The View from Burgundy

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No Good Deed Goes Unpunished

This issue of The View from Burgundy *represented a chance to look beyond the horizons of North America to a disturbing and shadowy struggle for control of one of our favourite companies, Deutsche Börse. Behind-the-scenes manoeuvring had led to the ouster of the CEO of Deutsche Börse (DB), Dr. Werner Siefert. The immediate cause of controversy was a bid by DB for the London Stock Exchange (LSE), which at 530 pence was considered too rich by a hedge fund manager in London. Since three years later, the current price of LSE stock is 1296 pence, we think that he was demonstrably wrong. Anyway, the themes of skullduggery and conflict of interest, and above all, short-termism, resonated with our audience, who are concerned about these issues as well. Stephen Mitchell and Ken Broekaert did most of the work on this well-received issue.*

Richard Rooney, 2007

On May 9, 2005, Dr. Werner Seifert, the CEO of Deutsche Börse AG, Europe's most important securities exchange, was forced to resign by dissident shareholders of his company. Over Dr. Seifert's 12-year tenure at the helm, Deutsche Börse emerged as an important innovator of new financial products and an unrivalled platform for securities transactions. The company had earned outstanding long-term returns for its shareholders. So why was its CEO forced to resign?

In this issue of *The View*, we go afield from our usual North American haunts to examine the shareholder revolt at Deutsche Börse. First, we will recount the story, then examine some of the underlying trends and, lastly, try to draw some lessons for long-term investors and corporate managers from this very instructive tale.

Deutsche Börse AG (DB)

Germany contains several stock exchanges, mirroring the country's fragmented past. In the post-World War II period, the exchange in Frankfurt am Main became predominant and today boasts a market share of about 86% of Germany's listings and trading. The Frankfurt Exchange (known as Xetra) became the core of a new public entity called Deutsche Börse AG in the early 1990s. (We briefly outline the various businesses of Deutsche Börse in the profile below.)

PROFILE OF DEUTSCHE BÖRSE (DB)

DB is among the most successful financial exchanges in the world. It has five closely related and highly profitable businesses that conduct pre-trading, trading and post-trading activities in stocks, bonds and derivatives:

- **Xetra** is built around the ancient Frankfurt Stock Exchange, one of Europe's oldest, founded in 1585. It accounts for 15% of the DB's operating profit, with 40% operating margins. This is what Dr. Seifert had as his original growth platform.
- **Eurex** is among the highest volume derivatives exchanges in the world with almost 100% share of the European derivative contracts that it trades. Eurex generates over 30% of DB's operating profits and earns over 43% operating margins. This business was virtually started from scratch and has grown organically to its current dominant position in head-to-head competition with Euronext.Liffe.
- **Clearstream** is one of two Pan-European securities settlement and custody businesses. It represents 31% of DB's operating profits and earns 30% operating margins. It was created from a combination of DB's domestic post-trade business and Cedel International's Pan-European and international business.

- **Information Technology** is the external sales arm of DB's large internal IT consulting department. It provides trading platforms for smaller exchanges such as Shanghai and Dublin. It represents 16% of DB's operating profit and earns 72% operating margins.
- **Market Data and Analytics** sells the pricing data from Xetra and Eurex to investors. It currently generates 8% of DB's operating profits at 37% margins.

With its rather closed financial system and lack of an equity culture, Germany's exchanges seemed ill-placed to compete in the deregulating late 20th-century environment against long-established international markets like the London Stock Exchange or new supranational exchanges like Euronext (the merger of the Paris, Amsterdam and Brussels exchanges) for the burgeoning volumes of internationally traded securities and derivatives.

But DB surprised everyone. Under the leadership of Dr. Werner Seifert from 1993, Deutsche Börse consistently won market share against all European exchanges. It launched products that met new investor needs and built systems capabilities that gave DB perhaps the most efficient, reliable and transparent trading platforms in the world. Financially, it was a home run with compound 11-year growth in earnings per share of 22% on compound revenue growth of 18%. The returns to shareholders were outstanding at 24% compound with dividends reinvested.

Dr. Seifert had a most distinguished record as chief executive of DB. He had the huge advantage of being in charge of a very good business with very high returns on capital and exceptional cash flow characteristics, during a very strong capital markets cycle. Though his capital allocation record was not perfect, in almost all cases, Dr. Seifert took strategic directions that allowed non-dilutive growth for shareholders. In our experience, that is a rarity – managers of really good businesses usually cannot stop themselves from "watering the weeds" by making dilutive acquisitions. There are thousands of CEOs more deserving of censure than this gentleman, in every market we can think of, and few more deserving of gratitude from shareholders.

Yet, despite this stellar record, Dr. Seifert was forced to resign by insurgent shareholders because he proposed an acquisition that made great strategic sense, but went against the wishes (and probably the short-term oriented trading strategies) of those shareholders. The whole issue centred on a proposed takeover of the London Stock Exchange (LSE) by Deutsche Börse.

Strategic Crossroads

In the late 1980s, the London Stock Exchange was considered perhaps the major market best positioned to benefit from the new trend to deregulation and European integration. Yet, it consistently finished behind DB and Euronext in returns and strategic aggressiveness. The LSE was managed unimaginatively and repeatedly missed opportunities, including losing to Euronext in a bid for the London International Financial Futures Exchange (LIFFE) despite offering a higher value bid. The result of these missed opportunities is that the LSE's market capitalization and operating profits are only 23% of Deutsche Börse's and 50% of Euronext's, making the LSE a logical acquisition target. Ever logical, DB management proposed, in late 2004, to acquire the LSE for 530 pence per share, a premium of 52.3% over its pre-bid price of 348 pence.

The proposal drew an immediate negative reaction from certain large shareholders, particularly and most prominently a London-based hedge fund called The Children's Investment Fund (TCI), led by the dynamic Mr. Christopher Hohn. Taking the majority of his position after the bid was proposed, Mr. Hohn pointed out in letters to the Supervisory Board of Deutsche Börse that, in his opinion, the proposed price was too high, and that a major share buyback would be a preferable use of DB's cash hoard and great financial strength. As a holder of perhaps 8% of Deutsche Börse's stock, TCI's opinions counted.

Although Burgundy owns somewhat less of DB, it is our largest European position, and we had a different assessment of the proposal. In our opinion, the proposal price of 530 pence was likely to provide an attractive return to Deutsche Börse shareholders over the medium and long term, given the attractiveness of the LSE's business and the high level of achievable cost savings.

We felt that the acquisition was more desirable than a stock buyback. Merger opportunities like the London Stock Exchange are scarce and unrepeatable, unlike a stock buyback, which is a permanent capital allocation option for any company with the financial wherewithal to undertake it. Presumably, a merger with the LSE would give DB management opportunities for innovation and growth, for expense reductions at the acquired company and for economies of scale for the merged entity. In turn, this increased scale, profitability and scope would give Deutsche Börse a competitive advantage, which, in the last analysis, is the source of superior returns for shareholders.

The Dissidents' Campaign

Of course, reasonable people can disagree on these matters, as Mr. Hohn and his allies clearly did. But, the debate on the merits of the London Stock Exchange proposal soon shifted to a very different type of campaign, one that brought into question the track record, corporate governance practices and even personal ethics of DB's managers. The dissident shareholders appealed to various prejudices and constituencies in the London financial establishment and media.

A potpourri of accusations descended on Deutsche Börse's management and Board both from dissident shareholders and from the media. Among them were accusations of insider trading by Board members in LSE shares; conflict of interest by the Chairman of DB (he was also the Chairman of Deutsche Bank, which would have acted as agent for Deutsche Börse's LSE bid); and improper accounting for the 2002 Clearstream acquisition in order to disguise its allegedly value-destroying characteristics.

The German regulators and the Board of DB launched investigations into all these allegations (in the case of the Board, hiring outside auditors and lawyers with no existing connection to Deutsche Börse). The investigations completely exonerated management of any wrongdoing prior to the May 25, 2005 Annual General Meeting. But the smear campaign had changed the whole focus of DB's management from selling the strategic acquisition of the LSE to defending against unfounded, and sometimes anonymous, allegations in the press and from shareholders.

Concurrent with this torrent of accusations, Mr. Hohn of TCI gathered together an alliance of hedge funds and some very large, long-only asset managers (managers who are not allowed to short stocks as part of their mandate, unlike hedge fund managers who are not similarly restricted). Even though they accounted for less than 20% of DB's voting stock, they would be able to oust management due to the very low historical proxy voting by Deutsche Börse shareholders (participation has traditionally been less than 35%). As the date of the annual meeting approached, it became apparent that the dissidents would indeed be able to impose their will.

Most of the dissidents' goals were accomplished before the actual vote, as they forced the resignations of Dr. Seifert and the Chairman, Dr. Breuer; the withdrawal of the London Stock Exchange proposal; and the initiation of the €1.5 billion share buyback program when it became obvious that they had enough votes to win. TCI did not actually have to vote their stock against management, and thus avoided regulatory scrutiny for this coup! They have continued to influence the Board significantly after the AGM by playing a role in selecting a majority of the new Board and will likely be closely involved in appointing a new CEO for Deutsche Börse. In other words, they effectively control the company with only about 8% of the stock – an absolutely remarkable result.

Motivations?

Shareholders often disagree with their managements about strategic matters. Most of the time, they are unwilling to impose their will on management, which is one reason that history is littered with examples of horribly overpriced and misguided acquisitions. Replacing managements expeditiously, even after such disasters, is a comparative rarity, and usually a management team that has performed its duties competently would be given the benefit of the doubt. Given its stellar long-term track record, why was that benefit not forthcoming for DB's management?

We suspect the reason is the financial motivation of the dissidents, especially those who were capable of doing paired (long/short) trades. Just consider the long/short profit opportunity that arises from destroying the DB/LSE proposal. The LSE's price was bid up substantially in the aftermath of the Deutsche Börse proposal to levels that actually exceeded the proposed bid price. DB's share price sagged as acquisitors' share prices usually do. So Deutsche Börse was trading well below its stand-alone intrinsic value and the London Stock Exchange was well above. If you went long DB and short LSE, foiled the bid and put a major stock buyback in place at Deutsche Börse, you could achieve paired trade nirvana – a huge immediate appreciation in your long position, and a major profit on your short position as London Stock Exchange, deprived of the takeover premium in its stock, declined towards pre-bid levels.

The strange twist in the Deutsche Börse story was that the behaviour of the longs and shorts was virtually the mirror image of a normal paired trade. Normally, the short sellers are slagging the company they have sold short, and puffing the company they are long. Normally, the managers of the company sold short are in an inimical position to the short sellers, while the management of the long position company are allied with their shareholders. In this peculiar instance, the managers of the London Stock Exchange were probably cheering for the shorts, since if DB's bid succeeded, their job tenure was very doubtful. And the long shareholders were attempting to discredit and replace the expert management of the company whose shares they owned outright.

For the long-only managers in the dissident group, the prize was the potential for an immediate gain from the Deutsche Börse share price appreciation. But there was another possible wrinkle. Some of the long-only managers involved in the dissident group were also very large shareholders of Euronext, and Euronext is the only other credible bidder for LSE. Since another bid by DB appears extremely unlikely, Euronext may in the future be able to acquire the London Stock Exchange at a very attractive price.

Now, here is an ethical swamp. Most economic theory, corporate governance activism and regulation are based on the assumption that shareholders are interested in the long-term best interests of the company in which they have invested. But what if some shareholders are sabotaging sensible strategic moves because they are seeking short-term profit opportunities while furthering the interests of a competing company? What if the shareholders have a conflict of interest?

Short-Termism

Stepping back from this peculiar example, what are the driving forces at work here? We believe that the overriding one is an emphasis on short-term profit at the expense of long-term value creation.

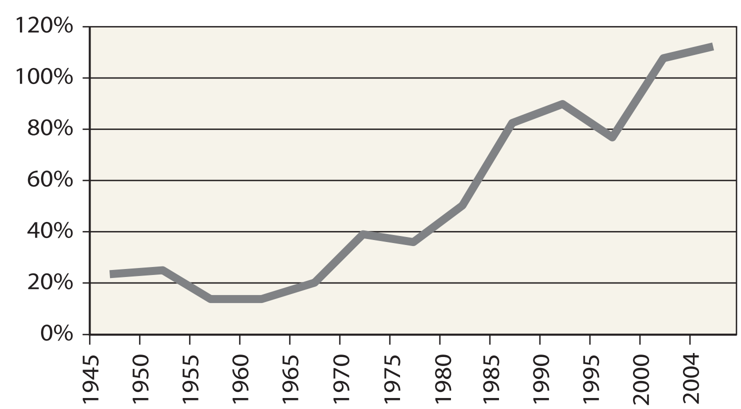
Short-termism in the capital markets can be seen in several guises – for instance, in the steadily rising turnover in mutual fund portfolios (see the following table). Clearly these funds, with an 11-month average holding period for their positions, care only about short-term trading profits. A great many shareholders do not exercise their voting rights, or even acquaint themselves with the managements or fundamentals of the businesses they own in their portfolios. They rush headlong and late into situations like the Deutsche Börse imbroglio that seem to promise short-term profits.

We have always advocated that shareholders behave like owners. They should seek to understand their companies, know their managements and vote their stock. The corollary of this type of stock ownership is that investments should be made only after performing careful research and should be held for the long term. We see no reason to change this position.

Even institutions that hold positions in equities for long periods contribute to the short-term orientation of today's capital markets by lending their securities in order to earn a small incremental return on them. The securities are loaned to people who want to sell them. Increasingly, these short sellers are hedge funds. Short sellers pay a rate of return to the lending institution, and undertake to pay the owner of the stock all dividends that the borrowed stock will pay during the period that the loan remains outstanding. The meter is running on the short sale from the moment it is made, and the sooner the short can "cover" by repurchasing the stock and returning it to the lender, the lower the short seller's costs, and the lower the price of the borrowed stock when the short covers, the higher the profit.

Institutions seem to assume that short selling is a passive activity, when in fact short sellers are always willing, and increasingly able, to negatively influence the fundamentals of companies in pursuit of short-term trading profits. We have heard stories of short sellers calling the auditors of public companies and threatening to sue if they issued a clean opinion; calling suppliers of public companies to tell them their customer was going bankrupt and that they should put them on cash terms; threatening directors with lawsuits to try to force high profile resignations; and making allegations that had to be handled by regulatory investigations. And, of course, the use of the business press by short sellers is now widespread, as reporters get to look like sophisticated and subversive muckrakers while acting as a cat's paw for those who make money from their bearish stories.

U.S. EQUITY FUND PORTFOLIO TURNOVER



Source: "The Mutual Fund Industry 60 Years Later: For Better or Worse?" *Financial Analysts Journal*, 2005, Vol. 61 No. 1

It follows that if short selling is a major source of a short-term orientation in the capital markets that is inimical to long-term value creation, then true investors should seek to make it more difficult and expensive to do. At the very least, such a result would thin the herd of hedge fund managers to those who possess skill, genuine valuation insights and value-added strategies.

The best way to limit the practice of short selling is to restrict the supply of borrowed stock. It is an absurdity that pension and endowment funds that are trying to generate returns based on long-only stock picking would give others the opportunity to speculate against their portfolios through lending securities to short sellers. We strongly recommend that investors discontinue the practice of lending securities.

So shareholders should act in their own best interests by attempting to know and understand the managers and businesses of the companies they own, and discharge their duties by voting on the issues that concern the company. They should refuse to lend their stock, whatever the blandishments and inducements of the trust companies, banks, brokerages and other custodians who make a great deal of money from this practice.

What can corporate managers do? Well, the flip side of shareholders behaving like owners is for managers to treat their shareholders like owners. They should seek out and sustain relationships with them, and refuse to indulge in short-term games like earnings guidance. Real owners don't care what next quarter's or next year's precise earnings will be – they are interested in the long-term strategy, culture, fundamentals and drivers of the business; in other words, in the creation of long-term value.

Educating long-term shareholders on these matters should be part of management's job. When one considers the huge amount of time that Deutsche Börse management spent responding to the demands and accusations of the dissident shareholders, the relatively small investment of time to keep long-term shareholders informed and supportive seems like a worthwhile activity.

Capital allocation can also encourage long-term shareholders. The best mechanism for this activity appears to be the dividend. Because shorts are responsible to pay dividends to the lender for the period of the securities loan, issuing dividends adds dramatically to the cost of short selling and, therefore, can act as an inhibitor. Dividends are also coming back into vogue because they are an indicator of corporate health. Corporate earnings have become too prone to manipulation in recent years. You can't fake a cash distribution, and managers are famously reluctant to cut or pass dividends.

By contrast, share buybacks (the major alternative to dividends as a cash distribution to shareholders) have been tainted by their more or less overt use to prop up stock prices for option-holding managements. Stock buybacks have their place, and should definitely be used aggressively when a company's stock price is depressed and for strategic restructurings of the balance sheet, but for ongoing distributions to shareholders, we have come to prefer dividends. (Intelligent public policy that would reduce taxation of dividends would also be useful.) Managements should always remember that a dividend returns cash to those who wish to own your stock; a stock buyback returns cash only to those who wish to sell it.

Conclusion

The Deutsche Börse story is a strange one in many ways. The reason it fascinates us is that it seems to typify the "what have you done for me lately" attitude of many shareholders in the new century.

Short-termism is not a victimless crime. It has been creeping up on us for years. In its earlier manifestations, it simply demanded earnings increases every quarter, and drove managements to give earnings guidance and sometimes manipulate earnings. Later it made managers embrace compensation schemes like stock options that aligned managers with very short-term oriented shareholders in seeking to pump up stock prices by any available means. And now, it appears that short-termism will increasingly affect the capital structure decisions and growth strategies that managers implement on behalf of their shareholders.

These decisions are the very essence of stewardship and we wonder if shareholders are aware of what they might potentially be losing if companies end up remote-controlled by financial engineers. A company is not just an accumulation of assets and liabilities. It is a living organism with its own culture and rules, and it needs strong and committed leadership in order to thrive.

We have always tried to be realistic about our place in the capitalist firmament – the real stars are the executives who can go out every day, energize their people and implement the strategies that make us wealthier as shareholders and as a society. Dr. Werner Seifert was one of these, and we regret his departure.

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