Short-Term Shareholders Aren't Looking Out For The Long Term, And Vice Versa

Dealbreaker
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Yesterday we talked a little about Dell and its vague desire to escape the short-term obsessions of the public equity market yesterday. Today I came upon this new paper by Harvard Law professor Jesse Fried, about how long-term shareholders are really just as bad as the short-term ones. The argument is:

- companies like to talk about favoring long-term shareholders over short-term ones, because
- they think (er, say) that short-term shareholders want things (slashing R&D, earnings manipulation) that reduce the overall economic value of the firm, while long-termers only want to grow its value, but
- in fact long-term shareholders *also* want things that reduce the overall economic value of the firm, so
- maybe favoring the long-term isn't as good an idea as people think.

The particular things that long-term shareholders prefer that are value-destructive involve transacting in the company's stock. On the buyback side, favoring long-term shareholders can mean using money to buy back stock when it's underpriced, even if spending that money on productive investments would be better for shareholders as a whole. It can also mean manipulating earnings *lower* to get more profitable buyback opportunities. There is some evidence that these things happen.[i]

On the issuance side, favoring long-term shareholders means issuing more stock when it's overpriced, for instance to engage in otherwise value-destructive M&A. Amusingly, Fried's example of this is AOL Time Warner, famously the worst M&A transaction from the invention of the corporate form until Countrywide; he argues that, despite this value destruction, AOL's long-term shareholders were enriched by AOL's purchase of Time Warner.[ii]

This perspective is worth keeping in mind when thinking about IPOs and LBOs. One pretty obvious and influential group of long-term shareholders in a lot of companies is the class of founder-CEOs. They tend to have even longer horizons than the longest-term public shareholders: unlike Fidelity or whatever, they typically owned stock in the company before it went public, and sometimes they own stock in the company after it stops being public.

Facebook has lost almost $30 billion of market cap since IPOing last year, and you could if you like attempt to attribute those losses among (1) value destruction just from being a public company, (2) changes in business performance and prospects in the last ~10 months, and (3) just being overvalued when it IPOed. A combination of categories (1) and (3) would support Fried's thesis: that Facebook top-ticked the market to increase the value of its insiders' stakes, even at the cost of reducing the overall value of the firm.[iii]

On other side, Dell was trading near its 10-year low when founder-CEO-biggest-shareholder Michael Dell offered to buy it. Given his and his board's fiduciary duties no one could come out and say "we think this stock is too cheap so we're buying it all," and so they had to come up with a lot of noise about how short-term public markets were a menace Dell's business and how the only way to improve its overall value was to take it private and put it solely in the hands of longer-term investors. Maybe? Another possibility is that those longer-term investors had a rather louder voice in the boardroom and pushed to get a bigger share of the pie than short-term investors – even those who, like Southeastern, would have preferred to stick around for the longer haul.

So it's an interesting framework, and it might argue against proposals, like Al Gore's, to increase the power of long-term shareholders by giving them extra votes, etc. But it's suggestive rather than dispositive – Fried admits that "my analysis cannot resolve the question of whether short-term or long-term shareholders have 'better' interests," only suggest that they might both be problematic. Here, for instance, you can read about a man who sold shares in himself *and gave them voting rights*, which seems super dumb. This ensued:

> [Mike] Merrill asked his stockholders to decide whether he should attempt something known as polyphasic sleeping. The idea—touted by Buckminster Fuller in the 1940s—was to cut total daily sleep time to less than four hours by taking naps throughout the day and night. …
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> [His girlfriend] thought it was a terrible idea and voted no with her 19 shares. … But now [random software engineer Gordon] Shephard, a total stranger, was the second-largest stockholder, and he was fascinated by sleep-modification strategies. He'd heard of polyphasic sleeping but had never given it a try. It was likely to be a massive disruption to Merrill's life, but here was an opportunity to test the idea vicariously. Shephard voted yes: His short-term goals outweighed any longer-term considerations.[iv]

I'm sure there's a corporate governance lesson in there somewhere.

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[i] *We've previously met Fried for his work on informed share buybacks, where corporate insiders cause the company to buy back stock cheap and enrich themselves by the concentration of their own shareholdings. Obviously there is evidence the other way too.*

[ii] *Non-intuitive! Here's the argument:*

AOL, with a market capitalization of over $200 billion, used $162 billion of stock to acquire Time Warner. The companies thus had roughly equivalent market capitalizations before the

merger. A hypothetical AOL shareholder owning 2% of AOL before the merger thus would have ended up with approximately 1% of the combined firm.

> There is little doubt, from an ex post perspective, that the acquisition destroyed long-term economic value. The expected synergy benefits failed to materialize. In fact, AOL and Time Warner parted ways nine years later, suggesting that synergy effects were actually *negative*. The economic costs of this failed marriage included the transaction costs associated with combining and then splitting the businesses, as well as the negative synergy costs incurred while keeping the two firms stapled together.
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> Nevertheless, AOL's long-term shareholders appear to have benefited from the transaction. When AOL and Time Warner were separated in 2009, AOL was worth $3.5 billion while Time Warner was valued at about $36 billion, for a combined value of about $40 billion. Assuming AOL would have been worth the same ($3.5 billion) in 2009 had it not acquired Time Warner, our hypothetical 2% AOL shareholder would (absent the merger) have owned shares worth $70 million. Instead, as a result of the merger, that shareholder would have owned 1% of AOL (worth $35 million) and 1% of Time Warner (worth $360 million), for a total value of approximately $400 million—more than five times the value of her hypothetical no-transaction stake in AOL.

*So the long-term 2% AOL shareholder whose stake was worth **$4 billion** pre-merger in 2000 ends up with a $400 million AOL/Time Warner stake in 2009, losing about 90% of her money. GREAT. The point is that if not for the merger her AOL-only stake would be worth only $70 million and she'd have lost 98% of her money, so the merger helped her out a lot. A lot of work is being done by that "Assuming AOL would have been worth the same in 2009 had it not acquired Time Warner," which is odd since Fried just got through saying that the merger destroyed value.*

*Still you get the idea: if, as seems at least plausible, AOL's "real" value in 2000 was only a tiny fraction of its $200bn market cap – that is, it was wildly overpriced – using that inflated market cap to grab some valuable property for long-term AOL shareholders might help them, even if it's value-destructive to everyone else. A fun thing to ponder is: what would have been the **best** thing to do for those long-term AOL shareholders in 2000? Big cash dividend? That $200bn market cap was based on expectations, not cash piles. Issue $162bn worth of stock to acquire some safer asset than Time Warner (e.g. sell $162bn of stock for cash, invest proceeds in Treasuries, which wouldn't lose ~75% of their value as Time Warner did)? That's obviously better ex post, but in practice it's hard to do a gigantic equity offering for cash – and probably impossible to do a hundred-billion-dollar one – particularly if your use of proceeds is like "put money in the bank for the day that everyone realizes our business model is garbage." (You could do a better merger than the Time Warner one, of course, but you could also do a worse one; it's hard to know ex ante – imagine if AOL had acquired Countrywide in a stock deal.)*

The answer is probably "turn them into short-term shareholders," i.e. sell. But a respectable alternative answer would be "don't buy Time Warner, focus on being an internet company, and try to innovate – maybe invent Facebook or something." It's certainly at least possible that that strategy would have lost less than 90% of their money. Anyway.

[iii] *Though one shouldn't be too critical as FB was to some extent forced to IPO when it did, having grown too large to stay private mainly through employee stock issuance. Also of course this is muddied because the insiders sold lots of stock in the IPO, top-ticking on their own. In general "issue more stock" is never a first-best way to favor shareholders in overpriced companies: the first-best way is for them to sell their stock. But then, analytically, they're not "long-term holders." I suppose unless they keep some.*

[iv] *It goes on from there. "He was a longtime Democrat, but his investors decided to make him register as a Republican, which they argued was more business-friendly." The girlfriend, understandably, leaves.*