk capital. Having tax rates that are out of whack with those in the U.S. and elsewhere is only asking for trouble.

The purchase of Falconbridge Ltd. by Xstrata PLC and Inco Ltd. by Companhia Vale do Rio Doce (CVRD) may be just the beginning of a rash of takeovers if we do not respond in an effective manner. The good news is that the mines, like the tarsands, cannot be moved. However, the decision making will be, and that is the sort of occurrence we must guard against if Canada is to realize its full potential. The best defence is a good offence, and governments must stay out of the way and allow our entrepreneurs to prove themselves. It is their intuition which is likely to carry the day, not yet another commission of bureaucrats without their jobs or own money on the line, and nothing to lose or gain no matter what their recommendation.

When all is said and done, the TSE is likely to remain the prominent exchange for the mining industry. Canada's prowess and powers will not shrivel up and die. Though a few big downtown head offices may disappear in time, our economy will not be hollowed out. The number of companies, the dollar value of trading, new listings, and the massive infrastructure in place will assure Canada's leadership position well into the future. For every multibillion-dollar takeover there are dozens, even hundreds, of smaller deals by Canadians for foreign assets. These transactions are the foundation for the head offices of the future. According to Crosbie & Company Inc., Canadians were involved in a grand total of 237 transactions in the first half of 2006, in the amount of $26.8 billion, versus foreigners announcing 103 for $56 billion, including the $41 billion proposed purchases by Phelps Dodge Corp. Since 2000, there were greater than 2000 worth $280 billion by Canadians, 1090 by foreigners for $342 billion. Simply put, bigger companies are being purchased by foreigners, Canadians involved in more numerous and smaller acquisitions. Cashing in one's nickel producer chips at a healthy premium may ultimately provide our up-and-comers with the additional capital and personnel they need to grow and prosper. Given as many of our entrepreneurs have a substantial stake in their enterprises, the chances are they would never look a $200-million gift horse in the mouth, as did the senior executives and directors of both Inco Ltd. and Falconbridge Ltd. Nor will it require a takeover bid to get and keep them on cue. So it is possible that these mega-takeovers will, in the final analysis, prove to be a blessing in disguise. All signs certainly point that way, particularly for investors, as the small- and mid-caps have far outperformed the large-cap mining stocks over the past many years, and are poised to continue doing so in the future.