
VALUE WIZARD INSIGHTER - March 2000

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In this issue:
1. Resource Conversions
2. Anti-takeover Defenses
3. Shareholder Rights Plans
4. State of Incorporation

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1. Resource Conversions

Companies grow two ways: internally through capital expenditures in expanded or new facilities, and externally through acquisitions of other companies. A strictly continuing long-term going concern would generate cash flow from operations only, but a company involved in resource conversions would generate cash flow from financing activities also. Resource conversions are changes either in the ownership or in the form of financing of a company. They include mergers, acquisitions, purchase of majority-ownership interests, initial public offerings, spin-offs, split-offs, divestitures, leveraged buyouts, management buyouts, and reorganizations.

Resource conversions, especially takeovers, are a reflection of what Joseph A. Schumpeter memorably referred to as the "perennial gales of creative destruction" in democratic capitalism (*Capitalism, Socialism, and Democracy*, Harper Torchbooks). Schumpeter was the Harvard faculty member who suggested to John Burr Williams, a successful stock market investor, that he write his doctoral dissertation on the subject of the valuation of investments. No one else on the world-famous faculty had expertise on the subject, and Williams thus would escape their academic heavy-handedness to the chagrin of his dissertation committee. The result was the classic book

"The Theory of Investment Value" published by Harvard University in 1938 and reprinted in 1999.

The U.S. economy in February 2000 entered its longest expansion, and the U.S. stock market is experiencing its longest bull run. The current market is generally overpriced relative to traditional measures of intrinsic value, and patient disciplined long-term value investors may spend a lot more time on the sidelines while looking for a company whose stock is trading at a price that offers them a sufficient margin of safety. At such times, value investors can either consider risk arbitrage or look for likely takeover target stocks. Risk arbitrage investments in announced deals usually will be resolved within five or six months, even if the deals are hostile and contested. In contrast, investments in unannounced but likely takeover targets may take a long time to be realized, if ever, because company-specific resource conversions are unpredictable.

Resource conversions are large enough and frequent enough to be a significant source of shareholder value. We have not seen an analysis of the frequency of takeovers among companies with publicly-traded common stock. Among the companies that are fully-reporting to the U.S. Securities and Exchange Commission, it would be interesting to know during a five-year period what percentage have takeovers and other resource conversions of a material size. Long-term value investors who see companies passively as strictly continuing going concerns benefit from resource conversions as unpredictable windfalls. Short-term value investors and risk arbitrageurs who see companies aggressively as deal makers benefit from resource conversions as predictable potential high returns from announced deals.

We would expect to see takeovers, either mergers of equals or acquisitions, to occur more frequently in infant industries and in mature industries that have saturated their product or service markets and entered a terminal phase of low or no growth. Such takeovers are commonly driven by cost reduction or quality improvement. Economies of scale and of scope motivate horizontal integration including industry consolidations ("roll-ups") and geographical expansion from regional to global. Dependency and pricing pressures motivate vertical integration including combinations with powerful suppliers and major buyers. Customer convenience motivates product bundling and one-stop shopping. In addition, technological and regulatory change throughout an economy can lead to new industries and redefined industries. In short, takeovers and other resource redeployments will be concentrated where the perennial gales are strongest.

A practical introduction to takeovers and other resource conversion activities in the market for corporate control is the book entitled *Big Deal: 2000 and Beyond* by Bruce Wasserstein. It was originally published as *Big Deal: The Battle for Control of America's Leading Corporations*, and the new updated edition includes mergers and acquisitions in the digital age. Part one is a history of mergers in the U.S., part two is about the corporate strategy behind mergers, and part three discusses the merger process. The 927-page book has a detailed Index (pp. 902-027) with numerous listings under the headings of "Courts", "Discounted cash flow model (DCF)", "Management", "Poison pill defense", "Shareholders", "Shark repellents", and "Valuation."
There is a discussion of Preventive Defense (pp. 791-815) which describes the evolution of poison pills from a preferred stock plan, then to a "flip-over pill" or rights plan, and then to a "flip-in, flip-

over pill." Pills also evolved from "dead-hand" to "slow-hand pills, and may or may not be redeemable by the board."

For more information about *Big Deal*, see Global Value Investing General Books H-Z at www.numeraire.com/books2.htm .

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2. Anti-takeover Defenses

Institutional activism has risen since the mid-1980s. Institutions hold more than half of publicly-traded common stocks outstanding, and individual investors in the aggregate hold the remainder. Institutional investors have taken both confrontational and behind-the-scenes roles in the debate and influence over corporate governance, proxy rule reform, executive compensation, boardroom practices, shareholder rights and shareholder communications. Aggressive shareholder activists and destabilizers assert their voting power to remove takeover defenses and change corporate policy, often to facilitate their investment activities in the market for corporate control. These institutional investors include insurance companies, investment companies (mutual funds), pension funds, endowment funds, and hedge funds.

The most controversial form of corporate growth in the public eye is probably the takeover of one company by another. It is difficult to generalize about the social impact of takeovers because the benefits and costs vary from case to case. Each situation should be considered on its own merits. Among the various takeover defenses are poison pills or rights plans, staggered boards of directors, and golden parachutes for incumbent managers. The best defense is a good offense based on acceptable performance by managers. If a company receives an unsolicited takeover offer, it should be evaluated ideally by the non-manager members of the board of directors, and if reasonable, should trigger an auction of the company to the bidder making the highest and best offer.

A poison pill may discourage some acquirers from bidding but it essentially buys time for the target company's management once a bid has been made. The following is about one type of poison pill and its impact on shareholder value. It is excerpted verbatim from an article by Japonica Partners, one such institutional investor. We have no affiliation with or financial interest in this firm.

Japonica Partners is a proactive investment and management firm. Its mission is to find and make business investments for their investor limited partners. The firm invests primarily in billion dollar, multinational situations where a substantial "value gap" exists between a company's current and potential value.

Dead Hand Pill:

Restricting Shareholder Value?

A "dead-hand" provision of a shareholder rights plan, also known as a "continuing director" provision of a poison pill, provides that the poison pill can only be redeemed by a majority of the directors who installed it or their approved successors. A dead-hand pill effectively stops a new slate of directors, likely brought in by an acquirer following a proxy fight, from redeeming the pill. The controversial provision was recently upheld by a Georgia federal district court in connection with the Invacare/Healthdyne takeover bid. While it is currently under appeal, if upheld it may have significant implications for shareholders, publicly held corporations and proactive investors.

A shareholder rights plan is a common and effective takeover defense tool. Essentially, a poison pill makes a tender offer that is not approved by the board of directors prohibitively expensive, through the issuance of new shares to existing shareholders. It is estimated that more than 1,800 publicly held companies have adopted rights plans since 1985, when the Delaware Supreme Court upheld their use in *Moran vs. Household International Inc.*.

Without a dead-hand provision, a rights plan provides protection, but is not a foolproof defense. In fact, one of the tenets of the 1985 *Household* decision was that even with a rights plan in place, a hostile takeover could still be accomplished by way of a combination tender offer/proxy fight. With the dead-hand provision, however, a new board is prevented from dismantling the pill so a tender offer can proceed, essentially eliminating the possibility of a sale, and leaving a company free to reject any and all offers, regardless of the benefit to shareholders.

What are the implications of the Healthdyne/Invacare decision? While the decision only applies to companies incorporated in the state of Georgia, it may hold significance in states that have similar statutes, including Indiana, Ohio, North Carolina and Pennsylvania. Legal experts do not believe that Delaware, where most companies are incorporated, would approve such a discriminatory poison pill. The New York statutes, which are similar to Georgia's in certain respects, were interpreted to prohibit dead hand provisions in the 1988 *Bank of New York Co. and Irving Bank Corp.* case. The dead-hand provision may also become an increasingly important takeover defense tool for corporations that do not have a staggered board.

Does the Healthdyne/Invacare decision maximize shareholder value? According to *Corporate Control Alert*, two professors of corporate law, William Carney of Emory and Lawrence Hamermesh of Widener, believe the Georgia court's opinion in favor of the dead hand pill to be poorly considered. Stated Hamermesh, "a broad dead-hand provision is just a gross imposition on the fundamental right of stockholders to elect a board." It means that shareholders "cannot elect a new board without losing the ability to sell the company, which is just too steep a price."

To express your opinion, visit Japonica Partners at http://www.japonica.com/network/deadhand.html and vote.

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3. Shareholder Rights Plans

How do corporate governance practices and policies relate to shareholder value? The following study attempts to quantify the impact of so-called shareholder rights plans or poison pills, one of the techniques to entrench incumbent managers of target companies.

Academic-type econometric studies make questionable assumptions in order to make a tidy fit between the available data and the simplified models. So-called data-mining or data-snooping can render hypothesis testing invalid as well as result in diametrically opposite findings.

The models and methodology used in this study raise several issues which are briefly mentioned. Four models and two data samples are specified to address different questions concerning the general benefits of poison pills to shareholders.

Model 1:
Adjusted Premium = b0 + b1*Pill + b2*MktCap + b3*P/B + b4*Attitude
where Premium = End Price - Base Price
and Adjusted Premium = Premium*(End SP500/Base SP500)
Significant coefficients: b0?, b1, b2, b4
Alternate Model 1: Premium = b0 + b1*Pill + b2*MktCap + b3*P/B + b4*Attitude + b5*SP500

Model 2:
Deal Withdrawal = b0 + b1*Pill + b2*MktCap + b3*P/B + b4*Attitude + b5*Premium.
Significant coefficients: b0?

Model 3:
Hostile Bid Defeat = b0 + b1*Pill + b2*MktCap + b3*P/B + b5*Premium
Significant coefficients: b0?

Model 4:
Takeover Target = b0 + b1*Pill
Significant coefficients: b0?

In Model 1, the left-hand or dependent variable to be explained is Takeover Premium or price appreciation. This is not total return which includes both price change and dividends. In addition, it does not include non-price terms of the deal, the most important of which is the form of consideration in either cash and/or new stock. Takeover premium was measured as the price appreciation from one week prior to the announcement of the first bid until the transaction's completion date. Adjusted premium is the takeover premium net of the change in the S&P500 index over the same period (to account for market factors). Thus, this is a cross-sectional sample with a single time period of five years duration. The more common method of using multiple time periods of one month duration each would result in this case of sample sizes to small for statistically significant findings.

In Model 1, the left-hand variable could be specified as Premium instead of Adjusted Premium. The time adjustment to the premium would be made by adding another right-hand variable as shown in Alternate Model 1.

In Model 1, the right-hand independent or explanatory variables are (1) Pill, (2) MktCap or Market Capitalization, (3) P/B or Price-to-Book Ratio, and (4) Bid Attitude. Pill is a category variable with two values: Pill Company, and Non-Pill Company. Market Capitalization is the product of Price and Number of Shares Outstanding. A division between Large Cap and Small Cap is arbitrarily chosen at US $1 billion. Price-to-Book Ratio is the share Price divided by Book Value per Share. Bid Attitude is a category variable with two values: Friendly (non-contested) or Hostile (contested).

In Model 1, two of the four independent variables are not conceptually valid because they are logically circular in this specification of the model. The variable Price is entailed in Takeover Premium, the variable to be explained on the left-hand side. The variable Price is also entailed in Market Capitalization and in Price-to-Book Ratio, both explanatory variables on the right-hand side. The circularity takes the form of identity and/or autoregression which result in non-independence of the allegedly independent variables. One way to avoid an identity is to operationalize the Price variable at different times (Price-t1, Price-t2, and Price-t3), but this introduces the issue of serial correlation in prices and thus non-independence of the variables that entail price. This leaves one conceptually valid independent variable, Bid Attitude.

For more about the logical circularity of capital asset pricing models, visit http://www.numeraire.com/abstracts.htm and review the abstract and paper entitled "Critique of Asset Pricing Circularity."

In Model 2, the left-hand side or dependent variable, Deal Withdrawal, is the deal withdrawal rate (opposite of deal completion rate) which measures the likelihood of withdrawal of a takeover bid. In Model 3, the left-hand side or dependent variable, Hostile Bid Defeat, is the hostile bid defeat rate (opposite of takeover success rate) which measures the likelihood of takeover failure expressed as the number of companies with announced takeover bids divided by the total number of companies in the sample.

In Model 2 and Model 3, three right-hand side or independent variables entail Price and thus are not conceptually independent of one another. Depending on operationalization, they may not be empirically independent either. This not only confounds the model but also confuses the interpretation of the resulting regression coefficients.

In Model 4, the left-hand side or dependent variable, Takeover Target, is the takeover target rate which measures the likelihood of a company being a takeover target. This model uses Sample 2 data.

Sample 1: The sample of all takeover transactions (mergers, acquisitions, tender offers, and acquisition of majority interest) over $250 million in deal size completed in the period between

January 1, 1992 and December 31, 1996 totals 416 deals. In cross-section, this is a sample with a single time period of five-year duration. The minimum deal size is chosen arbitrarily. The adjustment for changes in a proxy for the stock market as a whole (arbitrarily represented by the S&P 500 Index) does not accurately reflect changes in the economic, business and market environment. The alternative Model 1 demonstrates another way to adjust for the implicit time variable. Either method of adjustment is an attempt to compensate for using cross-sectional sample with one time period of long duration in order to have a sufficiently large sample size for statistically significant results instead of multiple sequential time periods of shorter duration. Of this original sample, 319 deals remained after excluding deals for insufficient information and for arbitrarily-chosen extreme values. Three deals were excluded for high takeover premiums (150%), and 29 deals were excluded for low (5%) or *negative* takeover premiums including 10 deals with negative premiums. Models 1, 2 and 3 use Sample 1 data.

Sample 2: The sample consists of the companies comprising the S&P500 and S&P400 (Mid-cap) indices in December 1993 for the period between January 1994 and December 1996. In cross-section, this is a sample with a single time period of three-year duration. Model 4 uses Sample 2 data.

Summary: We reject the models on conceptual and methodological grounds. Due to the logical circularity of Price-to-Book Ratio, it is surprising that the regression of Model 1 estimated for this variable a non-significant coefficient, b3 in the above specification. As expected, the circular b1 coefficient is statistically significant (probably at the conventional 5% level). The fourth variable, Bid Attitude, also reportedly has a significant regression coefficient, b4 in the above specification, which is surprising because of the small number of deals in the Hostile category of this variable, 19 successful and 25 defeated out of 319 deals in the effective sample. All models are assumed to be specified with an intercept term, but the intercept coefficient, b0 in all models, is not reported. Notwithstanding the invalidity of Market Capitalization and Price-to-Book Ratio and the small sample size for all the categories of Bid Attitude, the major conceptual flaw in the research design is the issue of causality versus mere correlation.

To the extent that target companies are performing poorly at the time of the takeover attempt, it is not surprising that companies with poison pills in place (six months prior to the first bid) on average received higher takeover premiums. Company managers of poorly performing companies usually learn from their larger investors sometimes years in advance that they are not meeting shareholder expectations, for example, with continuing low share Price and thus low Price-to-Book Ratio in the models. Sufficiently paranoid managers anticipate takeover threats and institute defense mechanisms.

In extreme cases, the establishment of a shareholder rights plan or other anti-takeover defense is inimical to the interests of shareholders. In the battle between management and owners of poorly-performing or under-priced publicly-traded companies, the incumbent managers want to keep their salaries and perquisites even while steering the company into the tar pits on their watch, while insurgent stockholders seek to wrest control and realize greater value.

If the alleged motive of anti-takeover provisions is to protect well-performing managers during recurrent cyclical economic downturns in their industry, sophisticated stockholders will make due allowance without such defenses. Alternatively, if the alleged motive is to protect the local communities where the company's facilities are located, there are more effective ways to defend the stability of immobile local workers' labor against the flight of highly mobile financial capital.

The study was done by Georgeson & Company, shareholder communication advisors and proxy solicitors who make more money when there are more deals requiring proxy contests. Anything that reduces deal flow, such as antitakeover provisions like poison pills, reduces the size of their potential market. This may cause bias regarding the reported findings of this study. We reconstructed the above models and samples from the study report. Please keep the above qualifications in mind when reviewing the following verbatim excerpt.

Georgeson & Company Inc.'s Research Group analyzed takeover data between 1992 and 1996 to determine whether shareholder rights plans (commonly known as "poison pills") had any measurable impact on shareholder value. Our findings are summarized as follows:

- Premiums paid to acquire target companies with poison pills were on average eight percentage points higher than premiums paid for target companies that did not have poison pills. This finding is consistent with earlier Georgeson studies and persisted after controlling for fundamental differences between pill and non-pill companies (model 1).
- We estimate that poison pills contributed an additional $13 billion in shareholder value during the last five years, and that the shareholders of acquired companies without pills gave up $14.5 billion in potential premiums.
- The presence of a poison pill at a target company did not increase the likelihood of the withdrawal of a friendly takeover bid nor the defeat of a hostile one.
- Poison pills did not reduce the likelihood of a company becoming a takeover target: companies with pills had a slightly higher takeover rate than companies without pills.

For details of Georgeson's analysis and conclusions, visit their website at http://www.georgeson.com/pubs/pill/pill.html and see the report.

For more on corporate governance, visit the Investors Responsibility Research Center at http://www.irrc.org/ and learn more about companies with anti-takeover defenses.

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4. State of Incorporation

An article in *The Wall Street Journal*, 28 February 2000, pg. C21, entitled "Firms Incorporated in Delaware Are Valued More by Investors" summarizes an academic study of U.S. firms by Robert Daines, a law professor at New York University School of Law. Daines finds companies incorporated in the state of Delaware are priced higher by the stock market than companies incorporated in the other 49 states. Delaware has significant antitakeover laws but fewer obstacles to takeovers than other states. Other states are more restrictive and some give boards the authority to consider the interests of other constituencies such as employees and communities in addition to the shareholders.

The study sample included more than 4,400 publicly traded companies from 1991 to 1996. A 5% percent higher stock price was found for 1996, but no reason was given for choosing this year as an example, and this difference was not reported to be statistically significant. No model is specified so we do not known what independent variables were controlled for in the model estimation. The methodology of the reported study may be merely data analysis with descriptive statistics rather than the more rigorous systematic econometric modeling with inductive statistics. In that case, the study has no predictive value and no causal implications.

As the article states: Companies can choose to incorporate in Delaware, or any other state, regardless of the actual location of the firm's headquarters. ... Delaware rulings are closely watched because more than half of public companies are incorporated in Delaware. ... Delaware has a respected court system and state bar, and there is quick adjudication of battles. Its judges deal with commercial matters full time.

The article continues: Mr. Daines says the reasons Delaware companies are more valuable include the higher likelihood of getting a takeover bid. He found Delaware companies receive more bids than companies incorporated outside of Delaware. "Firms in states that raise significant barriers to hostile bids are worth less and receive significantly few bids," he states.

Again, no model is mentioned for this second finding about the likelihood or frequency of bids. In this type of study, it is not possible to disentangle cause and effect. The direction of causality between any two variables may be one way or the opposite, or it may be reciprocal.

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