Roadkill

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Roadkill

Roadkill is the killing of an animal by a vehicle, or one that has been so deprived of life. Colloquially speaking, it relates to those who have been run over by others in the day-to-day rush to get ahead. Investors are rightfully concerned as to the methods employed to relieve them of their inherited, hard-earned, or even ill-gotten gains. Steamrolled by the fee and commission grabbers, many wonder who they should turn to to protect their nest egg, and have it grow more valuable in time. Unfortunately, the auditors, lawyers, underwriters, and many research analysts seem to be more intent on feathering their very own nests.

ONE PLUS ONE DOES NOT EQUAL TWO

I go back to the days when the Northern Electric Company was a wholly owned subsidiary of Bell Canada Limited, long before the formation of BCE Inc. and Nortel Networks Corp. came into being as publicly traded entities. Things were simpler then, and the accounting profession could be trusted to keep the books straight. Unfortunately, those days seem to be long gone. Nortel no longer trades at $124 per share as it did in 2000, but rather below $3.00 at last glance, which is not surprising given as it still does not have a proper handle on its financial statements for 2003 and beyond. All the while, the current CEO hopes to boost its industry market share to 20 percent, even though its auditors remain incapable of adding one and one to get to two.

Meanwhile, the recently completed restructuring of Stelco Inc. may possibly prove to be the crime of the century. The newly issued shares, doled out at $5.50 apiece to creditors, financiers, and the steel producer's new CEO, opened at $18.50 and rose as high as $24.90 within the first week of trading. The current price is approximately $18 per share. The old shareholders got nothing at all, thanks to the court-supervised restructuring following two-plus years of what many knowledgeable people felt was unnecessary bankruptcy protection, given as the company was quite profitable and could easily pay its bills. Worse still, the lawyers were paid nearly $200 million, and fully $500 million of enterprise value was destroyed along the way. Once again, one plus one did not add up to two!

THE INEFFECTIVENESS OF EARNINGS GUIDANCE

Ever since the U.S. Congress safeguarded issuers from liability for statements about projected performance, the practise of issuing quarterly per-share earnings guidance has become quite common. The aim is to gain higher valuations by increasing trading liquidity and lowering price volatility. Unfortunately, there is little evidence that such is so. Rather, there are additional costs involved given the great amount of management time and effort

spent preparing the reports, and the excessive focus on short-term results. Instead of trying to create the illusion of stability, it would be more beneficial if the culprits emphasized the key factors impacting the industries the company serves, business conditions, and the long-range plans and goals. The one exception, as was demonstrated by the sell off in Google Inc.'s shares when it failed to meet or exceed over-zealous earnings estimates, is to try to temper out-of-line bullish or bearish expectations. It is only fair to the investors, customers, and critics for the CEO to attempt to maintain some semblance of order when the research analysts and members of the financial press may have lost their heads.

To those CEOs who fear that to discontinue the practise would lead to the dungeons of hell, may I offer that nothing would be more heavenly for an investor than to read a well-constructed research analyst's report. At the moment, all most shareholders ever get is a guidance number, and if you think that the miles-per-gallon statistic is what ultimately sells top-of-the-line automobiles, you are sadly out of touch with reality. Rather, the star players on the world stage are those who get out and about on a very regular basis in order to allow the research analysts and longer-term investors to put a face to the company or income trust, and get to know firsthand as to what truly makes the outfit tick. Like product marketing, there is no substitute for a carefully orchestrated investor relations programme.

By the way, whisper numbers, so prevalent before the dot.com crash of 2000, are making a comeback. Given as most major stockbroking firm forecasts these days are little more than a reflection of guidance numbers, and the investing crowd's collective wisdom is always greater, smart investors have a tendency to bet the whisper numbers when they differ from the research analysts' projections. Which is all the more reason for CEOs to stop fretting about quarterly projections trying to keep the investment community and short-fused investors onside.

PRIVATE AND PUBLIC INEQUITY

Hotshot managers are fleeing public companies for the freedom and glamour of private equity. It is a freewheeling world where so-called sophisticated investors buy slumping companies and try to turn them around to resell or take public again, risking billions of dollars in challenging fate. With a freer hand to do the tough things necessary to reposition an enterprise for the long term, there is much less attention paid to near-term quarterly results. The focus is on longer-term performance. When successful, the rewards can be outrageously good even for lower-level executives, spectacular for CEOs, and there is less annoyance from the Sarbanes-Oxley Act. While the compensation of the highest-paid people need not be disclosed in excruciating detail, one would be wise to remember that the money is still coming out of the investors' pockets. That part of the equation never changes!

According to Thomson Venture Economics, more than U.S.$800 billion of private equity is currently at stake and the total is increasing rapidly, guided by at least 260 American firms. The Canadian tallies are $56.5 billion and ninety-eight firms. Flush with cash, these daredevils are buying bigger-name entities and enticing higher-profile public company executives to come on board for the ride to riches. The partners typically take 1.5 percent off the top as a management fee. They also get a share of the profits, usually 20 percent, when a company is sold or taken public, taxed at the capital gains rate, no more! Egging on the buyout boys are Wall Street's mightiest firms, which collect outrageous fees and commissions from all the buying and selling, amounting to U.S.$11.8 billion in 2005,

according to Dealogic. Goldman Sachs, which scooped up U.S.$870 million of the total, has now decided that rather than just enrich its clients by giving advice on mergers and acquisitions, it would do even better by putting its own money where the firm's mouth once was, and take a piece of the action for its own account. The ultimate goal is to provide its shareholders with a return on equity that is equal to or better than the industry's best, while continuing to grow the book value and earnings per share. No mention is made of the increased risks and multiple conflicts of interest involved in getting directly into the private equity game. If they get it right they will be heroes. Get it wrong and they will be in deep yogurt!

A word of caution – the private equity phenomenon is to a large extent cyclical. In time, the bull market for stocks will slow, and eventually reverse momentum. Wave millions of in-the-money stock options in front of a CEO and suddenly SOX and other headaches of running a public company will seem less painful. Sooner or later the current buyout craze will cool off as deal prices soar and the cost of loading companies up with debt skyrockets. When the boom goes bust, it will leave a pile of junk-rated companies, defaulted debt, and lost equity in its wake. Lest we forget, the capital markets are notoriously fickle, and there is a good chance that the credit cycle, underwriting revenues, and takeover fees are heading down from where they are today. So, if you are thinking about selling your business, pick up the phone and get on with it. A year from now the conditions may not be quite as favourable, and nobody enjoys being run over by a bear market.

If your outfit is underperforming, do not be surprised if a band of hedge funds takes a significant position and swarms all over management and the board of directors to force change, aiming to realize a higher share price. It is all part and parcel of fair play these days. Unlike mutual fund managers hoping to sell money management services, these high-powered types are not easily tempted to pull their punches. Furthermore, they are well bankrolled and do not have to borrow money from others as the corporate raiders of the 1980s did. They can well afford long-drawn-out fights for control. Power will no longer rest with the board of directors if a proxy battle ensues. Therefore, their demands must be taken seriously!

The spinoff of 16 percent of Tim Hortons from Wendy's International Inc. is the result of a battle between hedge fund managers, and a management heretofore loath to admit that the activists were capable of coming up with eminently sensible capital formation strategies. The one mistake made was to allocate 74 percent of the IPO to institutional investors, and only 10 percent to individuals, apart from the 16 percent set aside for the employees and franchisees. When the shares opened well above the issue price of $27 and rose to $38 before slipping back to close at $33 on the first day of trading, most of the selling came from the pampered professional money managers. It was the little guy who did the buying. If their demand had been better accommodated at the outset, the volatility would have been far less and the outfit's customers who bought the stock would have been left with a more palatable taste in their mouths. A no-brainer for everyone whose success is dependent on pleasing the many millions of people who stop by Tim Hortons nearly every day, versus the few big shots in high places who seldom do. Simply put, the underwriters gave management poor advice to satisfy the greed of their biggest trading clients. The stockbrokers dealing with individual investors and their clients got shortchanged. Very little was done to protect the integrity of the capital markets, and the best interests of the corporate client and its valued customers. Now that the shares are trading at or about $30

and the underwriters are on to their next deal, the investors are left to fend for themselves until a handful of research analysts get the urge to follow the company and put pen to paper, and that is not likely to happen for another three to six months. Delaying the whole process is a crazy law in the U.S. which precludes the company from providing guidance until such time as Wendy's announces its plans as to how it will distribute its remaining shares. Or, in other words, the majority owner can be kept fully in the know, the minority shareholders treated like roadkill. If such stands to reason to you, it surely does not to me!

BUYBACKS HAVE LIMITATIONS

When stocks were plodding along at very cheap prices at the bottom of the bear market, corporations became avid buybackers, the earnings yield of the acquired shares better than the after-tax cost of the borrowed money, or the after-tax return on idle cash. When coupled with the rash of mergers and acquisitions, the number of shares outstanding on the major exchanges has dropped over the past number of years. The reductions are especially marked amongst the largest of the large companies.

Those in favour of buybacks cite the inherent advantages of an improvement in earnings per share. Those against argue they are but an indication management is incapable of using the extra money to improve productivity and margins, to grow the business, or is unwilling to commit to a greater payout ratio or to paying a higher dividend. Moreover, many corporations have repurchased additional shares at bull market prices, to the extent of acquiring an even greater number than ever before. The good news is that buybacks appear to give a powerful boost to the stock price of undervalued entities with high-quality earnings. Those with questionable results seem to gain no benefit whatsoever. Obviously, roadkills are not worth purchasing no matter who happens to be the buyer!

BUY, HOLD, SELL, OR GO HOME

Is it not time we did away with the ambiguity of the research analysts and their wimpy recommendations? According to globeinvestor.com, fully 95 percent of all stocks and income trusts have either a buy or hold rating. While these terms are vague enough, when they apply to almost every listing on the TSE, they all but lose their meaning. The primary reason why the commentary is so flattering is that nearly every Bay Street firm is striving to establish lucrative underwriting and merger and acquisition advisory relationships with the very issuers their research analysts are responsible for pulling apart. While you and I might argue about the extent to which they are actually pressured by corporate clients to accentuate the positive, the fact that close to half the TSE-listed stocks are buys speaks for itself. It is especially insidious when the urging to maintain a buy recommendation comes from big institutional investors who threaten to take their commission business elsewhere as punishment for negative calls on stocks they own in various portfolios. If that were not bad enough, the very few sell recommendations are often a trailing indicator, reflecting what has already occurred, not what might happen in the future. In other words, they are useless, except at the bottom of a bear market, when the duds, stiffs, and out-and-out losers often outperform the buys on the initial rebound!

WHEN ALL IS SAID AND DONE

We all need critics; they are the best way to keep us on track and moving ahead. If we fail to learn from our mistakes, there is absolutely no chance of ever gaining a step or two on

the competition. CEOs with thin skin rarely make the grade. They are almost certain to be run over. The sooner such comes to pass, the earlier their replacement, a hedge fund or private equity firm will have a chance to set things right. From a successful investor's perspective, having spent the time and effort necessary to uncover good companies whose shares may be undervalued, it would be unwise to sell one's entire position just because the price subsequently got a bit ahead of the fundamentals. However, it may be necessary to reduce the relative weighting in a portfolio if it gets substantially out of kilter. Nonetheless, it is always best to swallow one's pride and sell the underperformers at the first indication things are not turning out to be as good as one had hoped for. Roadkills seldom get a second chance to strut their stuff. The truly great outfits, on the other hand, have an uncanny ability to keep chugging ever onward and will eventually justify a premium price. The stock market differs from the private equity game because of day-to-day liquidity, and one should take full advantage of this vital characteristic if one ever hopes to do better than the benchmark indexes during both bull and bear markets.

Also remember that the S&P/TSX composite index is not all it is cracked up to be. For example, it is already as overweighted in energy stocks, as it once was in Nortel Networks Corp., and yet royalty trusts are now being added to the mix, even though the accounting methods of some are under assault from none other than the forensic firm of Accountability Research Inc., and Standard & Poor's itself. No, it is not a perfect world. So every effort must be made to insure you never become little more than roadkill along your way.