Financial incentives resolve the shareholder-value puzzle

by Patrick T. Finegan

As Congress debates the merit of sweeping antitakeover legislation, one fact rings clear: financial restructuring is more than a device for fending off hostile suitors. Leveraged buyouts, recapitalizations, spinoffs, split-offs and partial public offerings have become valuable, proactive tools for unleashing hidden (or repressed) shareholder value.

One need only observe the market's reaction to FMC's 1986 recapitalization (21.6% appreciation upon announcement) or IC Industries' spinoff of the Illinois Central Gulf Railroad from its core soft-drink bottling business (17.5% gain) to find systematic shareholder support for reexamining the capital structure, resource allocation and competitive decisions of corporate America.

Tax benefits aside, **restructurings win plaudits because they stimulate reexamination of fundamental financial and strategic policies in light of the competition for (and high carrying cost of) invested capital, not just competition for business. And they require** management to **follow up on its reexamination with improved operating efficiency, plant manage**ment and, in many **instances,** market penetration.

As one example, **compare Chicago-based FMC's average perfor**mance in the **five years before re**capitalizing, to its **performance** during the three years after. Gross margins improved from 22.9% to 25.6%; net operating margins from 7.7% to 9.8%. **While inventory and** receivables grew slightly (from 85 to 89 days). they were more than offset by a **rise in** payables and accruals (from 88 to 122 days).

FMC's free **cash flow** (cash flow from operations after reinvesting in plant and working capital) leapt from $256 million to $315 million annually.

Moreover, after a brief interval of product redefinition and rationalization, FMC seems better positioned for growth in its core machinery and chemicals businesses than before recapitalizing. Sales were up 4.5% in 1987 and 4.7% in 1988, and are projected to increase 9.5% in 1989, according to Value-Line. Sales showed a 1.3% average annual *decrease* in the years before the recap.

As well as any company, FMC has unleashed the motivating and disciplining force of **restructuring** and rewarded shareholders accordingly. FMC's average return to stockholders since recapitalizing (dividends plus capital **appreciation,** *excluding* the $80 a share distributed as part of the exchange **offer) exceeded 24.2% from May 30,** 1986, to June 30, 1989. The **S&P** returned 12.2% over the same **period. Prior to the recap, FMC returned only 16.5%.**

Value of incentives

What restructuring boils down to is a keen, growing awareness by price-setting investors of the importance of direct and indirect in**centives.** (Direct incentives are tied directly to stock value: indirect **incentives** are tied to proxies like cash flow, operating income, earnings growth, return on capital, etc.)

Direct incentives are most **effective** at the highest levels, where the **link** between management **decisions and** stock price is most **visible. At** the business unit or operating level, **more weight** should be given to divisional proxies like operating profits, return on capital and, best of all, economic value added.

Together, direct and indirect incentives account for, much of the success of recent financial restructurings. Almost all motivate a push for **share value** appreciation by giving management a compelling **pecuniary** obligation to the company. Most do this **by asking** management to buy stock.

Flawed options

Notice that I did not **say stock** *options,* even though most **companies** today boast some kind of in**centive** stock option plan for **executives** (or. like Pepsi, **even** for the **rank** and file). Few companies, relying on options alone, have **experienced** the dramatic value **enhancement** generated by a **leveraged** buyout or recapitalization.

Of 23 prominent, successful recapitalizations that occurred between May 1984 and October 1988, ***all*** had stock option plans in place before their recaps. Yet the average exchange offer package exceeded preannouncement stock prices by 47%. The **empirical evidence** is **consistent: if** stock options motivate, they do so weakly, **and they can lull** managers into a false **sense of** kinship 'with outside **investors.**

Options fail to work because they **seldom require up-front** cash commitments **from** participants. Very few employers went as far **as Chrysler in** the early **1980s and** substituted options for wages. (Witness Lee Iacocca's $1 salary for 1980 versus Roger Smith's $275,000.) Options capture only one facet of ownership-the thrill of victory. The agony of defeat is left for outside stockholders.

Some companies rig the game

further by issuing reprieves for inopportune timing. Businessland, for example, didn't let Black Monday spoil its party: it exchanged options granted before Oct. 19 at between $12 and $16 a share for post-crash options exercisable at 6 7/8 per share. Outside shareholders wound up footing the bill, yet did not receive a comparable reinvestment opportunity.

Stock purchase plans, on the other hand, provide both a carrot and a stick by placing employees' cash purchases at risk of capital loss for as long as they participate in the plan.

Nor are options cheap. A typical five-year. at-the-money warrant is worth, on average, 25% to 35% of the underlying stock's trading value. Yet because the plan's cost to stockholders takes the form of diverted share -appreciation; managers and directors frequently view it as costless.

Share pain and gain

Option plans are not inherently bad, but to be effective, managers must exchange something of comparable value: wages, benefits or employee notes. In addition, the exchange should be significant enough to cause real pain in the event of failure: the idea is to make managers genuine stockholders, not just custodians.

One solution is for managers to buy, at fair market value and on high margin, a substantial amount of newly issued stock, financed by the cash contribution from management (perhaps matched by the company), plus a note to the company for, say, nine times the initial cash investment, secured by the contribution, stock and subsequent dividends.

Because management buys on margin, each rise or fall in share price is amplified approximately 10 times.

This is how Red Scott motivated the management of Simplicity Pattern after Intermark acquired the company in 1987 and how Mike Dingman motivated the management of Henley Group after its initial public offering and disposition by Allied-Signal.

Interestingly, Henley's plan was approved by 95% of its stockholders and was greeted with an 8.5% appreciation on announcement. Henley was so pleased with the experience that it repeated the plan at the divisional level by creating limited public markets (and leveraged equity purchase plans) for subsidiaries Fisher Scientific. Henley Manufacturing and Wheelabrator-Frye.

Though the units that made up Henley originally were dubbed "Dingman's dogs" because they had been such poor performers for Allied-Signal, these dogs have become respectable stock market performers. In its first three years, Henley's stock, adjusted for spinoffs, has risen 12% annually, nearly matching the total return (dividends plus appreciation) of the market. With management levered at 9: 1, incentives were substantial.

Leveraged incentives

The prime attribute of leverage is that it accentuates the power of direct and indirect incentives by amplifying feedback. For a company which compensates managers on the basis of earnings, leverage makes explicit a substantial portion of the carrying cost of capital.

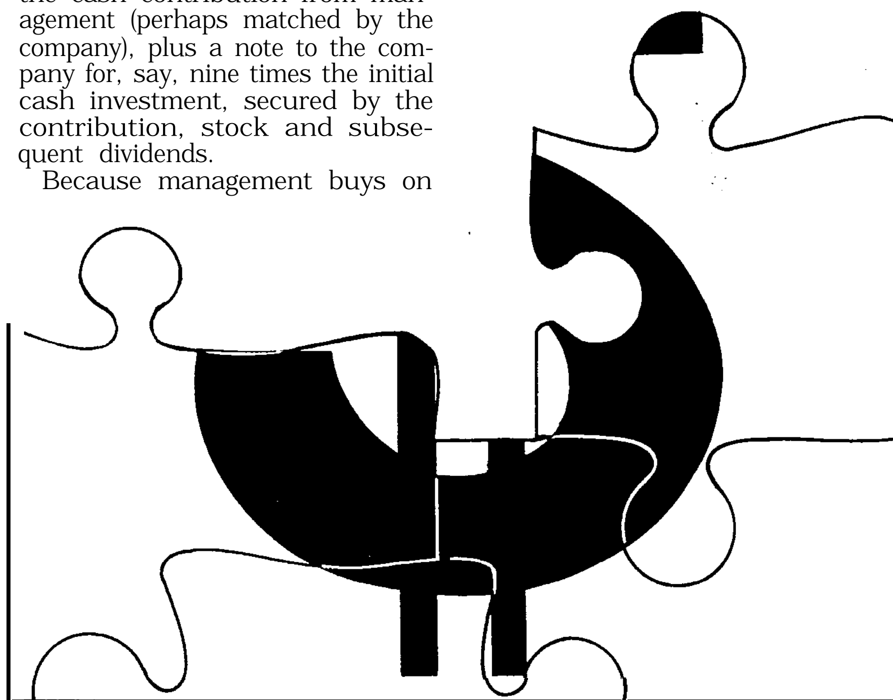
Leverage can be effective at both the individual and corporate levels. At the individual level, it permits high-growth, start-up, turnaround and already highly levered companies to enjoy the motivational stimulus of an LBO without curtailing growth or financial flexibility. At the corporate level, it threatens insolvency and job loss for those companies which fail to earn satisfactory returns.

Concern that the LBO market is mature and that leverage candidates are running low is-in many ways misguided. Opportunities for *'corporate'* leveraging may be getting thin, but the supply of companies that would get a boost from individual leveraged stock incentives is virtually inexhaustible.

There's an added bonus: such individual plans need not cause change of control. Henley's plan, for example, involved only 5% of outstanding shares. Since management shares are repossessed and retired as loan collateral if performance fails to improve, outside stockholders do not risk dilution, management does not become entrenched and raiders are not kept from pursuing an otherwise attractive acquisition. Management wins only by improving operating efficiency and thereby raising stock prices.

And because outside stockholders reap the benefits of leveraged incentives without tendering or exchanging a portion of their shares, as they would in a corporate transaction, their after-tax returns should be higher.

Additionally, where the company finances individually leveraged incentives, debt service costs can be indexed to the stock prices of a group of competitors to filter out industry trends and events beyond management's control. This encourages managers to put normal fluctuations in the stock market in perspective and concentrate instead on outperforming a portfolio of competitors.



The leveraged recap

Far more common than individually leveraged stock incentives is the leveraged recapitalization or **cashout.** In essence, a recap replaces outside equity with debt, thus increasing the concentration of equity held by managers and di-

rectors without triggering a change in control.

Such diverse companies as **Union** Carbide, Multimedia and Phillips Petroleum have used them, and they now constitute a potent defense against hostile activity. Of the 18 defensive recaps attempted between April 1985 and October 1988, 56% were successful, compared to 54% of the **LBOs** attempted during that period.

In cases where there was no prior offering or 13D filing, the **success** rate was 100% (11 of 11). Among similar **LBOs** (including RJR/Nabisco), only 57% succeeded.

One reason recaps have outscored **LBOs** is price. The average estimated premium of cash, notes and stub shares has been an impressive 147 % of **pre-announce**ment stock trading value, while the average **LBO** premium has been only 132%.

The disparity arises primarily from cutting out the wedge of value demanded by third-party mezzanine financiers and from preserving access to the capital markets in the event of financial duress.

Furthermore, recapitalizations are partially elective. Dissatisfied outside investors can always hold onto their equity stake by reinvesting the cash payout in stub shares (albeit in an after-tax transaction). Or they can **keep approximately** the same **risk-return profile** by using the cash to **buy the** junk bonds used to fund the payout.

The **combination of** the highly leveraged stub **shares** and relatively low-risk **junk bonds** should come **close to equaling** the underlying risk **of stockholders'** original equity. **Thus the recap** is intrinsically **fairer.**

The success of recaps at the bargaining table is overshadowed by their **success at the** operating table. **Post-recap audits of** three mature **deals—Multimedia, Owens**-Corning Fiberglas and Holiday Corp.-corroborate the FMC experience. Across the board, margins, plant utilization, working capital efficiency, returns on capital and operating cash flows have improved, sometimes dramatically. (See "Performance of recapitalized companies.")

While expansion may be sidelined temporarily, growth rates after the rationalization period seem to have improved.

Why pay **cash** bonuses at all?

Performance of recapitalized companies

	FMC	**Multi media**	**Owens-** coming Fiberglas	Holiday Corp.
Gross margin				
5 years preceding recap	22.9%	60.4%	21.2%	17.4%
Recap to present	25.6%	61.8%	26.3	23.7%
Net operating margin				
5 years preceding recap	7.7%	27.1%	5.1%	17.3%
Recap to present	9.8%	31.0%	12.9%	23.3%
Net working capital DOH •				
5 years preceding recap	14	37	39	**-3**
Recap to present	-6	13	44	**-5**
Fixed assets/sales				
5 years preceding recap	42.8%	104.5%	38.8%	111.3%
Recap to present	48.2%	84.0%	29.4%	103.6%
Sales growth				
5 years preceding recap	- 1.3%	17.9%	7.7%	-0.2%
Recap to present	0.3%	9.6%	-5.0%	0.2%
1989 to 1993 (Value-line estimate)	6.0%	5.0%	4.9%	2.4%

•Excludes marketable securities and short-term debt.

Why not rely solely on margined stock purchases by managers and aggressive corporate leveraging (borrowing when you can, not when you must)? Unfortunately, simply owning stock does not create a keen understanding of what drives stock prices.

To ensure effectiveness, such direct incentives should be combined with indirect incentives that reward management for strengthening the underlying determinants of share value.

Contrary to industry convention, the best measures of corporate performance are not earnings growth or return on investment. If anything, earnings-based **incentives** probably are the worst since they-encourage managers to invest in anything that can yield more than the company's after-tax cost of **borrowing** (typically **6%-7%).**

The carrying cost of equity (often two or three times that amount) is **forgotten.** But the market **recog**nizes and penalizes inadequate returns with a low multiple, opening the door to corporate raiders.

Compensating managers for enlarged earnings is like paying basketball players for points scored: everyone becomes a gunner, and the team loses, 140-120. What's missing is the cost of squandered opportunities-not passing off the ball in order to get a better shot. In short, ROI.

Yet measuring performance by shooting percentage is hardly an improvement. Then each player takes the lay-ups or passes off, reluctant to dilute his shooting percentage by attempting harder shots. The team loses 90-10. To summarize, profitability without growth does not win the contest for a high stock price.

A comparison of Marriott Corp. and Hilton International is instructive. Marriott has returned, on average, 21.3% to shareholders between 1982 and 1987. Hilton, now a prime takeover candidate, returned a mere 12.8%. Yet Hilton consistently returned more on capital during this period: 20.0% to Marriott's 13.5%.

The difference lay in investment strategy. Marriott reinvested 130% of its operating earnings in plant, property and working capital for its hospitality, food service, retirement communities and related service lines of business. Hilton reinvested only 66%.

The aggressive reinvestment in somewhat diversified businesses took points away from the return Marriott could have earned in the hospitality business alone, but investors were left with more than they reasonably could have expected to earn elsewhere, and, most important, Marriott was earning well on a much larger capital base.

The point is that return on existing capital is an irrelevant benchmark for testing the worthiness of new opportunities. What matters is that **incremental** capital earn more than investors could earn elsewhere in securities of comparable risk.

Both logic and evidence suggest that the best measure of share

value creation is economic value added (EVA). Unlike earnings or ROI measures alone, EVA combines the three determinants of a company's value:
- Growth,
- Profitability and
- Return on capital employed.

It is calculated as the spread between the return on capital and the cost of capital, multiplied by the total amount of capital tied up in the business. Basing performance evaluation on EVA accomplishes three things:
- It improves the efficiency of capital already employed.
- It commits new capital to projects where the rate of return exceeds the cost of capital.
- It liquidates or redeploys capital from underperforming operations.

EVA states by formula what LBOs imply through releveraging-that the carrying cost of debt and equity capital must be recouped before the size of the company's economic earnings (not accounting earnings) can be assessed.

Applied Power's stock price since it began compensating managers according to EVA bears out the similarity between EVA and LBOs as motivators. The company has seen stock appreciation of 58.1% since its IPO in August 1987, compared to 2.8% for the S&P 500.

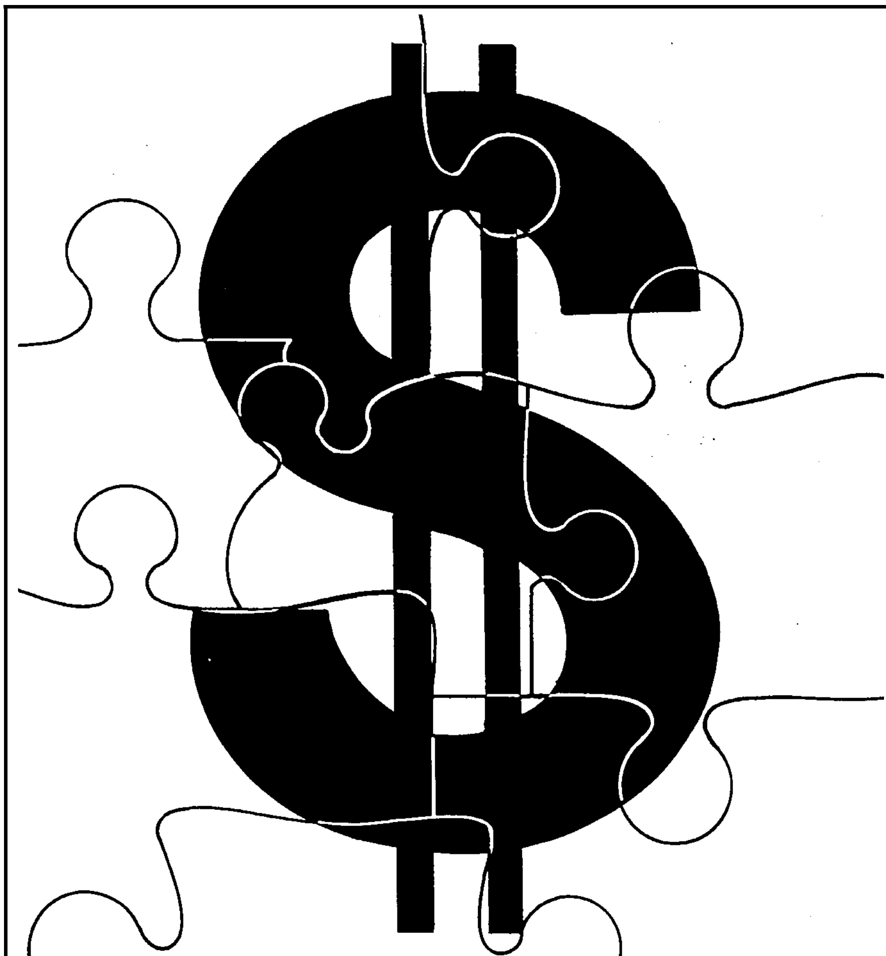
Furthermore, EVA can measure performance at both the corporate and divisional levels, and it is easy to track periodically.

Blocking irrelevant factors

Not all changes in EVA or stock price are attributable to managerial performance, of course, and it is important for incentives to filter out exogenous factors. One way to refine stock ownership is to measure performance against the stock price appreciation of an index of comparably risky industry competitors.

Unlike conventional stock options, a compensation plan based on relative stock price performance ensures that macroeconomic events like Black Monday are reflected in the performance benchmark and do not inappropriately increase or decrease management's reward.

It simply refines the EVA concept, where the return on capital is the employer's stock price return and the cost of capital is the return stockholders forsook by not investing in a portfolio of comparably risky companies.



Once a true framework for value-oriented compensation is adopted, caps and floors become unnecessary and contradict the notion that managers are partners in value creation. The potential for extraordinary bonuses should always exist, as should the potential for extraordinary losses.

Of course, this only works if managers are committed to serving the long-term interests of investors, if they don't depart after artificially priming results or riding a wave of temporary good fortune.

Therefore, awards should not be paid entirely in the year in which they are earned. A substantial amount should be "banked," with payment contingent on continued high performance. This way an employer really can demand his money back if bonuses prove to be unjustified.

The bank is essentially a phantom share with periodic dividends and the possibility of substantial capital gain or loss on the undistributed portion. The deferred portion is, in effect, a money-back guarantee, as well as a golden handcuff.

This, in conjunction with a benchmark of relative stock performance, dampens the impact of economic cycles and rivets management's attention on maximizing long-term share value.

In conclusion, most financial restructurings embody powerful motivational tools. Yet they may be inappropriate in many high-growth, start-up, turnaround or already highly leveraged contexts. The incentives still are available, however, on the individual level—directly through leveraged stock purchases or indirectly through an uncapped, unfloored cash bonus plan based on relative EVA and banked awards.

By using these incentives proactively, companies can divert the pressure from corporate raiders and diffuse the fury of Congress over corporate takeovers. □

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