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The value of "just say no"

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(Opinions expressed herein are strictly those of the authors)

On October 22nd 2014, ISS published a note on the financial consequences for shareholders to vote "NO" to a proposed takeover. The ISS note, and its conclusion, comes at a propitious time for the Valeant *cum* Pershing Square attempt to take over Allergan. The shareholders of Allergan, who may get to vote on this takeover on December 18th, are now "informed" that those shareholders who voted "No" to a proposed takeover of their company would have been better off financially, had they agreed to the takeover. "*For those* [proposed takeovers] *which do go all the way to a vote yet remain independent, however, the abysmal subsequent returns relative to shareholders' next best alternatives suggest something in the process has gone awry*". (ISS, *The IRR of NO*, page 3)

Unfortunately, the ISS note does not support such a blanket statement. Already, several commentators, notably Sabastian V. Niles of legal firm Wachtell, Lipton, Rosen & Katz (see – "Shareholder Returns of Hostile Takeovers"), have been sharply critical of the ISS paper: the very small sample size, the inclusion of two target companies with miniscule stock market value, the exclusion of a case where the shareholders eventually accepted a tender offer (thus not qualifying as a "No" vote) but only after management elicited a very large increase in bid price.

Our take on the ISS paper will highlight other debatable aspects of their analysis.

1. The ISS note is based on a very small sample of companies from vastly different industries (industrial gases, convenience stores, internet software, power production, etc.) and on takeover events scattered over four years. To increase their sample size, they include two micro-cap companies that should be removed from the analysis, as we shall do in the rest of this piece: Onvia (market cap-$36 million) and Pulse Electronics (market cap-$250 million). As per the ISS note, the bold numbers of **Table 1a** claim to represent the total market performance of the companies that have rejected the attempted takeover since the time of the "No" vote, compared to an S&P 500 index fund and "peer group" median performance.

Table 1a

	Absolute Total Shareholder Return Since Contest	Comparison with S&P 500 Index Performance	Comparison with Peer Median Performance	Years Since Contested Meeting	Market Value on date of Shareholder Vote ($M)
NRG Energy	18.7	-107.4	-99.1	5.3	7,915
AirGas	82.1	-5.2	20.8	4.1	5,478
Casey's	88.7	1.4	-91.8	4.1	1,962
Illumina	304.4	257.2	246.9	2.5	6,286
Onvia	10.4	-44.8	-65.1	2.4	36
Pulse Electronics	-98.4	-153.5	-153	3.4	250
Average	*67.7*	*-8.7*	*-23.5*	3.6	3,655
Median	***50.4***	***-25.0***	***-78.4***	3.8	3,720

Source: Data from ISS, "The IRR of 'No'"

Table 1b presents the same results but after excluding the two micro-cap companies. The picture is very different. Now, the four significant cases of takeover rejection produce a market performance equal to the S&P 500 and much closer to a supposed peer group (about which, much to come below). Note that ISS chose to present and use only the median results, never the average, a choice that serves well their thesis in this case.

Table 1b

	Absolute Total Shareholder Return Since Contest	Comparison with S&P 500 Index Performance	Comparison with Peer Median Performance	Years Since Contested Meeting	Market Value on date of Shareholder Vote ($M)
NRG Energy	18.7	-107.4	-99.1	5.3	7,915
AirGas	82.1	-5.2	20.8	4.1	5,478
Casey's	88.7	1.4	-91.8	4.1	1,962
Illumina	304.4	257.2	246.9	2.5	6,286
Average	*123.5*	*36.5*	*19.2*	4.0	5,410
Median	**84.5**	**-1.9**	**-35.5**	4.1	5,882

Source: Data from ISS, "The IRR of 'No'"

Then, **Table 2** shows the sensitivity of this whole exercise to small variations in the dates selected for the analysis. Hence, choosing between October 20th and October 21st for the final stock market value makes a significant difference in performance scores. (The ISS note refers to October 20th in the text (see pages 1 and 2) but to October 21st in various tables)

By October 31st, a mere 10 days later, the picture had changed substantially.

Table 2

	Total shareholder return, from the day before the vote to...		
	October 20, 2014	**October 21, 2014**	**October 31, 2014**
NRG Energy†	25.5%	26.3%	32.9%*
AirGas	83.6%	88.7%	84.9%
Casey's	87.8%	87.9%	100.9%*
Illumina	273.8%	308.1%	337.7%

*The dividend paid by NRG and Casey's on October 30, 2014 was considered in the adjusted price at closing on the day before the contested meeting for the calculation of the total shareholder return of October 31, 2014.

Source for stock price data: Yahoo! Finance

†We computed a vast array of permutations (average daily price, closing and opening prices, etc.) and we were unablee to replicate the 18.7% shown in the ISS analysis.

2. What is the stock market performance of these four companies ***from the day before hostile intentions were made public***, up to October 21st 2014?

ISS seems surprised that in the immediate period after a "No" vote, the company's stock price drops. But, rather obviously, as the bid price included a control premium and market price gravitated towards the bid price, a negative vote would immediately provoke a drop in price. The important point here for an investor (and the courts) has to be the long-term performance of the stock relative to the price before the hostile takeover attempt became public.

Table 3 shows the significance of this adjustment. Three out of the four companies now beat the S&P 500 index fund by a wide margin. This result tells investors that rejection of the bid was entirely justified as these companies (at least three of them) produced returns that surpassed the (unusually hot) S&P index.

Table 3

	Total Shareholder Return since day of the vote (ISS)	Difference with S&P 500 Index (ISS)	**Total Shareholder Return *Since the Day Before* the Announcement of Hostile Bid**	Difference with S&P 500 Index
NRG Energy	18.7	-107.4	**53.8**	-82.6
AirGas	82.1	-5.2	**184.2**	83.5
Casey's	88.7	1.4	**156.1**	76.9
Illumina	304.4	257.2	**376.4**	320.3

Source for stock price data: Yahoo! Finance. All returns calculated with the closing prices of October 21, 2014.

Indeed, as shown in **Table 4**, the annual compounded returns, *since the day before the hostile intentions* were made public, confirm this relationship.

Table 4

	Date of announcement	Compounded Annual Shareholder Return **(since the Day Before the Announcement of Hostile Bid)**	Compounded Annual Return, S&P 500 Index (same period)	Difference
NRG Energy	2008/10/19	7.4	**15.4**	-8.0
AirGas	2010/02/05	24.8	**15.9**	8.9
Casey's	2010/04/09	23.0	**13.7**	9.3
Illumina	2012/01/25	76.8	**17.7**	59.1

Source for stock price data: Yahoo! Finance. All returns calculated with the closing prices of October 21, 2014.

3. The ISS paper compares the stock market performance of each of these four companies to the S&P 500 index; but the real test here would be to compare the *market weighted performance* of these four companies with the (obviously) market weighted S&P 500 index. (Note that including the two small companies eliminated from analysis would not change appreciably the results of this test).

Let's build a portfolio, as an investor might, of "No" companies, investing $1,000 in the first company in 2008 (NRG) *from the day before the announcement of the hostile bid*. The portfolio is then re-evaluated to integrate new "No" companies as the events occur. The adjustment consists of allocating the value of the portfolio across companies at the time a new event occurs so as to reflect the new market-weighted capitalization of all "NO" companies at that point of time.

Table 5 presents the result of this operation. The weighted portfolio of NO companies beat handily the performance of the S&P 500 index.

Table 5

Initial Investment (Oct 20, 2008)	Portfolio Market Value (Oct 21, 2014)	Total Investment Period (Years)	Portfolio CAGR	S&P 500 Index Fund CAGR
$1,000	**$3,535.21**	**6.0055**	**23.40%**	**15.40%**

Source for stock price data: Yahoo! Finance.

4. The ISS paper contends that the performance of these "No" companies is even worse when compared to a «median peer group» company. We examine one particular instance we happen to know well as the bidding company is Canadian (Casey's, a chain of convenience stores) to show why this sort of comparison is highly questionable. The following companies (**Table 6**) were selected by ISS for the purpose of assessing Casey's performance:

Table 6

	Market value (M$) on September 22nd 2010	Compounded annual shareholder return
Casey's	2,181	16.7%
Susser Holdings	233	55.2%
Pantry Inc.	515	1.6%
Travelcenters of America	58	28.9%
Alimentation Couche-Tard	6,884	49.0%

Source for stock price data: Yahoo! Finance. All returns calculated with the closing prices of October 21, 2014.

The ISS paper then suggests that the performance of Casey's since the "NO" vote be compared with the performance of these "close" peers. By investing the proceeds of the sale of their Casey shares (N.B. without any consideration of capital gain tax) in a group of peers, ISS claims they would have realized, ***at the median***, an additional 92% between September 2010 and October 21st 2014. Impressive? No, misleading.

The graph on page 7 of the ISS paper which supports this 92% in additional return clearly maps out the stock performance of the median company in terms of performance. As Table 6 above shows, this median company happens to be Travelcenters of America, a truck stop servicer. Here's the profile of the company on Yahoo Finance:

TravelCenters of America LLC operates and franchises travel centers primarily along the United States interstate highway system. It offers diesel fuel and gasoline; operates full service restaurants under the Iron Skillet and Country Pride brands; and operates quick serve restaurants under the Arby's, Burger King, Dunkin' Donuts, Pizza Hut, Popeye's Chicken & Biscuits, Starbuck's Coffee, Subway, and Taco Bell brands. The company also operates truck repair and maintenance facilities, which offer maintenance and emergency repair and road services ranging from basic services, such as oil changes and tire repair to specialty services, including diagnostics and repair of air conditioning, air brakes, and electrical systems…

That company is as much a "peer" to Casey's as, say, Starbuck's. But, in the view of ISS, the shareholders of Casey's should have sold their shares and invested the $2.2 billion proceeds in a company with a market cap at the time of $58 million!! That would have produced a 92% increase in return.

5. Finally, we introduce a concept from Investment 101, the risk-return relationship. We show how the analysis leads to different conclusions if we introduce volatility in the assessment, by computing, for instance, the Sharpe ratio[1] for the different companies in Casey's supposed peer group. **Tables 7 and 8** present instructive information.

Whether the returns are calculated, as we contend is more appropriate, from the day before hostile takeover intentions are made public (Table 6) or, as ISS does, from the day before the vote (Table 7), the results give the same message: the worst company performance is posted by The Pantry, followed by Travelcenters of America. Actually, on the basis of risk-return, ***Casey's is the median company***.

1 The Sharpe ratio is simply the rate of return of a stock (or a portfolio of stocks) minus the risk-free rate of interest, divided by the standard deviation of the stock's price (a measure of volatility). The higher the ratio, the better investors are compensated for the level of risk (or volatility) they have incurred.

Table 7

Sharpe Ratio, for the period *from day before announcement of hostile bid* to October 21, 2014

Expected return: real compounded annual shareholder return

From April 8, 2010 to October 21, 2014	Compounded Annual Shareholder Return minus risk-free rate (2.33%)	Annualized Standard Deviation	Sharpe Ratio
Casey's	20.7%	24.8%	0.83
Susser Holdings*	61.6%	36.1%	1.71
Pantry Inc.	9.3%	41.1%	0.22
Travelcenters of America	18.5%	76.9%	0.24
Alimentation Couche-Tard	49.2%	24.5%	2.01

Source for stock price data: Yahoo! Finance.

*to August 29th 2014 for Susser Holdings

Table 8

Sharpe Ratio, for the period *from the day before the vote* to October 21, 2014

Expected return: real compounded annual shareholder return

From April 8, 2010 to October 21, 2014	Compounded Annual Shareholder Return minus risk-free rate (2.33%)	Annualized Standard Deviation	Sharpe Ratio
Casey's	14.4%	25.0%	0.58
Susser Holdings*	52.9%	35.7%	1.48
Pantry Inc.	-0.8%	40.1%	-0.02
Travelcenters of America	26.6%	77.3%	0.34
Alimentation Couche-Tard	46.6%	23.7%	1.97

Source for stock price data: Yahoo! Finance.

*to August 29th 2014 for Susser Holdings

Susser Holdings shows better results but it must be pointed out that this company was sold (closing on August 29th 2014; how did ISS get performance results up to October 20th??) for a price that included a 41% premium. As a going concern, its performance would have been much less favourable.

Of course, the best company here is Alimentation Couche-Tard (ACT), which happened to be the bidding company in this instance. In 2012, ACT made a large acquisition in Norway which boosted its stock price. Clearly, if the shareholders of Casey's had been offered to trade their shares for shares of ACT, they would have fared better, but that offer was not on the table and smacks a bit of Monday-morning quarterbacking.

All in all, the Casey's shareholders did better than an investment in an S&P 500 index fund and on a risk-adjusted basis fared quite well compared to supposed peers, with the exception of ACT; but ACT did better than most companies from almost any industry during that period.

The same analysis could be conducted for the other peer-groups with similar results.

CONCLUSIONS

The paper produced by ISS to support the position of hostile bidders falls flat. It is marred by dubious analytical choices, questionable metrics and the remarkable absence of a key investment parameter, the risk/return relationship.

Any shareholder would love to have the opportunity to go back in time – say five years – and choose between keeping his stocks or pick the next best alternatives depending on their future (now known) returns. All in all, it reminds one of the classic joke about how simple it is to make money in the investment business: "Buy shares and sell when the price goes up; yes, but what if the price goes down? Then, you don't buy!"

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- Contribute to debates, and the solution, of governance problems by taking positions on important issues and by a wide dissemination of information and knowledge about governance.

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