

Magna and the price of control

Yvan Allaire, Ph.D., FRSC

Chair

Institute for governance of public and private organizations

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Alas, the company's *magna cum laude* performance as a first rate industrial concern is not matched by its performance in the shareholder business, where it deserves a severe *magno cum opprobrio*. Let's see why.

The coattail

In an early, path-breaking move, the Toronto stock exchange decreed in 1987 that any company issuing a class of shares with superior voting rights would have to include a provision that no offer to acquire the class of controlling shares would be valid without the would-be acquirer making a concurrent offer at the same terms and conditions to the other class of shareholders (the "coattail provision"). The TSX did not impose a period of transition but grand-fathered the rights of dual-class companies to continue without a coattail provision. As a result, in 2006, more than 20 years later, 13 of the 96 Canadian companies with a dual class of shares still did not have a coattail provision, among which, Magna International.

Absent a coattail provision, it is consistent with financial market practices to be paid a "control" premium at takeover time or at the time of reverting to a single class of shares. Magna did not adopt a coattail provision (when many other companies, also "grand-fathered", did so); control is exercised by the founding shareholder through a very small fraction of the equity (66% of votes with 0.6% of the equity). What is it worth then to shareholders to be rid of that capital structure?

The irony here is that because the ownership structure of Magna is so unusual, even abnormal, the controlling shareholder can extract large sums of money to give it up! The management information circular on the transaction points to the fact that "...despite Magna's strong operating and financial performance, ...voting shares have traded at enterprise value, to EBITDA multiples that are significantly below Magna's industry peers" (page 7). No doubt a few years ago, Magna's management would have deemed this sort of calculus misguided, equivalent to comparing apples and oranges.

The Valuation Conundrum

Be that as it may, one can juggle the numbers in myriad ways but, in the end, there is little doubt that the market value of Magna would increase by some 15% to 20%, should its peculiar dual-class structure be eliminated. Given that Magna had a market value of some \$7.3 billion before the announcement of the proposed transaction, this premium would translate in an additional market value of between \$1.1 and \$1.4 billion. Is disbursing some \$840 million to the controlling shareholder to achieve that market premium fair and appropriate? Does it reflect an effective bargaining process between the special committee and the controlling shareholder? The controlling shareholder's leverage, and the putative value of his shares, comes from the fact that he could, on his own decision, sell the control of the company while all other shareholders get nothing. Would an outside party pay some \$840 million to gain control of Magna (but only 0.6% of the equity)?

The proposed transaction is, or should be, the outcome of tough negotiations between the special committee and the controlling shareholder. The result of that negotiation would normally be supported by both parties. Why is it that the special committee refuses to recommend that shareholders vote in favour of the transaction?

Recommendations

The Institute that I chair took a policy position in 2006 on capital structures with dual class of shares. Though generally favourable to this type of ownership structure, the policy paper made several recommendations, two of which are particularly relevant to the Magna case.

- 1. Tighten and broaden the coattail provision to all dual-class share structures such that any offer to buy control from a controlling shareholder in these companies must include an offer on the same terms and conditions to all other shareholders.***
- 2. Absolute, legal, control of a corporation through shares with superior voting rights should not be achieved without the controlling shareholder owning at least 20% of total equity.***

The voting power dilution resulting from dual-class shares varies enormously across Canadian companies. Overall, the *median* voting power dilution (in 2005) was 4.38 (meaning that the *median* controlling shareholder has 4.38 times more votes than the percentage of the equity he/she owns). Magna, at 100, is clearly an outlier.

A number of reasons support a 20% threshold. Indeed, that level of equity ownership by one shareholder is deemed to result in *effective* control of the company; no transaction is likely to succeed without the assent of that shareholder.

Empirical studies have pointed out that too large a discrepancy between voting power and the percentage of equity held by a controlling shareholder (referred to as economic interest) may

lead to an increased risk of misalignment between the interest of the corporation and the interest of this shareholder.

Therefore, a shareholder should own at least **20%** of the total equity to maintain absolute control of a company. Such a rule provides entrepreneurs with considerable latitude for growth of their company before their voting power falls below 50% (but their effective control would remain formidable even at that point).

Conclusion

By its ownership structure, Magna is a sort of dinosaur, a soon-to-be extinct species of corporation: huge voting power dilution for subordinate shares and the absence of a coattail provision. Is the cost of its extinction too high? Is the sharing of benefits between the controlling shareholder and the other shareholders fair?

At any rate, Magna should not become the stick to beat on dual class of shares. This form of ownership has played an important role in the make-up of the Canadian industrial structure and is generally beneficial as long as a suitable framework is in place to protect minority shareholders.