

Ford value enhancement plan essay sample



In April 2000, Ford Motor Co. announced a shareholder Value Enhancement Plan (VEP) to significantly recapitalize the firm's ownership structure. Ford had accumulated \$23 billion in cash reserves and under the VEP would return as much as \$10 billion of this cash to shareholders. In exchange for each share currently held, the plan would give stockholders one new share plus the choice of receiving \$20 in either cash or additional new Ford common shares. Shareholders electing to receive cash would be taxed on these distributions at capital gain rates. Among other things, the plan provided a means for the Ford family to obtain liquidity without having to dilute their 40% voting interest (even though they own only 5% of the shares outstanding). Background of Case:

Ford Company was founded by Henry Ford and 11 Investor in 1903. By 1906 Henry Ford had acquired a majority position in the company's stock. In 1956, Ford sold shares to the public. Until then Ford family and Ford Foundation (formed in 1936) had been the company's sole stockholders. The Ford Foundation pressured the company to create a public market for Ford common shares so that it could sell its Ford Shares and reduce its reliance on income received in the form of Ford dividends. Class A shares sold by the Ford Foundation became voting common shares. Ford modified its ownership structure of multiple share classes in order to preserve family control. Class B shares had special voting rights and could be owned only by Ford family members. As long as they owned a minimum number of class B shares, the Ford family would retain 40% of the voting power. When class B shares were sold outside the Ford Family, they reverted to common stock. The Ford Family strongly preferred receiving dividends despite the fact that dividends

were tax inefficient for many shareholders. Cash Dividends provided family members with liquidity without having to sell class B shares and run the risk of diluting the family's control. Questions involve in the case:

Does Ford have Too Much Cash?

Facts:

Ford has Net income of \$7 million with cash & marketable reserve of \$25 million, whereas their comparable competitors, General Motors (Exhibit 8) & Daimler Chrysler (Exhibit 9) have net income of \$6 & \$5.7 million with cash & equivalents of \$12 & \$9 million respectively. Ref. Exhibit 2&3, Company stock price is in dump & is at quite mature firm stage. Ref. Exhibit 6, it is generating lot of cash consistently in business. Implications:

Excess funds can be a signal to the markets that the company has very little investment prospects lined up. Although cash balances can sometimes be desirable, this is only once they are adequate enough to meet short term obligations. However it would appear that Ford's excess cash balances have arisen more from a lack of better options to management rather than necessity and this has been reflected in its undervalued stock. Ford has made past acquisitions and has exhausted that list by purchasing Jaguar Cars, Volvo Cars, and Land Rover. Investment in expansion without a solid reason would prove to be futile. Although Ford had acquired other auto manufacturers in the past, it would appear that they did not have more such opportunities available now. Therefore it would appear that Ford does have too much cash and is also not utilising it very well. How does the VEP work?

VEP is one of the powerful strategies applied by the company to make itself intrinsically valuable. Combines stock split and re-purchase. VEP is advantageous to both Shareholders and Company. Under the VEP, Ford would return \$10 billion of the \$23 billion in cash reserves to its shareholders. The VEP has the feature of stock split and share repurchase. — For every share of Ford Common or Class B stock held, the shareholder will receive a share of newly issued Ford stock plus a \$20 bonus. — This bonus can be taken as either cash, or the \$20 can be automatically reinvested in the newly created shares of Ford stock. Exchanging existing share for New Shares on a One for One basis. The VEP includes three options for different kinds of Shareholders: Option 1: Shareholders who prefer Cash.

Option 2: Shareholders who prefer More Shares

Option 3: Passive Investors

Value Enhancement Plan has tax consequences. Those shareholders electing to receive the new shares of Ford instead of the 20-buck bonus will not be directly affected by the tax. The new shares are considered a tax-free exchange, with the holding period of the new shares considered the same as when the original Ford stock was purchased. Shareholders choosing to re-invest in stocks can be incentivized by having more voting power and control over the management. Those shareholders choosing to collect the \$20 cash per share will have to pay capital gains tax on the cash distribution just as though they have sold part of their shares. This can be either considered a short-term or long-term capital gain, depending on when your original Ford shares were purchased. Benefit out of opportunity Cost for the shareholders to invest the \$20 in a different firm. Ford family benefited by retaining their

voting control since they did not have to surrender their Class B shares.

Since firms incur the re-purchase option by offering \$20 cash for each stock bought back, the number of outstanding shares will be reduced. The

Earnings per share will increase leading to an increased stock price. Long-term gains (held more than a year) are taxed at lower rates than the usual dividends, a comfort to those wishing to take the distribution in cash.

Additionally as part of the VEP, Ford would also distribute its ownership of Visteon to shareholders on pro rata basis. What are the alternatives for distributing cash?

Cash Dividends Share Repurchase

Paying Dividends attracts a certain clientele of investors.

Some investors prefer the certainty dividend payments to the possibility of substantially higher future capital gains. The dividend of the new Ford shares will be adjusted so that shareholders using their cash bonus to purchase new shares will receive the same total dividend as before the transaction occurred. Dividend payments provide important signals regarding the strength or quality of the firm's present and future cash flows. Dividends from stocks are taxable, as are any capital gains they generate. Ford Family prefers Dividends.

Ford shares are now priced at about \$41 and pay an annual dividend of \$2 per share, for a yield of about 4.9%. After a cash payout of \$20 a share, the new Ford shares will be worth about \$21 each. To make the transaction revenue-neutral, the \$20 cash distribution per share can buy about 0.95 (20/21) new shares of Ford for each of the old shares owned. Share

Repurchases mean a company buys its shares back from the market or from

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the shareholders who are willing to tender such shares. Repurchases have also been found to signal favourable information. Shares repurchase reduces the number of shares outstanding (i. e. supply), it increases earnings per share and tends to elevate the market value of the remaining shares. This gives the company a better opportunity to optimize investments. This flexibility can be used to increase repurchases when stock prices are low. Much lower personal taxes that result from share repurchases relative to dividends. Ford Family does not lose voting power.

What Problems is the VEP Designed to solve?

Increase share value and Performance of company:

—Ref Ex. 10, Ford EPS is much less than competitors, A recapitalisation plan would enhance and increase the value of Ford's share in the market. They also believe that re-capitalisation would align the interests of the shareholders and the Owners in a way that would further improve the performance of the company. — Ford intends to make the plan yield-neutral. Although the yield won't change, the dividend of the new Ford shares will be adjusted so that shareholders using their cash bonus to purchase new shares will receive the same total dividend as before the transaction occurred. — To keep the total dividend pay-out the same, the new shares of Ford would have to pay out an annual dividend of about \$1. 03 per share Company Control:

—Another goal of the VEP is to reduce the conflict between the Ford Family, who does to lose voting power, and the shareholders who want to receive cash distribution. —Since the new shares will sell for less than the old shares, the dividend on the new Ford shares will be lowered by the same

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proportion that the stock price drops. --- The company isn't actually giving away \$10 billion to shareholders. Those shareholders deciding to take the cash option will see the value of their remaining Ford stock drop by exactly that amount, at least initially. And such a shareholder will be left with a capital gains bill at tax time. --- Those choosing to reinvest their \$20 per share dividend back into the company will have more shares, but at a commensurably lower price. In that sense, this is a type of stock split, almost two to one assuming the price of Ford's stock doesn't change dramatically over the next few months. Concentrated Focus:

---It was expected that this spin-off would further help Visteon create its own customer base that would be separate from the client base of Ford. --- With fewer new shares outstanding, earnings per share increase, and there's an improvement in the supply-demand ratio for the stock. All these factors tend to increase share price in the long run. How to Approve to VEP: Cash or Shares?

Ford is having an Agency Problem:

--- Analyst argued that, " it is likely that most important conflict arises from the fact that as the manager's ownership claim falls, his incentive to devote significant effort to creative activities such as searching out new profitable ventures falls. --- Shareholders were sceptical of management's attempts to distinguish the present transaction from a stock dividend. Ford is sending Mixed Signals to the public: In a world of asymmetric information managers and insiders have superior information compared to investors, and management's decision to issue equity conveys information about a firms intrinsic value. Positive Signal:

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— Morgan Stanley, Goldman Sachs Auto Analyst reacted positively, as it was indication of management confidence in the future of new business model. — Ford's Market share was running below its " Intrinsic Value". So, repurchase of share will also have value. (Warren buffet) — Asquith P. Mullins D. W. (1986) that asserted" the announcement of equity offerings reduces stock prices significantly equity issues serve as signals which communicate manager's superior information independent of capital structure considerations. A stock price reduction is produced by rational investor's hedging against the risk that, in selling stock, managers are using their superior information to benefit existing shareholders at the expenses of new shareholders". Conclusion:

One important aspect of investing is to understand that when a particular stock is no longer doing the things that caused to invest in it. Ford shares are dropping in value. This VEP appears to be a strategy put in place with an obvious biased towards Ford Family. Presumably it will have \$10 billion less on the books, with sufficient cash left over for rainy day expenses during the next (inevitable) industry downturn. The stock price will be almost halved, but the dividend yield should remain the same. Depending on how much of the \$10 billion bonus is taken in cash, there will be fewer new shares outstanding. And those stockholders that still own the shares (like I will), will have done so through a conscious decision that they want to own the stock, shaking out any of the marginal investors — probably good for the stock price in the long run.

The effective earnings per share should increase, the P/E ratio should decrease, and the stock should appear to be a better value. Therefore, given

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everything that has been highlighted, as a shareholder after considering the tax liability due on cash income, also considering that Ford had stated that the cash would be tax as capital gain and not dividend, it would be better option to receive cash instead of shares, pay the required taxes and seek better investments for the remaining cash. Decision would be based on the potential risk of losing a significant portion or all of the investment versus regaining some of the investment as cash and paying either high rate of income tax or the capital gains rate as stated by Ford.