Achieving Fair Value

How Companies Can Better Manage Their Relationships with Investors

Mark C. Scott

John Wiley & Sons, Ltd

Achieving Fair Value

How Companies Can Better Manage Their Relationships with Investors

Mark C. Scott

John Wiley & Sons, Ltd

Telephone (+44) 1243 779777

Email (for orders and customer service enquiries): cs-books@wiley.co.uk
Visit our Home Page on www.wiley.com

Other Wiley Editorial Offices

John Wiley & Sons Inc., 111 River Street, Hoboken, NJ 07030, USA

Jossey-Bass, 989 Market Street, San Francisco, CA 94103-1741, USA

Wiley-VCH Verlag GmbH, Boschstr. 12, D-69469 Weinheim, Germany

John Wiley & Sons Australia Ltd, 33 Park Road, Milton, Queensland 4064, Australia

John Wiley & Sons (Asia) Pte Ltd, 2 Clementi Loop #02-01, Jin Xing Distripark, Singapore 129809

John Wiley & Sons Canada Ltd, 22 Worcester Road, Etobicoke, Ontario, Canada M9W 1L1

Wiley also publishes its books in a variety of electronic formats. Some content that appears in print may not be available in electronic books.

British Library Cataloguing in Publication Data

A catalogue record for this book is available from the British Library

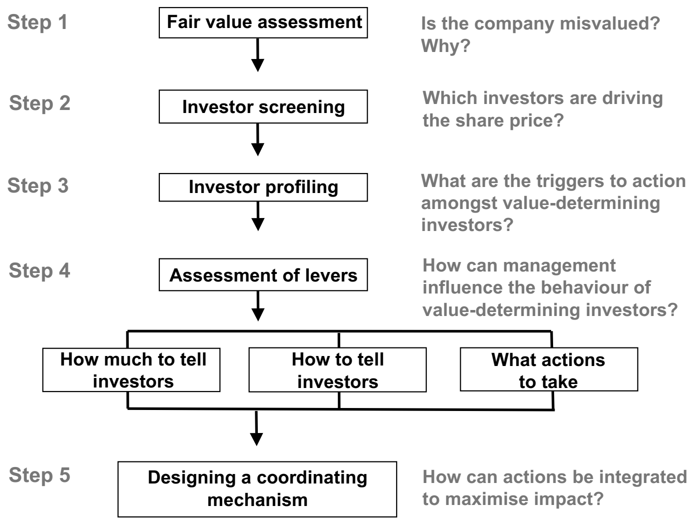
ISBN 0-470-02390-2

Project management by Originator, Gt Yarmouth, Norfolk (typeset in 11/16pt Trump Medieval)
Printed and bound in Great Britain by Antony Rowe Ltd, Chippenham, Wiltshire
This book is printed on acid-free paper responsibly manufactured from sustainable forestry in which at least two trees are planted for each one used for paper production.

Contents

Acknowledgements

THIS BOOK WOULD NOT HAVE BEEN POSSIBLE WITHOUT the support of the Ashridge Strategic Management Centre and the input of its directors and associates. Thanks are due in particular to Andrew Campbell and Michael Goold who have patiently helped guide the thinking behind the concept of fair value from its beginnings, through a lengthy research programme, to the final concept. The observations and insights detailed in this book have been gleaned through the input of a wide number of professionals involved in the investor relations (IR) process and also from the fund management and investment banking industry. Detailed interviews and analysis have been conducted with a large group of public companies and, in respect of the price-sensitive nature of many of their contributions, their names have been omitted from the text. Finally, I also owe a debt of thanks to Angela Munro, without whom I would have driven the production department of John Wiley & Sons to the brink of despair.



The fair value process.

Introduction: What is "fair value" and why does it matter?

If you ask CEOs of large public companies what is the most demanding aspect of their job, you are likely to get one answer – managing the relationship with the financial markets and investors. It is an extraordinary answer if you think about it. You might expect the demanding thing to be managing the business itself – dealing with tough customers, with demanding employees, with capital allocation issues, with cashflow. But dealing with the financial markets absorbs on average 25% of the time of the CEO and up to 35% of the attention of the CFO. That is the single largest drain on the most valuable resource the company possesses.

This in itself should sound a few alarm bells. Is attention being focused where it should be? What about corporate strategy, what about operations, what about marketing and HR – all those areas that management literature tells us are the business essentials? Is there something innately inefficient about the way large companies handle their relationship with investors and with the capital markets? A few influential titans, such as Intel, Coke and HP, have, in public at least, declared this is not where valuable time should be spent. But, for the vast majority of large quoted companies, it remains the single biggest drain on senior time.

To help them in the battle for fund manager support, most corporates have built up an investor relations function. This is typically comprised of an Investor Relations (IR) director plus a couple of analysts, whose primary role is to manage the large logistics exercise of interacting with institutional fund managers. They also retain a house broker, supported by the lead analyst, to help market the shares to existing and prospective investors. This is often supplemented by external IR advisors, PR strategists and a range of additional eyes and ears on the institutional marketplace. The average direct time and fee cost for a FTSE 250 company is probably in excess of £2m and a multiple of this if the indirect time costs of top management are accounted for.

The primary reason management are prepared to invest so much time managing the relationship with the financial markets is because it is the movement of the shareprice that determines whether they are seen to be winning or failing. The primary modern measure of successful management is the ability to maximise shareprice. The manager who succeeds, for a sustained period of time, to maximise shareprice receives universal accolades. They are the darlings of the City and Wall Street and they are rewarded accordingly. It is no longer sufficient to focus internally on long-term strategies to deliver earnings and revenue growth. Managers are required and incentivised to maximise the value attached to their efforts by the financial markets.

Yet, despite the resources committed to it, the battle to maximise shareprice is one that so few companies appear able to win at for long. The typical pattern of larger groups is shareprice boom and bust – historically over a 7-year cycle. Over the past decade the FTSE 100 and Dow Jones Industrial Average have on average suffered an annual 20% volatility – the average difference between their highs and lows on a moving 12-month basis. This is immensely disruptive to the businesses concerned, driving endless shifts in strategy and management. The average CEO's tenure is now down to 3 years, shorter than the classic strategy cycle of 5 years. As a result, both the strategy process and management are highly geared to managing and meeting market perceptions. This can and often does lead to distortions of behaviour, or what is labelled ''short-termism''.

The blame for this short-termism is usually put on the shoulders of ''the market'' and is in particular credited to the short time horizon of institutional fund managers. This suspicion has been so strong in the UK, for example, that the government has actually launched an enquiry to look into the sources of institutional short-termism.As this book will explore, the markets and institutional fund managers may be far from perfect. But much of the challenge lies with the way businesses manage their relationships with financial markets and investors. This book contests that it is ultimately within the power of executive teams to better manage their relationships with fund managers, with more effective use of their most valuable resource, by applying new approaches to the IR function. This book proposes a constructive way to reduce shareprice volatility and investor churn.

The concept of ''fair value'' is a simple one – that an appropriate strategy for management is to ensure that their business is fairly valued. In other words, to ensure that its market value accurately reflects the business's fundamental, sustainable worth. In some cases this may imply that management need to actively manage down situations of overvaluation. But, more generally, fair value means that the primary focus of management should be on fundamental, operational value creation and ensuring that this is as accurately valued by investors as possible. The idea of fair value often requires a major change of mindset on the part of management for whom share value maximisation is deeply ingrained. It also requires a change in the relationship the company maintains with its brokers, the analysts that follow the company and other advisors.

Pursuing a fair value strategy demands the development of a set of analytical tools and management processes which are typically underdeveloped in most companies. Most IR functions are not ideally equipped to undertake fundamental analysis of the share register, to identify active fund managers that might be setting the shareprice and to predict investor behaviour. Nor are they usually well equipped to provide detailed guidance on valuation. The fair value approach also requires the development of a set of skills and coordination ability at the corporate parent level which are often not present. Investor relations cannot operate as a stand-alone activity reporting to the CFO. It has to be a coordination function between corporate strategy, finance and the executive, focused on long-term valuation, analysis of the share register, and proactive management of investor perceptions. In this coordinating role it is one of the most important parenting functions at the corporate centre.

In the process of researching this book, I have been surprised how little strategic insight has been developed in the area of managing relationships with investors. The investor relations function itself has only been in existence for around 15 years, and hence is a relatively new discipline. It is typically not integrated with the strategy function which has an older heritage. Unlike strategy, there is virtually no academic or consulting wisdom on the subject. There are no robust strategic frameworks to guide management action. It has evolved through expediency and without design. The role of the IR director is not a board role, nor does it usually represent a genuine career avenue in its own right. Instead, this critical area of expertise remains largely outsourced to the broker community. It is now time that it was brought squarely in-house as a core competence.

This book is intended to provide a practical introduction to each of the core elements of fair value strategy and improve the ability of the company to manage its institutional investors. It is equally relevant for the IR director seeking to refine their approach to managing investors, or for a management team that senses they can improve their effectiveness or who believe they are currently being misvalued. It is the ability of corporate executives to manage their institutional investors that will determine whether they are perceived to have succeeded or failed.

Part One

The Imperative for a Fair Value Strategy