

MAXIMIZING SHAREHOLDER VALUE AT THE PRIVATE COMPANY

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All companies are in the same business—the competition for capital. In most instances, the issues that predominate are measuring performance, identifying profitable investment opportunities, and securing capital for expansion. Although the context sometimes differs for a private company (fewer disclosure requirements, more concentration of ownership and control, and informal methods of resolving disputes), these issues are still central management concerns. Yet the very features often cited as the attractions of remaining private—less scrutiny and interference from outsiders, and a family orientation—frequently conspire to make the issues more confounding.

Consider the case of Microsoft, arguably the most innovative and successful high-tech company of the 1980s. The company went public in March 1986, unleashing millions of dollars of hard-won value for its founder, Bill Gates, while fueling expansion for still greater value in years to come. So favorable was the market's reaction that four other software issues followed in Microsoft's footsteps. One would think, amidst the fanfare and applause, that the financial scrutiny paid by management to the offering would have rivaled what they paid to their highly successful products.

On the surface, this appears to have been the case. Total transaction fees, including underwriters' compensation, were about \$4.6 million, or only 7.1 percent of the \$65 million in primary and secondary shares sold. I say *only* 7.1 percent because that percentage is frequently higher, even for much larger

offerings. (Bet Public, for example, incurred \$2.8 million in exchange and listing fees alone on its \$75 million offering, nudging total fees above 12 percent.) For much smaller offerings—those, say, less than \$10 million—transaction costs can become stratospheric, consuming as much as 15 to 25 percent of the equity raised. It's not surprising that fees become the thorn in an owner's side when evaluating the prospect of going public.

So Microsoft did a good job of monitoring expenses, but then missed the boat on pricing. The closing price of Microsoft's shares on the day of offering was \$28, a price that held firm for several weeks thereafter. Too bad their shares entered the market at only \$21. The \$22 million in underpricing (or 33 percent of the \$66 million offered) dwarfed what Gates and Microsoft paid in fees (see Table 1)—a fact that escaped the press amid investor jubilation.

But why pick on Microsoft? Studies by several leading finance scholars confirm that the average first-day run-up for all initial public equity offerings, excluding investment funds, is on the order of 15 and 20 percent, and that the standard deviation of these run-ups is between 35 and 40 percent.¹ In layman's terms, not only is underpricing on the order of 50 to 60 percent not unheard of, it's statistically certain in one out of six public offerings. For very small offerings—those of companies with sales of less than \$500,000—the average run-up exceeds 25 percent, the standard deviation 50 percent. Add 15 to 25 percent in fees and it's little wonder so many cash-poor companies resist going public.

1. See Jay R. Ritter, "The 'Hot Issue' Market of 1980," *Journal of Business* 57 (April 1984) 225, Table 2. See also Clifford W. Smith, Jr., "Investment Banking and the Capital Acquisition Process," *Journal of Financial Economics* 15 (1986) 19-23:

and generally Roger G. Ibbotson, "Price Performance of Common Stock New Issues," *Journal of Financial Economics* 2 (1975) 235-272.

Companies contemplating the public markets are so often blinded by the simplicity of reported multiples and accounting results that they lose sight of what really determines value—the quality and level of anticipated cash flows.

TABLE 1
MICROSOFT'S IPO
(MARCH 13, 1986)

Explicit Costs:		Hidden Costs:	
Underwriting Fees ¹	\$4,054,450	Closing Price (Day of Offering)	\$28.00
Legal Fees and Expenses	94,000	- Offering Price	<u>21.00</u>
Accounting Fees and Expenses	73,000	Underpricing	\$7.00
Printing and Engraving	300,000	× Number of Shares Sold ¹	3,095,000
Exchange, Listing, and Misc.	74,000		
Total Fees and Expenses	<u>\$4,595,450</u>	Total Underpricing	<u>\$21,965,000</u>
Costs as % of Proceeds	7.1%	Costs as % of Proceeds	33.3%

¹Includes 300,000 shares subject to over-allotment.

Still, one wonders how often private companies labor, even today, to position themselves eventually to go public. And yet how poorly so many of them will fare. Were the distribution of winners and losers random, one could wax philosophical about the magnitude and disparity of price run-ups, attributing their size to an attempt to assuage investor uncertainty. But my suspicion, based on a number of client experiences, is that the investment banking community is sufficiently competitive to give credit where credit is due, provided managers can articulate their company's value correctly, and orchestrate a competitive pricing environment.

The problem, I believe, is that companies contemplating the public markets are so often blinded by the simplicity of reported multiples and accounting results that they lose sight of what really determines value--the quality and level of anticipated cash flows. And they resign themselves to a spot within the prevailing range of earnings (or, dare I say, cash-flow) multiples for publicly-traded counterparts, regardless of whether they account for those earnings (or cash flows) identically, or whether their operations are truly comparable.

I had the pleasure of working with one of the large regional drugstore chains, Arbor Drugs, before it went public in 1986. After weeks of evaluating the company's growth prospects, marketing strategy, and operating performance, we concluded the company justified a value in excess of \$80 million, or 30% more than the value implied by the highest **earnings multiple** in the industry. The first investment banker we solicited pored over our analysis, wrote a glowing corroboration of our assumptions, and submitted an expression of interest at \$60 million. We were dumbfounded. Did he not agree that the company was uniquely positioned in southern Michigan to expand and profit-with the same mighty clout as Walgreen's wielded elsewhere?

The banker's reply was mind-numbing:

Since you will be retaining far more stock than you sell, it is obviously to your advantage that the offering be successful. We strongly believe that this is most likely to occur when the stock is not so fully priced as to retard its rise in the aftermarket. Remember, underwriters must, by law, wait 90 days before beginning meaningful research coverage (emphasis added).

It smacked of a Microsoft in the offing. But it was worse; the investment banker justified his offer by appealing to the high end of industry P/Es, as if the range were somehow gospel. What bothered us, enough to open the process to sealed bidding and co-managers, was that he took the denominator of the P/E multiple for granted. Despite impressive retail credentials, he elected to overlook:

1. The large portion of otherwise distributable net income that had been reclassified as above-industry compensation to owner-managers in order to minimize taxes;

2. The fact that the company was expensing almost all of its leasehold improvements, while earnings-hungry public competitors were (despite higher taxes) stretching those expenditures out over the balance sheet; and

3. The fact that the company ignored industry convention by accelerating depreciation of what few capital expenditures it did not expense, thus deflating earnings further to minimize taxes.

All these factors combined to conceal, perhaps even to the experts, the extraordinary "quality" and level of Arbor's cash profits. Industry P/Es began to look less like a proxy for valuing future cash flows than an excuse for underpricing issues. It was no surprise that, in a highly competitive bidding situation, the company elicited interest at \$90 million

from Drexel, Salomon Brothers and William Blair, and was successfully taken public at \$102 million (after an accommodating decline in interest rates). I say “successfully” because their investors were not disappointed; they still observed a 6 percent run-up on the day of offering, and the price held firm for several weeks thereafter. And, yes, the bankers edged out 6 1/2 percent in fees for themselves.

Of course, all this may seem irrelevant in today’s environment, where the vogue (whether because of regulatory factors or otherwise) is staying private, employing bank lines judiciously, and sourcing extra capital through private placements. Why worry about the seemingly predatory practices of the new issue market when, for most private companies, the event seems remote? Because tacitly or explicitly, investors invest against value; and the same level of financial unsophistication that leads to predation in the public equity markets gives rise to fat fees and supra-competitive lending rates at the private placement level. They may even influence commercial bank relationships. It’s no secret that among the commercial bankers I call on, the middle market and emerging growth companies are the principal areas of marketing focus, the last glimmer of banking’s Holy Grail. The only difference is, in tapping private rather than public channels of financing, a company doesn’t receive a market account of its losses.

My objective here is to focus on what creates value, how value creation can be measured, and how conventional earnings-based benchmarks of performance, while frequently misleading in the public context, can be downright foolish in a private context. In short, the article attempts to demystify the valuation process, distilling from it a few basic guidelines that can be applied to maximize value at the private company. Not surprisingly, the first totem we bash is the accounting, or P/E-driven, model of firm valuation.

ACCOUNTING VS. ECONOMICS

Despite volumes of evidence to the contrary, many managers still believe that markets price securities by capitalizing earnings at pre-set, externally determined multiples, and that companies are essentially powerless to change anything but their

earnings. Yet P/E ratios are, in large measure, a reflection of particular accounting practices and the extent and quality of a company’s investment opportunities. One need only observe the stock prices of companies switching from FIFO to LIFO inventory accounting to confirm that, when earnings suffer but promote higher after-tax cash flows, shareholders will applaud the lower earnings.² The point is that earnings and earnings multiples are proxies for a more concrete, risk-adjusted appraisal of future investment opportunities and cash flows.

Ironically, my colleague Joel Stern popularized the discounted cash flow model of firm valuation after observing the privately-owned and operated corner grocer. He noticed that proprietors were generally more concerned with whether the cash register was empty or bulging than with how revenues and expenses were allocated between income statement and balance sheet. The irony is that for most private companies, this logic suffices until they begin thinking about raising capital; at that point they often succumb to the accounting model.

I met last summer with a privately-held manufacturer and distributor of high-grade graphite products for the aerospace industry that was “positioning” itself to go public. The company had a variety of business units, some strong, others weak, and should therefore have been focused on re-evaluating investment decisions at the weak ones, shoring up incentives, and exploring growth opportunities for the strong ones. Instead, management was obsessed with disposing of commercial real estate holdings that, far from consuming management time, were appreciating handsomely all by themselves. The rub, it seems, was that the rising value of those assets was not captured in reported earnings and thus, management argued, wasn’t contributing to the prospective IPO value. It was better, they reasoned, to pay taxes on the sale and to reinvest the proceeds in so-called “performing” assets.

This was nothing more than the accounting model cloaked under the mantle of opportunity cost. Had management the same confidence in the market’s ability to value unrealized appreciation as they themselves had when they bought the properties, they would have spared themselves needless taxes and anxiety.

2. See Shyam Sunder, “Stock Price and Risk Related to Accounting Changes in Inventory Valuation,” *Accounting Review* (April 1975) 305-315 (average 5 percent increase in stock price on announcement of switch from FIFO to LIFO);

Gary C. Biddle and F.W. Lindahl, “Stock Price Reactions to LIFO Adoptions: The Association Between Excess Return and LIFO Tax Savings,” *Journal of Accounting Research* (1982) (stock price gain proportional to tax savings from earnings “hit”).

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The economic model of firm valuation has its roots in project finance. Perhaps the most accepted principle of microeconomics is that the value of any project is the sum of anticipated cash inflows, net of outlays, discounted to present value at a risk-adjusted cost of capital. By extension, the value of a company is the sum of anticipated cash inflows from all future and existing projects, net of projected outlays, discounted at its weighted average cost of debt and equity capital. So long as investment patterns are predictable, growth opportunities and rates of return uniform, and levels of debt capitalization consistent, the valuation process can be reduced to an explanatory price/earnings multiple. But while this shorthand may be sufficient for the average price-taking investor—those at the beck and call of sell-side analysts—price-setting investors are not nearly so naive. The point is not that price-setting investors (Joel Stern coined the phrase “lead steers” to describe them) churn out real-time computer simulations of projected performance (although some do). It is that they intuitively and quantitatively redress the inadequacies of relying on multiples that are anything but stable and on reported earnings that are anything but uniform.

Even when investment patterns and opportunities are identical, earnings distort performance measurement in two important ways:

1. They charge management for only the debt in the business, forgetting equity. Were there a separate accrual for the opportunity cost of retained or paid-in equity, the accounting model would go a long way toward capturing whether a company was justifying the opportunity cost of forgone investments, and thus whether it deserved an attractive multiple.

2. They neglect the actual timing of cash receipts and disbursements, rendering impossible a fair extrapolation to companies with different mixes of current and accrued items.

Unfortunately, the distortions inherent in a public company context are magnified many times over in a private company.

KEY DIFFERENCES BETWEEN PRIVATE AND PUBLIC COMPANIES

First, accounting conventions differ—often materially. Discretionary owner compensation is a common example. Arbor Drugs' founder and chairman, Eugene Applebaum, listed his 1985 salary in

Arbor's IPO prospectus as \$451,630. Not a bad haul in a company with \$115 million in sales. Had Arbor Drugs already been public, he would have qualified as 467th in *Business Week's* listing of the 500 top-paid bosses. And yet his company wouldn't have made the *Business Week 5000*.

Does this mean that Mr. Applebaum was overpaid? Quite the contrary. He merely reclassified part of his fabulous return on equity as tax-deductible management compensation. Should he, as a result, have been penalized by a reduction in the firm's valuation? Only if he was unwilling, subsequent to an equity infusion, to remit the supra-competitive portion of his salary to the company as retainable or distributable net income. In actuality, Mr. Applebaum accepted a wage freeze for several years thereafter, and was credited for the diverted return in Arbor's offering multiple.

Another example: Arbor Drugs routinely expensed the cost of converting newly-leased space to storefronts. Many of these leasehold improvements would have instead been capitalized by Walgreen's, Revco or Jack Eckerd, despite a costly deferral of tax deductions.

But why focus on Arbor Drugs? We worked recently with a large, privately-held manufacturer in evaluating a financially-troubled competitor. Nearly \$10 million in “hidden” purchase value came from simply recasting the target's financials in conformity with our client's accounting for recoverable assets. The target was on FIFO, our client on LIFO. The target capitalized replacement parts; our client expensed them. The target depreciated property evenly over the longest classification periods allowed; our client accelerated depreciation over the shortest asset-lives allowed. In short, our client did everything legally in its power to reduce reported income and, therefore, its tax bill. The target did everything to increase it—despite pressure from creditors. As for goodwill, it never entered the valuation equation. What a shame if, in subsequent discussions with financing sources, the company were bewitched by industry P/E's in negotiating the terms of either debt or warrants.

By contrast, I worked with a relatively young publicly-traded laboratory testing company whose value quintupled during the 2 1/2 years since working with them. It last year purchased an environmental consulting firm that provided not only direct access to the highly lucrative environmental testing market but also indirect access to the fast-growing pharmaceuticals market. Had our client structured

the deal as an earn-out to prevent key talent from leaving (or underperforming), it would have had to recognize over \$1 million a year in amortized goodwill, dashing any hope of EPS growth, because the target had virtually no hard assets. So the company elected a pooling instead, despite the associated inability to bind management. The company had essentially come of age—it adopted a public company mentality. What a pity; we spent much of the summer crafting an incentive compensation plan for the selling shareholders that, in effect, replicated the forgone earn-out.

So, accounting conventions differ, and they systematically bias P/E-based valuations downward for the tax-conscious privately-held company. In addition, leverage ratios differ, and are often understated by a private company's audited financials.

Private companies love leverage, whether or not the debt is recorded as such by accountants. It's not unusual to see leverage ratios in rapidly growing private companies double those of publicly-traded counterparts, in large part because of the cost and (dilution of control associated with sourcing outside equity. Al Copeland Enterprises, owner of Popeye's 'Famous Fried Chicken and Biscuits, averaged 70 percent debt-to-book capital from 1983 to 1985—long before they acquired Church's. McDonald's, by contrast, averaged 37 percent, in line with an average 34 percent leverage for other publicly traded fast-food companies. The point is that, just as more aggressive accounting conventions bias P/E valuations of private companies downward, more aggressive debt policies bias P/E valuations upward. And as usual, reported financials tell only part of the story.

The most popular form of off-balance sheet financing is the operating lease, a form of vendor financing. Private companies, especially retailers, routinely lease facilities to augment balance sheet financing without tapping external equity. They may also build a portfolio of intertwined unconsolidated subsidiaries.

I worked in early 1987 with a successful northeastern residential real estate developer who was contemplating taking his company public. The issue at hand was valuation, and the owner was convinced that because his company had no **reported** debt, it should be accorded a more attractive multiple upon

offering than **Calton**, Hovnanian or Toll Brothers. Quite apart from whether his operations were as productive, the client misunderstood how markets assess value. It didn't occur to him that his 34 operating subsidiaries and limited partnerships, consolidated under the equity method of accounting, were leveraged well beyond industry norms. Rather than concede a below-average P/E, the owner withdrew from the offering process and rode out the collapse in the real estate market alone—a pale rider. The point, of course, is not whether the owner should or should not have cashed out, but whether he should have regulated his expectations by ill-fitting industry multiples.

Stern Stewart & Co. annually reviews the operating characteristics of all public companies with rated debt issues. Using a statistical procedure called factor analysis, we size up which operating features, objectively determined, contribute most to a company's public debt rating. Not surprisingly, factors like size and coverage matter a lot, but their explanatory power increases noticeably when double leverage—the leverage of unconsolidated subsidiaries is added to the equation. The implication is that parent companies—frequently stand behind the debts of their subsidiaries, regardless of legal obligation.'

Another common off-balance sheet financing vehicle is the joint venture. Joint ventures have become increasingly popular as a less expensive alternative to merger, and as a way to improve focus and specialization. Manufacturing companies are combining complementary product lines, leveraging off overlapping distribution channels, and pooling R&D. Joint ventures have also become a powerful form of poison pill, since the partners usually retain a purchase option in the event the other partner is taken over. It doesn't hurt if one of the parties is private, effectively shielding the business from takeover. Regardless of rationale, joint ventures are growing in popularity, especially among privately-held companies, further diminishing the usefulness of industry multiples.

A third distinguishing feature is that private companies' business capabilities differ from public ones', even where their products and services are the same. Robert Dedman's Club Corp. builds and manages more for-profit country clubs, business-lunch clubs, and athletic clubs than just about

3. For more on this, see G. Bennett Stewart III, *The Quest for Value* (HarperCollins:1990) pp. 392-408.

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anyone. And yet, unlike behemoth Bally, Club Corp. owns no properties. It fuels its expansion by pre-selling memberships that cover the cost of building or developing the facility, and then takes a fee for management. More precisely, it sets up facilities that borrow membership down-payments, interest-free, for periods of up to **30** years. Since the facilities are obligated to repay members eventually, the down-payments aren't recorded as income, despite the extremely low cost of invested funds. (Cooperatives operate the same way, and are generally more popular among capital-constrained, closely-held companies than capital-rich public ones.) Just as operating leases are a form of vendor financing, membership fees are a form of consumer financing.

Washington-based Carey International practices **distributor** financing. Although you can spot their limousines at any hotel or airport, they strive to own no vehicles. Instead, they sell the limos to their drivers, help arrange financing, and use what precious capital they have to broaden the number of drivers subscribing to their reservation and booking service. Apart from preserving capital, the arrangement forces drivers to behave like owners, presumably offering better service.

A similar phenomenon pervades the fast-food industry. At the end of **1988**, **68** percent of McDonald's outlets were franchised, **67** percent of Wendy's, **57** percent of Shoney's (owner of 282 Lee's Famous Recipe Chicken outlets), and a mere **29** percent of **Church's**. Compare that to **80.4** percent for Popeye's. The point is that private companies often cannot afford the luxury of maintaining the commodity-like aspects of delivering a product or service, or of engaging in passive real estate ownership; so they shed these functions to allow for growth. In so doing, they deliver lower, but higher-quality earnings for comparable levels of consolidated business revenue.

Of course, private companies are not alone. Marriott long ago learned that it could expand more aggressively into food service, retirement communities, and new hotels by syndicating ownership of the more mature hotels to limited partnerships. And Gary Wilson, then CFO of Marriott, brought that concept with him to Disney, where he syndicated movie distribution rights to newly-formed Silverstone Partners. But while in public companies the redefinition of a business along value-adding lines typically evolves from good business judgment, in private companies it arises from the sheer need to preserve capital.

THE SINGLE BEST PERIODIC MEASURE OF PERFORMANCE IS EVA

Having said all this, how do you adjust industry P/E's to capture differences in private company structure? You can't, unless you back into the multiple by projecting and discounting future cash flows, and then divide by the company's earnings. (Why anyone would want to go through this last step is beyond me.) There are simply too many distortions to fine-tune the simplistic accounting model.

How, then, is the sparsely staffed private company to measure value creation? First, recast reported financials on an economic basis to reverse out accruals, simulate competitive levels of owner compensation, and record all capital outlays, whether or not on the balance sheet. Second, monitor a refined economic measure of income called Economic Value Added, or EVA.

EVA is nothing more than net operating profit before accruals and non-economic charges (such as amortization of goodwill), less taxes paid on that profit, and less a charge for debt and equity tied up in the business. EVA looks remarkably like what a company would report as net income if it refinanced all its equity with current-coupon debt, but goes farther in reversing out the non-economic, non-cash entries that clutter a company's audited financials. EVA is, in short, an on-paper simulation of a company's cash income after performing an LBO.

It can be shown that a company's fair market value is nothing more than the economic book value of debt and equity invested (EBV), plus or minus the present value of projected future EVA.

$$M_{V_{D+E}} = EBV_{D+E} + \sum_{i=1}^{\infty} \frac{EVA_i}{(1 + c^*)_i}$$

Where c^* is the Company's weighted average cost of debt and equity financing.

EVA has the twin virtue of being a concise periodic measure of management's contribution to net present value as well as a useful guide in evaluating investment opportunities. Because EVA is expressed in dollars rather than as a return, it encourages managers to grow their business, **provided the** new operations yield more than the carrying cost of invested capital. It also encourages efficiency, since it can be propelled upward by improving the profitability of existing investments. Perhaps more

FIGURE 1
MVA VERSUS EVA:
AVERAGES BY
GROUPS OF 25

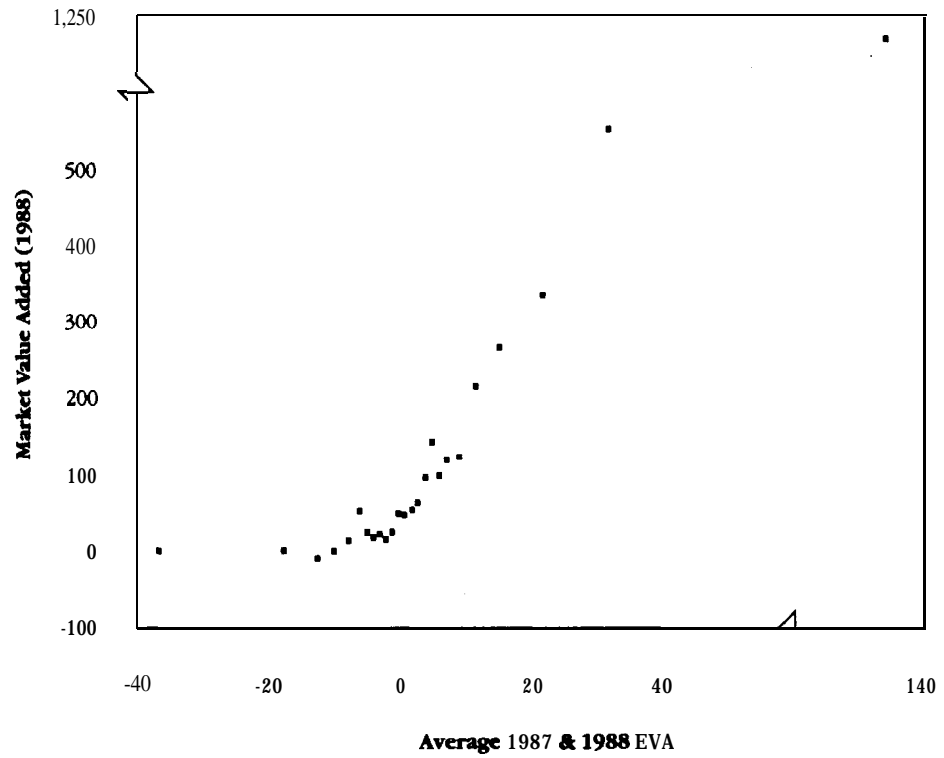
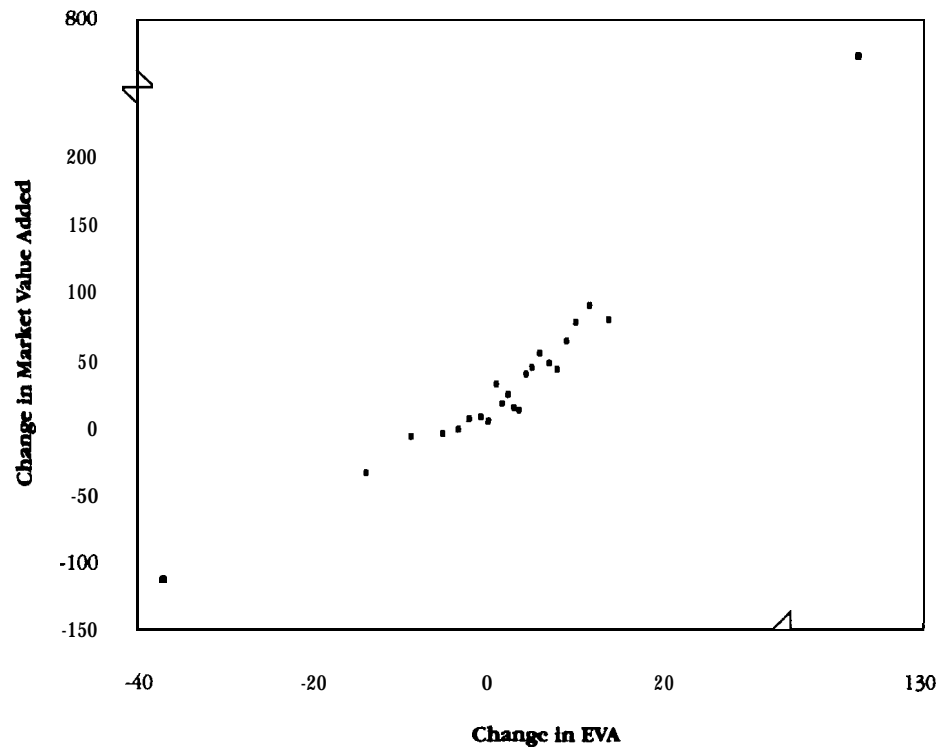


FIGURE 2
CHANGE IN MVA VERSUS
CHANGE IN EVA:
AVERAGES BY
GROUPS OF 25



Many private companies evolve over the generations into an amorphous, ill-defined mass. They begin with a profitable core business, mature, and then, to avoid taxable distributions to shareholders, reinvest in a variety of unrelated businesses.

TABLE 2
RESULTS OF REGRESSING
MVA AGAINST COMMON
PERFORMANCE MEASURES:
SAMPLE OF
467 INDUSTRIALS

Variable (Standardized)	R ²	Regression Coefficients		standard Error
		alpha	beta	
Return on Capital (1988)	0.47	-77.22 (9.86)	13.01 (0.65)	104.04
Return on Equity (1988)	0.20	33.96 (8.20)	4.62 (0.43)	127.16
Growth in Cash Flow (1984-88)	0.14	35.37 (9.17)	6.58 (0.75)	131.69
Growth in Dividends (1984-88)	0.13	31.19 (10.00)	5.55 (0.68)	132.98
Growth in Assets (1984-88)	0.10	70.18 (7.21)	2.14 (0.30)	135.09
Growth in EPS (1984-88)				

important, EVA encourages managers to revisit prior investment decisions and to redeploy capital more productively when prior investments don't cover their carrying costs.

EVA gained currency in the 1980s when raiders like T. Boone Pickens and Carl Icahn observed that you didn't have to earn a positive EVA to create significant value, you simply had to make EVA less negative. Thus, companies that sold at substantial discounts to book value were purchased, leveraged, and barred by the high cash cost of debt funds from continuing to invest in economically unproductive investments. The elimination of reinvestment risk and cross-subsidies for uneconomic activities explained a great deal of restructuring's popularity with investors during the 1980s.

That markets conform to the EVA model of firm valuation is borne out by cross-sectional research of stock price performance over the last decade. Stern Stewart & Co. recently completed its second annual survey of America's top performing companies ranked by total market value created or destroyed, net of capital retained or invested (Market Value Added, or "MVA"). Unlike conventional, size-based surveys MVA controls' for both growth *and* profitability, providing a better glimpse of who has, and has not,

created value for their shareholders. The survey also recasts traditional accounting statements into economically meaningful cash-based measures like EVA, enabling us to test how well markets measure performance.⁴

To filter out company-specific noise, Stern Stewart grouped 900 industrial companies into clusters of 25 arranged in order of MVA. We then plotted the MVA of these clusters against the average EVA of each grouping (see Figure 1). The consistency of the relationship was startling. The same strong correlation was apparent when we analyzed *changes* in MVA in relation to changes in EVA (see Figure 2). For any diversified portfolio, EVA turned out to be an extremely powerful indicator of MVA, or the portfolio's premium or discount to economic book value.

I recently extended the analysis to other measures. Returning to the sample of 900 industrials, I focused on the middle 450, where the MVAs were tightly clustered, and compared the explanatory power of EVA to more conventional performance measures like earnings per share, growth in capital, the return on capital, and even growth in cash flow (see Table 2). EVA outperformed the return on capital, return on equity, growth in cash flow, growth in dividends, and growth in assets-and exhibited

4. For a discussion of last year's inaugural study, see G. Bennett Stewart III, "Announcing the Stern Stewart Performance 1,000: A New Way of Viewing

Corporate America," *The Continental Bank Journal of Applied Corporate Finance* 3 (Summer 1990) 38-59.

TABLE 3
RESULTS OF REGRESSING
CHANGES IN MVA
AGAINST COMMON
PERFORMANCE MEASURES:
SAMPLE OF
467 INDUSTRIALS

Variable (Standardized)	R ²	Regression Coefficients		standard Error
		alpha	beta	
Return on Capital (1988)	0.35	-41.23 (7.04)	7.28 (0.46)	74.32
Growth in Cash Flow (1984-88)	0.21	14.36 (5.26)	3.08 (0.27)	81.62
Growth in Dividends (1984-88)	0.11	29.29 (5.33)	3.13 (0.41)	87.06
Growth in Sales (1984-88)	0.10	22.15 (6.06)	3.64 (0.49)	87.09
Growth in Capital (1984-88)	0.04	33.39 (6.58)	1.81 (0.41)	90.21

six times the explanatory power of earnings-per-share growth in determining MVA. I then repeated the analysis on changes in MVA and found EVA again the clear winner (see Table 3). Whether they acknowledge it or not-and indeed they may not even be conscious that their methods collectively promote this result-sophisticated price-setting investors credit companies with the level and growth in EVA, and only coincidentally with the growth in EPS.

VALUE-ADDED PLANNING FOR THE PRIVATELY-HELD COMPANY

The prescription for maximizing value? First, understand how price-setting investors assess value, and why value matters even if you're only negotiating debt terms. Second, recognize that the accounting model is a short-hand valuation tool with major shortcomings for both public and privately-held companies. Third, build capital budgeting, management incentives, and performance appraisal around EVA. And fourth, if you must compare the performance of publicly-traded peers, compare EVA. That's the economic model in a nutshell.

Decentralize!

But there's more. To truly keep tabs on value, a company should (1) separate the performance of

functionally distinct business units and divisions and (2) hold apart the issue of corporate performance from the portfolio concerns of individual owner-managers.

The first prescription-hold business units accountable for their performance-echoes the sentiments of most leading practitioners and scholars, Companies improve the odds of success by decentralizing investment decisions, decentralizing financing, and decentralizing review. Despite this, many private companies evolve over the generations into an amorphous, ill-defined mass. They begin with a profitable core business, mature, throw off cash, and then, to avoid taxable distributions to shareholders, reinvest in a variety of unrelated businesses.

What emerges is a mini-conglomerate that's difficult to evaluate in any satisfactory, piecemeal way. By monitoring the performance of each unit separately, and by partitioning as far as practicable the financing of these businesses, a private company can make considerable headway toward communicating its intrinsic value to intermediaries.

Take the case of Gates Corp. At one time, Gates was the premier manufacturer of fan belts. Charles Gates Sr. developed the V-belt in 1917 to offset the eclipsing market for horse halters and leather wheel protectors. He died in 1961, leaving behind a highly profitable tire and rubber-parts business. Rather than

How did they [KKR] accomplish this? Decentralizing debt, decentralizing ownership, and decentralizing day-to-day investment decisions--in much the same way McDonald's decentralizes financing, ownership, and decision-making in franchising outlets to its managers.

distribute idle cash, his son Charles Jr. diversified into "guest and cattle ranches, egg farms, trucking, lawn sprinklers, land subdivisions, mutual fund management and a 65 percent stake in Learjet."⁵ He explained in an article for *Forbes*: "Diversification is like drilling for oil. Sometimes you hit oil, sometimes dry holes, but you have to drill to hit."⁶ Well, perhaps.

Every such investment has since been shed. Worse, Gates lost sight of its core tire business, and was forced to divest it in 1974—a case study in sticking to your knitting and in decentralizing financing. Had Charles Gates diversified his own personal holdings by means of a financially separate enterprise, he might not have jeopardized his tire and rubber business.

Compare Gates Corp. to KKR, arguably the most successful conglomerate (and, incidentally, privately-held company) in the world. Despite occasionally being singled, KKR has amassed a portfolio of businesses that, at last measure, had combined sales in excess of \$60 billion. And it did so by diversifying into unrelated businesses devoid of scale economies or administrative efficiencies. Yet on a cash basis, KKR is immensely profitable. How did they accomplish this? Decentralizing debt, decentralizing ownership, and decentralizing day-to-day investment decisions—in much the same way McDonald's decentralizes financing, ownership, and decision-making in franchising outlets to its managers. Fit, focus, and management ownership—the watchwords of corporate restructuring—are also the fuel for stoking a private company's share value.

Just ask the Pritzker family, proud owners of Hyatt Corp., the Marmon Group, and Ticketmaster. They manufacture railroad cars, gloves, and chewing tobacco; refine copper; manage sports arenas; run credit checks for hire; lease cranes; and partially own a casino operator. They practice decentralized management:

Though *the Pritzkers essentially own everything collectively, they treat their operating companies as distinctly separate entities. "For years Bob wouldn't give us any of Marmon's business because he thought we charged too much," says Hyatt's president, Darryl Hartley-Leonard.... Edward Gill Jr., general manager of Colson Caster Corp., shares the same frustra-*

tion. "It infuriates me to see somebody else's casters on the bellman's cart at a Hyatt," he says. "But we just have to grin and bear it." The every-business-for-itself philosophy also applies to the earnings of Pritzker-owned companies. Robert Gluth, Marmon's executive vice president, says he has never seen any of the cash produced by Marmon go to support other family businesses?

How successful are they?

In its brochure for customers and employees, Marmon says its return on equity has averaged 20.2 percent since 1978. That compares with an average of about 13 percent for the Fortune 500 over the same period. Its profits of \$145 million last year were about what Hershey Foods and Cray Research earned.⁸

Beware Agency Abuse!

The second prescription is to distinguish corporate performance from individual investor performance. Stated bluntly, concentrated ownership mucks up capital budgeting.

An example: Company X has two investment opportunities, A and B. Project A costs \$10 million and is expected, on average, to yield \$1.5 million annually. Project B costs \$10 million but promises only 10 percent. Company X's after-tax cost of debt and equity capital is 12 percent.

	Project A	Project B
NOPAT	\$1.5	\$1.0
Capital Charge	1.2	1.2
EVA	\$0.3	(\$0.2)
Estimated MVA	\$2.5	(\$1.7)

The verdict? Accept Project A, and reject Project B. Simple enough.

But now suppose Company X has \$20 million of excess cash, and that there are two equal owners, owner-manager ("OM") and passive owner ("PO"). Their personal marginal tax rate is 31 percent, the corporate marginal tax rate is 34 percent, and the outside basis in Company X's stock is about zero.

5. Maggie Kirk, "Gates Corp.: Back to Knitting," *Forbes*, December 14, 1987, p. 154.

6. *Id.*

7. Ford S. Worthy, "The Pritzkers: Unveiling a Private Family," *Fortune*, April 25, 1988, p. 166.

8. *Id.*

After investing in Project A (a clear winner), Company X still has \$10 million. It has three basic choices:

1. Distribute \$10 million as a taxable dividend (after-tax proceeds: \$6.9 million);
2. Repurchase \$10 million of stock (after-tax proceeds: approx. \$6.9 million); or
3. Invest in marketable securities worth \$10 million (say, long-term government bonds yielding 8.5 percent). The inside value of the investment is \$10 million, the outside value less, but certainly greater than \$6.9 million since individual taxes are deferred until distribution or sale.

For the owner-manager, whose day-to-day expenses are limited to ongoing individual liquidity needs, it's not unusual to prefer the third option, investing in liquid securities. For PO, whose only source of livelihood is his passive investment in Company X, the preference may be for the first option, the dividend payout. To avoid an imbalance in voting strength, he will probably resist the second option, a selective stock repurchase. In addition, a repurchase may entail an untidy dispute over value. So fierce could tension become between paying out and retaining excess cash that it forces an impasse on other business issues.

Rather than disgorge scarce equity capital, OM may be tempted to invest in Project B. Its annual yield (10 percent) exceeds the government bond yield, forestalls the question of a distribution, and defers individual taxes indefinitely. And if he's ignored the first prescription of value-added planning ("Measure the performance of functionally distinct businesses separately"), he may well disguise Company X's pockets of under-performance.

The problem, alas, is that Project B's 10 percent return is not commensurate with risk.

$$\begin{array}{rcl}
 \text{Inside Value} & = & \text{EBV} \quad + \quad \frac{\text{EVA}}{c^*} \\
 & = & \$10.0 \quad + \quad \frac{(\$0.2)}{12\%} \\
 & = & \$8.33 \text{ million} \\
 \$5.75 \text{ million} & < & \text{Outside Value} < \$8.33 \text{ million}
 \end{array}$$

Because it defers personal taxes indefinitely, investing in Project B is arguably better than a dividend payout or stock repurchase-albeit inferior to investing in a portfolio of liquid securities. Still, it's

a convenient way for owner-managers to sidestep pressure for a pro rata taxable distribution. The problem with this tactic is that it's essentially rule by ignorance: tie up excess cash in illiquid operating investments and the pressure to deal with individual liquidity issues will be diffused. Stated differently, what *they* don't know won't hurt you.

What private companies overlook is that locking up excess cash in uneconomic "business" investments is a stopgap measure at best; the desire for liquidity merely festers. Had Company X addressed squarely the source of tension-shareholder illiquidity-the collective wealth of both shareholders could have been increased.

A case in point is \$2.5 billion Milliken & Co., the nation's largest and most profitable textile manufacturer. The company manufactures close to a third of the stretch fabrics used in sportswear and swimsuits in the United States, 40 percent of all acetate and acetate blends, a significant portion of the cloth used in uniforms, and 25 percent of all automotive fabrics. It is also the leader in research, state-of-the-art milling technology, and quality control. And yet Milliken & Co. has problems-big ones. The founder's grandson, CEO Roger Milliken, is locked in battle with some 200 passive shareholders *who have never seen the company's financial statements*.

The problem is this: The Strouds [dissident family members] want to maximize the value of their shares, while Roger Milliken hopes to keep the value of Milliken & Co. low enough so that when he, [his brother] Gerrish and [cousin] Minot pass on, estate taxes will not force the company to be dismembered?

To insulate himself from shareholder demands, Milliken changed the certificate of incorporation, created a self-perpetuating board dominated by outside directors hand-picked by him, installed a 75 percent super-majority rule on takeover proposals, and excluded his five children and 16 nieces and nephews from working for the company.

Make no mistake, Milliken manages operations well. His 50-or-so business units operate independently as profit centers, generating individual financial reports 13 times per year (shared only with Milliken). *Forbes* estimated 1988 profits at over \$200 million, and after-tax cash flow at over \$400 million.¹⁰

9. Alyssa A. Lappen, "Chink in the Armor" *Forbes*, November 13, 1989, p. 87.

10. Alyssa A. Lappen, "Can Roger Milliken Emulate William Randolph Hearst?" *Forks*, May 29, 1989, p. 52.

What private companies overlook is that locking up excess cash in uneconomic “business” investments is a stopgap measure at best; the desire for liquidity festers.

Still, the signs of solidarity are weakening. The company carries no debt, inflating the company’s tax bill and diverting otherwise distributable cash to capital expansion. (And though many of his competitors wish they had less debt, few would opt for none.) In addition, Milliken has begun to diversify in response to the relative scarcity of available properties in the textile industry, and also because of his unwillingness to disgorge cash through a taxable dividend or to pay anything approximating fair value in a repurchase. As an example, the company recently opened a chemical plant in Blacksburg, South Carolina that makes a clarifying agent for housewares and medical supplies—again, without consulting its shareholders.

One group of stockholders, the Strouds, sued three times to gain access to financial information. Failing that, they sold a small portion of their 15 percent stake to arch-rivals, Erwin Maddrey and Bettis Rainsford, co-founders of Delta Woodside Industries, laying a minefield for business planning and courtroom warfare.

The circumstances of the Milliken drama are complex, and not nearly as clear-cut as my numerical example. But the lesson is simple enough: Had Milliken fairly addressed the liquidity requirements of passive shareholders and taken the initiative in developing non-dilutive ways to service estate taxes (more on this later), his penchant for secrecy and diversification would have abated; he might even have changed his views on leverage.

That’s the first form of private company agency abuse—where concentrated ownership permits individual estate, tax, and liquidity concerns to depress total firm value at the expense of passive shareholders. The second form is **redistribution**—where the collective wealth of shareholders may even be increased by an unequal (and occasionally unfair) reapportionment of corporate value.

Example 1: Suppose, in the numerical example above, instead of choosing one of the four options described, that owner-manager OM distributes \$10 million to himself as additional compensation. Or, say, as the Armand Hammer Art Museum funded by Occidental Petroleum. Or the five-star American Club and world-reknowned Black Wolf Run golf (course in the Arctic tundra of Kohler, Wisconsin. Or, as was once the case with John Dorrance and Campbell Soup, providing on-site day-care facilities for all employees, furnishing extensive notice of plant closings, and forestalling necessary plant clo-

sures to preserve jobs—in short, becoming a model corporate citizen. In the example:

Tax on OM’s Additional Compensation	\$3.1 MM
Corresponding Corporate Deduction	3.4 MM
Net Value Added	\$0.3 MM

On the surface, this seems like good corporate strategy. Unfortunately, OM’s passive co-owner, PO, has borne 50 percent of the after-tax corporate cost, but shares none of the benefit.

	After-Tax Distribution	share of corporate Cost	Total
OM’s Return:	6.9	$-.5(1-34\%)(10.0) =$	\$3.6 MM
PO’s Return:	0.0	$-.5(1-34\%)(10.0) =$	(3.3) M M
Net Value Added			\$0.3 MM

Although OM and PO’s collective wealth is enhanced, there are significant adverse repercussions for non-management shareholders—repercussions which, over time, will generate a substantial minority interest discount.

Let’s consider another example: Suppose, to avoid pressure for a pro rata taxable distribution, that Company X invests in both Project A and Project B. Project B, you may recall, does not earn its cost of capital, but it does forestall the question of a taxable dividend. Suppose in this case, however, that PO is a tax-exempt charitable foundation.

For shareholder OM, deferring the tax on distribution is worth as much as \$716,667, or $1/2 \times (\$8.33 \text{ MM} - \$6.90 \text{ MM})$, even though Project B’s after-tax return fell shy of Company X’s required return. For shareholder PO, the investment represents an after-tax deadweight loss of \$833,333, or $1/2 \times (\$10.00 \text{ MM} - \$8.33 \text{ MM})$, since a ratable \$5 million distribution would have been tax-free. This is a less visible form of wealth redistribution than the first example, but one as likely over time to fuel family discord and a minority interest discount.

To summarize, as long as ownership is concentrated in the hands of owner-managers, some bloating of perks and payroll is tax-advantageous and inevitable. By the same token, controlling shareholders may find the easiest way to defer discussion of a large buyback or taxable distribution with minority

shareholders is to overinvest, thus sacrificing corporate EVA. The problem is that as ownership spreads among passive investors and descendants, the need to manage individual investments and taxes at the corporate level becomes less compelling, resulting in substantial redistributions of wealth from passive to active shareholders. Worse, second- and third-generation managers may become so indoctrinated with unbridled corporate spending and investment that it's difficult for controlling shareholders to evaluate their businesses economically, think in terms of maximizing value, or reverse uneconomic corporate behavior once the associated individual benefits recede or become parasitic. Such a path, once taken, virtually forecloses the possibility of a lofty multiple upon offering.

THE LOW-DOWN ON MINORITY INTERESTS

This path brings us, somewhat circuitously, to the subject of minority interest discounts. As a practical matter, minority interest discounts are quantified by court cases, an imprecise legal substitute for the only true test of value—a willing seller and buyer. The deliberative process is complicated by the wide choice of venues and jurisdictions (few private companies are incorporated in Delaware), the emphasis on prior precedent, and the inconsistency of applicable case law (contract law, property law, laws of descent, family law, and laws regulating trusts and fiduciaries). There are, of course, rules of thumb that practitioners use to predict outcomes.

I beseech you, "Cast them aside." Instead, let us focus on the economics behind minority interest discounts, conceding, however reluctantly, the fallibility of lawyers.

Of all possible reasons for a discount, only three are persuasive. First, minority shareholders may have less power than controlling ones to correct substandard performance (or the risk thereof). Second, there may be involuntary redistributions of wealth from minority shareholders to controlling ones. And third, there may be higher transaction costs associated with activating a minority shareholder's liquidity. All three reasons are qualified with "may." If a company manages its capital efficiently, is even-handed in divvying up spoils, and satisfies the ongoing liquidity

needs of all shareholders, there can hardly be cause for discontent. A prospective buyer would be indifferent to holding a controlling or a minority piece. At least that's my contention.

Let's consider the first factor, substandard corporate performance. Ronald Lease, John McConnell and Wayne Mikkelson conducted a study several years ago of companies with two different voting classes of traded equity—companies like **Brown-Forman** and **Wang Laboratories**, having Class A nonvoting shares and Class B voting shares. They found that the spread between trading values of voting and limited or nonvoting shares was a paltry one or two percent, despite the *de facto* minority position of the nonvoting and limited voting classes. In addition, they found that proposals to create limited voting stock were greeted by neutral, if not positive, stock market reactions, despite the concomitant "entrenching" of management-shareholders.¹¹ The implication was that, for management-held growth companies torn between diluting control with new equity or starving value-adding investment opportunities, limited voting stock offered a creative solution; no discount arose from being permitted to partner silently with management.

I recently examined a small sample of companies with unregistered voting stock and limited or nonvoting public stock. I focused on the newspaper publishing industry, where limited voting shares are commonly introduced to protect editorial autonomy. **Dow Jones**, **The New York Times**, **Washington Post**, and **Reuters** are longstanding examples of companies whose voting shares are closely held, but whose nonvoting or limited voting shares are public. Also in my sample were **Pulitzer Publishing**, **McClatchy Newspapers** and **E.W. Scripps**. On the other side of the equation were all publicly-traded news publishers with only one class of common.

Interestingly, the average trailing P/E at year-end 1988 for the limited voting issues was **19**; the average for the control group was **13** (the high and low were 20 and 9, respectively). Similarly, the average price-to-book ratio for the limited voting issues was 4.28, the average for the control group was 3.12 (high and low were 3.72 and 2.68). While it's impossible to judge whether the voting shares, if traded, would have outperformed the limited voting

11. Ronald C. Lease, John J. McConnell and Wayne H. Mikkelson, "The Market Value of Control in Publicly Traded Corporations," 11 *Journal of Financial Economics* 439-72 (1983). See also Ronald C. Lease, John J. McConnell and Wayne

H. Mikkelson, "The Evidence on Limited Voting Stock: Motives and Consequences," 4 *Midland Corporate Finance Journal* 66-71 at 68 (Summer 1986).

If a company manages its capital efficiently, is even-handed in divvying up spoils, and satisfies the ongoing liquidity needs of all shareholders, a prospective buyer would be indifferent to holding a controlling piece or a minority piece.

shares, one can surmise that the minority interest discount (if it exists) is minor.

Recent academic research relating management's percentage equity ownership to firm performance suggests that as percentage ownership rises, so too does the company's market-to-book ratio (or more precisely, its Q ratio, a close substitute)-at least up to about 45 percent ownership. After that, Q ratios tend to decline, although the pace of decline belies a substantial minority interest discount.¹² Moreover, recent research on CEO pay and performance, as well as on LBOs, supports the proposition that significant ownership spurs managers to promote their economic self-interest by maximizing the value of everyone's shares. Consequently, the greater the concentration of controlling shares-especially when operating management is monitored by a financial investor group like a KKR-the lower the risk of a minority interest discount from a lower consolidated firm value.

Of course, there are plenty of instances where management has destroyed value by entrenching themselves, but only rarely by buying a controlling piece of the equity. One need only review the SEC's research on poison pills to see that outside shareholders apprehend their adoption as a sign that their invested capital will remain underemployed.¹³ It's precisely because managers don't own a controlling stake that they may feel compelled to defend their jobs by wresting control from outside shareholders. Where managers invest heavily, they will likely preempt talk of raids by managing effectively.

What about declining Q ratios beyond 45 percent? The culprits here are the two other causes of minority interest discounts: unfair redistributions of wealth between shareholders and the higher transaction cost of liquefying investments. Neither is concerned with total company value, and only the first is concerned with its allocation.

Unequal allocations of wealth are a fact of life in private companies, motivated, in many instances, by a desire to offset personal taxes with legitimate

corporate deductions. That this makes an active investor's shares more valuable than a passive one's is undeniable. But if management, in planning for value, monitors carefully the extent of discretionary redistributions, they are in a good position to reverse those redistributions and eliminate the associated discount when negotiating with prospective investors, positioning the company to go public, or dealing fairly with minority shareholders.

The third economic justification for a minority interest discount is higher transaction costs--the search cost of finding a willing buyer. Yakov Amihud and Haim Mendelson examined seven large samples of NYSE companies, sorted on the basis of percentage trading costs. They found that less liquid stock--those with higher bid-ask spreads-earned proportionately higher rates of return over long periods of time. Such higher returns, they concluded, were not only associated with higher risk, but also reflected the added compensation demanded by investors for bearing higher trading costs.¹⁴

Of course, a controlling shareholder in a private company also faces illiquidity. But he is in a better position to assemble financial information, articulate strategy to a prospective buyer, launch a public offering, or put the company in play. Alternatively, he is in a better position to propose a recapitalization, extraordinary dividend, or major stock repurchase. The opposite can also be true. Brown-Forman's nonvoting A shares frequently outperform the voting B shares, despite identical dividend and liquidation rights. The reason is that there are more A shares traded than B shares; so their bid-ask spread, and hence cost per transaction, is lower. The point is that the more proactive a company is in addressing the liquidity needs of individual shareholders, the less important the minority interest question becomes.

To summarize, the value-added planning framework is seamless. Private companies should measure all investments against their after-tax corporate cost of capital, regardless of whether they generate excess cash. They should separate functionally distinct busi-

12. See generally "CEO Roundtable on Corporate Structure and Management Incentives," 3 *The Continental Bank Journal of Applied Corporate Finance* 6-35 at 14 (Fall 1990). See also Michael Jensen, "LBOs, Active Investors, and the Privatization of Bankruptcy," *The Continental Bank Journal of Applied Corporate Finance* (Spring 1989).

13. Gregg A. Jarrell and Annette B. Poulsen, "Shark Repellents and Poison Pills: Stockholder Protection-From the Good Guys or the Bad Guys?" 4 *Midland Corporate Finance Journal* (Summer 1986) 39-47; also John A. Pound, "Takeover Defeats Hurt Stockholders: A Reply to the Kidder Peabody Study," 4 *Midland Corporate Finance Journal* (Summer 1986) 33-38.

14. Yakov Amihud and Haim Mendelson, "Liquidity and Cost of Capital: Implications for Corporate Management," 2 *The Continental Bank Journal of Applied Corporate Finance* 65-73 (Fall 1989). They tested the hypothesis that higher bid-ask spreads, and therefore lower after-transaction-cost returns, would explain seeming deviations from the risk-return tradeoff. They measured incremental transaction costs (the added appreciation an investor would need to remain indifferent between holding a relatively illiquid stock and a relatively liquid one) as the sum of the incremental trading costs from all projected future transactions, discounted to present value, since subsequent buyers would face the same dilemma. Their findings were supportive and statistically significant.

nesses into distinct legal entities to assure accountability and enhance flexibility. If possible, they should decentralize debt financing by business unit, preferably nonrecourse to other units and the parent. Above all, they should measure and reward EVA. But beyond this, private companies should assess periodically the extent to which they recharacterize returns as expenses to avoid taxes; and they should be prepared to forgo these in a post-IPO environment. Finally, to the extent possible, they should decentralize *equity* financing-in effect, by making separate businesses stand on their own. Only by following the steps logically associated with maximizing value will they coincidentally cure the minority interest discount.

SURVIVING GENERATIONAL TRANSFERS

There are other benefits of value-added planning. For one, it improves the prospect of surviving the second and third generation. Isn't it curious, only one-third of all generationally transferred private companies survive the second generation; only one-sixth survive the third? Of course, some attrition is inevitable because of fecundity, family feuds, splintering of fortunes, or plain bad luck. This article offers little comfort for the Rockefellers, whose 75-plus members are down to the "Cash Out Generation."¹⁵ Or for the several hundred fourth-generation Bacardis, who run their company as "a loose confederation of seven or eight semi-autonomous distilling and marketing concerns."¹⁶ Or for Roger Milliken, who never saw fit to induct his children or relatives into management.

Frequently, generational transfers fail because they leave the successors marooned, bereft of any guiding principles other than bigness and inertia. It's little wonder that so many private companies founder in the absence of an elder statesman or central authority (witness the impact of John Dorrance's death on Campbell Soup). By separating core operations from "portfolio" investments, developing rigorous tests of financial performance like EVA, and constantly revisiting whether diversifying investments justify the after-tax required returns of constituent shareholders, a company can install a series

of focused, manageable controls for grooming better managers, resolving emerging disputes, and recruiting and retaining professional managers.

Compare S.C. Johnson & Son Inc., makers of Johnson Wax, with the megalithic Gallo Winery of Modesto, California. Although Gallo's performance has been spectacular, it is a management debacle in the making. Despite surrounding themselves with Ivy Leaguers and MBAs, Julio and especially Ernest have been loathe to share information. One former marketing manager lamented that, "Ernest wouldn't tell anyone the cost of raw materials, overhead, or packaging....*I never saw a profit-and-loss statement.*"¹⁷ In consequence, management turnover is rife, and few have persevered into the ranks of "middle management." The biggest fear is that control will pass to Ernest's sons-neither of whom has actually managed a business.¹⁸

Contrast this with the decentralized, open, but financially demanding approach of SC. Johnson. To provide liquidity for passive shareholders, Sam Johnson in 1985 led management and a group of family members in a leveraged buyout of the recreational gear business from Johnson's core consumer products business, thus freezing cross-subsidies and forcing the distributor to increase cash flow. He brought the new company public shortly before the October 1987 market crash to increase liquidity further, and thus gained valuable feedback as to the quality of investment decisions--all without touching his core wax business. In addition, he has carved out well-defined business units for each of his four children and generated an environment conducive to a smooth succession. By making a serious independent commitment to the recreational gear business, backed by the offer of independent stock ownership, he has also recruited *and retained* an impressive cadre of professional managers.

Johnson also improved the company's ability to service estate taxes. By unbundling operations, the company broadened significantly the family's alternatives to selling partially or leveraging the estate's holdings in the wax business. He's also expanded the company's overall debt capacity by running operations efficiently, setting demanding financial targets, and decentralizing financing.

1986, pp. 26-38 at 26. "The Rockefellers: End of a Dynasty?" *Fortune*, August 4,

16. Michael Ozanian and Tina Russo. "Private Enterprise," *Forbes*, December 14, 1987. pp. 150-151 at 151.

ber 1, 1986, pp. 26-38 at 26. "How Gallo Crushes the Competition," *Fortune*, September 1986, pp.

18. *Id.*

By unbundling stock units, passive shareholders don't have to sell hard-to-value equity securities to activate liquidity, companies don't have to increase corporate leverage, and controlling shareholders don't have to surrender votes to service individual estate taxes.

But what if, as in the case of Milliken & Co., the businesses are not logically divisible? Just as the value-added planning framework preaches decentralized (or unbundled) business units, it endorses unbundled stock units. Shearson made an ill-fated attempt to popularize unbundled stock units (USUs) for public companies; but it should instead have focused on where they're needed—in the capital constrained privately-held company.

Briefly, unbundling a stock decomposes the instrument into two or three distinct parts: a yield portion (or portions) plus a warrant. Structured properly, the recapitalization leaves intact the aggregate amount of cash disbursed annually by the company to investors, but provides shareholders with a repository of easy-to-value installment notes or preferred stock which can be redeemed or sold with little dispute as to value. More important, activating liquidity does not dilute control, since votes (and appreciation) stay embedded in the warrants. Finally, the recapitalization is tax-free with respect to warrants and preferred stock, and, unlike a public company, tax deferred with respect to any installment notes.

Unbundled stock units are the extension of decentralized *corporate* planning to *individual* planning, a way of accommodating capital structure preferences to the requirements of individual shareholders. While redundant and thus unnecessary in the public markets, where shopping ensures a match between the financial preferences of investors and the financial policies of issuers, there is no lateral freedom for the private company. By unbundling stock units, passive shareholders don't have to sell hard-to-value equity securities to activate liquidity, companies don't have to increase corporate leverage to accommodate shareholders (although some portion of a company's common stock dividend may be reclassified as an interest payment on installment

notes), and controlling shareholders don't have to surrender votes (or appreciation potential) to service individual estate taxes. More significantly, **owner**-managers can put income in the hands of their children without violating the remaining restrictions against estate tax freezes and without surrendering control prematurely. One need only observe Leonard Shoen, ensnared in the most brazen family battle of our day, to know that he should have waited before deeding 98 percent of U-Haul's voting stock to his sons. A clear case for unbundled stock units and/or limited voting stock.

CONCLUSION

Private companies frequently bemoan their inability to extract full value from the public and private capital markets despite vigorous efforts to "reposition" their accounting practices and reported earnings. The very practice, however, betrays a fundamental misconception about the way **price**-setting investors evaluate securities, one which was pervasive among public companies during the 1970s, but largely corrected by the surge of restructuring activity in the 1980s.

If we are to learn anything constructive from that transition, it is that:

- Investors go far beyond earnings in evaluating performance;
- The best determinant of value creation is EVA;
- Investors demand accountability by business unit, in the form of debt and equity decentralization; and
- Even small and private companies operate more effectively when their managers have direct or indirect leveraged stakes in the units they manage. Managing with these principles in mind and understanding the benefits of unbundling will go a long way toward maximizing the value of a private company's shares.

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