

# Ford case essay sample



## Abstract

Excessive cash and undervalued stock price forced Ford to conceive an unprecedented cash payout system - Value Enhancement Plan in 2000. For a dual-stock-structure company, this recapitalization did favor much Ford family which held the dominant voting power by giving it larger flexibility, enhanced control with less capital as well as tax benefit and confidence improvement. While the common shareholders may benefit less compared to other alternatives, as like a stock repurchasing plan, given their preferences and different interest to the family.

On the other hand, it is not yet sure whether this VEP could really enhance Ford's value by enhancing public confidence towards company's future growth, as it already decreases company's fundamental value due to tax payment. Moreover, from a long run perspective, a highly cyclical company as Ford should have been more prudent in taking strategies. Large cash payout strategy will weaken its immunity to future economical downturn.

Keywords: Value Enhancement Plan, dual-stock-structure, voting power, public confidence enhancement, stock buyback, cash dividend payout.

## Main Points Overview

\* Problems identification: excessive cash and undervalue stock. \* Supported by comparison with GM and DaimlerChrysler

\* Research on VEP and alternative cash payout methods:

\* From ford family's point of view, VEP is the best in the way of more flexibility, higher voting power, higher percentage share holding, lower taxes, most positive signaling to the market and so on. \* From common

shareholders view, we believe people with different preference ranks these methods differently. \* Research on different aspect of VEP, since it is the most possible real cash pay out plan: \* Share holder's choices: Shareholders choose according to their preference as well as the most prevailing factors brought by different methods. \* Cash need: Sensitive analysis show breakeven points for the 10 billion ceiling of cash can be used \* Spin-out plan: Do enhance company value in the short term by more net income, though noncash accounts, and may increase cash flow in the long run \* Value enhancement: Decrease company fundamental value immediately as cash is taxed, but PE depends on people's confidence. So whether the plan increased company value is not sure yet \* Our comment on the plan and our believe of how to use the cash \* Cyclical companies as Ford should keep exceeded cash in industry peak and used them in the future downturn

## Content

### 1. Background

In this case, two problems are identified in Ford Motor, i. e. excessive cash and undervalued stock. We'll demonstrate some arguments underlying each problem to give you a more comprehensive background at that very point of time. \* Too Much Cash?

From this case, we know that the Ford Company would like to distribute \$10 billion to share holders. The biggest reason was that the company thought it had too much cash (\$23 billion in its account), and the board couldn't find a good way to deal with this cash. The table below illustrate whether the company had too much cash. Figure 1: Financial Summaries in 1999

Selected balance sheet items| Ford company| GM company| DaimlerChrysler|

Cash and marketable securities| 25, 173| 12, 140| 9, 163|

total long term debt| 78, 059| 129, 697| 64, 940|

Total revenue| 162, 558| 176, 558| 151, 035|

total assets| 276, 229| 274, 730| 175, 889|

cash/debt| 32. 2%| 9. 4%| 14. 1%|

cash/revenue| 15. 5%| 6. 9%| 6. 1%|

cash/assets| 9. 1%| 4. 4%| 5. 2%|

According to the data from the balance sheet of the three auto companies, we can get three cash ratios showed in table1. The cash/debt is the ratio shows the ability of paying debt, and the higher ratio means that the company has less financial risk. The other two ratios tell us the cash amount exclude the scale of the company. The higher ratios show that the company has more cash under the same scale. The result is that all the three cash ratios of the Ford above are larger than the other two comparative companies. So we can draw the conclusion that the Ford Motor Company surely has too much money. \* Undervalued Stock ?

The undervalued price was the other problem that the Ford concerned about.

The Figure 2 below shows us valuation information. Figure 2: Auto Company

Valuation in 2000

| Ford| GM| Chrysler|

Stock price| \$51. 38| \$82. 06| \$63. 25|

Beta| 0. 81| 0. 93| 0. 8|

Dividend per share| \$1. 88| 2. 00| 2. 50|

EPS in 1999| \$5. 86| \$8. 53| \$6. 25|

Growth in EPS| 8. 0%| 7. 6%| 8. 9%|

30-year U. S. Treasury bonds interest rate: 5. 79%

Market risk premium: 5%

Where:

b= retention ratio

R= cost of equity

g= growth rate

We can use this equation and the data above to estimate the stock price of these three companies. Under CAPM model we can calculate R as:

$R = \text{risk free rate} + \text{Beta} * \text{market premium}$

Here we use 30-year U. S. Treasury bonds interest rate as risk free rate.

Historical returns data suggests that the global market risk premium has between 4% and 6%, on average. So we use 5% as our market premium.

Figure 3: Intrinsic Price Information

| Ford| GM| Chrysler|

R| 0. 0984| 0. 1044| 0. 0979|

1-b| 0. 32| 0. 23| 0. 40|

P/E| 17. 43582| 8. 255866| 44. 94382|

EPS in 1999| \$5. 86 | \$8. 53 | \$6. 25 |

intrinsic price| \$102. 17| \$70. 42| \$280. 90|

Figure4: price comparison

As we can see from the figure1, the Ford's price is definitely undervalued under our calculation. 2. Value Enhancement Plan

To solve or at least alleviate the two problems, Ford came up with a brilliant

plan to enhance value for its shareholders. The so-called Value Enhancement Plan (VEP) was just designed for this purpose.

This section first lays out basic material of VEP, and compares several alternatives in cash distribution to justify feasibility of VEP in perspective of common shareholders. Then, we evaluate three options from the common shareholders' perspective. Sensitivity analysis is conducted to give a broader picture of VEP under slightly different assumptions. Spin off related issues are discussed at last.

## 2. 1 Overview

Before we dig into the details of this plan, let's have an overview of relevant data in the case (Figure 5). Further elaboration on these figures is largely skipped. However, there are three points worth noting: \* Stock price would drop by \$20 immediately upon announcement of VEP, without consideration of market reaction. \* Dividend yield remains unchanged, thus is subjected to adjustment in dollar terms. \* Stock option should be adjusted to reflect VEP effect. Employees are entitled to purchase 131. 64mn common shares at an average price of \$18. 68.

The way VEP works is quite straightforward (Figure 6). Shareholders would exchange their old common and Class B shares one-for-one for new Ford common and new Class B share, respectively. Besides, every shareholder would have the option to receive either \$20 per share in cash (the default option if no election) or equivalent value in new common share, which turned out to be 0. 748 shares. A third option is a \$20 combination of cash and new common share, with share interest unchanged before and after the transaction. Figure 6: VEP Structure

Old Common / B

New Common / B

Option

20\$ Cash (default)

20\$ (0.748) Common

20\$ Cash + Comn

## 2.2 Alternatives Comparison

We discuss in this part the pros and cons of these three options from the sake of different Ford shareholders. 2.2.1 Ford family

\* Share percentage

Cash dividend doesn't change the ownership structure while repurchase increase the individual shareholders' ownership percentage as the denominator becomes smaller, thus the same effect will happen to Ford family as they don't let their B shares bought back.

Similar to a stock split, VEP increases proportionally shareholders' stock package. However, as some shareholders are assumed to receive cash instead of stocks, the stock takers' percentage increases more. (See figure 7(a) )

Given the uncertainties lying in stock buyback (how many stocks can be bought back eventually?) and VEP execution (how many shareholder will choose cash option?), we can hardly compare the ownership percentage incremental, therefore, we put the same score for these two methods. \*

Voting power

Cash dividend doesn't change the voting power structure either.

In contrary, Ford family can hardly get special benefit from stock buyback plan. The family held all B shares which account for 40% of voting rights plus 0.16% of common shares at the beginning of 2000. The stock buyback may probably bring a higher stock price, however, Ford family cannot sell its B shares (which accordingly convert to common shares in the open market) to run the risk of losing its control over the company. Meanwhile, the common shareholders' voting power increases due to a smaller denominator, which in our conclusion will not be desired by the family. So we give stock buyback the lowest score.

As a result of VEP, Ford family actually gains its share percentage from 5.8% to 7.4% in ownership structure (Figure 7) due to additional common shares (53.0mn), though with a slight (1.6%) decline in B shares (70.9mn). Voting power increases 2% in common shares, and remains at 40% in B shares.

Figure 7: Structure Change of Ford Family

\* Flexibility

Cash dividend gives the shareholders an immediate liquidity while repurchasing limited Ford family from selling its B shares. VEP increases the family's common shares, which means larger potential liquidity. In other words, the family can maintain its control by using less capital. Thus, we marked VEP with highest score in this part and cash dividend the lowest. \*

Taxation

Cash dividend received by shareholders will be taxed as income with a rate of 39.6% while stock buyback caused stock price increase will be taxed as



capital gain with a rate of 25%. Thus, obviously, cash dividend bears more tax than stock buyback. For VEP, for those who choose cash option will be taxed by 39.6% while the others including big shareholders covered by special tax treatment will be taxed by 25%, as a whole, the total tax payment will be between the cash dividend and stock buyback. \* EPS

We calculated possible EPS for each listed methods and the results are shown as below.

Assumptions:

1□ Stock buyback is executed by a tender offer of a total 10 billion without premium and finished in short term without any fluctuation in stock market price.

2□ 40% of shareholders choose cash in VEP which means that 10 billion is totally spent out.

As a higher EPS gives a better push in stocks' development, we conclude Buyback the best method from this perspective and Dividend is still better than VEP. \* Timing

Dividend plan can be finished several days after announcement without a shareholders conference. Stock buyback in open market is regulated by SEC strictly 3% per day which according to our gross calculation will be finished in 4000 days! If the stock buyback is prosecuted by a tender offer, a general meeting of shareholders is still needed to negotiate an agreeable premium for each party. VEP also needs a general meeting. However, as the Ford family has already 40.6% voting power, it will be easier to pass this decision with just another 9.4% common shareholders' support. Thus, VEP seems

theoretically faster than stock buyback while the dividend is the fastest one.

#### \* Signaling

All the three give out a positive signal to the outer market which implies company's future capability of cash flow and profit generating. Stock buyback has a stronger effect than dividend theoretically. In VEP, as manager board and Ford family will both hold stock, it gives out also a strong implication of future growth. \* Execution cost

Stock buyback method has the highest cost since it pays a premium. VEP has cost associating with new stock issuance and other affairs than dividend.

Based on the analysis above, we have the following table as a resume:

#### 2. 2. 2 Approval from Common Shareholders?

For common shareholders other than Ford family, we conclude that stock buyback is more favorable than VEP, as shown in the following table. (Items highlighted in red are disadvantages)

#### \* Small shareholders (less than 1%)

Stock buyback favors common shareholders by an offer price with premium. In addition, stock buyback is prior to cash dividend by lower taxation. (They cannot benefit from special tax treatment) At the same time, their voting rights will be enhanced by stock buyback as the denominator become smaller. VEP gives common shareholders choices between cash and stocks according to their preference. However, common shareholders' voting right is diluted as Ford family gets an extra portion (generated by B shares) in total common shares. \* Manager board and Employees

Ford adopts an 'adjustable' option incentive plan which enable employees a fixed value when they exercise the option. Thus, this part will not be affected by dividend policy. Thus, similar to small common shareholders, they will favor stock buyback prior to the other two. \* Institutional investors (more than 1%)

Represented by TIAA and Chapler, this group is offered with a special tax treatment and a mixed option to keep their same interest percentage and voting power. However, they may benefit more from stock repurchasing which gives in addition a premium and an enhanced interest and voting power.

So, for common shareholders other than Ford family, stock buyback is more favorable than VEP. However, due to Ford family's dominant voting power, the VEP can definitely be passed if 16.7% or more common shareholders vote for the plan. Therefore, it seems that most common shareholders have no choice but to accept VEP. 2.3 VEP Three Options Election

Due to subject view of growth prospect and specific individual needs, shareholders have different preference among three options. Thus, a case-by-case analysis is preferable in this situation.

Key factors influencing shareholders' preference include but don't necessarily limit to share percentage, voting power, tax, and confidence. We rank three options under each factor, with quantitative analysis of share structure and voting power changes in Figure 11. Figure 11: Structure Change of Common Shareholder

Underlying reasons of our evaluation are as follows:

#### Option 1: Cash

We can't find much evidence in favor of cash option, because both share percentage and voting power drop after the plan. However, cash is indeed an appropriate bet for those shareholders who \* Weight favorable capital gain tax on this one-time dividend over ordinary income tax on regular dividend in long term. \* Are not that optimistic about Ford's prospect.

\* Lack liquidity at that very time point, maybe for specific uses in daily life. \*

Forget to elect the options, as regulated in the VEP procedures. Option 2:

#### Common Share

Among the three options, common share seems to be the most attractive on an aggregate level, except for tax and liquidity issues. Potential justifications include \* Both share percentage and voting power rise after VEP.

Shareholders who care voting rights are expected to favor this option. \* With more shares in hand, It is reasonable to conclude that optimistic investors (both insider and outside) would choose the common option. Option 3:

#### Combination

This option is sort of a tradeoff between option 1 and option 2. Passive investors, such as pension funds, are more likely to choose a combination of cash and common share. After VEP, share percentage remains constant, with a slightly decline in voting power though. The weights of common shares and cash in the combination are determined by shareholder percentage in option 2 and option 3, because only in this manner can the interest of combination picker remains constant as before VEP.

Figure 12 summarizes each option's pros and cons. Rank 3 marks the most favorable option in each category, and Rank 1 the least.

## 2. 4 Sensitivity Analysis

Here we propose three questions.

Q1: What if option picker deviate from ex ante estimates (40%, 40%, 20%)?

Q2: Where is the break even level of 10bn cash?

Q3: What if cash distributed is more or less than 10bn?

\* A1: Deviation of picker percentage affects almost all the variables (Figure 14 and Figure 15). We view option 2 and option 3 picker percentages as the key drivers in our model, thus further analysis relaxes only one estimate with the other unchanged at previous level.

It turns out 10bn cash is inadequate under previous assumptions. Therefore, option 2 percentages should exceed around 45% to limit cash distributed within 10bn maximum. Option 3 percentages should reach at least 30% to maintain a feasible cash distribution. In addition, we can see that option 2 percentage plays a bigger role than option 3 percentage. \* A2: Given option 3 percentage constant at 20%, we find a break even point of 47. 3% for option 2. Given option 2 percentage constant at 40%, we find a break even point of 32. 2% for option 3. \* A3: If cash distributed is more than 10bn theoretically, Ford is supposed to prorate 10bn as illustrated in VEP procedures. If cash distributed is less than 10bn, however, things are much more complicated. Since we can't figure out how Ford actually spent the excessive money, our suggestions are listed from an ex post perspective in Section 3 (Comment).

## 2. 4 Spin off

As a part of VEP, spin off of Visteon did enhance value from both the perspective of company and common shareholders.

For the company, spin off is usually classified as a non-operating item, not impacting cash flow but does impact net income in current year. Increasing net income would generally boost market confidence on announcement of annual report. In the long run, monetary gain from this one-off spin off should not be considered as a plus for analysis purpose, but it does pave the way for Ford's focus on its core business. It is for this reason that we believe spin off is likely to lift Ford's value in the future.

For the common shareholders who got additional shares of Visteon, spin off endowed them with benefit of diversification and flexibility. Because before spin off, Visteon was taken as a part of Ford, their value were bonded together and reflected in Ford's stock price. While after spin off, shareholders who viewed Visteon as a burden could freely sell Visteon shares in the market place, and put the money elsewhere he valued. In addition, spin off of Visteon and Associates First Capital (1998) both had consequence on shareholders' tax basis in VEP.

## 2. 5 Whoever Pocketed Value?

We broke the value into two parts, first the real fundamental of Ford Company, which is depend on its business and profit. So we just simplify is as earning or real company value. The other part is the other investors' confidence on the company's long term growth, which is could be reflected in PE ratio. Company with high PE can also have a high stock price and these part of company value is not real and vulnerable to change and the future prediction. In short, in order to see the effect of the VEP to companies' value,

we see " Earning " and " PE" one by one and decide the total result.  $P = E \times P/E$

Growth value - from confidence

Fundamental value -real

Let's look at Earning first,

| Company share holder| Other entity in market| Government| Repurchase| Wealth decrease| Wealth increase| Wealth increase by 20% tax rate of 10 billion| Dividend| Wealth decrease| Unchanged| Wealth increase by 39. 4% tax rate of the 10 billion| VEP| Wealth decrease| Unchanged| Wealth increase by 20% tax rate of the used cash| As we always believe, none of the cash payout plans, including the repurchase, dividend payout and VEP are value enhancement plan according to their nature, since none of them have productivity as production and services work do. So basically from their nature, these plans just change the wealth distribution like any of the cash payout systems. If we look Ford Company and all the share holders as a whole, we understand cash paid out in any form are subject to taxes, we mean their basic value will decrease by the amount of taxes.

While in repurchase, since the price used in repurchase are often higher than the market price, so the wealth of remaining shareholders will decrease and the leaving shareholders' wealth increase. Comparing these different methods, the VEP is the one with less value decrease, since the tax rate is low and it do not distribute value to the outside entity, but only the shareholders of Ford Company. Then we think about P/E ratio. In fact we can not calculate the right numbers, but there are only three kinds of results. PE

increases due to the higher confidence in Ford stocks, because Ford management uses the plan to show positive signal to the market. Other results are PE remains the same or even gets down. One may not take the company's positive signal as matter, or the signal is hit by the bad financial results in the following years. So for the PE part, the confidence value remains still hard to say. Given the real effect of VEP to company value is still hard to say, we believe the most possible result of the VEP is that the value of the company is decreased.

### 3. Our Comments on How to Use the Cash

We comment on Ford's VEP from an ex post perspective in this section. Our analysis lays out on both macro and micro level, and leads to two pessimistic views on VEP. Box 1 gives us detailed information about VEP for reference.

Box 1: Ford completes \$5.7 billion Value Enhancement Plan

DEARBORN, Mich., August 7, 2000 - Ford Motor Company [NYSE: F]

confirmed today that \$5.7 billion in cash will be distributed to its shareholders through the company's Value Enhancement Plan (VEP). The total number of new Ford common and Class B shares outstanding will be 1.893 billion. \* Under the VEP, Ford shareholders exchanged each of their old Ford common or Class B shares for one new Ford common or Class B share, as the case may be, plus either \$20 in cash \* 0.748 additional new Ford common shares

\* a combination of \$5.17 in cash and 0.555 additional new Ford common shares

These amounts were based on the volume weighted average price of Ford



stock of \$46.7317 for the period July 24-28. Ford shareholders approved the VEP Aug. 2. The company plans to credit the new Ford stock to shareholder accounts and distribute cash beginning tomorrow. The new Ford Motor Company stock [NYSE: F] has been approved for listing and will be available for regular way trading beginning Aug. 9 on the New York Stock Exchange.

Source: [http://media.ford.com/article\\_display.cfm?article\\_id=5586](http://media.ford.com/article_display.cfm?article_id=5586) 1) VEP

is sort of

short sighted without consideration of economic downturn.

On the macro side, U. S. GDP seems pretty volatile over past 54 years (Figure 18). As a cyclical company, Ford's sales and net income are exposed to economic fluctuations (relevant evidence can be found in annual report in the following years). It is obvious that the U. S. economy peaked in 1999 with a growth of 4.5% in GDP, and since then things changed so dramatically that GDP growth rate posted at merely 0.8% in 2001. Thus, we have very reason to believe that Ford was probably unaware of the forthcoming sharp downturn in Apr. 2000, when it announced VEP at the almost turning point of economic cycle. Source: CEIC

To further confirm our point, we crosscheck that with Ford's dividend distribution history. As we have calculated, dividend was adjusted to around 30 cents immediately after VEP, and remained at this level until 4th quarter in 2001, when the company declared a cut to 15 cents. According people familiar with the situation, this move was prudent and fully expected by the investor community during such an unfavorable environment. Here, we can turn back to answer our previous Q3, i. e. 'What if cash distributed is more than 10bn?' Our suggestion is that Ford can store or invest this excessive

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cash in liquid asset; it may be a powerful backup in economic downturn.

Extremely, if Ford had sat around those 10bn cash for just several months, cash flow stress might be alleviated in 2001, and probably there would be no need to halve regular dividend, which is usually a negative signal in the U. S. market. 2) VEP adds little to firm value in the long term.

Let's have a look at the stock price performance in 2000 to get broader picture of VEP (Figure 19). Price did jump up sharply on both announcement (Apr. 14) and confirmation (Aug. 7) of VEP, outperforming S&P 500. But Ford couldn't manage to beat the market in the long run, because its stock begun to follow S&P 500 within 2 month. This support our basic conclusion in this part, that is, VEP is just a one-off plan (something like special dividend), and stock price in the long run is determined by company fundamentals and growth prospects. Source: Google Finance

#### 4. Conclusion

##### 1. Ford family likes VEP

From figure 9 we used before, we conclude that ford family like VEP compared with other alternative methods, since it will bring more flexibility, more voting power, more share percentage, and less taxes (since ford family will chose stock instead of cash.) Other factors such as time and cost are not ford family's major concerns.

2. Other shareholders choose different methods according to their preference and the prevailing benefit brought by these methods

3. Among the options provided by VEP, shareholders choose according to their preference and the prevailing benefit brought by these options as we show in figure 12

4. Spin-out plan do enhance company value in the short term by more net income, though as non-cash account, and may increase cash flow in the long run. However, the value enhancement plan, just like any of the cash payout system, is not a real productive event and can even decrease company fundamental value immediately, since taxes must be paid to government. But company's future PE depends on people's confidence. So whether the VEP increases company value is not sure yet. 5. Our comments on VEP is that it is sort of short sighted without consideration of economic downturn and it increase little value of the company. Maybe a better way to use the cash is that cyclical companies as Ford should keep exceeded cash in industry peak and used them in the future downturn.

## 5 Take Away

1. From this case, we get more understanding of different dividend policies, from dividend payout to repurchase, from combination of last two methods to value enhancement plan. These analyses make us realize the difference and effect of these practices. 2. We get more knowledge on the voting power embedded in different classes of the shares, like the dual share system. We also saw a game in getting control of a company, especially from traditionally family owned companies. 3. Ford true experience (as mentioned in the last ex post analysis part) also let us be aware of the strategy that a highly cyclical company should take, which should have been quite prudent.

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