Fletcher’s experiment with targeted stocks
Can you re-slice a pizza to be bigger and tastier?

By Josh Bolot

With a history dating back to 1851, by the mid-1980s Fletcher Challenge Ltd grew to be a stalwart of the New Zealand economy. As a diversified conglomerate, however, Fletcher often had analysts flummoxed. Diverse activities and inconsistent financial reporting across divisions complicated analysis.

The company was not oblivious to this and vast organisational reform during 1993 saw Fletcher refocus its operations, including the spin-off of “non-core” activities through the listing of Wrightson Group and St Luke’s Group.

In August 1993, CEO Hugh Fletcher announced the possibility of further changes, with the concept of a separate forestry share, potentially using targeted stocks. Two divisions were to emerge – Fletcher Challenge Forests (FFS) and Fletcher Challenge Ordinary (FCL Ordinary¹), each with its own shares.

FFS represented New Zealand and Chilean forestry and log-trading activities, while FCL Ordinary incorporated energy, building, paper and residual forestry assets. FFS was considered to have a unique business cycle and asset base. In contrast, FCL Ordinary was a diversified manufacturer and the Fletcher board believed its share price was being unfairly influenced due to the association with forestry. The board believed that to maximise shareholder value, a split was essential.

¹The NZSE ticker code for the ordinary share was FLC, but in this article the abbreviation “FCL Ordinary” is used.
Targeted stocks facilitate distinct divisional shares while retaining a consolidated company, with joint tax, dividend, corporate governance and debt functions. Although targeted stocks were for the most part unheard of in New Zealand and were still in their infancy in the United States, Hugh Fletcher, the current CEO, mooted and promoted a targeted stock structure (Wallace, 2001). The restructuring was confirmed in October 1993, approved by shareholders in November and commenced trading by early December.

While targeted stock had been applied to a handful of high-profile US cases, this was the first instance of its use outside the US. Like the American companies it mimicked, Fletcher (initially Hugh and later the company) contended that substantial “hidden value” would be realised. As this investigation of Fletcher Challenge illustrates, however, the use of targeted stocks to expose such value is both theoretically questionable and practically sketchy and unproven.

Using targeted stocks, companies hope to entice investors who seek focused stocks and to allow the market to have a more fundamental understanding of operations by using specialised shares. But for Fletcher Challenge and companies in general, evidence suggests that little value is gained from targeted stock structures. In the case of Fletcher, maintaining consistently rated and lower-cost debt funding seems to be the only advantage in using targeted stocks.

While potentially hefty taxation was possibly avoided by retaining a single entity, ultimately this was resolvable upon separation. In the light of such evidence, targeted stocks appear to have limited use in providing companies with the necessary mechanism to uncover unrealised value. As illustrated by Fletcher, asset sales, spin-offs and de-mergers may often be ultimately more appropriate methods of deconglomeration.

This article provides a brief history and explanation of targeted stocks and their application by Fletcher Challenge. An assessment of the Fletcher stocks is then structured around the stated objectives of the mechanism. The eventual disassembly of targeted stocks and of the company itself is reviewed, with lessons from the “experiment” included among final comments.

**PREVIOUS USE OF TARGETED STOCKS**

Targeted stocks (also known as tracking stocks) originated from General Motors’ 1984 acquisition of Electronic Data Systems. Vendor Ross Perot requested part-consideration in GM shares that tracked the performance of his business. GM designed and distributed GM-E, stock that reflected the underlying performance of EDS, despite the fact it was entirely owned and operated by GM. Shares were paper representations following the performance of EDS, rather than the entire GM empire. Dividends were based on divisional performance, but no separate “E” company was established.

Pleased with its reception, GM repeated this with its purchase of Hughes Aircraft, forming GM-H in the process.

2 The term “letter stocks” was derived by the use of “E” and “H” by GM. There is a subtle but important difference between letter stocks and targeted/tracking stocks often overlooked by the general media. Letter stocks apply only to those stocks issued by GM. The primary distinction is asset disposal and control, where targeted stockholders enjoy superior rights (Neish, 1995, and Logue et al, 1996). “Tracking” and “targeted” (but not letter stocks) are interchangeable terms developed by investment bank Lehman Brothers in an attempt to place proprietary rights over the technique (Neish, 1995).
Corporation issued targeted stocks for its steel activities and oil operations and, later in 1992, for gas pipeline investments.

Like virtually every mechanism in corporate finance, targeted stocks attempt to maximise firm and, therefore, shareholder value. While corporate diversification was widespread between 1950 and 1980, conglomerates have since been found to be undervalued by the markets, with shareholders benefiting from specialisation of operations.

Through specialisation, focused operations appear more visible to the market as value potentially hidden in a conglomerate is no longer dominated by one division, which may be no bigger or smaller than other divisions, merely more visible. Value may be disguised where consolidated reporting does not provide the necessary details to fully understand the operations and performance of the entire company.

In dismantling a conglomerate, transparency in operations reduces the information gaps that exist between the company and its analysts and shareholders, thereby allowing the market to identify the previously hidden value (Gilson et al, 1998). A clientele effect has developed for specialised, single-industry corporations, where operations are based on a single industry or sector focus (commonly known as “pure plays”) and where shareholders are able to diversify their own investments, selecting specific-industry risk exposure levels as desired.

Spin-offs and equity carve-outs are more traditional methods of specialisation, where separate companies are born from the original parent. In contrast, targeted stocks attempt to provide operational specialisation, corporate focus and shareholder appeal, without creating a separate legal entity.

The main features of targeted stocks are:

- Shareholders are issued with new shares free of charge with no taxable consequences.
- Share price and dividend policy is based on specific divisional performance, but there is no separate ownership of that division.
- Targeted stocks are not separate legal entities, but notional values over portions of the entire company’s assets and liabilities.
- Shareholder voting rights are weighted by market values.
- Debt is raised at group level, then apportioned to the targeted divisions.
- Tax is also paid at the group level and in the event one division goes bankrupt, the entire group is liable.
- A single board of directors oversees all operations, producing financial statements for targeted divisions as well as for the consolidated company.

**Figure 1** compares the capital structure of a multi-divisional company with one class of common stock and that of a targeted stock company. The underlying corporate body is unchanged, but the stock is marketed differently to the investment community and voting rights are weighted accordingly.
THE FLETCHER CHALLENGE EXPERIENCE

In 1993, Fletcher issued one FFS share and four FCL Ordinary shares for every four original shares held. While a notional separation of assets and liabilities was made, on consolidation there was one single legal entity, Fletcher Challenge Ltd, under a single board of directors. FFS shareholders were given proportional voting rights based on annual reviews of market values. This fresh approach to share structure received mixed reactions, but no consensus formed. Some applauded the intent to improve poor share performance, but most predicted no new real wealth would be created.

Despite the 1993 changes, doubts continued about whether shareholder value had been increased. While FFS was separate, FCL Ordinary was far from “pure play”. In September 1995, retiring chairman Sir Ronald Trotter lamented the FCL Ordinary share was like a “beautiful flower opening but not yet in full bloom” and hoped that within a year the share price of $4.11 would reach $6. As Figure 2 indicates, however, neither FCL Ordinary nor a synthetic holding of both FFS and FCL Ordinary reached $5, let alone $6.

3Closer analysis of the asset allocation did not truly reflect the separation of all forestry assets. Only 50 per cent of forestry assets were tracked by Forests, with Australian, Canadian and Brazilian operations still a part of FCL Ordinary. The company explained that this allowed FCL Ordinary shareholders to retain the benefits of forestry assets, while providing a “pure play” forestry stock to those who demanded it.

4Based on one Forests share for every four FCL Ordinary shares.
Such optimism was either misguided or value was still going unrecognised.

Speculation peaked before the interim results announcement in February 1996. Media and equity analysts anticipated further capital structure changes, with energy operations as the most likely target. One analyst predicted that an energy stock was “on the cards” and would be tidier if a stock was also created for the building division. While rumours raged, FCL Ordinary rallied under anticipation.

At the analyst briefing, Hugh Fletcher declared that the declining share price was of considerable concern. He stated that it was not the failure of divisional performances, growth or management, but the underlying desirability of the FCL Ordinary stock. It was suggested that the stock was still too complex for analysts to value and unattractive to a growing investor community who sought “pure plays”. Specifically, the share was being valued as a pulp and paper stock, with energy and building activities providing supplementary income.

Several options were considered. Equity carve-outs of building and energy, resulting in FCL Ordinary shareholders as majority stakeholders, were dismissed as this defeated “pure play” objectives. Concern was also raised regarding increased tax and borrowing costs resulting from separation. The sale of building and/or energy was disqualified as the directors were adamant that significant gains could still be achieved and no buyer would pay a price reflecting this potential. Full spin-offs were rejected due to the loss of synergies and the belief that major tax, transaction and borrowing costs would result. Specifically, share distributions (treated like dividends) could trigger a potential tax bill, although this was not certain and estimates ranged between nil and more than $1 billion for domestic shareholders (Wallace, 2001).

Hugh Fletcher was still interested in targeted stocks and sent a team of senior executives to the United States to see further examples in action. On return, these executives were sceptical of the structure.
Forcing investors to hold “pure plays” and the risks associated with reduced liquidity in a small market meant foreign shareholders might not bother investing in New Zealand at all.

one suggesting that it “seem[ed] to be associated with companies that are in trouble in some form”. Promoted by Hugh Fletcher and under advice from an investment bank, however, the company set about to continue with targeted stocks. Alongside FFS, Building (FLB), Energy (FEG) and Paper (FLP) shares were proposed. The company was finding “a way of cutting a delicious pepperoni [pizza] into three wedges that would be bigger and tastier than the original”.

By mid-March 1996, four shares, united under one board of directors, now traded under Fletcher Challenge Ltd. One FLB, one FEG and two FLP shares replaced every four FCL Ordinary shares, with no cash transfers or tax implications. No shareholder approval was necessary under the new constitution.

Again, assets and liabilities were allocated to each division, with all legal ownership remaining with Fletcher Challenge. Debt was controlled by head office and attributed by divisional usage. Joint liability meant all shareholders had to vote on divisional matters that affected the entire group. Dividend policy was based on divisional performance.

At first, analysts congratulated the bold decision to provide focused, single-industry stocks. But any gains were short-lived and within days the FCL share price declined below pre-announcement levels. Journalists wrote of the structure’s complexity, uncertain divisional values and corporate governance concerns. The 333-page Information Memorandum was considered “devilishly difficult to understand” and “enough to test the stamina of all but the most ardent investor”.

While analysts understood the tax implications, many were dissatisfied that separation was not completed through spin-offs. Concern was raised regarding the impact of foreign investment in New Zealand, as international investors who sought New Zealand economic exposure were traditionally able to select Fletcher as a diversified player in the market. Forcing these investors to hold “pure plays” and the risks associated with reduced liquidity in a small market meant they might not bother investing in New Zealand at all.

WERE THE TARGETED STOCKS SUCCESSFUL?

In assessing Fletcher’s use of targeted stocks, the fulfilment of objectives can be examined. References to academic theory and actual outcomes assist in understanding the success or failure of the structure.

Greater transparency to markets

The separation of Fletcher intended to provide greater divisional transparency for analysts and investors through separate reporting rather than relying on summarised and sanitised financials. Fletcher believed analysts did not comprehend its various activities and were valuing the whole, rather than the sum of the parts. Value would come from specialised analysts looking at specialised divisions.

Analysts have strong influence in the equity capital markets and specialise into specific industries, providing higher levels of accuracy in their research. Diversified companies present difficulties to investment

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5Craig Howie, The Dominion, March 2, 1996.
houses, often straddling several industries with little cross-related value. Accordingly, some analyst houses may be unwilling to commit necessary resources to accurately forecast them.

Cursory research of archived records suggests that more than 15 New Zealand analysts from seven firms covered Fletcher and its divisions. Historically, coverage in New Zealand was fairly standardised where houses followed the majority of the firms in the NZSE40 (including all Fletcher stocks). While specialisation of coverage exists in New Zealand, there is little evidence to suggest that this is as widespread as overseas, with broader industry groups assigned to fewer analysts in New Zealand.

Local analyst coverage did not alter in a significant manner following the Fletcher splits and was, therefore, inconsistent with the hopes of greater coverage. This is consistent with D’Souza and Jacob (2000), who find no substantial increase in analyst coverage in the year following the launch of targeted stocks.

While analyst numbers may not have changed, it is possible that analysts are able to be more accurate in their estimations of future performance. Billett and Vijh (2001) find increases in the magnitude of earnings forecast errors, the dispersion of analyst forecasts and the market reaction to earnings announcements following the issuance of targeted stocks (although for statistical purposes, only the first two are significant). While specific evidence is unavailable for Fletcher, overall targeted stock evidence fails to support greater benefits of transparency for targeted stocks and refutes secret Fletcher value being discovered by analysts through greater transparency.

**Provision of “pure play” appeal to investors**

It was intended that targeted stocks would provide investors the opportunity to select that portion of Fletcher they wished to be exposed to, but allow others to remain shareholders of all divisions. Diversified companies have lost favour among a growing investor community who wish to select their own diversification strategy, rather than allow directors to decide for them. For targeted stocks to effectively become “pure plays”, they should trade with a reasonable level of independence (assuming the market recognises the different drivers behind each) and a distinct set of shareholders should be found both between targeted stocks and compared to the original share.

Because shareholders invest in specific industries to seek industry-specific risk exposure, the correlation between stocks should be no greater than that seen between those industries the stocks belong to. There is evidence, however, that strong interdependence exists among targeted stock returns. D’Souza and Jacob (2000) find this positive correlation between targeted stocks is greater than the relationship with industry-matched non-targeted stock comparables, in both daily and monthly stock returns and quarterly cashflows.

Diversified companies have lost favour among a growing investor community who wish to select their own diversification strategy, rather than allow directors to decide for them.
**Figure 3** shows share price movements of FCL Ordinary and FFS following the FFS issue. The correlation between share price movements indicates a partial recognition by investors of the distinction between FFS and FCL Ordinary.

**Figure 4** examines the period following the listing of FLB, FEG and FLP, indexed at listing date. Overall evidence fails to support independent trading intentions and is consistent with the findings of D’Souza and Jacob (2000). Unlike the previous split, strong correlation was found between FLB, FFS and FLP, questioning their independence and the “pure play” status of the Fletcher stocks. Only FEG was distinct, with consistent growth through to October 1997.

It should not be surprising that strong correlation exists in the targeted stock framework as no separate legal entity exists. Thus assets and (more importantly) liabilities are shared among all shareholders, with the potential for significant cross-subsidisation.

While shares are meant to track divisional performance, shareholders remain exposed to the risks of others – likened to being financial “Siamese twins” (Haas, 1999). Cross-subsidisation may occur when one stock overwhelms the remaining targeted stocks (Logue et al, 1996). This may explain the different interdependence observed between the 1993 and 1996 issues. In 1993, while FFS performance was far from exemplary, the market did not attack FCL Ordinary in frustration. But the correlation following the 1996 issue may have reflected the continued problems associated with FLP, the victim of an unfashionable paper and pulp commodities market. FFS and FLB, as implicit co-shareholders, may have suffered alongside FLP. Significant oil finds and the launch of retail petrol operations were potentially the saviours of FEG.

Underlying changes in ownership are also useful in assessing shareholder preferences, as a clientele effect should emerge. Fletcher contended that this would occur, with an increase in demand by foreign investors, as the stock would now be considered “pure play”. The foreign ownership of FCL

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7Summary statistical tables can be found in the Endnotes. Further analysis is available upon request.
8Analyst recommendations suggested that this stock was cheap by international standards and strong buy notices were issued globally.
Ordinary and subsequent FLB, FEG and FLP shares indicates levels consistent with the overall market.

However, the percentage of FFS shareholders of non-New Zealand domicile was distinctly higher than the other Fletcher stocks between 1996 and 1998. While this decreased in later years (bringing it in line with the rest of the company), this high level may be attributable to a European-focused placement of FFS shares when there was a reallocation of assets to the FFS division in 1996. While FFS may have initially induced international investor interest, it was only a temporary characteristic.

Many financial commentators, both locally and in the United States, have rebuked use of targeted stocks to meet “pure play” objectives. Graeme Hunt, of the National Business Review, declared that the Fletcher stocks were not floats but merely investor-relations marketing strategies, used when companies believed the stockmarket was telling the truth when their shares traded at a premium, but thought it faulty when they considered their shares were trading at a discount. If this were true, then Fletcher’s use of targeted stocks was an unsuccessful (and expensive) marketing exercise. While there is some support for the emergence of a short-lived “pure play” identity for FFS, little permanent support for any of the Fletcher stocks exists.

**Capital markets, corporate governance and dividend policy**

In theory, targeted stocks provide divisional access to the equity markets using “pure play” appeal to entice investors with returns and dividends based on the industry they wish to be exposed to. Regardless of such dubious “pure play” status, this fails to recognise several consequences of such a structure.

Corporate governance issues complicate matters where potential conflicts among shareholders develop. As a single board is elected by all shareholders to serve all their interests, competing demands arise and the potential for cross-subsidisation can result. The required arm’s-length nature of transactions, which attempts to protect the distinct shareholder interests, can impair the attempted retention of synergistic benefits. Conflicts may be exacerbated when an
unrepresentative number of directors are also officers from various divisions (Neish, 1995). Figure 5 provides a breakdown of directors who were also members of senior management. This fails to provide compelling evidence for the representation of all shareholders.

The “floating” nature of voting rights also makes it difficult for shareholders to unanimously agree on direction. In the extreme, these disputes can end in legal battles. Such issues occurred in the restructuring to disassemble targeted stocks, where FFS shareholders were perceived to have been isolated and ignored by the repackaging. A vote on a proposed $427 million rights issue to re-capitalise FFS was dominated by FEG and FLB shareholders (with larger market capitalisations), despite the fact that FFS shareholders had to front up with the cash.

While the board was undoubtedly qualified and knowledgeable, the scarce and erratic nature of divisional representation may not have provided shareholders with assurance that their divisions were being adequately spoken for. Despite shareholders being on a divisional basis, the board remained on a group basis.

Fletcher’s structure was not entirely typical of all targeted stock. Billett and Vijh (2001) indicate one fundamental difference between Fletcher and the remaining 19 issues they examine. Post-issue, in all cases but Fletcher, they identify one “general division” (the original pre-targeted stock company) and at least one or more targeted divisions. For Fletcher after 1996, however, four comparable-sized targeted divisions existed, with no remnant of the original company. In other cases, the corporate role was undertaken by the general division and charged back to the tracked division on a usage basis.

Fletcher had a distinct umbrella division, solely to perform “shared” corporate duties. As this did not produce anything and was not represented through shares, no mechanism existed to monitor its performance or effectiveness. Discussions with analysts suggest that head office duties were performed with competence and efficiency, with a reduced number of experienced personnel. But divisional management was annoyed that head office was preoccupied with its own functions, enjoying kudos when it flowed but unwilling to assist when divisional performance drew the attention of shareholders, media and analysts (Wallace, 2001).

The use of a division solely for interdivisional and external relations differentiated Fletcher from the dozens of targeted stock examples undertaken in the United States. D’Souza and Jacob (2000) found that many targeted stocks had separate committees of outside directors to deal with interdivisional disputes, but there is no evidence that Fletcher used such a mechanism. If divisional representation on the board of directors can proxy for unity

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NOTE: shading denotes director served more than one division. SOURCE: ANNUAL REPORTS

**Figure 5**

Directors according to management of targeted divisions
for synergistic purposes, then it is questionable if Fletcher succeeded in this task (see Figure 5). While divisional management teams reported directly to the corporate body, views on the value and continued use of targeted stocks differed greatly among divisions (Wallace, 2001).

Dividends for targeted stocks are theoretically based on the underlying performance of assets “allocated” to the stock. Dividend payout ratios differ according to industry, economic cycle and required reinvestment. It is suggested that division-specific dividends are a benefit of targeted stocks. However, this does not incorporate the conditions existing on the payment of dividends, many beyond the control of the individual targeted stocks.

Primarily, Fletcher dividend payments were conditional on solvency tests of the entire corporation (required by legislation). A dividend-paying division also had to meet solvency tests as if it were a stand-alone company (stated in both the 1993 and 1996 reorganisation Information Memoranda). This added hurdle was arguably to protect the potential cross-subsidisation of dividends, where low/non-profitable divisions use other divisional reserves to pay dividends. While Fletcher was never prevented from paying dividends from failure of solvency tests, it is virtually impossible to establish if any cross-subsidisation occurred, especially in the periods when FFS (1998) and FLP (1997-1999) experienced losses yet still paid (albeit reduced) dividends to shareholders.

Secondly, dividends are declared after interest and tax of the entire consolidated group, as required under the single legal entity structure. Although borrowings are at the group level, the notional allocation of debt is observable. Shareholders unhappy with high borrowings and taxes of other divisions are still affected by their co-shareholders’ excesses, both in subsidising the associated cash outflows and receiving reduced dividends. Discussions with analysts suggest that tension among shareholders grew as FEG and FLB shareholders implicitly paid for the leverage and losses of FLP and FFS through reduced dividends. The reality of targeted dividends for these investors was far from the optimistic objectives intended.

D’Souza and Jacob (2000) found that in their sample set, targeted companies paid 12 per cent more of earnings than the matched (untargeted) counterparts, possibly a method of reassuring earnings quality in a market sceptical of targeted stocks. While Fletcher established dividend payout ratio guides in restructuring documents, significant (interest and tax) difficulties are encountered in trying to establish if these were met. However, Figure 6 suggests that dividend policy was “sticky”, focusing on absolute cents per share rather than the stated boundaries. The poor performance of FFS

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**FIGURE 6**

Dividends per share (cents) from 1992-2000

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NOTE: combined figure incorporates and adjusts for one share held in 1993. Shading denotes division declared net earnings losses for that financial year. SOURCE: ANNUAL REPORTS
and FLP supports implications that later dividends potentially may have been partially subsidised by FLB and FEG investors.

Evidence on corporate governance and dividend policy suggests that these may have been impediments to the success of the stocks. While it was theoretically possible for divisions to approach the equity markets, none did between 1993 and 1999, suggesting that the markets may not have treated any issue kindly. There seems to be little support for the objective of Fletcher having better access to equity markets.

**Advantages of conglomerated cost of debt**

In contrast to full separation, remaining part of a substantial umbrella organisation provides strong credit ratings and lower debt charges. Fletcher was enticed to targeted stocks for their ability to maintain the benefits of conglomerated debt, while providing divisional separation to investors.

Ratings methodology information from Standard and Poor’s suggests that larger, diversified and more established conglomerates enjoy lower costs of debt than smaller, narrow-focused and younger firms. This advantage is derived from reputation, collateral and survivorship characteristics providing security to debt-holders. Attempts to separate such an entity may destabilise this. Unlike spin-offs, debt-holders are unaffected by the transition to targeted stocks due to the continuation of the single legal entity (Logue et al., 1996). This advantage implies any targeted stock should have a lower average cost of capital than industry comparable companies.

Lack of research in this area makes assessment difficult. Between 1996 and 1999, Fletcher had a consistent credit history as a consolidated single entity. However, as individual segments were never primary borrowers, they never received official ratings. As ratings are based on industry risk, diversification, size and management considerations, Fletcher may have feared that only certain divisions would maintain the stand-alone credit ratings quality. Analysts considered FEG as the closest to receiving a comparable rating, although even this could not be guaranteed. FFS and FLP risked receiving lower ratings due to excessive leverage and poor commodities outlook9. In separating the divisions entirely, poor credit ratings may have destroyed any hopes of unlocking shareholder value.

The consistency of ratings offers insight into the retention of a single borrowing entity. **Figure 7** details the credit history of Fletcher over the period. Records show relatively consistent ratings — evidence for the benefits of targeted stock. A significant ratings change occurred in August 1995 when Fletcher received BBB “investment grade” status. This move was made following Standard and Poor’s satisfaction that the company had “strongly improved operating cashflow being applied to meaningful debt reduction [and] lower-than-expected leverage”10.

Considering the significant leverage of FFS and FLP, this may support the use of targeted stocks, as these divisions would have encountered difficulty in retaining their historic costs of debt. Thus, evidence supports use of targeted stocks to retain a lower cost of debt, available for all divisions to utilise.

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9The investment statement for the Forests rights issue (November 7, 2000) discloses that while no decision had been made on the issuance of debt following the formal dissolution of the Fletcher group, it is likely that any credit rating would be lower and the cost of debt would be higher than that previously held by the consolidated group.

**Tax issues**

Some investment bankers believe spin-offs and targeted stocks are substitutes, with the latter merely tax-free spin-offs. However, spin-offs that simultaneously send investors new share certificates and tax bills are deemed unpopular. As targeted stocks issue only the former, they are a considerable improvement (Neish, 1995). This apparent anomaly in tax legislation has not gone unnoticed by authorities. In the United States, the Inland Revenue Service has not made a ruling and has threatened potential review at any time if overuse, misuse or abuse is suspected. President Clinton’s administration proposed (but did not pass) legislation that would have implemented tax on targeted stock issuances.

The New Zealand Inland Revenue Department guaranteed immunity of the Fletcher issues from either corporate or individual tax. Although no guarantee was given for foreign shareholders, it was not suspected to be different for these investors. While the targeted stock structure was retained, Fletcher represented that it successfully avoided the tax effects of break-up. But it is questionable if these tax issues were insurmountable. Analysts suggest that complex tax issues could have been resolved whenever they had to be and the company would have been able to “sort it out” if required.

Utilisation of tax losses is another benefit in retaining a single tax-paying entity. This provides the opportunity to offset losses of one division against profits of another, thereby reducing the total tax bill (Cornell, 1998). While this works under the New Zealand tax framework, it may create a small inconsistency in relation to imputation credits. Divisions paying dividends despite declaring losses (such as FFS and FLP) may still have imputation credits generated courtesy of profit-making, tax-paying.

**FIGURE 7**

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<td>BB+</td>
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<tr>
<td>January 1994</td>
<td>B</td>
<td>BB+</td>
<td>Stable</td>
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<tr>
<td>January 1995</td>
<td>B</td>
<td>BB+</td>
<td>Positive</td>
</tr>
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<td>August 1995</td>
<td>B</td>
<td>BBB</td>
<td>Stable</td>
</tr>
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<td>January 1996</td>
<td>B</td>
<td>BBB</td>
<td>Stable</td>
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<tr>
<td>January 1997</td>
<td>B</td>
<td>BBB</td>
<td>Stable</td>
</tr>
<tr>
<td>March 1997</td>
<td>A-2</td>
<td>BBB</td>
<td>Stable</td>
</tr>
<tr>
<td>January 1998</td>
<td>A-2</td>
<td>BBB</td>
<td>Stable</td>
</tr>
<tr>
<td>July 1999</td>
<td>A-2</td>
<td>BBB</td>
<td>Negative</td>
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</tbody>
</table>

*SOURCE: STANDARD AND POOR’S*
divisions. Anecdotal evidence found that loss-making divisions did, in fact, pay dividends with imputations, providing support for potential cross-subsidisation among supposedly “independent” shares.

While tax issues surrounding Fletcher are consistent with both theory and research, analysts questioned their importance in decision making. At the time of the 1996 split, the avoidance of dividend taxation by issuing targeted stocks ranged between $0 and $1113 million (Wallace, 2001). One director favoured discussing this issue with the Government to work toward an acceptable solution, but this was not supported by the rest of the board (Wallace, 2001). The ultimate dissolution initiated in December 1999 highlighted that, when required, any tax issues could have been resolved and were simply a matter of working through complications. Offsetting tax losses among targeted stocks adds further concern surrounding the independent “pure play” proposition and investors were not ignorant of this potential cross-subsidisation.

**SHARE PRICE — THE ULTIMATE PERFORMANCE MEASURE**

The ultimate goal of Fletcher’s targeted stocks was to unlock hidden value through improved share price. Fletcher hoped that in repackaging, its share performance would improve.

While Fletcher is not included in their studies, D’Souza and Jacob (2000), Elder and Westra (2000), and Haushalter and...
Mikkelson (2001) all find positive abnormal returns in the short-term reaction to targeted stock announcements. Figures 8 and 9 provide an indication of market reaction to Fletcher’s announcements.

It is difficult to substantiate large differences with the overall market (proxied by NZSE40) in the days before the announcement. Similarly, post-announcement differences between FCL Ordinary and the market do not seem marked, even though the reaction changes direction between years.

Billett and Vijh (2001) examine the long-term performance of targeted stocks using a buy/hold strategy. On average, all measures showed large negative cumulative returns in the three years after issuance. This was also found to be true for FFS (1993 and 1996), FEG, FLB and FLP.

Figures 10 and 11 illustrate the movements in Fletcher’s value for long-term investors. Between the first and second targeted stock issue, price is mostly higher than the market. Following the February 1996 issue, however, movement is consistently below the market, intensified by the 1998 Asian crisis11. It is reasonable to suggest that Fletcher’s long-term returns did not meet the intention of improving shareholder value.

THE DISASSEMBLY OF TARGETED STOCK

In December 1999, Fletcher’s board confirmed market speculation that the targeted stock structure was to end. There was an irony in the reasons given for disassembly, with complexity of structure, perceived corporate governance issues and inability to correctly value operations cited. Fletcher’s board was not unanimous regarding the status of the targeted stocks as a permanent mechanism or merely as “stepping stones” to separation. But there is little doubt that the decision to separate was welcomed by the market as a method of removing complexity and improving share price. Billett and Vijh (2001) find that Fletcher was not the only company to dismantle targeted stocks citing complexity, debt cross-subsidisation and corporate governance issues raised as main reasons.

Within days, investment bankers were scrambling to arrange potential transactions. The first of these was the sale of FLP to Norske Skogindustrier ASA for approximately $NZ5 billion (at the time, the largest deal in New Zealand history) in July 2000. The final stages of separation saw:

- The majority of FEG assets sold to Shell Oil and Apache Corporation following close Commerce Commission scrutiny.
- A new company Rubicon was formed and listed, with a focus on biotechnology assets in forestry and horticulture. This company formed partial consideration for FEG shareholders.
- FLB was spun off as a stand-alone company called Fletcher Building Ltd.
- Following the closure of all corporate operations, only forestry assets remained and that arm was renamed Fletcher Challenge Forests Ltd.

1Fletcher’s exposure to Asia and the commodities markets, alongside its leverage, were the primary causes of the extreme sensitivity to the economic downturn.
Share price based on holding one Fletcher share at the start of October 1992 and retaining holdings in proportion to issues in December 1993 and February 1996.

Graph as above, indexed to price at first issuance in December 1993.
In the aftermath, financial media attributed poor performance to the confusing and complex nature of targeted structures. In contrast, discussions with analysts suggest that asset-quality issues were at the heart of understanding the perceived failure, with a belief that excessive prices were paid for poor-performing assets in commodity-based industries with cyclical difficulties. An internal Fletcher report by its specially formed Shareholder Value Committee concluded in December 1992 (before either targeted stock issue) that “the key problem is value creation, not value recognition” (Wallace, 2001). Poor returns may not be attributed to targeted stocks per se, but it is possible that this structure did not suit Fletcher’s operations.

CONCLUSION

**F**letcher Challenge has provided an insightful example in the use of targeted stocks. While debt benefits seem justifiable, the majority of evidence suggests that these stocks failed to meet their desired effect. Greater market transparency, “pure play” appeal and improved access to capital markets were not forthcoming under the retention of a single legal entity. The majority of empirical studies on the issue support these findings. While it is easy to evaluate with the benefit of hindsight, the Fletcher experience provides a local example where some of the expectations of targeted stocks seem implausible in retrospect.

Although Fletcher was correct in its recognition of the complexity and undesirability of a single conglomerated stock, it is difficult to maintain that targeted stocks were the best solution. Recently, Australian companies Pacific Dunlop, Southcorp, Boral and BHP Billiton have embarked on processes to remove their “diversified conglomerate” image. In doing so, these companies have selected a combination of asset sales, spin-off and de-mergers as methods. While some of these processes are yet to be finalised, in both theoretical and practitioner realms they are considered mainstream mechanisms by the market and sufficient empirical evidence exists to substantiate the benefits of such methods.

Future research would have to assess the success of the next generation of Fletcher companies that have come into existence. If successful in reviving shareholder value through another “re-branding” of equity, this will provide further evidence against targeted stock. If there is a continuation of chequered share performance, however, then the trial of targeted stocks may receive partial vindication.

It is difficult to conclude that Fletcher greatly benefited from implementing targeted stocks. The restructuring altered neither the flavour nor overall size of the Fletcher pizza, but instead was an expensive experiment – one highly unlikely to be repeated in the New Zealand market.
REFERENCES


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NOTE

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FURTHER READING

The number of companies who have issued targeted stocks is far less than any other restructuring mechanisms. As a result, research to date has been limited. Earlier papers, such as Neish (1995) and Logue et al (1996), are solid and practical in their explanation of targeted stocks. More recently, however, D’Souza and Jacobs (2000) and Elder and Westra (2000) are far more comprehensive in their testing of targeted stock performance. Billet and Vijh (2001) discuss those companies that have since selected to eliminate their targeted stock structure. For Fletcher-specific information, Wallace (2001) provides a dramatic insider account of the modern history of Fletcher Challenge, including a comprehensive chapter on the targeted stock decision-making processes.

Correlation within Fletcher stocks and with relevant commodity market indices, as measured by R². This was calculated using a regression on weekly share price data between the stocks’ inception and September 2000. Dow Jones commodity indices have been selected as indicators of global industry trends, rather than local indices, which were heavily weighted by Fletcher stocks. FEG has the lowest correlation with its “Siamese” stocks and the highest correlation with the Dow Jones Energy Index. In contrast, the remaining stocks have a stronger correlation with each other, than with their relevant commodity indices.

ENDNOTES