Shareholder value

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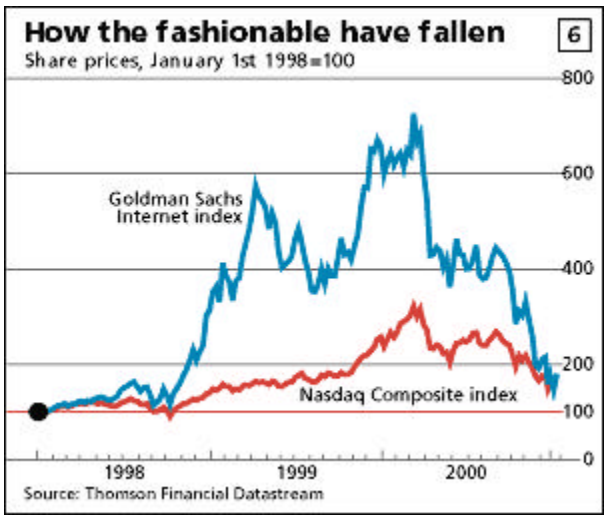
How can you tell what a company is worth?

IT IS painfully clear by now that at least one part of America's stockmarket (and the same bit in Europe, Japan and just about anywhere else) was rather generously valued until the first few months of last year. Shares in TMT (technology, media and telecoms), that paradigm-shifting, blockbuster sector, have fallen spectacularly. Microsoft, Lucent, Dell, Intel, Toshiba, NEC, to name but a few: all have seen their share prices drop through the floor. Nasdaq, chock-a-block with technical wizardry, which had racked up gains of 85% in 1999, had a rather less joyous experience last year: it fell by 39% over the year, and by 51% from its high in March.

Don't even ask about Internet shares, which have plunged. An index of Internet stocks compiled by Goldman Sachs has fallen by 75% since March of last year. Companies such as Pets.com, Boo.com and all too many others have had to close their virtual doors. Helpfully, there is another Internet company, outspokenly entitled fuckedcompany.com, that lists many of those that have gone out of business or are in severe difficulties. A lucky few have managed to raise new cash, but many of these have had to become less virtual in the process. Amazon discovered that it had to build more warehouses; Britain's lastminute.com, a fancily packaged online travel agency with paltry revenues and a drooping share price, is to send out brochures.



For all the recent hype about shareholder value, almost no value for shareholders has been created by pure Internet companies—except for the lucky few who managed to get out in time. More fundamentally, for all the corporate-finance theorists' efforts to find a rigorous method of pricing equity, such attempts seem to have failed, or there would have been no bubble. And now there are worries that the TMT bubble may have distorted the way in which older companies have organised their balance sheets.

Technological innovation has always encouraged the formation of bubbles, a phenomenon that has been charted

by Robert Shiller, an American economist, in a recent book, “Irrational Exuberance" (Princeton University Press, 2000). At the turn of the 20th century the stockmarket was transfixed by new technology. “Guglielmo Marconi made the first transatlantic radio transmission in 1901, and there were predictions that we would soon be in radio communication with the planet Mars,” writes Mr Shiller. The stockmarket rose to ever giddier heights. There was also lots of talk of mergers, he points out, which was good for share prices. Alas, in 1907 the market crashed spectacularly, and was rescued only by the intervention of J. Pierpont Morgan, the grand old man of American banking.

In the 1920s, Mr Shiller relates, electricity became widespread. By 1929, 20m American households were wired, almost half of these had vacuum cleaners, and a third washing machines. John Moody, the founder of the rating agency that bears his name, wrote glowingly in 1928: “In fact, a new age is taking form throughout the entire civilised world; civilisation is taking on new aspects. We are only now starting to realise, perhaps, that this modern, mechanistic civilisation in which we live is now in the process of perfecting itself.”

Another century, another technology, but the basic message remains the same: fundamental innovations rarely make shareholders rich in the long term. There is no reason to think that the Internet, and the firms that try to make a living from it, will do better for shareholders than the railways or the airlines did in their time. In fact, there is good reason to think that they may do worse, because the barriers to entry are so low. The only thing that might give an Internet firm an edge is the power of its brand. That is why so much attention has been focused on Amazon, which almost uniquely, though very expensively, seems to be building one.

Corporate-finance theory, you might have thought, would have had something to say about some of the absurd valuations in the Internet and high-tech sector. Investors seemed to be throwing cheap or free money at many such firms even though the chances of any profits in the foreseeable future were minimal.

Since equity is riskier than, say, Treasury bonds (on which you get your money back when they mature), the returns for shareholders—and thus the cost of equity for firms—normally need to be bigger. The greater the risk, the bigger the return needs to be. That would suggest that Internet companies should have found equity very expensive.

What do you earn?

One way of looking at this is through a company’s price-to-earnings ratio, or its reciprocal, the earnings yield. Shares with high p/es (or low earnings yields) are valued more highly because investors believe that they will deliver better returns. Those returns can come from income, capital gains, or both. Firms might choose to reinvest all of their profits in their business, which means that all of the returns to shareholders will be in the form of capital gains. But eventually, to be worth anything, the equity has to deliver money to shareholders, either through dividends or share repurchases.

Yet the expectations built into America’s stockmarket in general and the high-tech companies in particular were extravagantly optimistic, not least because some of the newest, brightest stars had no earnings, and therefore nothing to measure their performance by. No matter, said the boosters: in time there will be earnings, and lots of them. In the meantime, look at their price-to-revenue ratios. In fact, those looked pretty scary, too. But many people seemed convinced that anything with a dot.com after its name would do brilliantly.

The Capital Asset Pricing Model (CAPM) offers a more rigorous approach to gauging the cost of equity. It compares the overall extra riskiness of equities and the extra riskiness of individual shares with a riskless investment (such as Treasury bonds). The overall extra riskiness is captured by the so-called equity-risk premium. The extra risk for each individual security, called its beta, is compared with the market as a whole (in a portfolio, some risks net out: one share might go up at the same time as another goes down). On this view, shares that offer higher returns than the risks that investors are willing to take are cheap; those with lower returns are expensive. So the cost of equity is defined as the risk-free rate plus the share’s beta multiplied by the expected equity-risk premium.

That sounds reasonable enough, but there are one or two problems with it. Many stockmarket boosters argue that the equity-risk premium has fallen because investors have realised that, over time, stocks are not as risky as they had thought. But as Mr Shiller points out, such arguments were already being trumpeted back in the 1920s. And anyone who invested in, say, Japanese shares over the past decade is unlikely to be convinced.

Then there is the problem about how volatility should be measured. Investors have to base their forecasts of a share's future volatility on its performance in the past, but they are only guessing. As the experience of the past couple of years shows, companies with hitherto fairly stable share prices can become very volatile indeed.

That leads to the third problem: is volatility the same as risk? Only up to a point. One difficulty is that as shares fall, their beta generally rises. If that happens, investors will not buy them even though they are cheaper, and thus presumably less risky.

But the main trouble with CAPM is that it is a static, backward-looking theory. Investors generally want to buy into those areas that grow fastest, because they hope that the returns will be juicier. One risk for them is in not being invested in these stocks. Volatility does not really enter the equation: new firms are, by definition, too young for it to matter. "It's like asking how big a baby will be when it grows up," says Bob Gumerlock, a risk consultant. So it is no surprise that investors rushed into high-tech firms even though the volatility of their shares was many times that of their old-economy counterparts.

Into the unknown

But they are still uncertain over how to square traditional notions of value with extraordinary growth rates and unusual profits (or lack of them). Had they gone by the book, investors would not have touched high-growth, loss-making companies with a bargepole. Investors have to take a view on how fast a company will grow in the future, bearing in mind that even the headiest growth rate has to slow down eventually. But in the end it still comes down to a decision whether to buy or not to buy. If they decide to buy, investors may drive up the price of a share in short supply, thus providing the company with cheap or, in effect, free capital.

Theories have their limits. Harch Capital Management's Mr Lewitt puts it bluntly: "It's just dressed-up rampant speculation. There's no way to value these things."

But while everyone was merrily speculating on apparently high-flying growth companies, the more old-fashioned companies that actually produce profits found themselves shunned by the stockmarket. Many of them dressed themselves up as growth stocks to get back into favour. They added the dot.com suffix to their names or gave themselves modish monikers. Ray Soifer, a banking consultant, tells the story of a company he bought shares in, California Microwave, a maker of telecoms equipment. The shares languished at a few dollars each until 1999, when the firm changed its name to Adaptive Broadband. Its shares climbed to $100. But nothing else changed, and now the shares are back where they started.

Others tried more substantial remedies; in particular, they cast around for mergers and acquisitions. Naturally they put forward the best of reasons: cutting costs, building scale, acquiring technologies. But they also knew that nothing sets the pulse racing like a big merger. A few worked; many others didn't.

Another sure-fire tactic for old-fashioned companies to boost their appeal was to use borrowed money to buy back their own shares. On paper, that increased their earnings per share, though not, of course, their underlying profitability (return on capital).

For all the talk about radical restructuring, flexible labour markets, and the miraculous effects of new technology, the truth is that American companies' underlying profitability has not increased that much. Smithers & Co., an economic-research outfit that has been a perennial scourge of bulls everywhere, has crunched the numbers and produced some striking results. Since 1991, the return on equity for American companies has risen by a spectacular 108%, and is now some 30% above its long-term average. Their return on capital (before depreciation, interest and tax), on the other hand, has risen by a much less spectacular 13%, and is now back to its long-run average of just under 9%. Much of the higher return on equity was due to greater leverage and, oddly (in the absence of corporate-tax cuts), lower taxes.

It would be hard to argue that all this was done exclusively in the interests of shareholders. The same is true, with even greater force, of the way in which American companies' managers are paid.