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J Castle and B Kantor*

Tracking stocks - an alternative to unbundling for the South African group[1]

**Brain Kantor is a Professor in the School of Economics and the Dean of the Faculty of Commerce, University of Cape Town, Private Bag, Rondebosch 7701, Republic of South Africa. Email:bkantor@commerce.uct.ac.za.*
Jarrod Castle was with the Accounting Department at UCT. He is now with Goldman-Sachs, London, U.K. Email:jarrod.castle@gs.com.
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1. Control, ownership and diversification - the trade-offs

Tracking or as they are also widely known target stocks have become an important class of new issues on the New York Stock Exchange (NYSE). By holding a tracking stock the investor can share in the performance of the division of a diversified company rather than in the company as a whole. However the voting power of the owner of the tracking stock in the issuing company is a limited one. The purpose of this paper is to examine the essential features of these tracking stocks in order to consider whether the use of tracking stocks might provide a viable alternative to the unbundling of South African listed companies.

The attraction of a tracking stock is that it enables investors to share in the performance of a division of a diversified company and to avoid dependence on the fortunes of the whole much more diversified parent company. Yet perhaps less widely recognised is that the issue of a tracking stock also helps maintain control of the corporation in the hands of established managers or controlling shareholders. This feature should make tracking stocks attractive to the tightly controlled South African groups. That tracking stocks are acceptable to American investors should also help make them worthy of consideration by South African groups anxious to raise capital from international sources.

The issue for any controlling owner or manager of any firm is that while raising ordinary outside capital may generate higher incomes for all shareholders it will bring with it the greater risk of losing control. The established controllers of the firm may have in the past exercised such control to diversify the operations of the firm. A primary purpose of such diversification may well have been to reduce the labour market and bankruptcy risks faced by the established owner/managers of any highly specialised organisation. Losing control to the suppliers of ordinary capital from outside the firm may well threaten such private risk reducing arrangements.

In well developed capital markets such diversified firms are usually not well appreciated. This is because savers and their agents are able to diversify effectively by holding a variety of shares. They do not have to rely on any firm to diversify for them. Investors therefore as a rule prefer to invest in more specialised firms which may be presumed to be more efficient and profitable than firms which combine a number of unrelated activities. Thus the capital market provides incentives in the form of lower costs of capital for firms to become more specialised.

The challenge to the controllers of the growing firm is to find ways to reduce the costs of raising capital without necessarily having to risk sacrificing their management control. Tracking stocks can be a useful means to this end which should be seriously considered by South African controlling shareholders and managers.

2. Identifying the Key Features of the South African Corporate Structure[2]

[2]For a full description of the structure of ownership and control in South Africa see (Barr,Gerson, Kantor(1995) Kantor (1998) also Gerson (1992)

The JSE, measured by market capitalisation, has long been dominated by large groups of listed companies. All the group companies have a common controlling shareholder. The shares in the listed subsidiary and associate companies that give voting control over the listed subsidiary and associate companies will be held by another listed (share) holding company. The assets of the group parent company consist largely of shares held in listed subsidiary companies. There will also be large percentage share holdings in unlisted subsidiaries on the balance sheets of both holding and subsidiary companies in the group.

The listed holding company may in some cases be a clone of the listed subsidiary company that produces goods and services. This pure, so called pyramid holding company, will then hold no other assets and be without any debt of its own. The shares in such a company are in fact a listed derivative of the operating division.
The financial structure of the listed controlling holding company and its relationship with its listed subsidiary will usually be much more complicated. As indicated, the holding company, as opposed to the pure pyramid holding company, will have debts and other assets of its own. The subsidiary company may also hold shares in a variety of legally independent businesses, some of which may also be listed.

The group parent company may well supply management and financial services to group subsidiaries and associates in exchange for a management fee. Dividends will flow up the chain of shareholding and equity accounting principles will be applied to account for the holding company's share of the earnings retained by associates.

The general process by which ownership is separated from control can be repeated as many times as is practically convenient or permitted by the stock exchange or other regulations. For the purposes of maintaining voting control owning 50% of the shares in a company that owns 50% of the shares in another company is all that is required to maintain control. In such a scheme the ownership stake in a subsidiary is reduced to 25% (50% X 50% = 25%). This stake can be further reduced by establishing additional layers of companies between the operating company and the ultimate holding company through which voting control is exercised. The ownership stake of the controlling shareholders can in this way become a very minor one.

At each level of the group structure outside shareholders can be introduced, naturally only with their agreement, to share fully in the dividends flowing up. By so doing they concede the power to control managers to the controlling shareholders of the ultimate holding company. The non controlling outside shareholders at all levels of the group structure therefore accept what is in effect a low voting arrangement in exchange for their ownership proportion of dividends.
They also have a proportionate claim on the underlying assets of the companies in the event of liquidation. Cross holdings and voting arrangements may also be used to reinforce control.

These arrangements have helped the controlling shareholders of the South African groups to attract outside capital for growth or acquisitions without having to risk their management control. Outside capital may also be used simply to replace the capital of the original set of owners with others without sacrificing management control.

It should moreover be recognised that the purpose of these arrangements is not only to secure control but to enable the controlling shareholders to appeal to different constituencies of shareholders with different appetites for bearing risk. Outside shareholders, depending on their taste for risk, are thus able to choose between an investment in a holding company with a more diversified portfolio of assets or one in a listed subsidiary company with a more specialised focus. Both the holding and subsidiary company are moreover controlled by the same managers or owner managers. By attracting a different and wider constituency of shareholders the costs of capital can be reduced.

The same outcomes can be achieved by a diversified parent company issuing a tracking stock linked explicitly to the performance of a division. In this way too the investor gets the choice of a more or less diversified stake in assets under the same secure management control. In the US, taxes on inter-company dividend flows give tracking stocks obvious advantages over the alternative widely used in South Africa and elsewhere which is to house divisions in a legally separate company.

Issuing low voting shares may achieve the objective of raising capital without risking the loss of control. But low voting shares in a company do not provide any escape for potential investors from what may be regarded as an overly diversified company. Low voting shares have the advantage of making for a much simpler arrangements than those typical of the relationships established between pure holding companies and their operating subsidiaries. There is then simply only one company which issues shares that carry different voting rights. The low voting power may be transparently unequal but there are no management fees and shared expenses or different debt to equity ratios at the different tiers to complicate the valuation process. Furthermore, there are no implicit or explicit guarantees to debtors of the subsidiary company by the parent that further complicate the measurement of relative value in the shares of the holding or subsidiary company. The danger that a holding company may pursue a different financial or investment policy from that of the operating subsidiary always adds uncertainty to the valuation exercise of even the purest of holding companies. But the low voting shares cannot be used to track the performance of a division. They are shares in the whole company. Of course low voting shares could also be combined with tracking stocks.

While pure or pyramid holding companies were permitted[3] by the JSE the issue of low voting shares was strongly discouraged until recently. It is now somewhat tolerated and increasingly resorted to, especially in black empowerment exercises. Some of the large well established groups listed on the JSE have been collapsing their listed holding and operating companies into a single or smaller number of listed vehicles issuing a combination of ordinary and low voting N shares.

[3]There were restrictions on the number of tiers of pure pyramid or holding companies that could be listed on the JSE. See Gerson (1992)

3. US Tracking Shares Examined

In the US low voting shares were prohibited by the NYSE in 1926 and only re-introduced to the New York Stock Exchange (NYSE) in 1984 under pressure from General Motors (GM) who were determined to issue dual class stocks and tracking stocks. The American Stock Exchange appeared to be more sympathetic to firms with multiple classes of voting or alphabet stock, though use of such provisions was fairly limited until 1980. (See Gerson, 1992).

Tracking stocks were introduced to the NYSE by GM in 1984 with their acquisitions of Electronic Data Systems (EDS) and Hughes Electronics. In the Hughes acquisition, GM acquired 100 % of Hughes Aircraft Company and its subsidiaries for $2,7bn in cash and cash equivalents and 100 million shares of GM Class H common stock, having an estimated value of $2561,9 million.[4] Each H common share entitled the holder to half a vote per share, and a dividend policy at the discretion of the board of directors, which in 1996 and 1997 was 35% of Hughes net income. Both these transactions were reversed in 1997 when GM's holdings in Hughes and EDS were spun off to shareholders, including holders of the H (Hughes) and E (EDS) tracking stocks.

Another important development in the recent history of tracking stocks was the response made by the USX Corporation to the demands made by corporate raider Carl Icahn for a split of the steel and energy components of USX Corporation. During the 1980s, USX Corporation stock generally traded at lower market-to-book ratios and lower earnings multiples, than did its energy and steel company industry peers. This discount prompted Carl Icahn to accumulate a stake in the business which he used to force a shareholder vote in 1990 to spin-off USX Corporations' steel division. This he argued would have enhanced shareholder value.

Icahn lost in the subsequent vote by a narrow margin but management did begin to explore alternative restructuring plans. to enhance the company's market value and recapture some of the discount. On January 1991 the company announced its Tracking Stock plan. The result of the announcement was a cumulative two-day (day prior to and day of announcement) market-adjusted abnormal return of approximately 1,8 % on the NYSE. (See Logue, Seward and Walsh, 1996).

[4]General Motors Corporation, Form 10-K, Annual Report for the year ended December 31, 1996 IV26

In April 1998 it was estimated that there was $100bn invested in Target Shares. Sandler (1998) Thus the tracking share is beginning to rival the more traditional forms of equity restructuring that allow investors more choice, namely Carve-Outs, Spin-Offs and Dual Class Common Stock[5]. Clearly these unbundling exercises do appeal to different investor constituencies. There is only limited overlap in the shareholdings of the US parent companies and their subsidiaries. The top 25 investors in the parent, with between 60-80 per cent of the parent company, held 19 per cent of the shares in the spin-offs and 27 per cent of their tracking stocks. Outside shareholders held 17% of the shares in the parent majority owned carve-outs. See Anslinger et al., (1999 p 22).

[5]An Equity Carve-out is the sale of some portion of a wholly-owned subsidiary's common stock to the public. A Spinn-off divides the existing asset base of a companyinto two or more separate companies, distributing the shares to existing shareholders. Dual Class Common Stock are shares with unequal voting rights.

Tracking shares are a class of parent company share that tracks the performance of given business divisions. The value of each targeted business division is reflected in its own class of common stock, the Tracking Stock. Thus, when General Motors bought Hughes and issued tracking shares against the different business divisions, the value of this stock fluctuated according to the performance of the division, instead of the company as a whole. The holders of tracking stocks have no claim on the underlying assets and liabilities of the division, but as with other ordinary shareholders, only on the total company. But the holders of the tracking stocks have agreed rights to the dividends declared from the division.
Tracking shares are common stock of the company and not the division itself, and the company, when issuing the tracking stocks, can decide on the dividend pay out ratio for the division. Furthermore, tracking stock holders do not have the right to vote on policy for the division, only on policies affecting the company as a whole. In effect therefore, they have only indirect voting rights over policies taken for the division. In the case of Hughes each H class share carried a fixed voting right of half that of the ordinary shares. It was this feature that forced the NYSE, under pressure from GM, to relax its one share one vote regulation.

The voting rights attached to the E and H class GM stock were fixed. However, the voting rights attached to each class of tracking stock can be designed to fluctuate in proportion to the relative values of the divisions. Thus, if division A is relatively successful and counts for a larger share of the value of the company, holders of tracking stock A, could be allocated a proportionately increased share of the total vote. These floating rights have the advantage in preventing shareholders in weaker divisions taking over the company by buying the cheaper shares. But even then, such take-over prospects would depend on the size of the tracking stock relative to that of ordinary shares, as well as the voting rights attached to them. In the case where the voting rights are predetermined, the tracking stock would be similar to N shares, in that one group of the tracking stock holders, will have permanently inferior voting rights to that of the ordinary shares.

Recently AT&T acquired Tele Communications Inc.(TCI). TCI is the largest US cable TV company and has two tracking stocks listed on the NYSE, namely Liberty Media and TCI Ventures Group. AT&T offered TCI tracking shareholders its own tracking stock in exchange for their interest in Liberty Group. Furthermore, AT&T will have an initial public offering of tracking stock in the AT&T Consumer Services Division.

It is intended that AT&T will allocate only a minority of the dividends declared for the Consumer Services Division to holders of this tracking stock. Thus shareholders in AT&T will still have a substantial economic interest in this division. The value of the proposed merger of AT&T with TCI was estimated as $48bn. (AT&T 1998)

The structure of the deal is not surprising when one considers that Michael Armstrong the recently appointed chairman and CEO of AT&T, used to run Hughes Electronics. Armstrong explained tracking stocks as follows:

" You and your brother own a house together and rent out the top floor, sharing the rent equally. After a time, your brother thinks you could charge more rent by redecorating the apartment. You're not interested, though, because your money is tied up in pork bellies. So you reach an agreement. Your brother pays you to give up part of your claim to income from the apartment. He, in turn, is free to spend on new wallpaper, carpeting and anything else, knowing that a bigger chunk of income from renting the top floor is his to keep. So while you still both own the underlying asset - the house - more of the apartment's economic risk and reward belong to your brother."[6]

More recently it was reported that Microsoft were contemplating the issue of a tracking stock for its Internet investments. This stock it was thought might assist Microsoft to bid for another cable company MediaOne for which AT&T had made a large $54b bid. This came after a hostile bid for MediaOne had been made by ComCast for which Microsoft had been seen as a likely partner[7]. AT&T's bid was accepted and Microsoft has itself made a large investment in AT&T to give it access to this important cable network.[8]

[6]AT &T mid-year report (1998) P3. To be found on the AT&T Web Page, http://www.att.com/tci_merger/merger.html
[7]"Microsoft Mulls 'Tracking Stock in its Gambit for MediaOne", Wall Street Journal, Interactive Edition, May 4,.99.
[8]For a report on Microsoft's investments in cable TV see "Microsoft is in Talks With Cable and Wireless", Anita Raghavan, Steven Lipin and David Bank, Wall Street Journal, Interactive Edition, May 12th 1999.

4. Implementation of a Tracking Stock Issue

Since General Motors issued the first tracking stock in 1984 to March 1999 a total of twenty-three tracking stocks have been listed in the United States. (Anslinger et al., 1999) These tracking stocks cover segments as diverse as banks, industrials, utilities, health care, cable, telecommunications and retail. The stock market performance of these tracking stocks has been considered in detail by Logue et al., (1996) and Anslinger et al., (1999).

Logue et al. (1996) describe the process as one of three steps.

Firstly, features of each tracking stock must be established. Such features include details of voting rights, liquidation rights, dividend policy, redemption provisions, exchange provisions and amount of tracking stock to be authorised and issued in each targeted business. Such features are usually initially determined at the discretion of the board of directors. It is noteworthy that dividend policy is usually based upon the earnings of the tracking divisions and will either be a fixed dollar amount or pay-out ratio.

The definition of these terms is of utmost importance to ensure that the US Internal Revenue Service (IRS) considers the tracking stock as common stock of the company rather than stock of the division. If the latter is the view taken by the IRS then this could result in potential tax liabilities at the time of sale or distribution of tracking stock. Furthermore, individual tax returns would have to be filed instead of a consolidated tax return. When establishing the features of the tracking stock the board of directors need to consider debt covenants to comply with the company's consolidated credit agreements. Indeed, as the company is still viewed as a consolidated entity the company's debt capacity would be greater than were it to engage in a spin off.

Secondly, the financial design of the tracking stock must be determined. Each business division has to be clearly defined. This would include the composition of each division's assets and liabilities and the retained income in each division. Furthermore, management has to determine how joint costs are to be allocated and the prices to be charged for goods and services transferred between divisions. At financial year end separate results would need be presented in detail for each division, instead of consolidated results which probably would not provide as much divisional detail.

Thirdly management has to design and send out a proxy statement describing the proposed amendments and calling for a shareholder meeting. Based on the results of the shareholder meeting the company's charter will be adjusted accordingly, incorporating the changes necessary to affect the issue of tracking stock.

Tracking/Target shares can then be distributed as follows. Firstly a public issue can be orchestrated offering tracking shares to the investing public. Proceeds from the tracking share issue can then be allocated against the divisions the tracking shares were issued against or distributed at the discretion of the parent company. Secondly, tracking shares in an acquiring company can be issued to the tracking company shareholders. Such is the case with AT&T's planned issue of tracking stock to holders of TCI's programming arm, Liberty Media Group. Lastly, the most common form of issuing tracking stock is by the parent company distributing tracking stock via a stock dividend. It must be emphasised that none of the above tracking stock transactions result in any taxable events as no legal separation of business divisions occurs, as would be the case in an equity carve-out for instance.

5. Advantages and Disadvantages of Tracking Stocks for a South African Corporation

There are considered to be no legal barriers to the issue of a tracking stock by a South African company. The SA Companies Act of 1952 (subsequently amended by s.29 of Act 68 of 1957) does not permit the issue of no voting shares. But the issue of any other class of shares would appear to be allowed provided they were authorised by the company's articles of association. To quote one leading authority *"....Shares need not be of equal amount. Nor is it necessary that equal rights and privileges should be attached to all shares; ... "* Henochsberg (1998)

In a comprehensive study on the legal issues raised by tracking stocks were they to be issued in South Africa, it was found that the only statutory impediment to the listing of tracking stock on the Johannesburg Stock Exchange would be their inability to possess floating voting rights. All the other opportunities available to issuers of tracking stocks under US law would be available in South Africa. See Marais and Botha (1997)

One advantage of listing a tracking stock over a listed subsidiary for a SA group may be its greater familiarity and acceptability to the US investor and to the Stock Exchanges themselves. However aside from the perhaps greater acceptability to the US investor of a tracking stock there may be other advantages over listed subsidiaries that should be considered by the controllers of SA groups.
The benefit of using tracking stocks rather than a separate company to raise capital is that legally there is only one company liable for taxation. The company either operates with divisions or makes acquisitions that are folded into it as further divisions. Therefore, in South Africa and the U.S.A, there would be no ring fencing of legally separate companies that can work to increase overall tax payments. In the U.S.A 50 % of companies that have issued tracking stocks take advantage of the parent's or the subsidiary's net operating loss in this way.
(Anslinger et al., 1999)

As indicated, in South Africa the benefits of a focused holding of a tracking stock, could be achieved by spinning off a division into a new subsidiary, in which the holding company retains a controlling shareholding and into which new

outside shareholders are introduced. The South African holding company, planning to list a division, would form a new company for the subsidiary to be housed in. After the company is formed, the parent holding company would sell the assets and liabilities of the division into the new company, in exchange for a 100% share interest. The parent could then either sell up to 49% of these shares without losing control. Or it could instruct the new subsidiary to issue shares to the public so that new finance is introduced into the group structure at that level.

Yet with the transfer of assets and liabilities there are certain accounting and tax complications. Firstly the assets would need to be transferred at tax values in order to prevent a taxable event arising for the holding company. This would result if the assets are transferred at a value greater then their tax value. If the assets are transferred at values greater then the tax values, past tax allowances would be recouped by the South African Revenue Services and taxes paid on these amounts. If the assets are transferred at a value below their tax values, then the holding company would not be able to claim a deduction on the difference for tax purposes, as the transaction would not be deemed to result in a scrapping allowance. Furthermore, the subsidiary would then only be able to claim future tax allowances on the reduced value of the assets.

Moreover, unless the tax values of the assets are equal to the accounting values, the holding company will have to recognise a profit or loss in their books when the division is sold to the new company. However, this profit or loss upon will be reversed upon consolidation of the accounts of the new subsidiary with the holding company. It may also be presumed that the distribution of tracking shares would not be deemed a dividend.[9] Consequently there would be no Secondary Tax on the Company for a tracking stock issue. Such a conclusion was also supported by Marais and Botha. (1997).

[9]*In terms of S 64B and S 64 C of the South African Income Tax Act.*

Tracking stocks also allow the credit rating of the division to be dependent on the status of the whole company. There would be no necessity for the company to issue explicit guarantees, or so called back ranking agreements, to outside suppliers of debt or equity capital, on behalf of what may be regarded as a more vulnerable subsidiary of a legally separate holding companies. Without these guarantees a subsidiary raising capital would have to pay a higher risk premium to stake holders. Of course, providing such surety, is not a costless exercise for the holding company still carrying the risks. Such extra risks will influence the value of the parent company. With tracking stocks any bankruptcy or other risk premium would not be based on the prospects for the division but for the company as a whole. The cost of capital in the form of a tracking stock issue will then be lower if the risks are more widely spread. Both USX and Circuit City chose tracking stocks, in part, to maintain the ability of the disaggregated entities to borrow at the debt rating of the consolidated company. (Anslinger et al., 1999).

Nevertheless some issues will naturally present themselves to both the holding company of a listed subsidiary or a parent company issuing tracking stocks. One issue unlikely to be easily resolved is that close control of a company represents a barrier to hostile take-overs. This will always raise resentment if the established controllers seem unable to realise the economic potential of the firms or divisions they control and are unwilling to sell control. Another issue common to both systems will be to allocate on some agreed basis overhead costs and the flow of fees and services between the division or subsidiary and head office. Clearly the management in control will be in charge of such decisions and shareholders with different interests may not be easily satisfied that all is fair, especially in the case of an under-performing division or subsidiary. The managers of the divisions or subsidiaries, especially if their bonuses or share options depend on such cost allocations, will also raise such issues with the managers in overall control.

In the case of a holding company and its listed subsidiaries, it is possible to calculate whether the whole, that is the holding company, is worth more or less than the sum of its listed parts. Much attention in South Africa is given to the measurement of what is usually a discount of the share market value of the holding company to its Net (stock market measured) Asset Value. The conclusion drawn from this discount is that shareholders in the holding company would be better off if the listed assets were "unbundled" and spun off to its shareholders. In this process, so it is said, value would be unlocked and any discount to net asset value would be eliminated.

The problem with the calculation of Net Asset Value in this way, is that it presumes that the market value of the parent company of the group and the listed subsidiaries it controls, are determined independently of each other. Clearly this is not the case given the overlapping shareholdings and mutual interests. As indicated above, the parent company may well guarantee the debts of its subsidiary. Such an action will clearly enhance the value of the subsidiary and may reduce that of the parent. Any effective subsidy of this kind would do the same, while any, what may be described as a tax placed on the subsidiary, in the form of an excessive charge for head office services rendered, which the subsidiary has no way of avoiding, will have the opposite effect on relative value.

Breaking the umbilical chord that connects head office and its subsidiaries or its divisions may well add value to the holding company while taking something away from the value of its now stand alone subsidiary or vice versa. One may, depending on the circumstances, be justified in describing part of the value in the subsidiaries or tracked divisions, as a premium for being part of a supportive larger whole. Unbundling therefore may reduce the value of what was a subsidiary, while adding something to the value of the holding company. On balance all shareholders may not therefore benefit from the restructuring. (See Barr and Kantor 1994).

Issuing tracking stocks may make it harder to criticise established management or controlling shareholders in this particular discount to net asset way. But the case for changing the management of under-performing divisions which are being tracked, or altering the relationship between head office and the division would have to be addressed. With a tracking stock as with a listed subsidiary the performance of the division is fully exposed. This is of course a primary reason why tracking stocks are appreciated by investors. They attract much more attention from analysts than would any unlisted division. This attention can help to add share value. (See Anslinger et al., 1999)

6. Conclusion

The paper has shown that tracking stocks do for American companies and their controlling shareholders or managers what group structures have been designed to do in South Africa. That is serve to maintain control within the group parent company while raising additional capital for investment in a subsidiary company or a division. It was also shown that issuing tracking stock rather than listing separate companies may offer advantages for South African conglomerates considering unbundling options. The advantage of utilising tracking or tracking stock over the more traditional forms of retaining control, such as holding-subsidiary company structures and N shares, is the familiarity of tracking stocks for the US investor. Furthermore, as tracking stocks become better known in the USA it can be expected that their acceptability will grow.

With South Africa increasingly part of the global capital market it is important that criticisms of the South African corporate structure are addressed if South African corporations are to reduce their costs of raising capital. Adopting tracking stocks may help do this, even though they are a device for separating control from ownership.

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