

Financialization and competitiveness

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How the comp. story changes:

- **(a) from later 1990s demands of an active financial sector:**
 - **Shareholder Value as the demand that corp PLC management competes by meeting the performance requires of the stock market**
- **(b) to the late 2000s threats of a passive aggressive financial sector**
 - **Warnings and threats about the dangers of undermining the financial sector eg PE resisting disclosure and higher CG tax**

A story about performance:

- **Performance in a double sense:**
- **(a) theatrical performance** of the active elite group for the passive saving masses (supply feedstock but do not speak or act)
- **(b) contractual legal performance** ie promising + then delivering a behaviour or outcome (eg outcome of higher returns ex SV + VBM)
- Performance (not performativity) as unkept promises for the masses and accumulating questions about self serving elites

Performance through time with conjunctural change

- **Two phases of performance connected through conjunctural change:**
- **(a) late 90s non delivery for the masses:** SV did not raise the stream of value created by management effort in corporate business
- **(b) later 2000s delivery for elites:** activism and PE embraced point concepts of value and positioning for value extraction...raised questions about the elite even before the credit crunch
- **Change increasingly highlights gap between intermediary elites + saving masses.**

(1) 1990s Shareholder Value

- **Stock market fund managers + analysts challenge an underperforming corp sector**
- **Late 90s question arising: would SV impose a single logic of corporate behaviour ?**
- **(a) some pro** eg Lazonick and O 'Sullivan's hypothesis about "downsize and distribute" in S and P
- **(b) many anti** eg Froud et al on higher returns as "cheap tricks" given product market limits

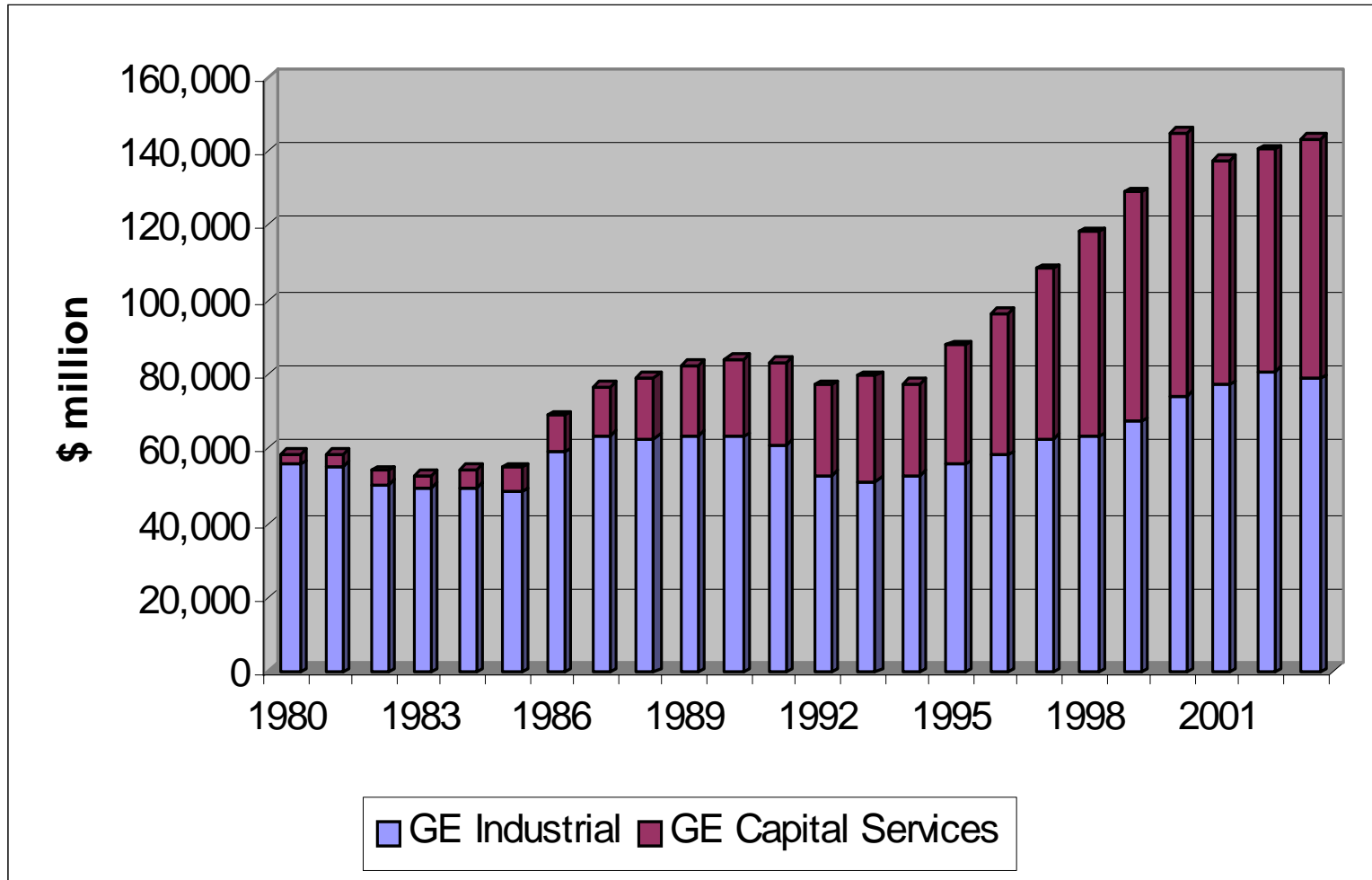
In retrospect looking back at 90s from 2000s

- Accumulating empirics and argument reinforces early suspicions about incoherence:
- (A) stock market demands were not coherent and consistent eg on profits + ROCE
- (B) various national corp sectors eg Brit and French responded differently to the same fund managers
- (C) SV everywhere delivered more for top corporate managers than for shareholders
- All this prepares the way for subsequent develops in the 2000s

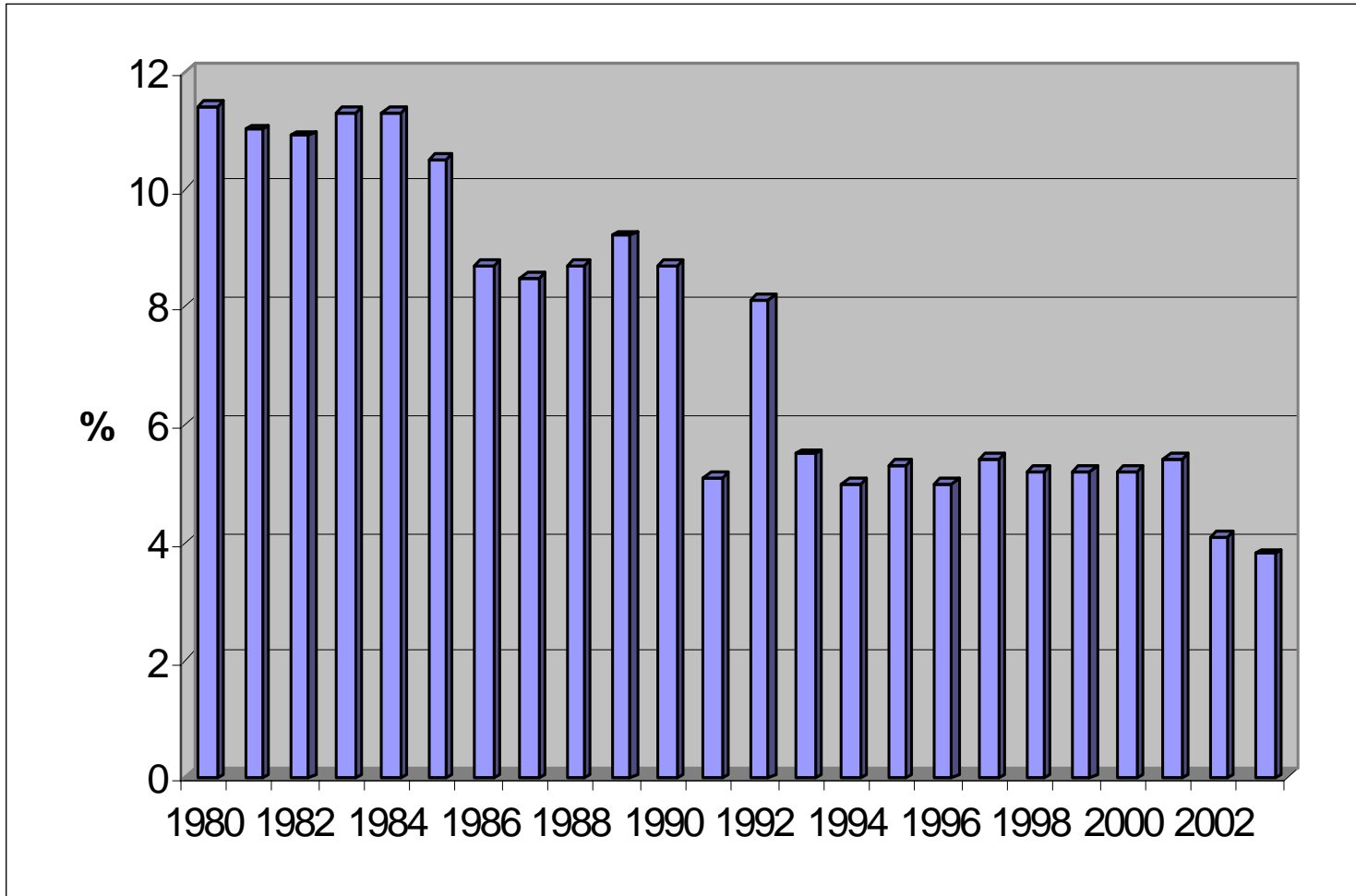
(A) market double standards, inconsistency

- New Econ double standard: 1996-2000 high valuations for cos like Netscape without profits or business model v demands solid old econ cos. should deliver more
- Old econ incoherence eg chasing up the shares of GE under Welch which combined growing sales + profit with collapsing ROCE + value destruction
- **Lesson: Finance theory may be consistent, the markets are not because they run on narrative as much as numbers**

GE real sales revenue 1980-2003 \$million (in real 2003 prices)



GE consolidated (post-tax) return on capital employed (ROCE)

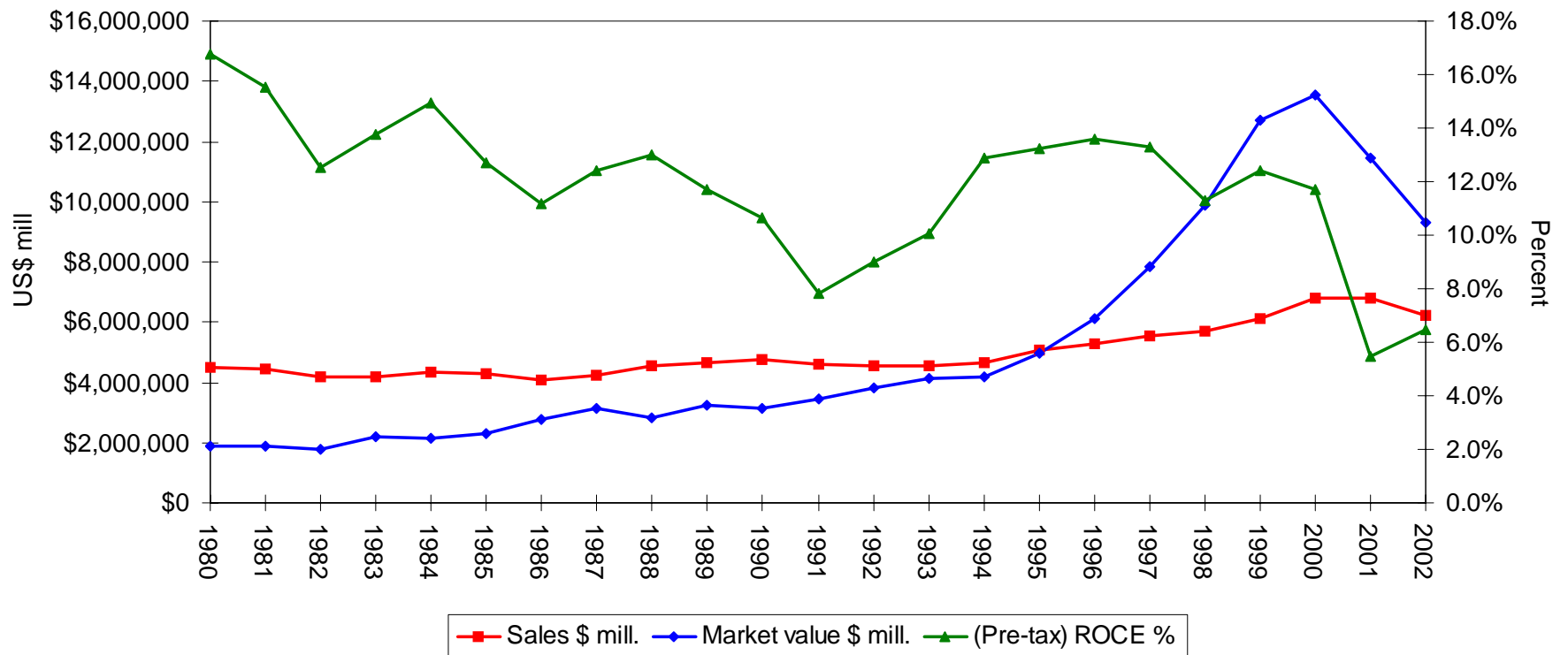


(B) different national responses: FTSE or S and P v CAC 40

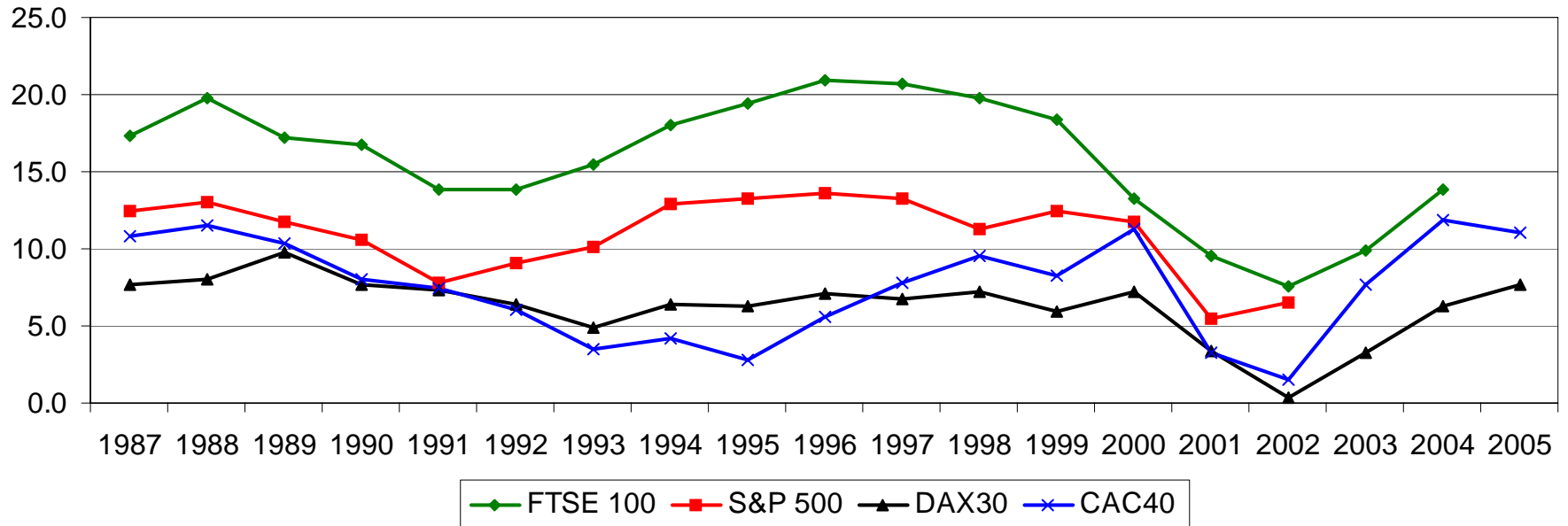
- FTSE 100 and S and P 500 continue along a trajectory of cyclically varying ROS and ROCE + low sales growth/about as fast as GDP
- CAC 40 did not rectify ROS and ROCE ratios (half of FTSE or S and P) but embarked on high growth via a global acquisition spree funded by new issues
- Brit CEOs listened to fund managers from s'ndary market and French CEOs hired investment bankers from primary market for US and UK acquisitions (indirectly encouraging convergence in returns)
- **Lesson: intermediary elites have different agendas + the power of finance is one of temptation not discipline**

S&P500 Annual Constituents: Selected performance indicators

(All money values in real 2003 prices)

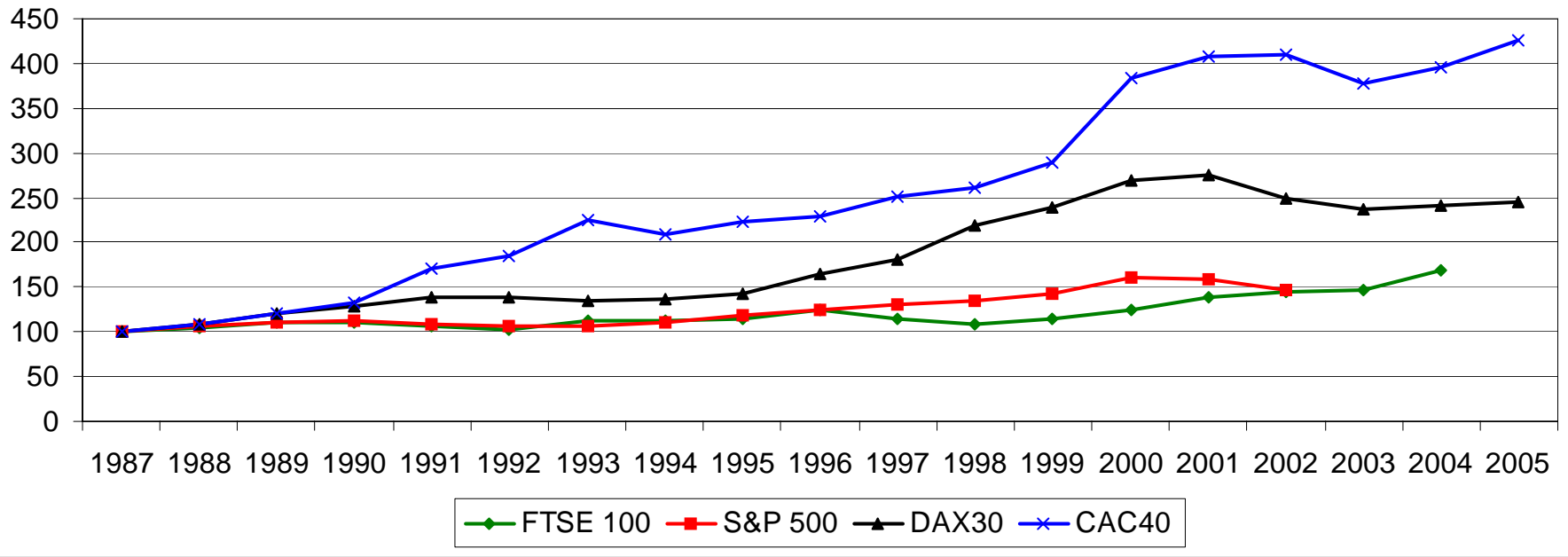


Annual Constituents: (Pre-tax) Return on Capital Employed (ROCE)
(%)



Annual Constituents: Index of Real Sales

(1987=100)



(C) SV delivers for corp CEOs not s'holding masses

- Permanent gains + modest enrichment for CEOs whose incomes ratcheted up by 10-20% per annum to £2 million in FTSE ie much faster than profits, sales or anything driven by management effort
- Insecure gains of shareholders ex DIY value creation in 90s bull market (>s market prices ex rising p-e ratios with weight of savings + lower rates of interest); then closure of DB pension funds in bear market after 2000
- **Lesson: fized capism not like Ronseal which “does what it says on the tin” because its complicated by intermediary self interest; in retrospect CEos were rather innocent value skimmers.**

UK and US giant-firm performance between 1983 and 2002 (Real 2003 prices)

	% total real change 1983 to 2002					
	Sales	Pre-tax profit	Market value	Director's pay	Dividends (UK) Dividends and interest (US)	Employment (Headcount)
FTSE 100 (Constituents)	53.4	53.7	365.7	523.5	380.0	22.4
FTSE 100 (Survivors)	38.3	110.3	349.4	570.5	335.5	16.8
S&P 500 (Constituents)	49.8	29.3	265.2	n/a	56.6	23.3
S&P 500 (Survivors)	74.6	50.1	223.3	n/a	86.4	30.2

The sources of shareholder gains in the UK and US (based on real 2003 values)

		Total shareholder return %	Of which		Price-earnings ratio (average during year) Ratio
			Share price %	Dividends %	
FTSE 100 (constituents)	1983-1992	20.4	72.8	27.2	12.7
	1993-2002	7.9	57.2	42.8	21.9
	1983-2002	21.8	63.4	36.6	17.3
FTSE 100 (survivors)	1983-1992	17.7	69.7	30.3	14.1
	1993-2002	10.4	59.6	40.4	18.7
	1983-2002	21.4	63.2	36.8	16.4
S&P 500 (constituents)	1980-1991	13.3	57.4	42.6	12.4
	1992-2002	17.7	78.6	21.4	26.9
	1980-2002	24.7	72.9	27.1	20.7
S&P 500 (Survivors)	1980-1991	13.5	57.6	42.4	12.2
	1992-2002	15.3	72.8	27.2	22.8
	1980-2002	22.5	68.3	31.7	18.3

Sources: DataStream (UK data) and Compustat (US data). Based on the summation of annual changes

(2) 2000s activism, private equity hedge funds

- **Alternative strategies move into the main stream** with “ 2 and 20 capitalism” raising new questions about the balance of rewards between masses and new elite financial intermediaries who direct and benefit from new strategies
- **Old strategies survive:** Mercer (2007) 58% of Brit pension funds invested in equities + most of the rest is in triple A bonds
- **But new activists:** PE gen partners, hedge fund managers playing the markets in coupons and whole companies: Pelz + break up of Cadbury, PE buys Boots

Point concepts of value and leverage

- **Background = unsuccess of transformational SV + post 2000 conjunctural shift** (limits long only strategy in a bull market, Greenspan cuts interest rates to 1%, excess liquidity ie more funds than good assets).
- **(a) Point concept of value** ie cash out when ahead by selling coupon or company (cf stream concept of value in SV)
- **(b) Leverage** ie small gains could be magnified by borrowing to buy more coupons and/or by creating classes of owners with different entitlements (cf one class of owners in SV)

PE as the exemplary innovation of the 2000s

- Supplanting the predatory conglomerate (eg Hanson) before the credit crunch
- A financially engineered set of arrangements for differentiating ownership claims + cashing out rewards in 8-10 years:
 - (1) Reliance on debt/capped returns + leverage/multiplied returns
 - (3) Two classes of equity holders (GPs and LPs) so financier elites claim lion's share

Debt and leverage

- PE expansion = based on co purchase with 70/30 debt/equity ie higher equity returns by capping returns to the majority of capital providers whose 2000s return = typically 9% ie not doubling debt holder's money in 9 years...
- With risks to principal ex (a) overambitious gearing so eg in late 80s US LBO boom ended with 90/10 debt/equity; (b) overpay as with Brit PE buying at higher multiples and doing secondary deals

Equity and general partners

- Financier GPs provide 2% of equity or less. But in return claim 20% of profits and a 2% annual management fee at expense of (pension fund) LPs GP's also benefit ex treat of profits as cap gains not income
- LPs have the chance to 2 times their money if GPs get 10 times so individs extract £10s of millions...if that goes wrong GPs have a management fee of 2% per annum on huge funds

PE as special case?

- Similar priorities elsewhere even in cases of PLC activism justified with ideols about benefits for all shareholders:
- (1) Sizeable gains eg ex Pelz break up of Cadbury require the same holding profile (large position and similar buy and sell timing)
- (2) Some gains are only for those with short positions eg hedge funds benefited from price fall in LSE shares after they blocked the DeutscheBorse takeover of LSE
- Similar instruments eg leverage
- Financial intermediaries drive a new game + financial elite enrichment makes 1990s CEOs look timid eg £8-900 million in one year for Chris Hohn at TCI;

Competitiveness now of financial sector

- Keeping it going is increasingly about fighting off changes in regulation + tax which threaten to limit benefits of financial intermediaries
- The Brit panic about PE Feb-Summer 2007; including Treasury Select Committee about higher rates of tax on capital gains + non dom status.
- Upcoming bigger fights in 2008 and after if the financial sector is blamed for recession and threatened with (re)regulation
- Response of the City trade associations = warnings and threats about dire consequences of undermining the competitiveness of our national financial sector; whose benefits are presented in traditional productionist terms of jobs and contributions to the balance of payments

Conclusion:

- Our pension fund capitalism has always been intermediary dominated: Gordon Clark's book has no mention of trustees or ultimate owners
- Late 1990s SV was part of an earlier more innocent period with CEOs taking an undeserved million or two in income after interrogation by fund managers
- Late 2000s operation of the financial sector by and for intermediary elites could become a major political issue when principals are extracting tens of millions in wealth.