

# ***Thematic Investing—*** **Corporate** **Restructuring**

**C15.0042**

**Lesson 5**

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# What is “restructuring”?

- ◆ Consolidation of industries (M&A—friendly and hostile)
- ◆ LBOs of entire companies (popular in 1980s)
- ◆ Streamlining of diversified companies by spinning off divisions to shareholders or via sales to other corporations
- ◆ Acquisitions designed to raise the acquirer’s technological sophistication or alter its business mix
- ◆ Heavy use of leverage and share repurchases to return capital to shareholders, raise EPS and discourage hostile tender offers.

# Types of “restructuring”?

- ◆ Industry consolidation. Firms can get top-line growth with limited risk by acquiring a firm, cutting overhead, consolidating operations. Made sense in fragmented industries such as banking
- ◆ Buy a nickel for four cents. Commodity firms such selling below replacement value
- ◆ Strategic acquisitions: synergies

# The benefits of restructuring

- ◆ It shifts resources to more profitable economic sectors.
- ◆ Allows investors to realize underlying values in their equity holdings that had not been reflected in rising profits and stock prices.
- ◆ Restructuring leads toward very large, focused companies (“Gorillas) and toward small, well-focused, entrepreneurial companies.
- ◆ The fear of being restructured by outsiders prompts managements to take difficult and controversial steps such as plant closings and layoffs, that raise profitability and stock prices.

# Restructuring in 1980s fueled by

- ◆ Disinflation, which radically altered the valuation structure of both real and financial assets, creating gross disparities between market prices and underlying “private market” values.
- ◆ The economic impact of disinflation, broadly defined to include industry deregulation, intense foreign competition and the shift of the U.S. economy from manufacturing to services
- ◆ Innovation on Wall Street: Junk bonds, M&A departments, bloc trading, merger arbitrage, LBOs.
- ◆ Active support of government policymakers—a highly supportive legal and political environment. With foreign competition intense, antitrust concerns lost their urgency.

# Restructuring in 1980s fueled by

- ◆ Low effective corporate tax rates. The accelerated depreciation in the 1981 tax bill dramatically improved corporate cash flow, increasing the ability of companies to service debt
- ◆ Willingness of managements to leverage balance sheets. This was due, in part, to the enhanced stature of entrepreneurs and venture capitalists

# Restructuring in 1980s ended by

- ◆ The Crash of 1987
- ◆ The banking and S&L crisis of the late 80s/early 90s
- ◆ The demise of corporate raiders such as Boesky and their backers such as Milken

***“Highly Confidential”***

# Factors behind “destructuring”:

- ◆ By the early 1990s, however, investors started to view companies as portfolios of businesses that should be disassembled and restructured in order to maximize shareholder values.
- ◆ Poor corporate profit growth—in the intensely competitive, deflationary environment of the early 1990s, many companies were producing poor financial results. Faced with the reality of minimal top-line growth, managements focused on cutting costs in order to raise profits.

# Factors behind “destructuring”:

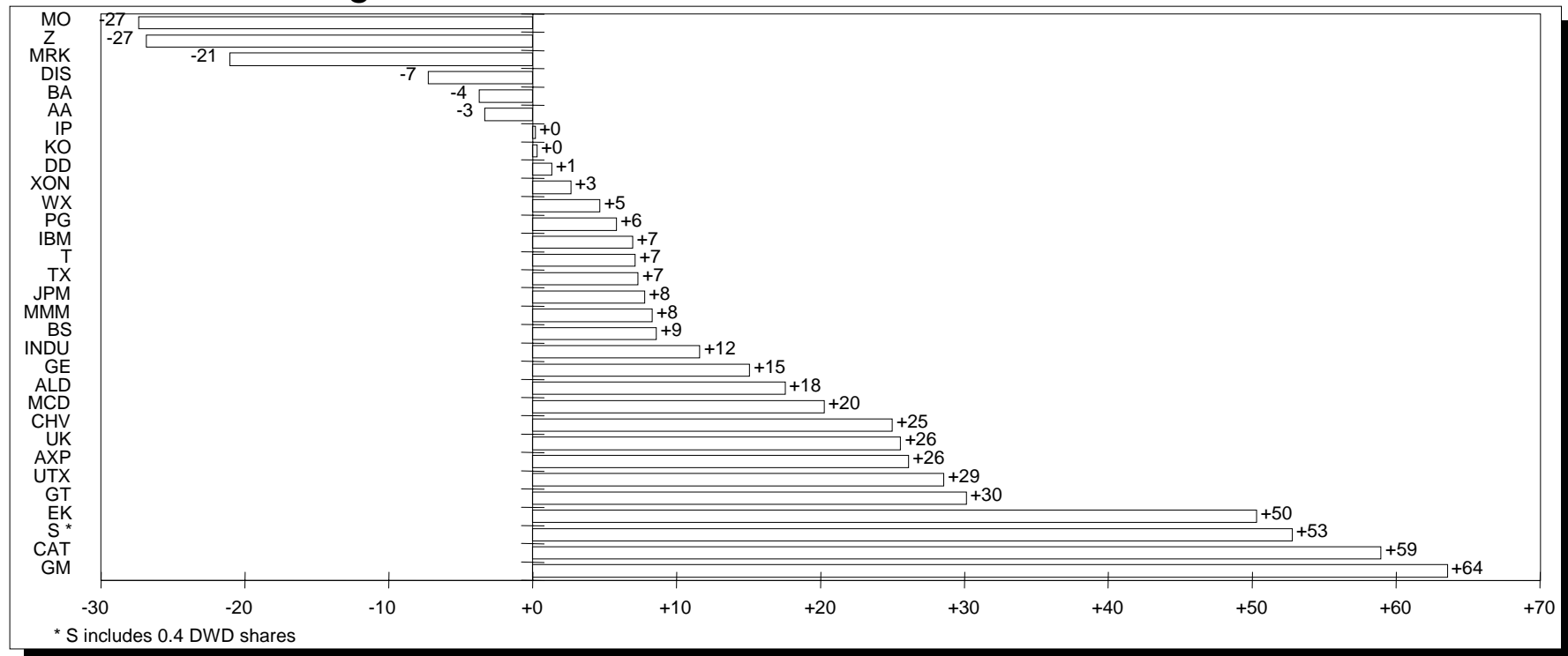
- ◆ Restructuring is contagious; when one firm does it, so must competitors.
- ◆ Restructuring is habit-forming. A firm does it more often than once because the first effort does not boost profitability as much as expected.
- ◆ Giant pension funds and mutual funds owned large, illiquid positions in troubled companies pressured boards of directors to improve performance. More active institutional interest in the performance of corporations was widely viewed as beneficial to U.S. competitiveness.

# Factors behind “destructuring”:

◆ In 1993, leadership of the DJIA was delineated not by classic market sectors such as “growth” or “cyclical” but by destructuring stories such as GM, Kodak, Goodyear Tire and Sears.

## 1993 DJIA performance

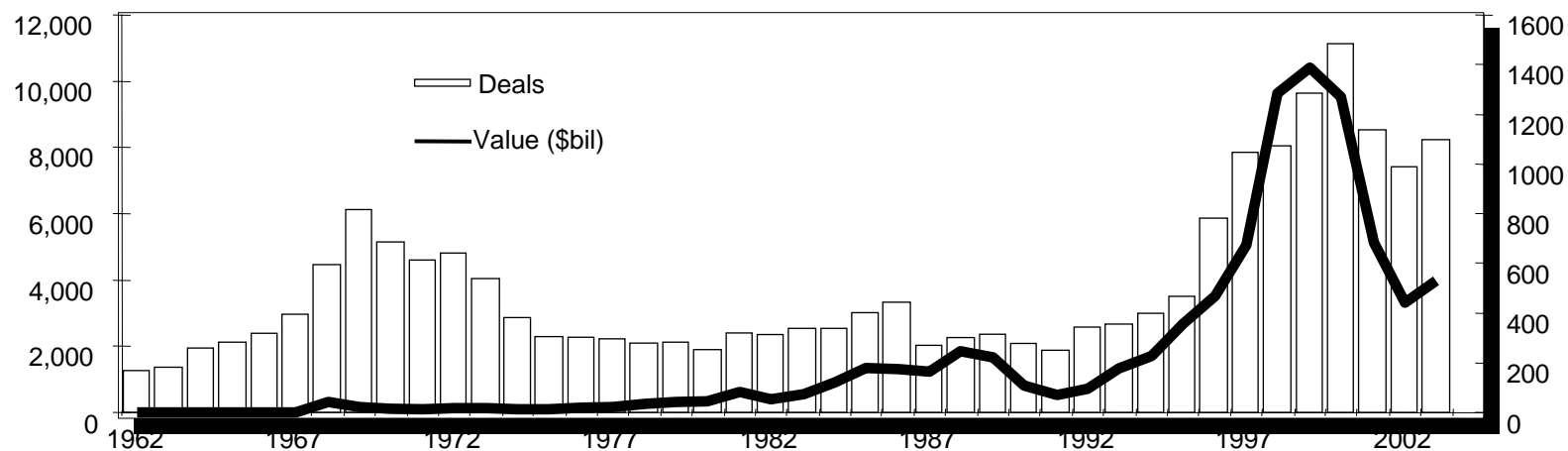
*Year to date through November 30*



# 1994 M&A became more active

◆ By 1994, those companies that had already cut costs to the limit, turned to growing the top line again. However, in an environment that continued to be marked by low inflation and very low real growth, top line growth could not be achieved by merely adding new capacity where ample capacity still existed domestically and globally. Consequently, in its search for top-line growth, corporate America increasingly turned to strategic acquisitions—takeovers.

## *M&A Activity*



Source: [www.mergerstat.com](http://www.mergerstat.com)

# 1994 M&A became more active

- ◆ M&A became more numerous in '94 for four reasons:
  - Pent-up demand after a three-year hiatus
  - Declining interest rates and an expanding economy increased the confidence of CEOs and their bankers
  - Rapid strategic changes in such sectors as health care, entertainment and telecom
  - The currency of acquisitions had become more valuable as P/Es of many firms had risen, while P/Es of others had remained low
- ◆ In the mid 1990s, M&A activity jumped to levels not seen since the merger mania years of the 1980s. However, toward the end of the decade, Strategic Action had run its course.

# Restructuring Ends Again

- ◆ As a result of destructuring, a large section of corporate America was lean, mean and highly competitive
- ◆ Most of the logical acquisitions already had been made, and more than a few acquisitions that never should have taken place also occurred
- ◆ Next catalyst for corporate transformation was the shift to the New Economy at the turn of the 21<sup>st</sup> century.

# Restructuring and the New Economy

- ◆ In the Information Age division of labor moves from the worker to the entire organization; moving from bureaucratic, vertically integrated organizations to flexible firms where decisions are driven by market forces.
- ◆ Just as, in the early 20th century, electric utilities permitted firms and households to “outsource” the age-old function of power generation . . . . . so in the early 21st century is the Internet making it possible to outsource another age-old function: information management.
- ◆ One way for a company to protect its core competency is to assiduously focus on it while **outsourcing** non-core operations. The Internet makes it much easier to coordinate internal operations with services provided by outsiders.

# Restructuring and the New Economy

- ◆ With the market collapse in 2000, the Restructuring of the New Economy ground to a halt.
- ◆ Scrutinized by cautious investors and zealous regulators, many corporate managements are now reluctant to give even the appearance of artificially boosting earnings growth. Look for less aggressive M&A activity and slower R&D growth.
- ◆ Corporate leadership is moving from the risk-takers of the 1990s to the risk-controllers of today.
- ◆ This rotation is reminiscent of the change from the marketing gurus who set the agendas in the 1960s and 1970s, to the financial gurus who took the reigns in the 1980s and 1990s. Now its the turn of the “control-types”—accountants and lawyers

# Turning Assets: Efficiency Wins

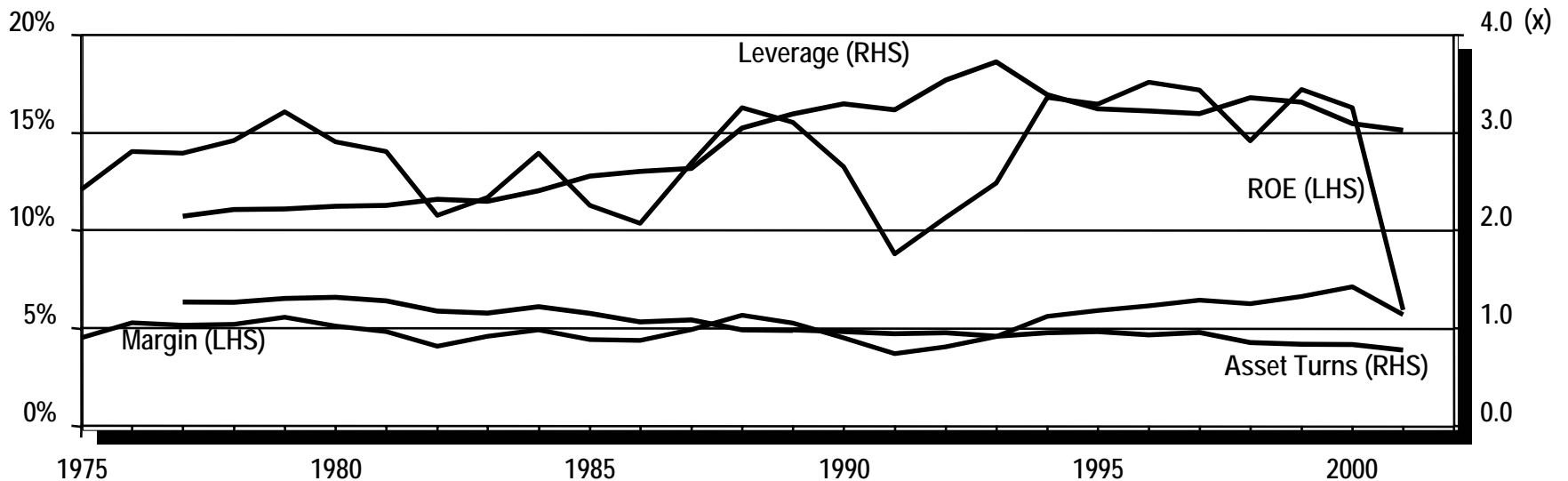
- ◆ Growth will come from companies who use existing assets more efficiently, rather than those who try to grow through M&A, leveraging balance sheets, or who are dependent upon pricing power/rising margins.
  - In the 1980s rising leverage drove ROE.
  - In the 1990s rising net margins drove ROE.
  - Throughout, asset turns have been declining.

# Turning Assets: Efficiency Wins

DuPont model:

$$\begin{aligned} ROE &= \frac{\text{Net Income}}{\text{Equity}} = \frac{\text{Net Income}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets}} \times \frac{\text{Assets}}{\text{Equity}} \\ &= \text{Net Margin} \times \text{Asset Turnover} \times \text{Leverage} \end{aligned}$$

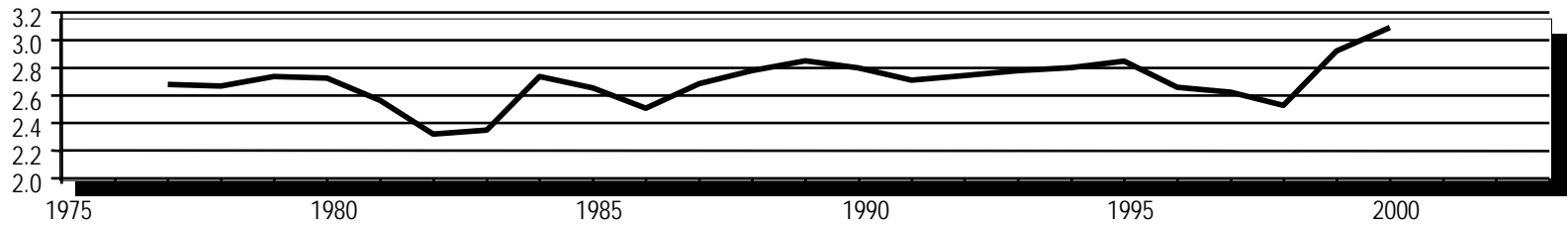
## DuPont Analysis: S&P Industrials



# Turning Assets: Efficiency Wins

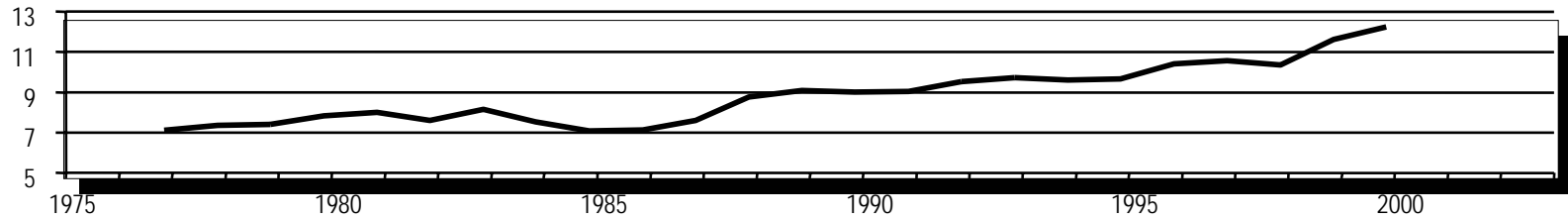
- ◆ Turnover of Plant, Property & Equipment has been rising.

Turnover of Plant, Property & Equipment (Net)



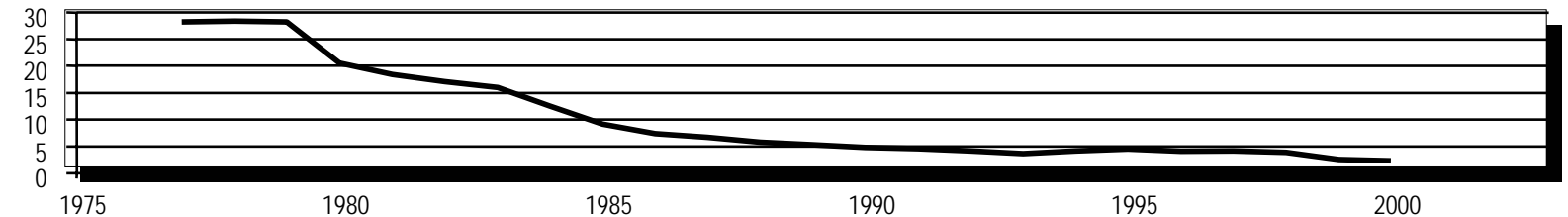
- ◆ Inventory Turnover has risen dramatically.

Inventory Turnover



- ◆ Turnover of "Intangibles and Other Assets" declining.

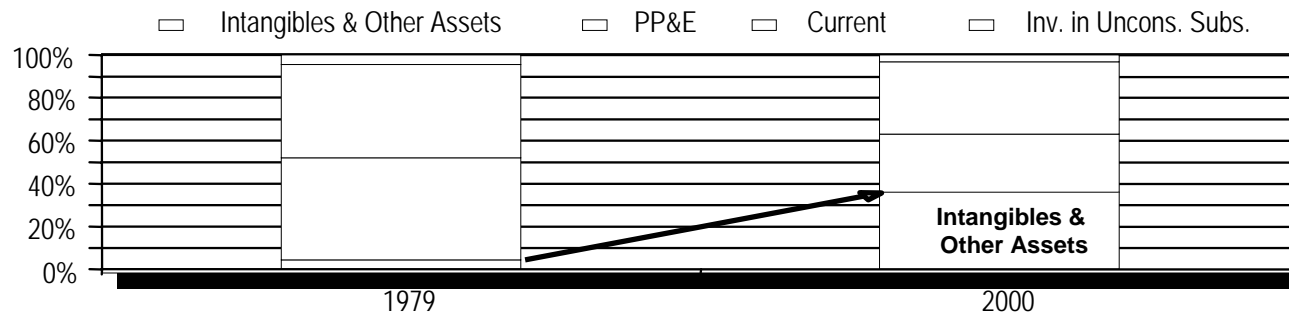
Turnover of Intangibles and Other Assets



# Turning Assets: Efficiency Wins

- ◆ Intangibles and "other assets" accounted for 36% of all assets in 2000, up from 5% in 1979. Not "just M&A" — "goodwill" less than 30% of total.

Asset Categories as a Percentage of Total Assets, 1979 Versus 2000



- ◆ Intangibles and "other assets" seem difficult to "turn."

## Items Included in "Other Assets"

- |  |   |   |
|--|---|---|
| 1. Acquisition costs   | 12. Deferred financing costs  | 25. Pre-opening expenses  |
| 2. Advances to staff   | 13. Deferred policy costs   | 26. Prepaid pension costs (if rept'd as a separate line item in long-term assets) |
| 3. Amounts due from directors, officers, and employees             | 14. Deferred taxes  | 27. Property not used in operations   |
| 4. Assets of discontinued operations                               | 15. Deposits  | 28. Publishing and prepublication costs   |
| 5. Banks' and S&L acceptances and all other assets                 | 16. Finance svc. companies deferred finance charges on installment obligations when presented as a deduction from receivables | 29. Publishing companies' royalty advances to authors                             |
| 6. Broadcasters' program rights, film productions, film rights     | 17. Idle land   | 30. Purchased technology  |
| 7. Cash on deposit pursuant to loan agreements                     | 18. Long-term inventory   | 31. Restricted cash   |
| 8. Cash surrender value of life insurance policies                 | 19. Long-term prepaid expenses  | 32. Start-up costs  |
| 9. Claims in litigation  | 20. Materials and supplies  | 33. Stock issuance costs  |
| 10. Computer software costs (not in PP&E or on Schedules V and VI) | 21. Minority interest in consolidated subsidiaries  | 34. Timberlands other than those owned by forest and paper companies              |
| 11. Contracts  | 22. Motion picture companies' film distribution systems   | 35. Tooling costs   |
|  | 23. Negative goodwill   | 36. Treasury stock reported on the asset side of the balance sheet                |
|  | 24. Pension and other special funds   |   |

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# Turning Assets: Efficiency Wins

- ◆ Having made the case that ROE would now be driven by asset turn (unlike the 1980s when it was leverage or the 1990s when it was margins), the report identified all the Buy- and Strong Buy-Rated S&P 500 Stocks with asset turns and ROE superior to their sector averages.
- ◆ So the list was very diversified.
- ◆ The stocks mentioned were up about 36% from the time of the report through year-end 2003 versus 21% for the S&P 500.