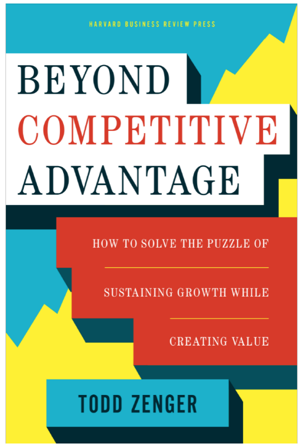
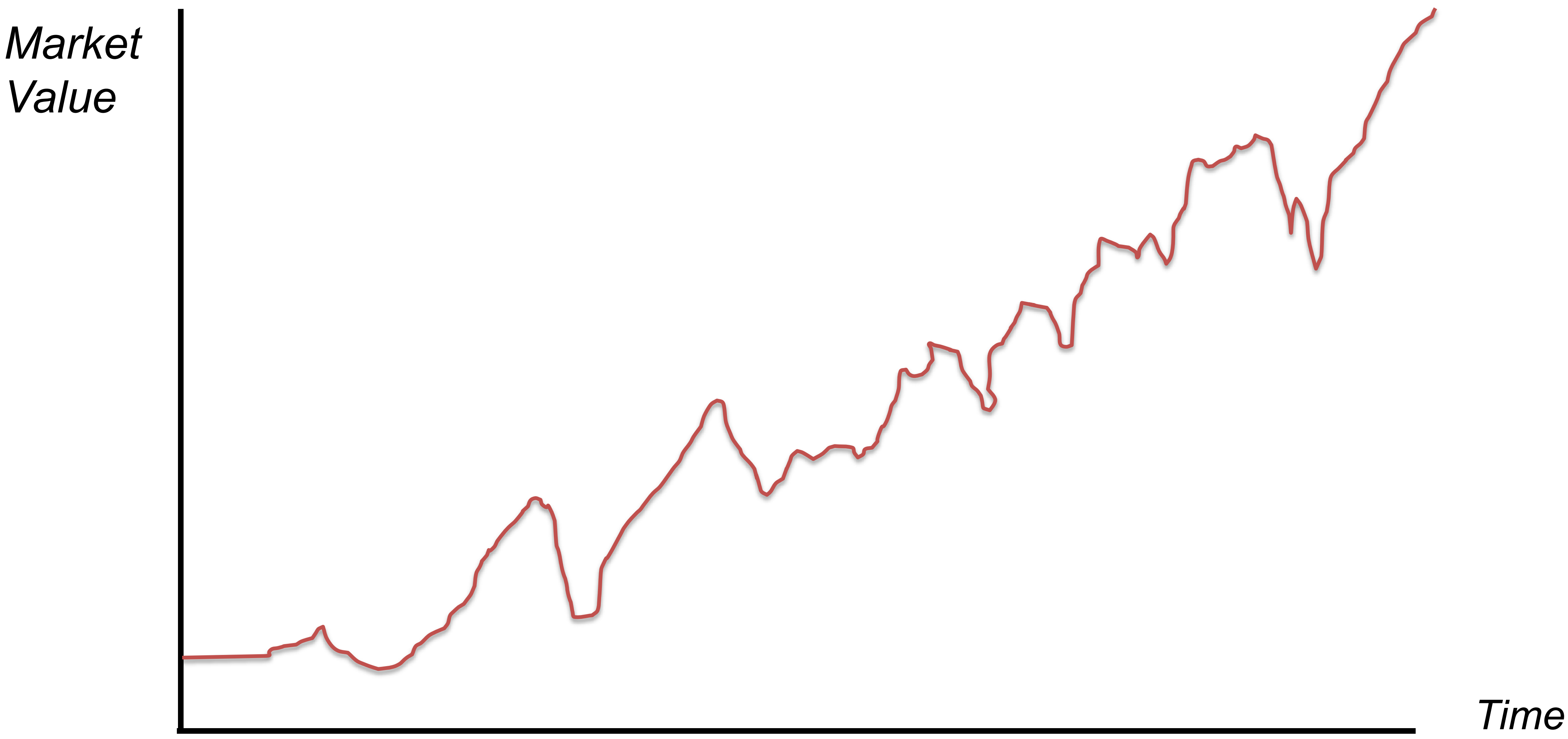
Strategy & Capital Markets: Contrasting Perspectives on Value Creation

(Chapter 3)

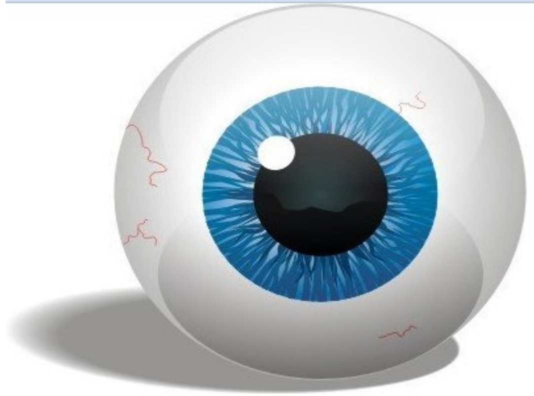


SUSTAINING VALUE CREATION

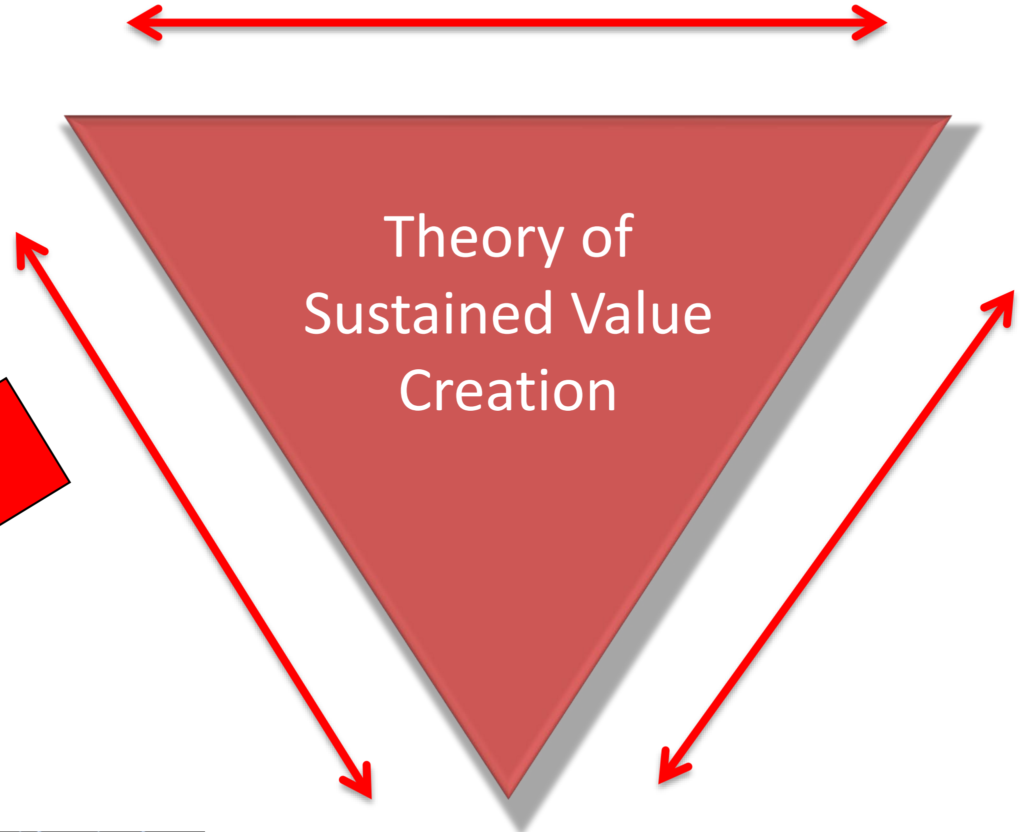


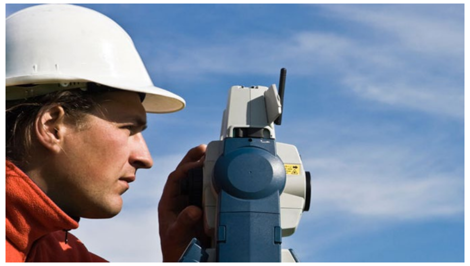
A Corporate Theory

Foresight regarding evolution of industry, demand, technology, and customer tastes



Cross-sight regarding synergies among available assets, resources, and activities





The need for financing ensures that most managers own only a minority of the corporations they operate

Insight regarding sustainably unique assets, resources, and activities within the firm

WHO SHOULD DETERMINE STRATEGY?

PEPSICO

PEPSICO SNACKS

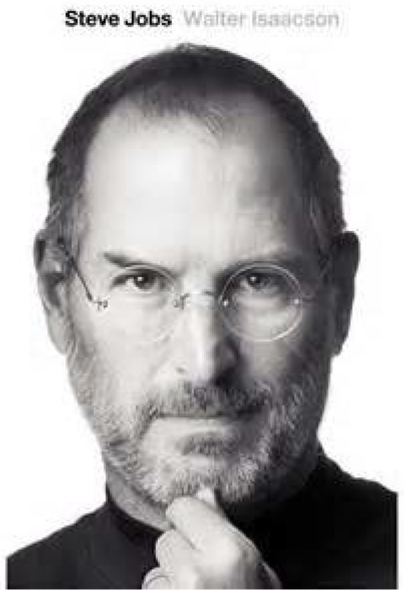
PBC

PEPSI BEVERAGES COMPANY

VS

Who should determine strategy?

vs.



Kraft seeks to acquire Cadbury 2009

Kraft share price declines

KRAFT'S BREAKUP

A Closer Look at the Brands | Global revenue for the split companies

GLOBAL SNACKS: $32 BILLION

The plan: Give investors a growth stock that focuses on developing markets, where sales of snack food are increasing.

Other products include: Trident gum, Jacobs coffee, Tang powdered beverages; LU biscuits; Milka chocolates

NORTH AMERICAN GROCERY: $16 BILLION

The plan: Create a slower-growth, high-yield stock that invests in new products and marketing for well-known grocery staples.

Other products include: Philadelphia cream cheese, Miracle Whip; Capri Sun beverages; Jell-O

The problems

The investors

Pershing Square Capital Management's **William Ackman**, right, owns 1.3% of Kraft

Nelson Peltz holds less than 1% and Warren Buffett holds 6%.

The future

Hammering out structure, management and governance is expected to take a year or more. The spinoff also needs a favorable IRS ruling. It's unclear what role **Irene Rosenfeld**, current CEO at left, will have after the spinoff.

Sources: the company; WSJ Market Data Group; WSJ reporting; Bloomberg News (product photos), Reuters (Ackman, Rosenfeld)

KRAFT-CADBURY-SPINOFF

- “In our opinion, Kraft's motivation leans more toward unlocking a higher multiple for the faster-growing snack business that was being unappreciated when combined with the more mature North American grocery brands.”

-- Erin Nash, Morningstar

FIGURING OUT THE GAME

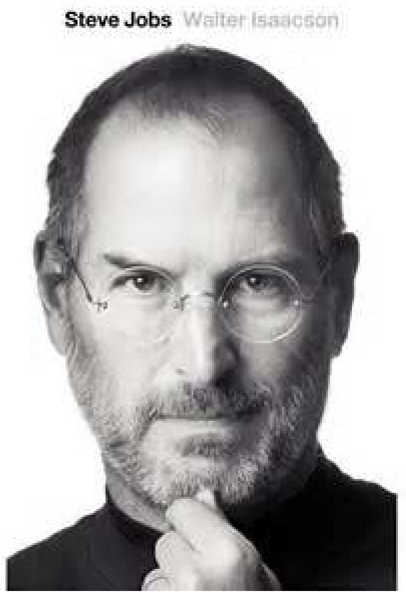
- Hedge-fun noodge Bill Ackman already made a tidy sum on the breakup of Fortune Brands, and on his efforts to shake up J.C. Penny. And it now appears he has struck gold again with Kraft. Ackman's Pershing Square Capital was among the pushy Kraft investors who had pushed for a split-up for the parent company of Oreos, Velveeta and Oscar Mayer reported our Deal Journal colleagues. Kraft yesterday announced plans to do just that in an effort to "unlock value" in the company's stock price. (Where is all this locked up value held?)"

-- Shira Ovide, WSJ, Deal Journal

QUESTION?

- Who is in charge of Kraft's strategy?
  - The CEO
  - Investors
- What is the optimal path to value creation?

vs.



FINANCE: VILLAINOUS MANAGERS AND GENIUS MARKETS

Managers

- Lazy
- Deceitful
- Greedy

Capital Markets

- Efficient
- Void of incentive problems

$

- *Solve the moral hazard problem*
- *Increase transparency*
- *Maximize information disclosure*

STRATEGY: LAZY MARKETS AND CLAIRVOYANT MANAGERS

Managers

- *Well-intentioned*
- *Creative*
- *Searching*

Capital Markets

- Lazy
- Myopic
- Rife with incentive problems

$

- Solve the adverse selection problem
- Find patient money

THE WISDOM OF THE MARKET

- Markets and prices provide advice concerning optimal investments.
- Remarkable accuracy of non-expert, collective judgment
- Wisdom of crowds relative to experts (Surowieki)
  - Independence
  - Private information
  - Efficient Aggregation

PREDICTING FAULT WITH CHALLENGER DISASTER

Table 1
Daily stock market behavior around the challenger crash

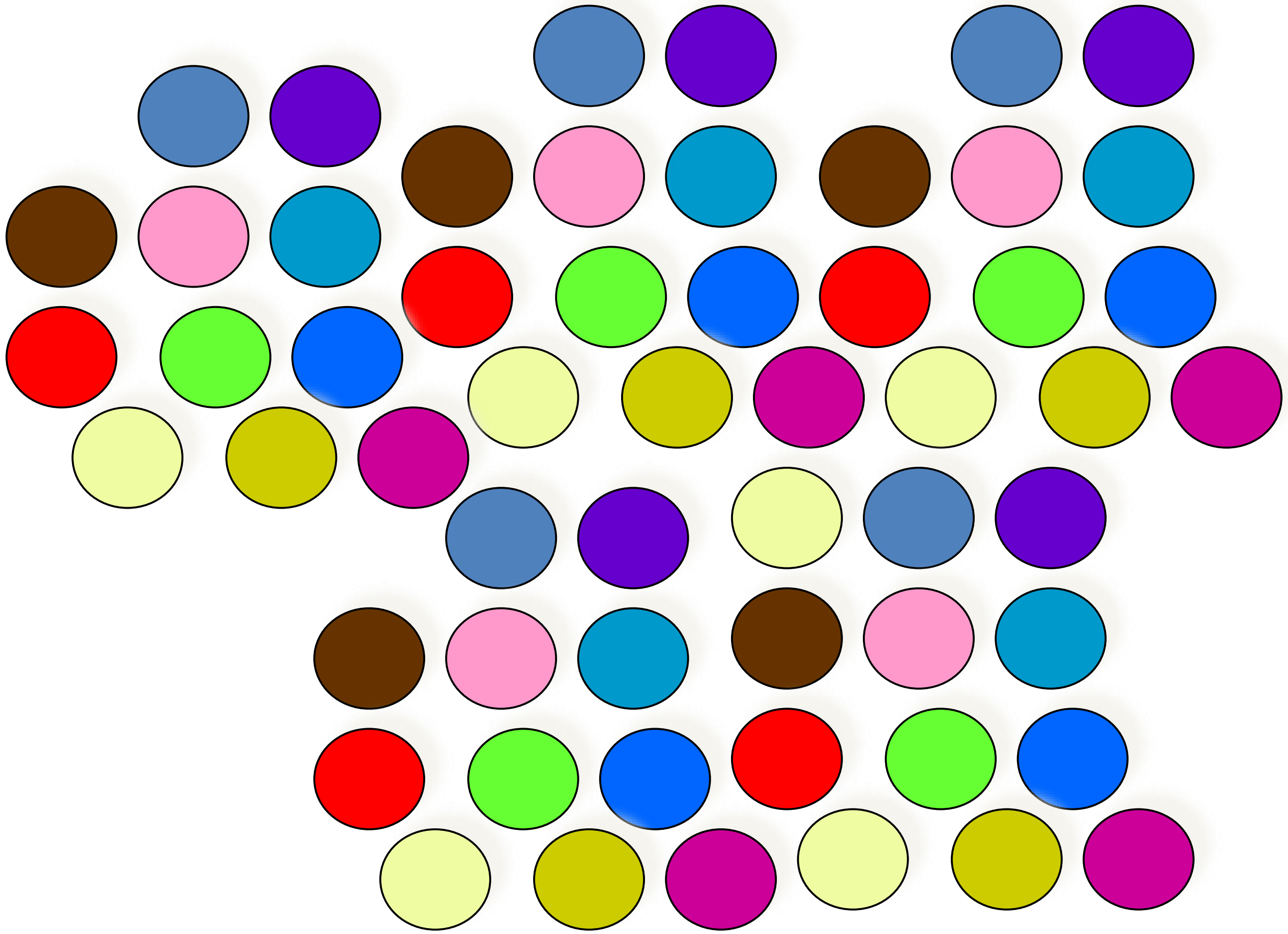
Variable	Morton Thiokol	Lockheed	Martin Marietta	Rockwell International
Panel A. Daily stock returns				
January 28	−11.86%	−2.14%	−3.25%	−2.48%
3-Month average	0.21%	0.07%	0.14%	0.06%
3-Month standard deviation	1.86%	1.36%	1.79%	1.79%
Z statistic	6.49	1.63	1.89	1.42
Panel B. Daily trading volume				
January 28	1739.9	667.5	446.2	563.2
3-Month average	100.5	347.9	199.9	221.2
3-Month standard deviation	59.5	159.4	136.5	117.1
Z statistic	27.57	2.00	1.80	2.92

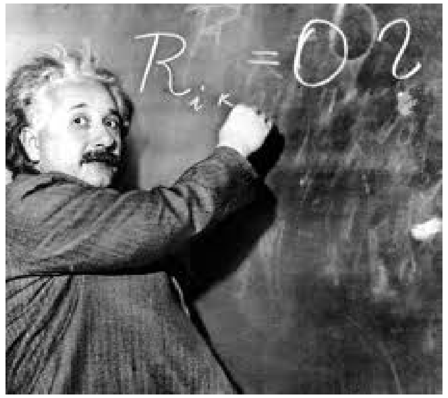
This table compares the stock returns and trading volume of the four major space-shuttle firms on January 28, 1986, the day of the Challenger crash, to averages of the same variables in the 3 months (October 28, 1985 to January 27, 1986) prior to the crash. Trading volume is in thousands of shares. Z statistics test the null that the observation on January 28 equals the average from the prior 3 months. Data are taken from the *S&P Daily Stock Price Record.*

WHAT IS STRATEGY IN FINANCE?

- If you just fix CEO incentives to respond to what capital markets say, then CEOs will choose high quality strategies.
- If you fail to resolve incentives, managers will adopt low quality, self serving strategies.

STRATEGIC PERSPECTIVE

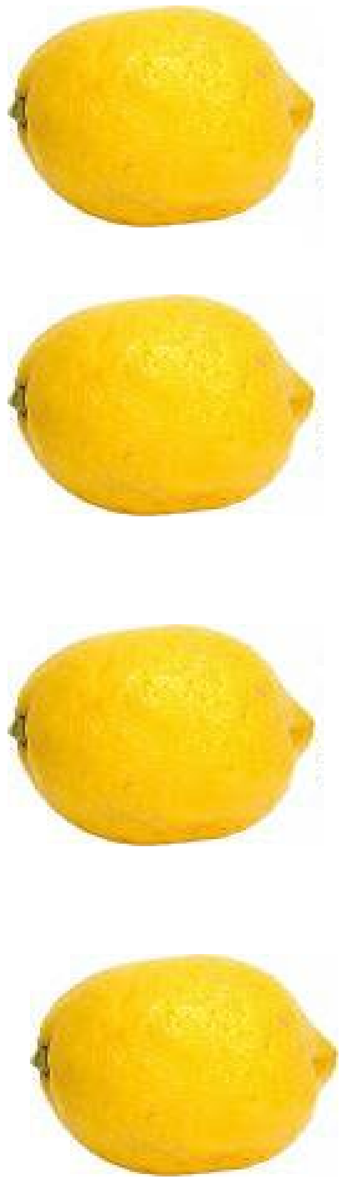




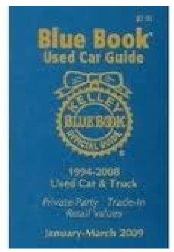
STRATEGIC MANAGEMENT PERSPECTIVE

- Managers seek to create valuable strategies.
- Managers confront information problem in capital markets.
  - Laziness
  - Greed
- Quality of strategy choice compromised by information problem, i.e. capital markets can't see the value, CEOs see.

THE LEMONS PROBLEM (ADVERSE SELECTION)



Buyer purchases at price reflecting average quality



- Buyers cannot ascertain quality of seller goods. Use an average quality statistic to establish price.
- Sellers have incentives to sell lemons.
- High quality goods withheld from the market, until market is composed of only lemons.
- Buyers assume all goods are lemons and accordingly discount.

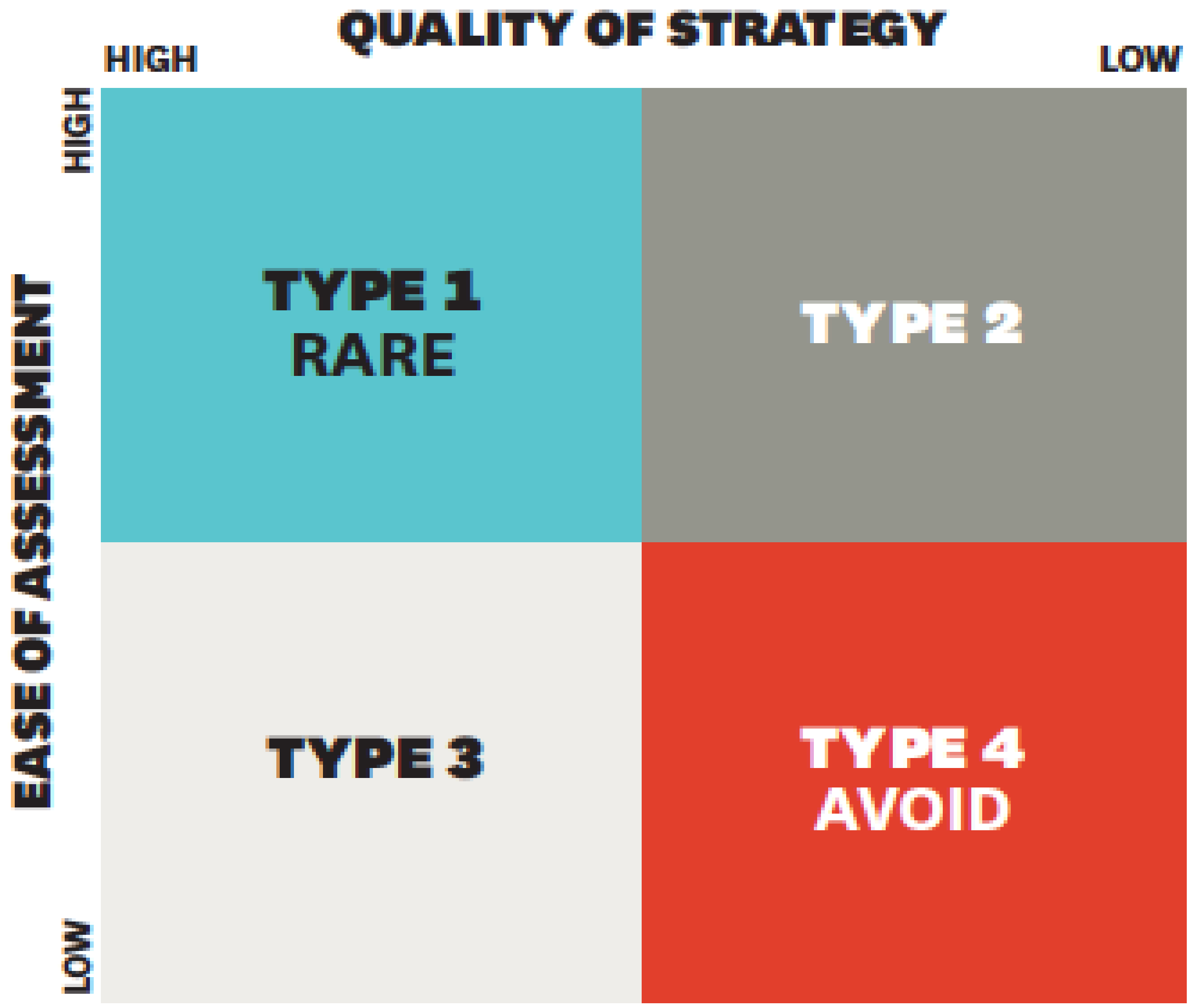
DOT COM BOOM AND BUST

- Large number of Internet firms go public between 1995-2000
- All you needed was a website, and a strategic story
- Few companies had revenues
- Hits to the website was the only real measurable performance indicator
- Hence, firms listened to investors and developed strategies that generated hits to the website
- The result was an abundance of strategic lemons—worthless strategies that the market initially seemed to like

LEMONS PROBLEM IN MARKETS FOR STRATEGY

- Strategies are also costly for capital markets to evaluate.
- But, strategies systematically vary in the scope of these costs.
  - Can choose strategy that is easy to assess or difficult to assess (though better strategies are generally more unique and harder to assss).
- In selecting a strategy, managers simultaneously choose quality ***and*** observability.
- In selecting a strategy, managers choose both future returns and the scope of the lemons problem they impose on capital market.

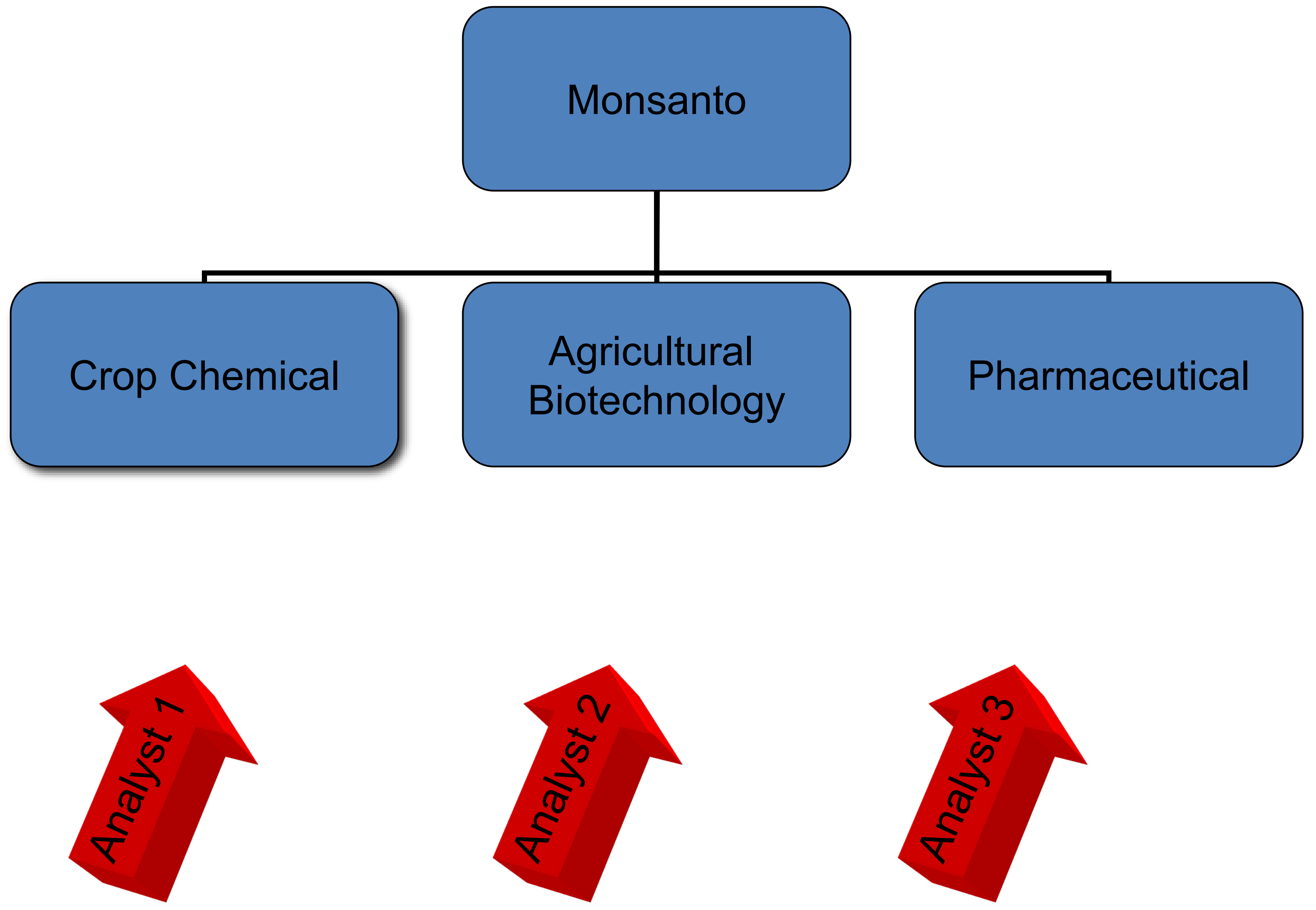
THE UNIQUENESS PARADOX



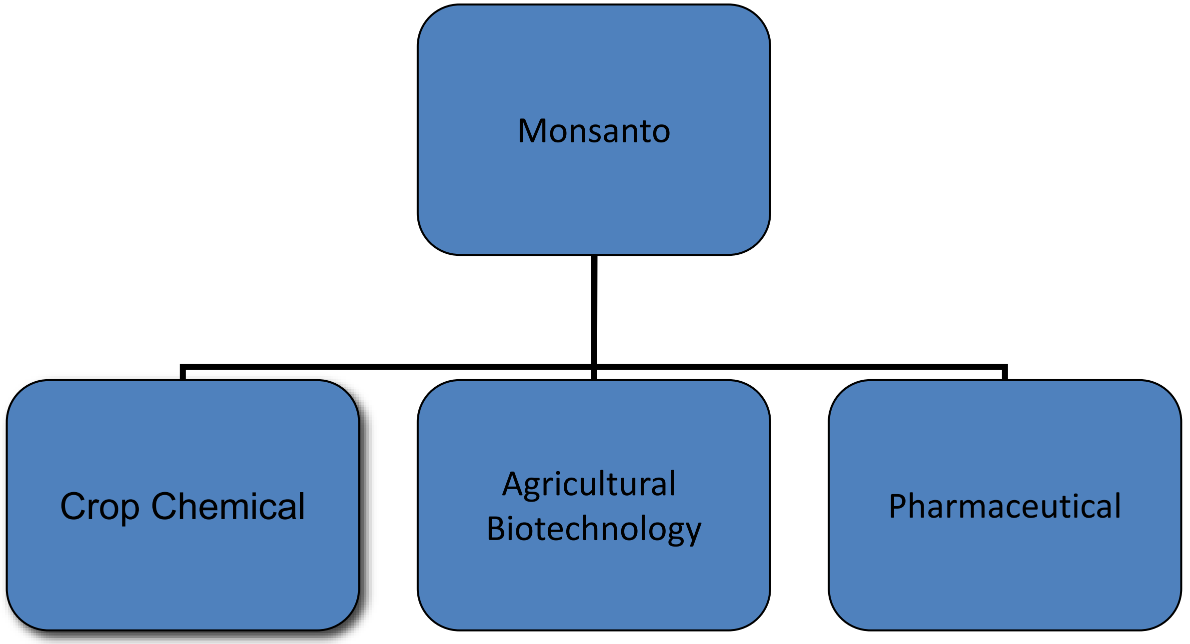
- *If all high quality strategies are easy to assess then strategy choice is simple.*
- *If high quality strategies are generally hard to assess then paradox emerges.*

WHAT SHOULD MONSANTO DO?

MONSANTO


Monsanto
Crop Chemical
Agricultural Biotechnology
Pharmaceutical
Analyst 1
Analyst 2
Analyst 3

MONSANTO



- The Life Sciences experiment is not working… Proper analysis of Monsanto requires expertise in three industries: pharmaceuticals, agricultural chemicals and agricultural biotechnology. Unfortunately, on Wall Street, particularly on the sell-side, these separate industries are analyzed individually because of the complexity of each… At PaineWebber, collaboration among analysts brings together expertise in each area. We can attest to the challenges of making this effort pay off: *just coordinating a simple thing like work schedules requires lots of effort.* While we are willing to pay the price that will make the process work, it is a process not likely to be adopted by Wall Street on a widespread basis. Therefore, Monsanto will probably have to change its structure to be more properly analyzed and valued.

PaineWebber, Research Note, 2 November 1999.

MANY COMPANIES FACE THIS PARADOX

BOEING

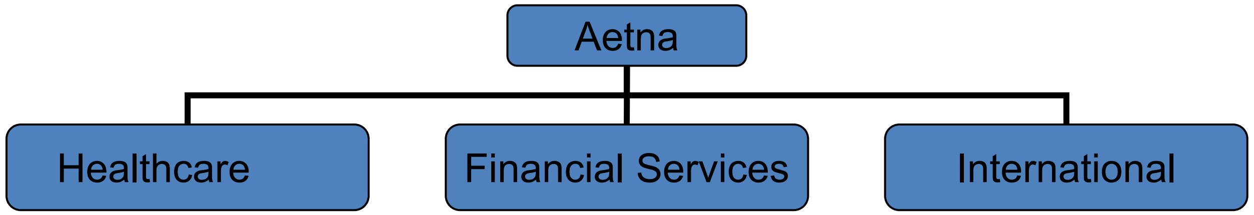
MONSANTO
imagine™

We want you to know™
Aetna®

CardinalHealth

AT&T

AETNA

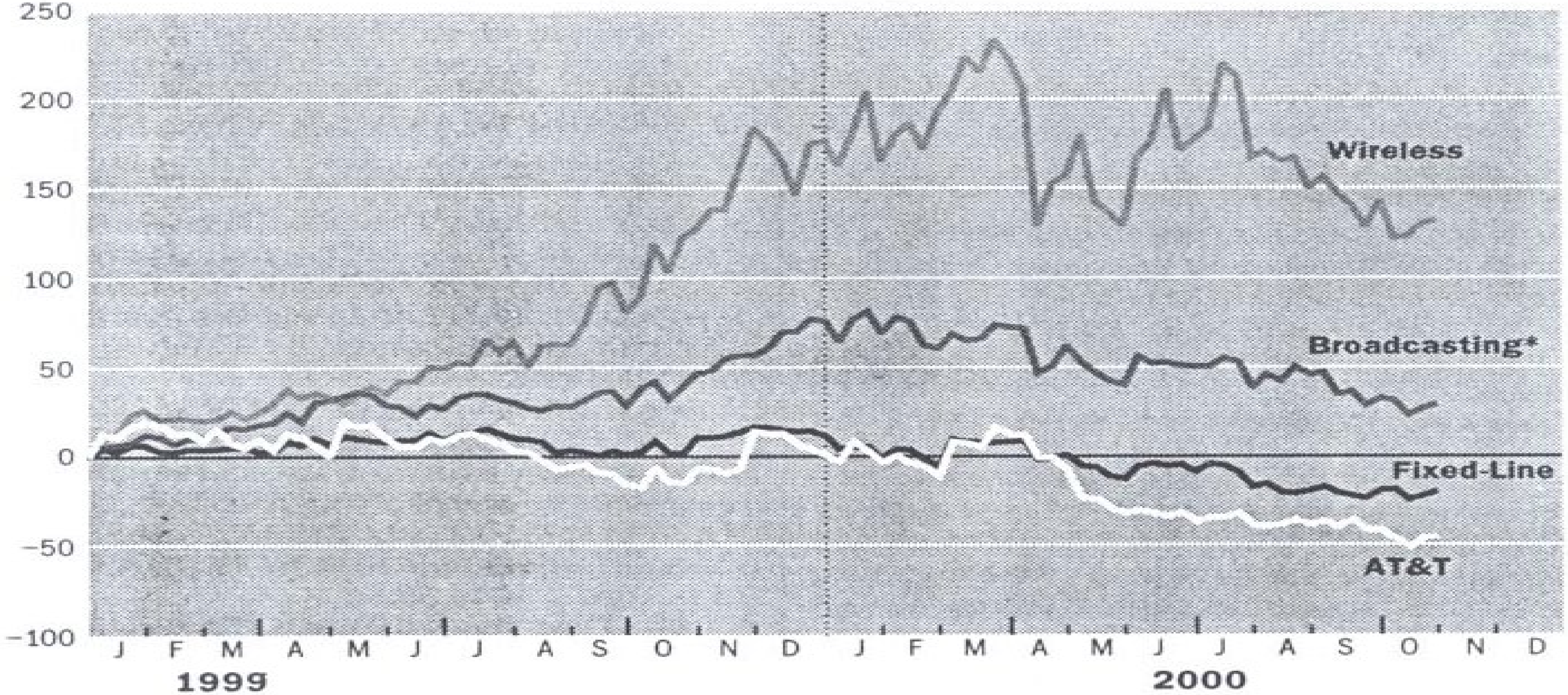


- *All 19 analysts focused on healthcare.*
- *Aetna CEO claims total valuation would be double if all divisions were independently and correctly valued.*

AT&T

Pure Plays Beat the Conglomerate

Comparative performance of AT&T shares and the Dow Jones U.S. Indexes for broadcasting* and fixed-line and wireless telecommunications; percentage change in weekly closes from Jan. 1, 1999.



*Includes cable television

Sources: Reuters, Dow Jones Indexes

INDRESCO

Why Is Indresco's Stock Lagging?

It's not that Indresco is a financial loser. It's just difficult to describe what Indresco does.

The hodgepodge of businesses it owns bothers Wall Street. *Financial analysts can't categorize Indresco.*

"Indresco's crisis is defining what it is: Are they an underground mining equipment manufacturer? A refractories company?" says [Tobias] Levkovich, [a] Smith Barney analyst.

Some analysts are calling for Indresco to narrow its focus by shedding businesses, such as the air tools and mining equipment units.

J. L. Jackson, CEO: "We're not going to get out of some business *so we can make some analyst happy, so he can compare us* with just the steel business or just the refractories business."

Dallas Morning News March 14, 1995

GEORGIA PACIFIC

As reported in the Financial Times, Georgia Pacific's assets… "…have underperformed the broader S&P500 index partly because it has an awkward mix of assets that are difficult to value together. Some of its consumer products, such as tissues, are in solid, high-margin niches that deserve a relatively high share-price multiple. Other activities, such as selling building products, are in volatile sectors where investors are beginning to worry about the effects of a downturn in the US housing market…. The combination means an otherwise strong company has been trading at a significant discount to the sum of its parts at a time when potential buyers have lots of cash and borrowing is cheap."

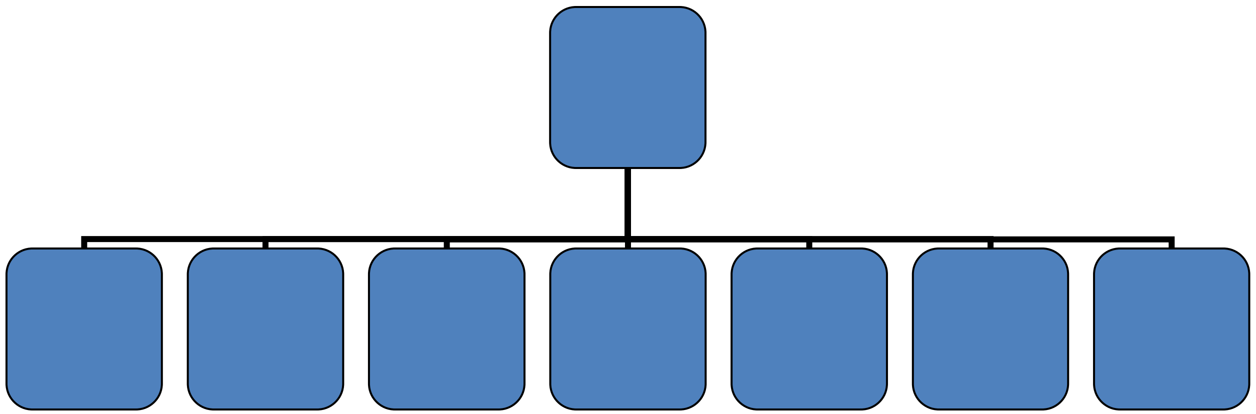
AMAZON

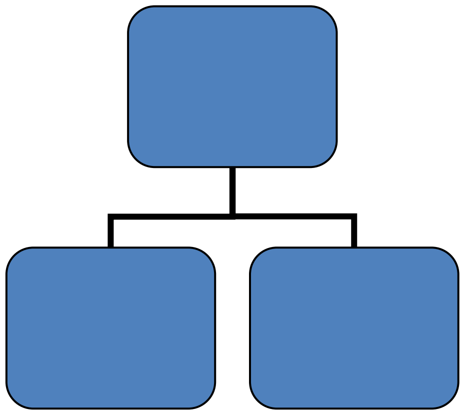
- "We are willing to think long-term. We start with the customer and think backward. And, very importantly, we are willing to be misunderstood for long periods of time." -- Jeff Bezos

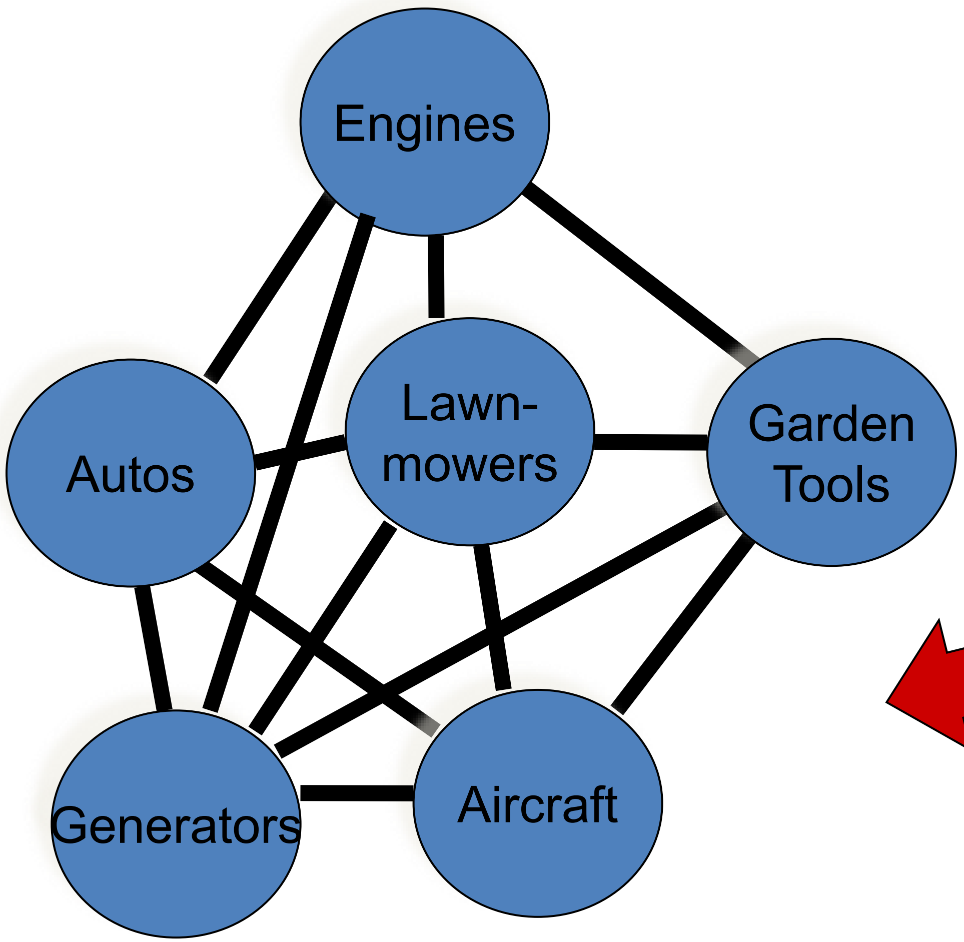
WHAT TYPES OF STRATEGY ARE COSTLY TO ANALYZE?

- Diversification: Multiple business units, each requiring unique expertise to analyze, elevates information costs.
- Unique strategies: Unusual combination of businesses or unfamiliar business strategy elevates information costs.

WHAT MAKES A STRATEGY COSTLY TO EVALUATE?







HOW COMPLEX?

HOW UNIQUE?

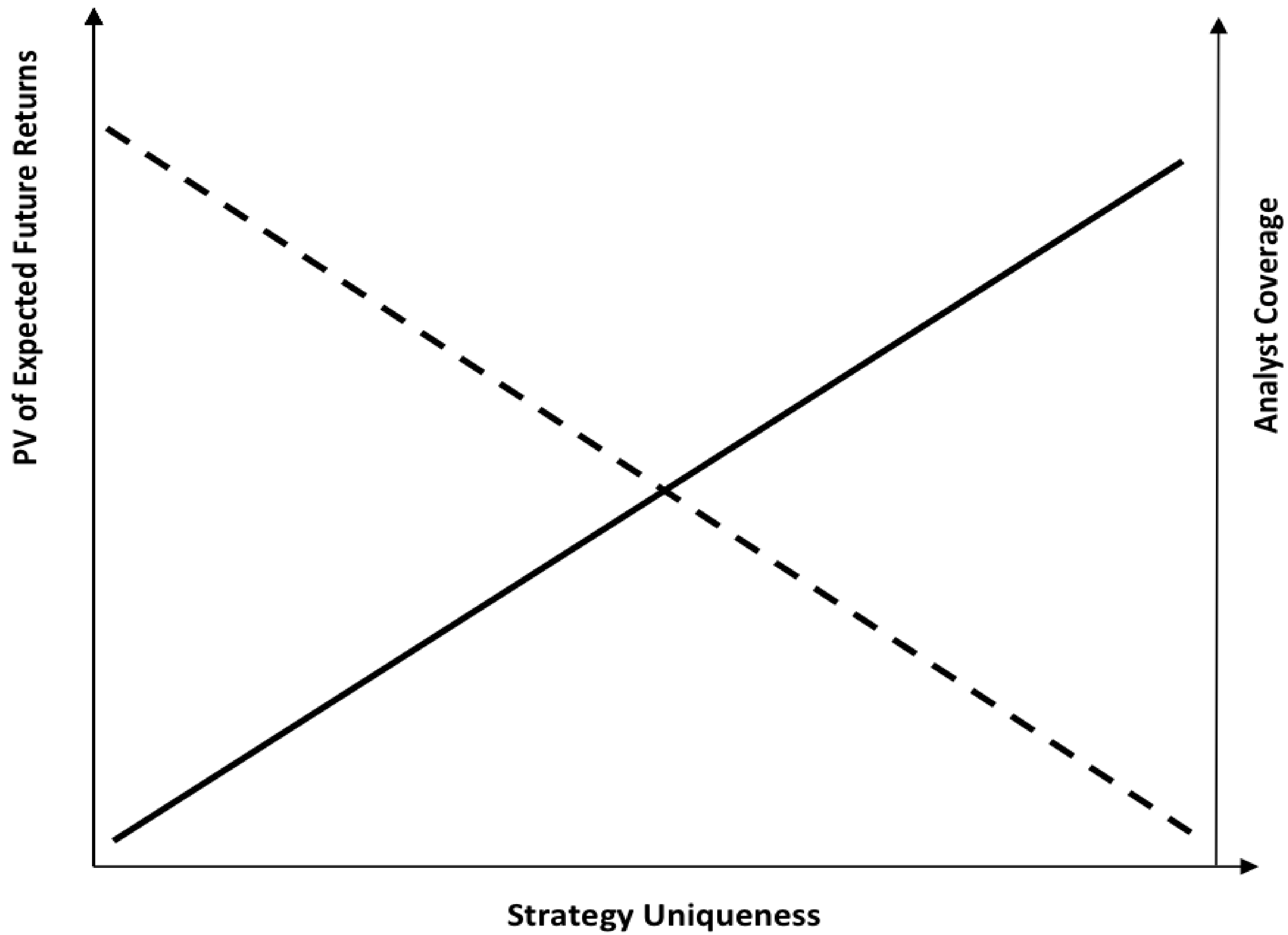
MARKET INTERMEDIARIES

- 3rd Party verification
  - Provide information or certification to buyers
- Securities analysts in markets for firms
  - Provide performance forecasts; provide buy and sell recommendations
- However, analysts' incentives are massively distorted
  - Buyers don't directly pay for analysis
  - Public goods problem
  - Analysts are effort averse; they prefer easily analyzed strategies over difficult-to-analyze strategies, all else equal

THE UNIQUENESS PARADOX

- A unique strategic theory or a unique bundle of complementary assets is a necessary condition for value creation.
- However, uniqueness raises the cost of evaluating a strategy and is discounted in the market.
- Therefore, an entrepreneurial manager faces a tradeoff: *higher expected operating returns and lower valuation OR lower expected operating returns, but higher valuation.*

PREDICTIONS RE: UNIQUENESS



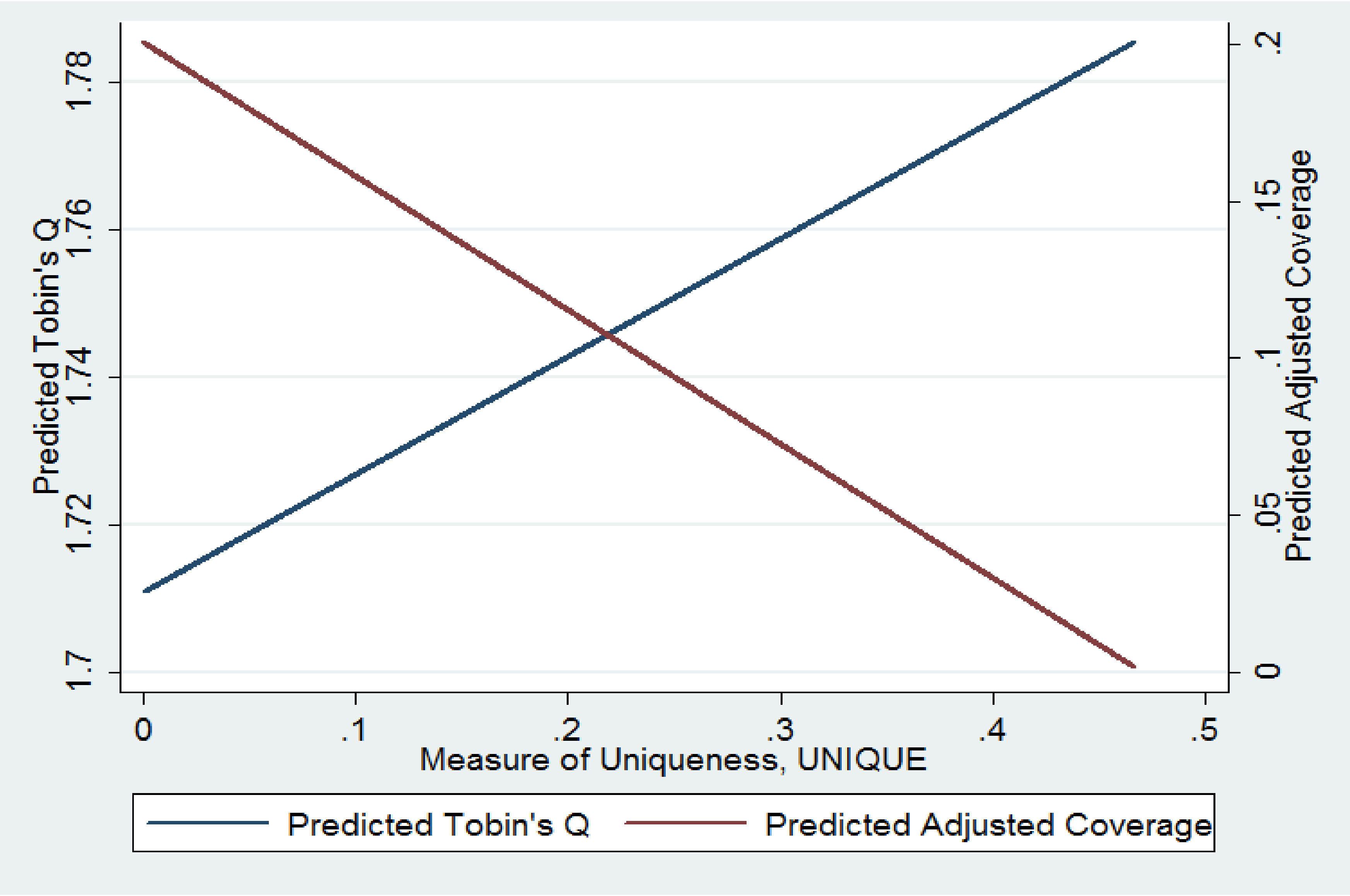
IS THERE EMPIRICAL EVIDENCE OF THIS PARADOX?

- STUDY
  - Do costly-to-analyze strategies receive reduced analyst coverage?
    - Diversified strategies
    - Unique strategies
  - Does the amount of coverage a firm receives influence its valuation?

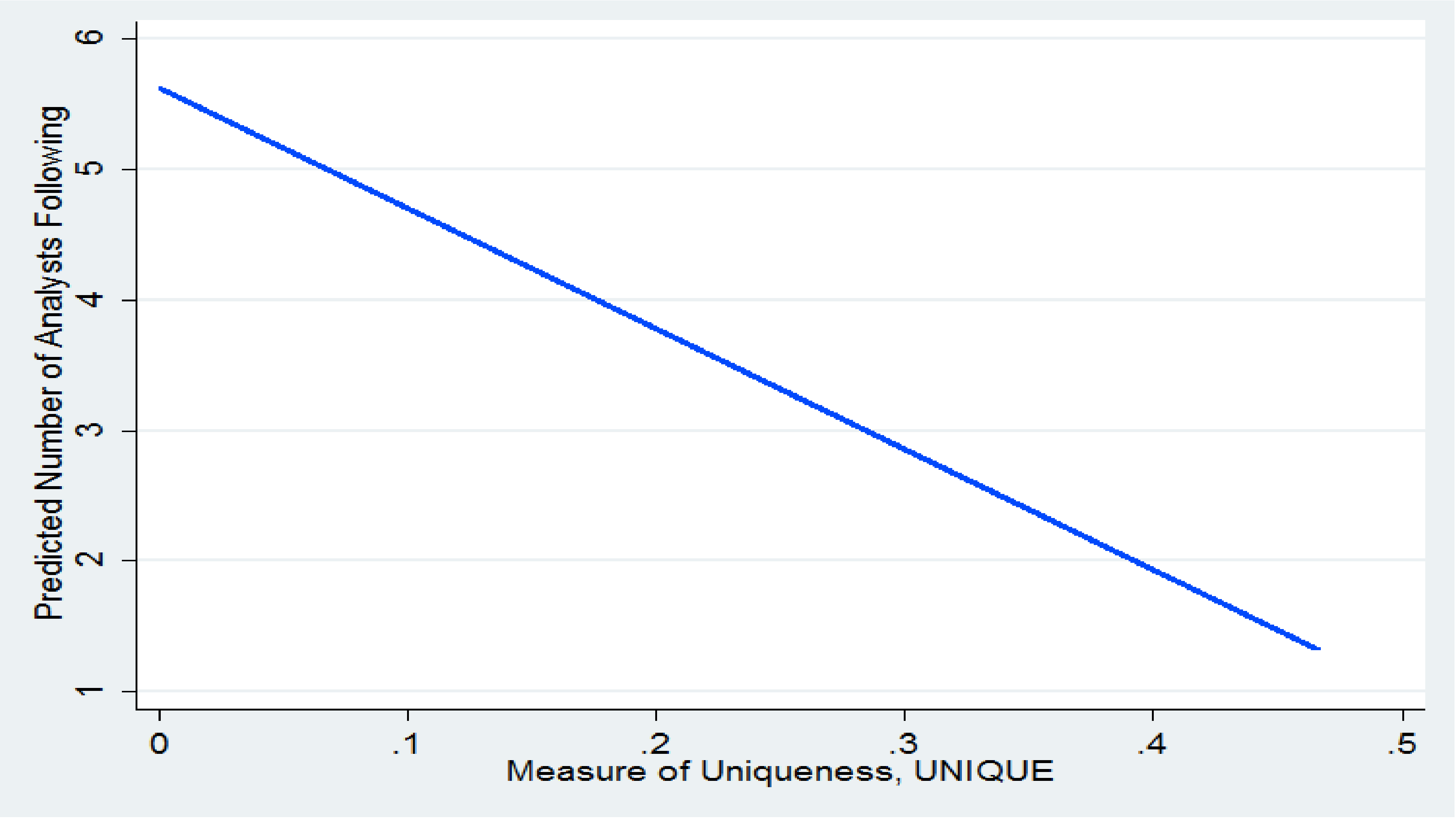
EMPIRICAL FINDINGS

- When strategies are more diverse…
  … less analysis performed; fewer analysts covering firm
  … valuation discount
- When strategies are more unique…
  … less analysis performed; fewer analysts covering firm
  … more effort required to analyze the firm.
  … firms receive a premium, but a discounted premium (discounted relative to valuation with more extensive analysis)

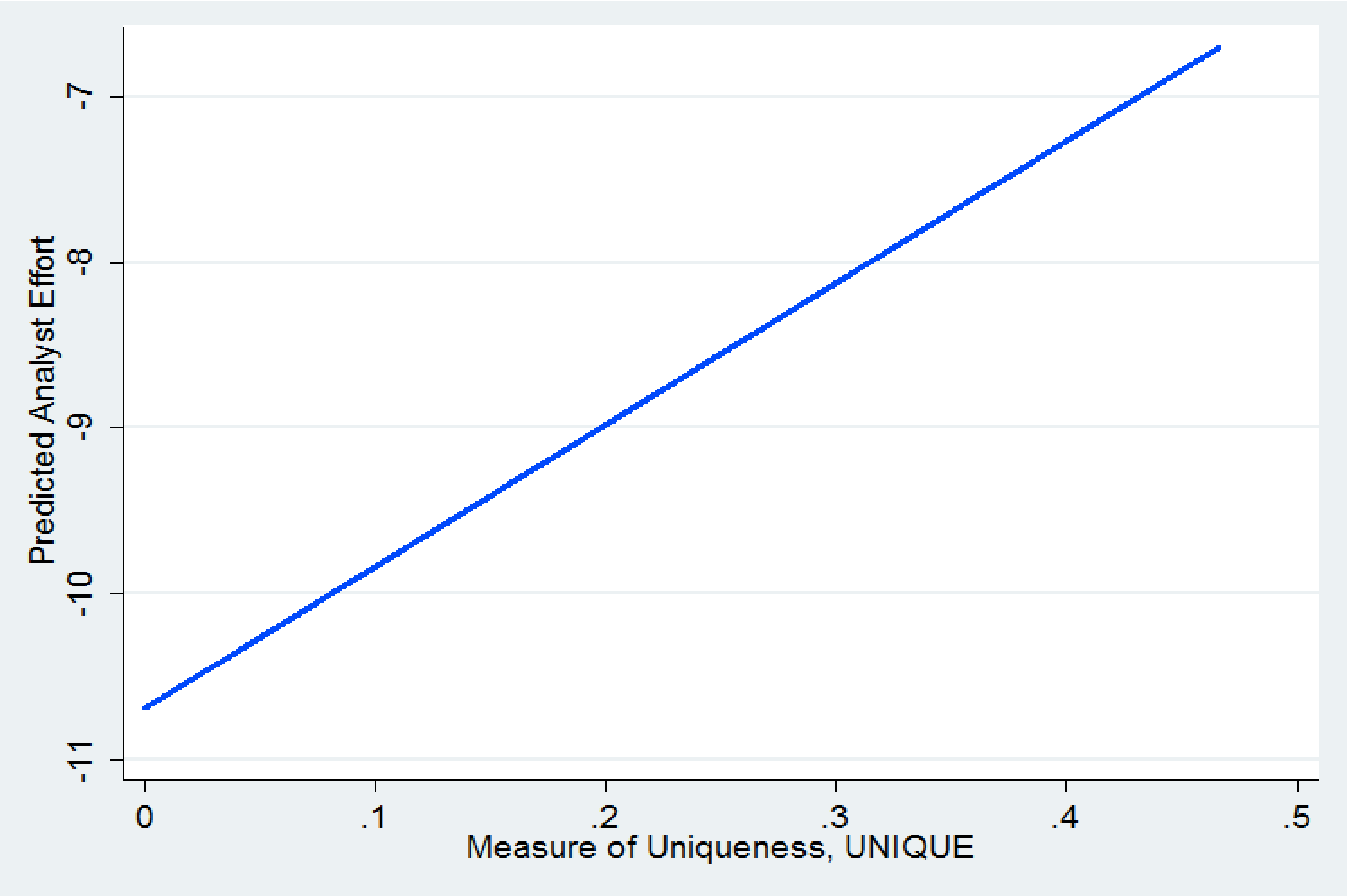
MARKET VALUE INCREASING WITH UNIQUENESS, BUT…



ANALYST COVERAGE DECREASES WITH UNIQUENESS



ANALYST EFFORT INCREASING WITH UNIQUENESS



HOW SHOULD MANAGERS RESPOND?

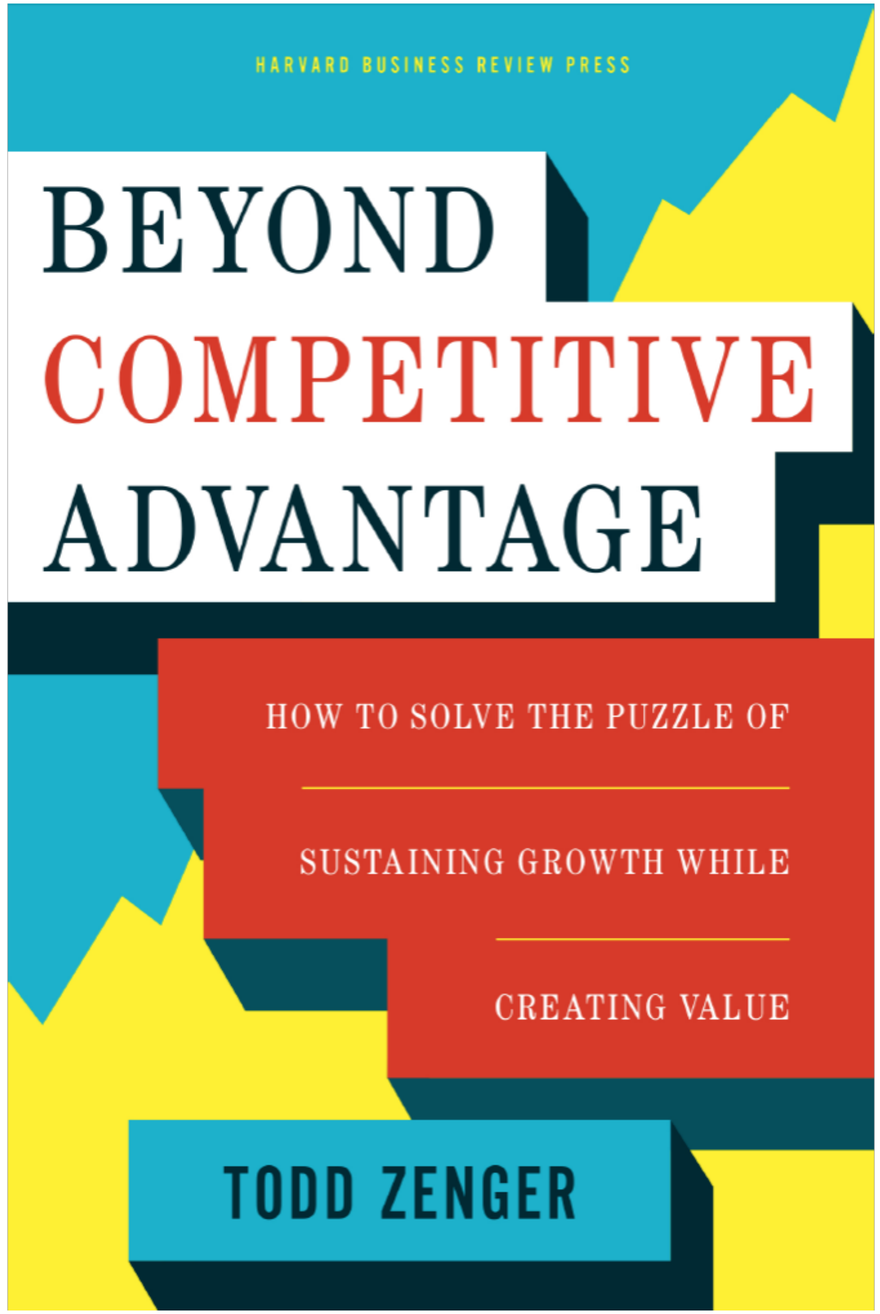
- Option 1: Thumb Your Nose at the Market
  - Find investors who support your theory
- Option 2: Compromise the Strategic Theory
  - Break up and simplify
  - Compromise on quality
- Option 3: Increase information disclosure
  - Tracking stocks
  - Strategy marketing
  - Pay for analysis
- Option 4: Find Patient Money
  - High information cost strategies migrate to private equity
  - Conglomerates have not really disappeared, they have merely become private equity firms.

CONCLUDING THOUGHTS

- Managers routinely face paradox in strategy choice: observability vs. quality.
- Capital markets may discourage precisely those strategies which we would hope they encourage.
- Capital markets may discourage valuable unique strategies and valuable diversified strategies.
- Efforts to motivate managers to respond to shareholders may discourage the pursuit of the most valuable strategies.
  - Do we need to rethink CEO/management pay?

OTHER THOUGHTS

- CEOs should not be pandering to 24-year old Wharton-trained analysts.
- Private equity justified as solving moral hazard problem—providing incentives (finance story). Primary benefit of private equity may be solving the adverse selection problem—enabling pursuit of quality strategies (strategy story).
- Some degree of management insulation from shareholder short term pressure may be desirable.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