

Half-listening to the market

The manager's mantra is to add value for shareholders. So why make acquisitions of other large, listed companies?

When Anglo made its bid for Australian iron ore producer North, its share price, adjusted for the market as a whole, went down. And when it conceded North to Rio Tinto, its share price, again market-adjusted, improved.

Portfolio investors in general do not like companies to make acquisitions. The evidence for this from the financial economics literature is unambiguous. Companies on average generate negative short-term returns for their shareholders when they announce significant acquisitions.

One reason is that in order to take over a company you invariably have to offer more than the ruling price. The market is in the business of valuing assets. It would include in such valuation the likelihood of a takeover bid. And so by definition the bidder will be paying more for a stream of income than the market thinks it should. So, unless the buyers can convincingly claim synergies or cost savings as a result, they should expect a slap on the wrist for putting the balance sheet at risk and overpaying to boot.

Do managers get it right...

Does this mean companies should never bet against the market by making large investments? Should they only give the market what it expects? History tells us that every great company has succeeded against the market judgement of its worth. They performed much better than the market expected them to and so provided outstanding returns for their shareholders as the value of their shares rose with unexpectedly good results.

What the market expects is all in the current price of the shares. Perform only as well as you are expected to and your share price will only do as well as the market generally. Only by doing surprisingly well can a company hope to earn exceptional returns for its shareholders.

...or wrong?

Yet for every company that has succeeded in this way there are many more that have disappointed shareholders – some for taking on risks they should not have and many others for not accepting the risks of economic change that mere survival demanded of them.

Share market sentiment is typically risk-averse and highly sceptical about the capabilities of management. The investor in shares of established companies is generally only comfortable with incremental growth generated, as they put it, organically, not through acquisitions. Such growth is more predictable and less risky and can more easily be given a present value.

Have you ever wondered why the share market valuations of a highly cyclical company go up and down in step with the cycle of current earnings? It is as if the market takes no account of the upturn or downturn in the economic cycle that is bound to happen. As if, in fact, there is no economic cycle to worry about. Current earnings seem to be all that matters.

Beating the market...

So managers, if they hope to beat the market, have to be prepared to prove the market wrong. Taking uncomfortable risks, which will not usually be sanctioned by the market, may be the only way to do this. If the managers prove to have been right, the market will make up to them with great

enthusiasm and revalue their shares accordingly. But even successful managers should recognise that they are only as good as their next set of results. If hindsight reveals that the managers overestimated their own capabilities, the market will drop them.

The relationship between any market and the market-makers is a tense and high-maintenance one. When managers do only what the market expects them to do, even the most competitive can only provide their shareholders with an average market return.

...is in everyone's interest.

But beating the market is no simple task. It takes courage in managers and complete honesty about the prospects of the investment projects under consideration. Which may well mean investing more rather than less. Too little capacity to take on risk is potentially as serious as too much fondness for it. And managers should have no illusions about the opportunity cost of the shareholders' capital that is being put at risk. The strength in the firm's balance sheet belongs to shareholders, not to managers. It should not be regarded as insurance against management failure. So if managers believe they cannot use the capital at their disposal, they should give it back to shareholders.

But if the returns they generate unexpectedly exceed the cost of the capital they invest, then the market will add the extra value to the shares in issue. So good luck to all the potential market-beaters out there. We need you to raise the return on capital generally and so to take on the extra risk, even when the market tells you not to try. We must hope you succeed not only for your shareholders but for the sake of a successful economy.

Further reading

Manne, HM (1965) "Mergers and the market for corporate control", Journal of Political Economy, Chicago, USA.

This Briefing Paper was written by Professor Brian Kantor of the University of Cape Town, and first appeared in the Financial Mail, September 2000.