ADDING VALUE FOR SHAREHOLDERS IN SOUTH AFRICA: AN ANALYSIS OF THE REMBRANDT RESTRUCTURING*

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South African companies, long inhibited by exchange control and international opprobrium, are responding energetically to the opportunities and threats, to the risks and rewards, provided by increasingly global capital markets, of which the Johannesburg Stock Exchange (JSE) is now so much more an accepted part. It has taken the new democratic dispensation in South Africa, the removal of sanctions, and the relief of exchange control to encourage this process of change. The tightly controlled JSE-listed companies have in response become both more specialized and much more international in their operations, and they now appear to attach much less importance to the need to maintain their control structures.

The South African corporate landscape has in fact changed quite materially from the system dominated by family-controlled groups of companies that I described in this journal six years ago.¹ The Anglo-American Corporation (Anglo), by far the largest of these groups listed on the JSE, has been in the vanguard of such responses. Anglo has also listed on the London Stock Exchange and moved its head office to the U.K. in 1999. More important, the cross holdings between Anglo and the De Beers Corporation, which effectively secured the Oppenheimer family control over Anglo and De Beers, were eliminated in June 2001. De Beers itself was delisted and converted into a private diamond mining and distribution company, in which the Oppenheimer family company and Anglo each holds 45% of the shares (and which the

family effectively controls). The other 10% of the new De Beers is held by the Botswana government. In this way, Anglo has become a management-controlled company with a highly diffuse group of shareholders, none of which holds more than a minor stake in the company.²

South African Breweries (SAB), the largest industrial company listed on the JSE, also moved its primary listing to London. It did so after unbundling and selling much of its nonbrewing portfolio to focus on its international brewing business. The holding company Bevcon, which held a 30% stake in SAB and through which Anglo, with others, exercised shareholder control over SAB, distributed its SAB shares to its shareholders in an unbundling operation.

The two major mutual life assurance companies that controlled two other important groups of companies on the JSE, Sanlam and the Old Mutual, have given up their mutual status and become stock exchange-listed companies themselves. And the Old Mutual has also become a U.K.-domiciled company with its primary listing on the LSE.

The Rembrandt group, the other major family-controlled group of companies listed on the JSE, has undergone a major restructuring designed to simplify its conglomerate nature and split the company into two more specialized parts. The founding families, however, continue to maintain control over the two new JSE-listed components of the group. And the Rembrandt restructuring is one of the main subjects of this paper.

In the pages that follow, I begin by analyzing the general forces that determine the value of a holding company whose most important assets are shares held in a variety of listed

^{*} I should like to thank Investec Securities for permission to include some of their tables and analysis and in particular Kalinka Anjelopolj and Anthony Geard of Investec Securities for their most helpful assistance. I must also thank my colleague Graham Barr for his advice and assistance with the model building exercises. The responsibility for any errors and inadequate analysis is of course mine alone. ¹ Barr, Gerson and Kantor (1995).

² Full details of these transactions are to be found on the Anglo American plc web site, www.angloamerican.co.uk

subsidiary or associate companies. I explain why unbundling, while reducing the discount to what is described as Net Asset Value, does not necessarily add value for shareholders. And, as I go on to show, adding value for shareholders requires changes that are much more fundamental than those that are likely to be accomplished by the recent restructuring of the Rembrandt group.

WHY NAV IS THE WRONG INDICATOR OF SHAREHOLDER VALUE ADDED

Given the opportunities provided the SA groups to restructure and unbundle, the spotlight has been cast ever more brightly upon what is widely assumed to be the counterproductive for shareholders--namely, the conglomerate nature of many of the South African groups.³ In attempting to arrive at an assessment of what is popularly called "the conglomerate discount," financial analysts and asset managers pay particular attention to the relationship between the market value and the net asset value (NAV) of the South African Holding companies. On the basis of such calculations, almost all of the listed holding companies have a market value that is less than their NAV--that is to say, they trade at a discount to their NAV. And from this finding alone, analysts often infer that the company would be worth more to its shareholders if its assets were liquidated. That is, either the constituent parts should be sold off and the cash distributed to shareholders; or the shares they own in other companies (which account for most of the NAV)

³ Such controversies are by no means unique to South Africa but occur wherever the system of listed holding and subsidiary companies is applied, as for example in continental Europe. By way of illustration there is at this time of writing a dispute between Investment Banks UBS Warburg and Lazards concerning three French holding companies run by Lazards in which UBS holds stakes, Eurafrance SA, Azeo SA and Societe Immobiliere Marsellaise SA. To quote The Asian Wall Street Journal (Ruling Escalates Tension between Lazard, Warburg, November 24-26th 2000 p 13) "Warburg believes that the companies, which trade below the value of their assets, should be broken up to release their latent value for shareholders...." See also Truce Agreed in Battle at Lazard, Financial Times November 28th 2000 p17.

should be distributed to their shareholders. This kind of "unbundling," it is widely argued, would eliminate the discount to NAV and thereby add value for shareholders generally.

Some Leading Questions

To show why this argument is misleading if not wrong, we need to explore the following questions:

1. When will the value of a holding company stand at a discount to its NAV?

2. Why does the discount go up or down?

3. When will unbundling reduce or eliminate the discount to NAV?

4. How can unbundling hope to add value for shareholders?

The simple answer to question 1 is that the market believes the management of the holding company will destroy shareholder value by making future investment decisions that cost shareholders more than they prove to be worth—and, more generally, by the pursuit of corporate empire building rather than value maximization. The upfront discount has the effect of compensating new shareholders for these disadvantages by converting expected below-normal *operating* rates of return on investment into expected, normal *share market* returns.

The opposite is true of the rare holding company that stands at a premium to its NAV. Take, for example, Warren Buffett's Berkshire Hathaway. In that case, the fact that its shares are worth more than the sum of the values of it publicly traded subsidiaries (and at least the book value of its untraded assets) reflects the expectation that management will continue to make above-normal returns. As the history of Berkshire Hathaway suggests, shareholders are willing to pay a premium for the privilege of sharing in them. In other words, investors have to pay to enter the premium club and are offered a discount to join the low-life types at the back of the bus. A little bit of algebra can make this point very clearly and help us address some of the further implications indicated above.

$$\% Discount(MVNAV) = 100 * \frac{MVNAV - MV}{MVNAV} \%$$
.....(1),

where MV represents the market value of the holding company and MVAdjNAV represents its NAV (or rather, as discussed below, its market value adjusted NAV). If MVAdjNAV>MV, as is almost invariably the case, the holding company will trade at a positive discount. But in cases where MVNAV<MV, the discount will be a negative number and called a "premium."

The Different Definitions of NAV

First let us be perfectly clear what we mean about the NAV of a holding company when we refer to a discount to its NAV. Most important is to recognize that this NAV is *not* what is usually meant by the NAV of a company, which is simply the *book value* of its assets less its debts. In what has become a common practice not only in South Africa, but in equity analysis throughout the world, the NAV of a holding company is calculated by continuously converting the value of the holding company's assets from book to market value. It is therefore best described as a market value adjusted net asset value, or MVAdjNAV.

Following the practice of the South African Mining Houses,⁴ this MVAdjNAV can in turn be defined as follows

MVAdjNAV = ML + BU + Cash - Debts....(2),

⁴ The mining houses, which reported such numbers in their annual reports, must have thought it advantageous to point to the fact that their NAV was greater than their market values. They did so presumably because it improved their credit worthiness

where ML represents the market value of the listed assets of the holding company and BU represents either the book value of the unlisted assets of the company or the director's estimate of that value (which in most cases would exceed the original book value).

Alternatively, an analyst might substitute for BU an estimate of the market value of its unlisted assets, in which case:

MVAdjNAV = ML + MU + Cash - Debts....(3)

Using some of the same terms, we can define the market value of the holding company as follows:

 $MV = ML + MU + MH + MP \dots (4)$

That is, market value can be expressed as the sum of the market value of its listed assets (ML) and the market value of its unlisted assets (MU), plus two other variables: MH and MP. MH can be thought of as the market value of the holding company's head office operations that provide services (and charge fees) to the subsidiary companies--both listed and unlisted. MH will usually, though not always, have a positive value, especially if the subsidiary companies receiving these financial and technical services are paying above market-related fees for the services provided. (Thus, another way of viewing MH is as the net present value of the wealth transfers from the subsidiaries to the parent.)

This brings us to MP, which is really the critical variable in the valuation of a holding company, as well as the most important determinant as to how a holding company trades in relation to its NAV. MP reflects the net present value of all the projects the management of the holding company is expected to undertake in the future (as well as the likelihood that management will either discontinue currently value-reducing investments, or convert them into value-increasing investments). Net present value is the difference between the present value of

the operating surpluses the investment is expected to realize and the cost of undertaking these investments. This may be their acquisition costs or the value of a series of disbursements that might have to be made over time to bring a green-field project to completion. MP represents the market's estimate of the value of the gleam in the management's eye. If these projects are expected to add value for shareholders over and above the value of the cash that will be paid out to undertake the projects, then MP will have a positive value. If not, MP will take on a negative value.

Reformulating the Calculation of the Discount

If we now substitute for MVAdjNAV from equation 3 and for MV from equation 4 into equation 1 we get the following expression for the discount from NAV:

% Discount = [ML + MU + Cash - Debt - (ML + MU + MH + MP)]/ML+MU+Cash-Debt

The MLs and MUs cancel out in the numerator, reducing the expression to the following:

% Discount = (Cash - Debts) – MH - MP/ ML+MU+(Cash-Debt).....(5)

If we instead use the mining house definition from equation 2, the equation would take the form

(6)

% Discount= BU+ (Cash - Debt) – MU – MH - MP/ ML+MU+(Cash-Debt)

A number of points become clear when we examine the right hand side of equation 5. First of all, the larger the absolute value of the numerator, the larger will be the discount. At the same time, the larger is the absolute value of the denominator, the smaller the discount will be. Thus, for any increase in the market value of the listed or unlisted assets of the holding company, which are represented in the denominator of equation 5, the discount will be smaller. What is important to recognize, then, is that the discount will change in response to market-wide changes in the value of assets, changes over which management has little if any control. If underlying market conditions improve, the value of a holding company's investments will rise and the discount will narrow; but the discount will widen if general market conditions deteriorate. In such cases, to repeat, the movement in the discount mostly will have nothing to do with the actions of the managers of the holding company who exercise control over the managers of their listed and unlisted subsidiaries.

A True Value Proposition

But in cases where the value of the assets under holding company control moves independently of the broad market, it may make sense to praise or blame the management of the holding company for the lower or higher discount to MVAdjNAV. The value added or lost might then be properly attributed to the exercise of effective or ineffective corporate governance by the controlling shareholders over the managers of their subsidiaries. The opportunity for the holding company to exercise shareholder control over the management of a listed or unlisted subsidiary may add value to it and, in so doing, reduce the size of the discount. This essentially is the justification for a closely controlled (if not owned) holding company--namely, that it provides the means for superior managers to exercise shareholder rather than management control over companies at all levels of the group structure.⁵

Let us now turn to the numerator of equation 5. There it can be seen that the greater the expected market value of new projects (MP), the smaller the absolute value of the numerator and so the lower the discount. It thus becomes clear from equation 5 that a persistently large discount reflects in large part investors' pessimism about the value of the future investment

⁵ See, again, my article with _____, cited in footnote 1.

program of the holding company (as well as the extent of management's commitment to maximizing the value of existing operations). That is, the appearance of a persistently large discount will reveal that a large negative value has been attached to MP. This would be especially true in cases where the market value of listed and unlisted assets, represented in the denominator, is large and therefore will tend to reduce the discount. The more valuable are these assets, the larger is the market value of ML and MU, the larger the absolute size of the denominator, and so the smaller the discount--for any given value of the numerator. MH is unlikely to have a material effect on the value of the numerator, given that the present value of head office fees over the cost of providing service is unlikely to be material one way or another for most large companies.

Thus, in order for the management of a large holding company to reduce the discount, it would have to increase MP, the net present value of their investment program. (Alternatively, it would have to convince the market that it was committed to either ending or improving the efficiency of existing value-destroying operations.) Naturally words alone cannot hope to overcome a high degree of market skepticism as reflected in a large discount. It would require the convincing adoption of a clearly more disciplined process for undertaking investments—one in which the firm demonstrated its commitment to pursue only those investment projects that promised to provide returns exceeding the opportunity cost of the capital invested.

UNBUNDLING BY ITSELF IS NOT THE SOLUTION

Unbundling is the distribution of listed assets held by the holding company to its shareholders. This action by itself cannot add value for shareholders—and for essentially the same reason that 4 - 2 = 2 and not 3. What is gained by shareholders in the form of shares previously held on their behalf by the holding company must by the same token mean a less

valuable holding company. In fact, simply distributing some listed assets to shareholders, all other things (especially MP) remaining the same, will actually increase rather than reduce the discount. A reduction in the ML of equation 5 means a smaller denominator and so a larger ratio or discount, provided MP, the negative value attached to the company's investment program, is unaffected.

If all the listed assets were distributed to shareholders, the company would cease to be a holding company for which a market value adjusted NAV could be calculated. A stand-alone company would normally have a market value that exceeded or fell short of its book value and the success or otherwise of the company would be gauged in significant part by the ratio of the firm's market value to its book value.] But if a separate market value was attached to some of its important unlisted assets, especially if they were less than wholly owned, then a discount to MVAdjNAV would still be possible. And if book values or directors' valuations were instead used to estimate MVAdjNAV as per equation 2, then the discount (applying the original mining house convention) would decline after distribution or sale of an asset, provided the book or directors' valuation exceeded the market value of the listed or unlisted asset being disposed of or unbundled to shareholders. But if book values fell short of the implicit market value of the unlisted subsidiaries, then the opposite would happen--the discount would widen.⁶

For this reason, then, an unbundling exercise with no significant change in managerial control or decision-making is unlikely to add value for shareholders even if the discount increases or decreases. In other words, the critical issue is the relevance of any unbundling exercise for the value of MP of equation 5. Will unbundling lead to better investments or, perhaps better yet, be associated with the complete abandonment of clearly failing investment

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programs? Or, to propose the unthinkable, would the managements of some holding companies even choose to liquidate their entire firms? In cases where MP has a sufficiently large negative value, such acts of managerial self-abnegation would surely add value for shareholders.

Is Balance Sheet Strength Good or Bad?

To expect the managers or owner-managers of a holding company--especially one with a successful track record of adding value for shareholders--to give up simply because the market is skeptical about their investment program is usually to expect too much of managers. They will be well aware that the judgment of the market is subject to change. And given a degree of insensitivity to market valuations by controlling managers or shareholders, the fact that the holding company has a significant portfolio of cash and other liquid listed assets will be highly relevant for the estimation of MP and the market value of a holding company. When the holding company has valuable assets in the form of cash and shares in listed companies, it has the power to pursue projects relatively unhindered by the need to raise additional finance from the capital markets. Listed assets are almost as good as cash for the purpose of generating cash for the purpose of financing investment decisions. This is especially true if the sales of shares in the listed subsidiaries or divisions can be effected without reducing the holding company's control of the subsidiary. This will be the case when the holding company holds significantly more than the 50% of the voting rights in the subsidiary or tracked division, or when control can be maintained in other ways even when the controller's share falls below 50%.

But financial strength is not always a source of value. In cases where a company's future investments are not regarded as promising by the market, but are expected to be undertaken anyway because of the financial strength of the holding company, then more balance sheet

⁶ The numerator and denominator would both decline by the same amount causing the ratio to

strength is a disadvantage rather than an advantage to shareholders. In short, the value of MP becomes even more negative for companies that can afford to ignore financial markets. And in the case of holding companies with listed assets, it is not only the waste of cash that may be of concern to shareholders, but also the waste of the listed assets that can easily be converted into cash.

Signals From Management

Thus the greater the firepower of a holding company in the form of cash and shares held in listed companies, the more vulnerable are shareholders to the danger of poor investments that are expected to have little or even negative value for investors. Such dangers will be reflected in a lower market value for the holding company and a large discount to MVAdjNAV.

In such cases, unbundling of listed assets may add value simply by signaling to the market that management is about to take a more disciplined approach to investment. The willingness of a holding company to reduce the strength of its balance sheet and dispose of its highly liquid listed assets could be a sign to shareholders that management will be less likely to proceed with unprofitable projects in the future. A similarly positive signal would be provided by the holding company's announcement of its plan to buy back its shares with surplus cash or with cash generated through disposals of assets.

Value can only be added for shareholders if projects are undertaken that are expected to return more than their cost of capital. This criterion applies equally to stand-alone, singlebusiness companies and to diversified holding companies. Holding companies can add value to their listed subsidiaries by ensuring that the managers of the listed subsidiaries they control undertake only those projects that promise to add value for all their shareholders. In effect the market is judging the value of a holding company as it judges a successful standalone company—primarily on the basis of its future performance not its past record of achievement (which can be inferred from a large positive market-to-book ratio). Converting book NAV into market adjusted NAV is consistent with such a forward-looking approach. But when used for purposes of performance evaluation, there is a problem with this approach. Requiring the managers of holding companies to achieve market values in excess of their market-adjusted NAVs effectively sets the bar too high. By **c**onverting book values into current market values, stock analysts are asking successful companies to continually exceed the expectations created by their past successes.

In many cases, then, the market is clearly skeptical about the ability of managers of holding companies to add additional value in the future. In such cases, an unbundling strategy that promises major improvements in operating and investment strategy could succeed in adding significant value—and perhaps even in eliminating (at least for a time) the discount to NAV. But for those holding companies with a highly successful track record of delivering value to shareholders, selling at a discount to a market value adjusted NAV is not a sufficient reason to unbundle. Indeed, the only way that a consistently successful value-adding holding company can continue to add value is by continuously exceeding the market's expectations—that is, by continually surprising the market with new and even more profitable investments. But since markets are forward looking, once the company fails to match the expectations built into its listed assets, any premium of its market value to its MVNAV will quickly turn into a discount.

A MEASURE OF WEALTH CREATION: THE CASE OF THE REMBRANDT UNBUNDLING

A case study of the effects of unbundling is provided by the restructuring and unbundling exercise conducted by the Rembrandt Group of companies in the year 2000. The holding company, Rembrandt Group Limited, was converted into two listed entities Venfin, which now holds the group's technology interests, and Remgro, which houses the more traditional industrial interests of Rembrandt. The restructuring was also accompanied by the removal of the four listed pyramid holding companies through which family control of Rembrandt had been secured. The controlling stake in Rembrandt was held through a tier of JSE listed holding companies,⁷ conferring the equivalent of a 6.7% ownership stake, which was swapped for B shares in the new companies. These unlisted B shares came with with highly differential voting rights that maintained family control. In this way the structure of assets was changed, but without any change in the control structure.

As I argued earlier, unbundling in and of itself will not add value for shareholders unless the unbundling exercise is regarded as a reliable signal of improved investment decisions and greater operating efficiency. Unfortunately, there is no obvious reason to believe that the Rembrandt unbundling provides such a signal. The fact that the two new companies are closely

⁷ The pyramid structure that secured family control of Rembrandt Group Limited consisted of a tier of holding companies, four of which were listed on the JSE. At the apex of the structure was a private company Rembrandt Trust that held 44.5% of the shares in a listed company TIB. TIB in turn held 60.4% of the listed company Tegkor. Tegkor in turn held 40.6% of RBB, another listed subsidiary. The only asset of RBB was a 51.1% controlling stake in the parent company, Rembrandt Group Limited. The ownership stake of the unlisted family controlled Rembrandt Trust in the Rembrandt Group Limited that secured control of the major holding company was thus approximately 5.6%. (44.5*60.4*40.6*51.1) Some additional direct holdings took the effective ownership stake of the families to the 6.7% ownership share represented by the B shares.

controlled by the same group of shareholders and managers that controlled the old Rembrandt was not likely to encourage the market to believe that the investment process has changed materially.

Did this transaction add value for shareholders? The proof of the pudding is in the eating--that is, [how did the market respond to the announcement of the Rembrant unbundling on June 15, 2000, and] how have the shares of Remgro and Venfin performed since the restructuring exercise concluded on September 26, 2000?

Conducting an Event Study

The most challenging part of any such calculation of value creation following some important event of this kind is to factor out the impact of the market itself on shareholder returns. This therefore presumes a significant statistical relationship between the value of the shares and the market itself. A significant statistical relationship between changes in the daily value of Rembrandt and the market, as represented by the Financial and Industrial Index of the JSE, was found for the months leading up to announcement of its intent to restructure, which was made on the June 15, 2000. Having established this statistical relationship, which is reported in Table 1,⁸ and illustrated in Figure 1, it was then possible to use this equation to predict, taking into account the actual behavior of the market after June 15, what the value of a combined holding in Venfin and Remgro might have been in the absence of the unbundling exercise. The difference between the predicted by the model value and the actual value may then be attributed, within appropriate confidence limits, to the event--in this case the unbundling and restructuring of Rembrandt.

⁸ As may be seen in the table of regression results daily movements in the Index explain about 45% on average of the daily movement in Rembrandt. The Rembrandt beta is 1.16.

The relationship between the market, as represented by the Financial and Industrial Index of the JSE, and Rembrandt before and after the unbundling exercise, is indicated in Figure 2.⁹ After the unbundling "Rembrandt" is represented by the sum of the share prices of the new Venfin and Remgro.

As can be seen from Figure 2 The near-term reaction of the market to the unbundling up (from June 15 until November 17, 2000) was ambigous[cut:, as may be seen below from the accompanying graphs]. There appeared to have been an initially positive reaction, followed by a two-month period where Rembrandt appeared to lose ground relative to the market (though most of this underperformance had disappeared by the time the new shares were trading in late September. Thus, based on the market reaction between the unbundling announcement and the listing of the two new companies, it is unclear that shareholders enjoyed any obvious gains or losses from the unbundling exercise.

The actual value of a combined stake in Venfin and Remgro between September 26, when they were first listed and November 17 when this statistical exercise was concluded, has been, if anything, a little below their value as predicted by the model. The model used for this purpose included as explanatory variables the actual value of the JSE index over the period. In sum, the Rembrandt unbundling exercise in and of itself does not appear to have added value for shareholders in any obvious way.

⁹ The model as may be seen is estimated in daily change form. These daily changes and their values, as forecast by this model, given the actual fluctuations in the market, have been converted into a series of actual share prices for easier reference.



Figure 2

(For the period after the listing Rembrandt is represented as the sum of Venfin and Remgro as indicated in figure 3)

Figure 3



Figure 4



Table 1

REGRESSION RESULTS

for daily Changes in Rembrandt explained by daily changes in the Financial and Industrial Index.

Dependent Variable: DREM (daily changes in Rembrandt) Method: Least Squares Sample(adjusted): 11/19/1999 6/14/2000 Included observations: 149 after adjusting endpoints

Variable	Coefficie nt	Std. Error	t-Statistic	Prob.
С	0.130028	0.164309	0.791363	0.4300
DFI	1.163293	0.105037	11.07507	0.0000
R-squared	0.454	Mean dependent var		0.188
Adjusted R-	0.451	S.D. dependent var		2.705
squared				
S.E. of regression	2.00	Akaike info		4.242
criterion				
Sum squared	590.71	Schwarz criterion		4.28
Log likelihood	-	F-statistic		122.65
	314.0375		-	
Durbin-Watson	1.85	Prob(F-st	tatistic)	0.00000
stat	ee	<u></u>		0







CONCLUSION—COSMETIC CHANGES VERSUS VALUE-ADDED RESTRUCTURING

Value can be added for shareholders only if restructurings are expected to (1) increase the efficiency of existing operations; (2) discontinue value-destroying investments; or (3) encourage investment only in projects that are expected to return more than their cost of capital. This criterion applies equally to stand-alone companies and to holding companies. Holding companies can add value to their listed subsidiaries and to themselves if they ensure that the managers of the listed subsidiaries they control only undertake projects that return more than their cost of capital.

Clearly, in many cases, the market is skeptical about the ability of managers of holding companies, even those with a good track record, to add additional value in the future. In the case of a holding company, this skepticism reveals itself in a discount to market value-adjusted NAV. For managers of holding companies that are subject to a discount to market-adjusted NAV, it is important to realize that if they succeed in their mission of identifying investments that return more than their cost of capital, they may take the market by surprise and be rewarded with a higher share price. But their shares are still unlikely to trade at a premium to MVNAV. A premium is only awarded to those few holding companies that are expected to find *new* cost of capital-beating investments, not merely to those with a history of them.