A case study in value destruction: Eastman Kodak & Sterling Drugs

Kodak enters bidding war

- In late 1987, Eastman Kodak entered into a bidding war with Hoffman La Roche for Sterling Drugs, a pharmaceutical company.
- The bidding war started with Sterling Drugs trading at about $40/share.
- At $72/share, Hoffman dropped out of the bidding war, but Kodak kept bidding.
- At $89.50/share, Kodak won and claimed potential synergies explained the premium.

Kodak wins!!!!

Kodak’s market reaction indicates that investors expected no synergies:
- Kodak’s bid = $5.1 billion
- Sterling’s market value = $5.6 billion
- Prior to announcement = $5.1 billion
- Premium bid = $2.2 billion

Source: The Aler Group, Inc.
Sterling Drug under Eastman Kodak: Where is the synergy?

Revenue
Operating Earnings
An article in the NY Times in August of 1993 suggested that Kodak was eager to shed its drug unit.

- In response, Eastman Kodak officials say they have no plans to sell Kodak’s Sterling Winthrop drug unit.
- Louis Mattis, Chairman of Sterling Winthrop, dismissed the rumors as “massive speculation, which flies in the face of the stated intent of Kodak that it is committed to be in the health business.”

A few months later...Taking a stride out of the drug business, Eastman Kodak said that the Sanofi Group, a French pharmaceutical company, agreed to buy the prescription drug business of Sterling Winthrop for $1.68 billion.

- Shares of Eastman Kodak rose 75 cents yesterday, closing at $47.50 on the New York Stock Exchange.
- Samuel D. Isaly an analyst, said the announcement was “very good for Sanofi and very good for Kodak.”
- “When the divestitures are complete, Kodak will be entirely focused on imaging,” said George M. C. Fisher, the company's chief executive.
- The rest of the Sterling Winthrop was sold to Smithkline for $2.9 billion.
The connection to corporate governance: HP buys Autonomy... and explains the premium

Accountants reassessed value of assets on balance sheet and added $2,533 million to reflect "intangible" assets.

The market was attaching a premium of $1,300 million to the post-deal book equity and $3,833 million to pre-deal book equity.

HP paid a premium of $5,200 million over the market value.

The difference between the acquisition price ($11,100) and the post-deal book equity ($4,600) was recorded as goodwill ($6,500) on HP's balance sheet.

Aswath Damodaran
A year later... HP admits a mistake...and explains it...

- **Premium for non-existent synergy paid by HP ($4,451 m)**
  - Primary culprit: Leo Apotheker (HP’s old CEO)
  - Secondary culprits: HP’s deal bankers

- **Accounting impropriety effect on synergy ($749 m) and on pre-deal market value ($1,700 m)**
  - Primary culprit: Autonomy’s managers
  - Secondary culprit: Deloitte

- **HP’s remaining write off ($1,900 m) for post-deal deterioration at Autonomy and/or comparison game playing**
  - Primary culprit: HP’s current management
  - Secondary culprits: HP’s auditors

Aswath Damodaran
Application Test: Who owns/runs your firm?

- Look at: Bloomberg printout HDS for your firm
- Who are the top stockholders in your firm?
- What are the potential conflicts of interests that you see emerging from this stockholding structure?

Control of the firm

Outside stockholders
- Size of holding
- Active or Passive?
- Short or Long term?

Inside stockholders
- % of stock held
- Voting and non-voting shares
- Control structure

Government
- Managers
  - Length of tenure
  - Links to insiders

Employees

Lenders
Case 1: Splintering of Stockholders
Disney’s top stockholders in 2003

<table>
<thead>
<tr>
<th>Holder name</th>
<th>Portfolio Name</th>
<th>Source</th>
<th>Held</th>
<th>Percent</th>
<th>Latest Filing</th>
<th>Change Date</th>
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<tbody>
<tr>
<td>1Barclays Global</td>
<td>Barclays Bank PLC</td>
<td>US</td>
<td>83,630M</td>
<td>4.055</td>
<td>1,750M</td>
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<tr>
<td>2CITIGROUP INC</td>
<td>CITIGROUP INCORPORAT</td>
<td>US</td>
<td>62,057M</td>
<td>3.078</td>
<td>4,011M</td>
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<td>3FIDELITY MANAGEMENT</td>
<td>FIDELITY MANAGEMENT</td>
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<td>4STATE STREET</td>
<td>STATE STREET CORPORA</td>
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<td>54,635M</td>
<td>2.675</td>
<td>2,239M</td>
<td>09/02</td>
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<tr>
<td>5SOUTHEASTN ASST</td>
<td>SOUTHEASTERN ASSET M</td>
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<td>47,333M</td>
<td>2.318</td>
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<td>6GEFAR MU AUTO</td>
<td>STATE FARM MUTUAL AU</td>
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<td>2.054</td>
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<td>7TWIGUARD GROUP</td>
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<td>8MELLON BANK N A</td>
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<td>1.601</td>
<td>957,489M</td>
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<td>9PUTNAM INVEST</td>
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<td>10LOD ABBETT &amp; CO</td>
<td>LORD ABBETT &amp; CO</td>
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<td>24,541M</td>
<td>1.202</td>
<td>5,385M</td>
<td>09/02</td>
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<td>11MONTAG CALDWELL</td>
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<td>1.198</td>
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<td>1.130</td>
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<tr>
<td>13MORGAN STANLEY</td>
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<td>19,655M</td>
<td>0.962</td>
<td>3,482M</td>
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</tr>
<tr>
<td>14HARICE T ROWE</td>
<td>T ROWE PRICE ASSCIA</td>
<td>US</td>
<td>19,133M</td>
<td>0.937</td>
<td>2,925M</td>
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<tr>
<td>15ROY EDWARD DISNE</td>
<td>n/a</td>
<td>PROXY</td>
<td>17,547M</td>
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<td>16RODA FINANCIAL</td>
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<td>17JP MORGAN CHASE</td>
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<td>14,209M</td>
<td>0.699</td>
<td>462,791M</td>
<td>09/02</td>
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</tbody>
</table>

Total: 599,159M

* Money market directory info available. Select portfolio, then hit IP<GD>.

Aswath Damodaran
Case 2: Voting versus Non-voting Shares & Golden Shares: Vale

Vale has eleven members on its board of directors, ten of whom were nominated by Valepar and the board was chaired by Don Conrado, the CEO of Valepar.
Case 3: Cross and Pyramid Holdings
Tata Motor’s top stockholders in 2013

Aswath Damodaran
Case 4: Legal rights and Corporate Structures: Baidu

- **The Board**: The company has six directors, one of whom is Robin Li, who is the founder/CEO of Baidu. Mr. Li also owns a majority stake of Class B shares, which have ten times the voting rights of Class A shares, granting him effective control of the company.

- **The structure**: Baidu is a Chinese company, but it is incorporated in the Cayman Islands, its primary stock listing is on the NASDAQ and the listed company is structured as a shell company, to get around Chinese government restrictions of foreign investors holding shares in Chinese corporations.

- **The legal system**: Baidu’s operating counterpart in China is structured as a Variable Interest Entity (VIE), and it is unclear how much legal power the shareholders in the shell company have to enforce changes at the VIE.
Things change. Disney’s top stockholders in 2009
II. Stockholders' objectives vs. Bondholders' objectives

- In theory: there is no conflict of interests between stockholders and bondholders.

- In practice: Stockholder and bondholders have different objectives. Bondholders are concerned most about safety and ensuring that they get paid their claims. Stockholders are more likely to think about upside potential.
Examples of the conflict.

- **A dividend/buyback surge**: When firms pay cash out as dividends, lenders to the firm are hurt and stockholders may be helped. This is because the firm becomes riskier without the cash.

- **Risk shifting**: When a firm takes riskier projects than those agreed to at the outset, lenders are hurt. Lenders base interest rates on their perceptions of how risky a firm’s investments are. If stockholders then take on riskier investments, lenders will be hurt.

- **Borrowing more on the same assets**: If lenders do not protect themselves, a firm can borrow more money and make all existing lenders worse off.
An Extreme Example: Unprotected Lenders?

RJR Nabisco’s Bonds Sink Following Announcement of the Leveraged Buyout

RJR Nabisco 30-year bond (6¾%, due 2016)
III. Firms and Financial Markets

- **In theory**: Financial markets are efficient. Managers convey information honestly and in a timely manner to financial markets, and financial markets make reasoned judgments of the effects of this information on 'true value'. As a consequence-
  - A company that invests in good long term projects will be rewarded.
  - Short term accounting gimmicks will not lead to increases in market value.
  - Stock price performance is a good measure of company performance.

- **In practice**: There are some holes in the 'Efficient Markets' assumption.
Managers control the release of information to the general public

- **Information management (timing and spin):** Information (especially negative) is sometimes suppressed or delayed by managers seeking a better time to release it. When the information is released, firms find ways to “spin” or “frame” it to put themselves in the best possible light.

- **Outright fraud:** In some cases, firms release intentionally misleading information about their current conditions and future prospects to financial markets.

*Aswath Damodaran*
Evidence that managers delay bad news?

DO MANAGERS DELAY BAD NEWS?: EPS and DPS Changes - by Weekday

<table>
<thead>
<tr>
<th>Day</th>
<th>% Chg(EPS)</th>
<th>% Chg(DPS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monday</td>
<td>2.00%</td>
<td>6.00%</td>
</tr>
<tr>
<td>Tuesday</td>
<td>4.00%</td>
<td>6.00%</td>
</tr>
<tr>
<td>Wednesday</td>
<td>4.00%</td>
<td>8.00%</td>
</tr>
<tr>
<td>Thursday</td>
<td>2.00%</td>
<td>4.00%</td>
</tr>
<tr>
<td>Friday</td>
<td>-6.00%</td>
<td>-4.00%</td>
</tr>
</tbody>
</table>

Aswath Damodaran
Some critiques of market efficiency.

- **Investor irrationality**: The base argument is that investors are irrational and prices often move for no reason at all. As a consequence, prices are much more volatile than justified by the underlying fundamentals. Earnings and dividends are much less volatile than stock prices.

- **Manifestations of irrationality**
  - **Reaction to news**: Some believe that investors overreact to news, both good and bad. Others believe that investors sometimes under react to big news stories.
  - **An insider conspiracy**: Financial markets are manipulated by insiders; Prices do not have any relationship to value.
  - **Short termism**: Investors are short-sighted, and do not consider the long-term implications of actions taken by the firm
Are markets short sighted and too focused on the near term? What do you think?

☐ Focusing on market prices will lead companies towards short term decisions at the expense of long term value.
  a. I agree with the statement
  b. I do not agree with this statement

☐ Allowing managers to make decisions without having to worry about the effect on market prices will lead to better long term decisions.
  a. I agree with this statement
  b. I do not agree with this statement

☐ Neither managers nor markets are trustworthy. Regulations/laws should be written that force firms to make long term decisions.
  a. I agree with this statement
  b. I do not agree with this statement
Are markets short term? Some evidence that they are not..

- **Value of young firms**: There are hundreds of start-up and small firms, with no earnings expected in the near future, that raise money on financial markets. Why would a myopic market that cares only about short term earnings attach high prices to these firms?

- **Current earnings vs Future growth**: If the evidence suggests anything, it is that markets do not value current earnings and cashflows enough and value future earnings and cashflows too much. After all, studies suggest that low PE stocks are under priced relative to high PE stocks.

- **Market reaction to investments**: The market response to research and development and investment expenditures is generally positive.
If markets are so short term, why do they react to big investments (that potentially lower short term earnings) so positively?
But what about market crises?

- **Markets are the problem:** Many critics of markets point to market bubbles and crises as evidence that markets do not work. For instance, the market turmoil between September and December 2008 is pointed to as backing for the statement that free markets are the source of the problem and not the solution.

- **The counter:** There are two counter arguments that can be offered:
  - The events of the last quarter of 2008 illustrate that we are more dependent on functioning, liquid markets, with risk taking investors, than ever before in history. As we saw, no government or other entity (bank, Buffett) is big enough to step in and save the day.
  - The firms that caused the market collapse (banks, investment banks) were among the most regulated businesses in the market place. If anything, their failures can be traced to their attempts to take advantage of regulatory loopholes (badly designed insurance programs... capital measurements that miss risky assets, especially derivatives)
IV. Firms and Society

- **In theory:** All costs and benefits associated with a firm’s decisions can be traced back to the firm.

- **In practice:** Financial decisions can create social costs and benefits.
  
  - A social cost or benefit is a cost or benefit that accrues to society as a whole and not to the firm making the decision.
    - Environmental costs (pollution, health costs, etc.)
    - Quality of Life' costs (traffic, housing, safety, etc.)
  
  - Examples of social benefits include:
    - creating employment in areas with high unemployment
    - supporting development in inner cities
    - creating access to goods in areas where such access does not exist

*Aswath Damodaran*
Social Costs and Benefits are difficult to quantify because ..

- **Cannot know the unknown:** They might not be known at the time of the decision. In other words, a firm may think that it is delivering a product that enhances society, at the time it delivers the product but discover afterwards that there are very large costs. (Asbestos was a wonderful product, when it was devised, light and easy to work with... It is only after decades that the health consequences came to light)

- **Eyes of the beholder:** They are ‘person-specific’, since different decision makers can look at the same social cost and weight them very differently.

- **Decision paralysis:** They can be paralyzing if carried to extremes.

*Aswath Damodaran*
A test of your social consciousness:
Put your money where you mouth is...

Assume that you work for Disney and that you have an opportunity to open a store in an inner-city neighborhood. The store is expected to lose about a million dollars a year, but it will create much-needed employment in the area, and may help revitalize it.

Would you open the store?
- Yes
- No

If yes, would you tell your stockholders and let them vote on the issue?
- Yes
- No

If no, how would you respond to a stockholder query on why you were not living up to your social responsibilities?