Case Overview

Ford Motor Company was founded by Henry Ford and 11 investor’s in 1903.

By 1906 Henry Ford had acquired a majority position in the company's stock.

In 1956, Ford sold shares to the public. Until then, the Ford family and the Ford Foundation (formed in 1936) had been the company’s sole stockholders. The Ford Foundation held by far the majority of the shares outstanding, although its holdings were non-voting Class A shares received upon the deaths of Edsel Ford in 1942 and Henry Ford in 1947.

Going public also gave the company increased access to the capital markets. At that time, Ford was in the midst of a large research and development expenditure related to the Edsel, a car the company hoped would return it to parity with General Motors.

The Ford Foundation pressured the company to create a public market for Ford common shares so that it could sell its Ford shares and reduce its reliance on income received in the form of Ford dividends. Class A shares sold by the Ford Foundation became voting common shares.

Ford modified its ownership structure of multiple share classes in order to preserve family control. Class B shares had special voting rights and could be owned only by Ford family members. As long as they owned a minimum number of Class B shares, the Ford family would retain 40% of the voting power. When Class B shares were sold outside the Ford family, they reverted to common stock.

As of February 2000, Ford had 1.15 billion common shares and 70.9 million Class B shares outstanding. The Ford family retained its 40% vote as long as it owned at least 60.7 million shares of the Class B stock. If Class B holdings fell between 33.7 million and 60.7 million shares, the family retained voting power of only 30%. Below 33.7 million Class B shares, all special privileges were lost. Ford’s special ownership structure meant that the interests of the Ford family would play a role in determining the company’s financial policies. Cash dividends provided family members with liquidity without having to sell Class B shares and run the risk of diluting the family’s control.

The Ford Family strongly preferred receiving dividends despite the fact that dividends were tax inefficient for many shareholders. Cash dividends provided family members with liquidity without having to sell Class B shares and run the risk of diluting the family’s control.

In April 2000, The Board of Directors of Ford Motor Company approved two major actions to further the company’s transformation into a consumer-focused business and effectively reward shareholders:
Value Enhancement Plan

- A Value Enhancement Plan that offers Ford shareholders new Ford shares plus either $20 cash per share or new Ford shares of equivalent value;
- An independence plan for Visteon Corporation, the company's $19 billion automotive components and systems subsidiary, whereby Ford shareholders will receive 100 percent of Visteon shares.

Characteristic of VEP

The Value Enhancement Plan has the feature of stock split and share repurchase. Under the VEP, Ford would return $10 billion of the $23 billion in cash reserves to its shareholders. The VEP has the feature of stock split and Share Repurchase. Exchanging Existing Share for New Shares on a One-for-One basis.

The VEP includes three options for different kinds of Shareholders:

Option 1: Shareholders who Prefer Cash.
Exchanging existing shares for new shares on a one-for-one basis, shareholders are also offered the option to reinvest $20 to receive additional new Ford common shares. In this sense, share price would decrease while the number of shares outstanding is going to increase.

Option 2: Shareholders who prefer More Shares
According to Ford's announcement mentioned in the case, shareholders choosing the share option would receive 0.748 new Ford common shares in lieu of $20 cash. So, the effect is similar to 1.748 for 1 stock split.
Stockholders thus would have the choice to receive $20 of cash or half a share of new Ford common. Shareholders also could elect to receive a combination of cash and new Ford common stock with an aggregate value of $20.

Option 3: Passive Investors
Shareholder could elect to receive a combination of cash and stock worth $20, where the relative cash/stock proportions would be chosen to allow shareholders to maintain the same percentage interest in the company as they did before the transaction.

Additionally as part of the VEP, Ford would also distribute its ownership of Visteon to shareholders on a pro rata basis. Ford Motor Company will distribute its 100 percent interest in Visteon to Ford common and Class B shareholders. Shareholders will receive a distribution of Visteon stock based on the number of Ford shares they own and the total number of Ford shares outstanding on the distribution record date.

Dividend Declaration
The Board also declared a second-quarter dividend of 50 cents a share on the company's common and Class B stock - unchanged from the prior quarter.
Value Enhancement Plan

Reason for going with this VEP by Ford can be too much cash?

Ford had accumulated $23B in Cash and Reserves by April 14, 2000. Cash represented 40% of Market Capitalization.

Relative to its main competitors, in 1999 Ford had cash of $25B compared to General Motors ($12B) and DaimlerChrysler ($9B). In terms of Utilization Ratios, Ford’s return on cash (Net income /Cash) was 29% far beneath the 49% and 63% of GM and DaimlerChrysler respectively. This suggests clearly that Ford’s excess cash balances are not working for it or its shareholders.

In spite of all this liquidity, the share price was consistently falling, although both the Auto industry and the S&P had been consistently rising for the corresponding period. (Based on Exhibit 1)

Excess funds can be a signal to the markets that the company has very little investment prospects lined up

Although cash balances can sometimes be desirable, this is only once they are adequate enough to meet short term obligations. However it would appear that Ford’s excess cash balances have arisen more from a lack of better options to management rather than necessity and this has been reflected in its undervalued stock

Although Ford had acquired other auto manufacturers in the past, it would appear that they did not have any more such opportunities available now

All investors are total return maximizing, precluding any preference for dividends (Annuities or pension funds) or for capital gains. The primary objective of a company is survival; secondary is maximizing value for its shareholders. The cost of capital for Ford in 1999 was 11.2%, hence it can be assumed that it would not change drastically for 2000.

A company’s stock price will increase only if the company can reinvest the money and earn a higher rate of return than the required rate of return demanded by investors. The additional growth of a company’s earnings has net present value of growth opportunities (PVGO).

\[ PVGO = ROE - Required \text{ Rate of Return} \]

If its ROE is greater than the required rate of return, then its PVGO is greater than zero, and the stock price will increase if the company reinvests some of its earnings for further growth. If the PVGO is zero, meaning that the ROE equals the capitalization rate, then it makes no difference to the stock price if earnings are reinvested or not; however, an earnings retention rate greater than that necessary to maintain liquidity will lower the dividend without increasing the stock price. If PVGO is negative, then the company will still grow, but it’s overall ROE will decline, and with it, its stock price. Therefore, the company should distribute most of its earnings as dividends, since that will yield the greatest return for stockholders.
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It can be proved that Ford is a business with a lower Present Value of Growth Opportunities (PVGO) component to the P/E ratio and individuals would have a preference for a stable and continuous stream of income, and decide on investment themselves.

Return on Equity (k) = 11.2%
Stock Price = 51.38
Earnings Per Share (EPS) = 5.86
Therefore:
Present Value of Growth Opportunities (PVGO)
PVG0 = Stock Price – EPS/k = 0.423

The current price of the Ford share owes only a little amount of it to its growth potential; hence the best alternative is an extraordinary cash dividend as it would create greatest value for the common shareholder.

Therefore it would appear that Ford does have too much cash and is also not utilizing it very well.

Advantages of VEP

With the combined feature of stock split and share repurchase, VEP has its strength.

In terms of cash option, since there is no good things to do with the massive cash reserve, returning the excessive cash allows shareholders to make profitable investment by themselves. Unlike cash dividend, returned cash is taxed as capital gains, so it generates tax efficiency for shareholders. In addition, though the price of new Ford shares would decrease, shareholders will not bear any loss, because the reduced price is offset by the cash they receive. But from the company’s point of view, they can reduce dividend payment. Companies tend to keep dividend payout ratio constant, so dividend for each new Ford share will decrease because share price falls. For those who choose to receive $20 in cash, they keep the same amount of shares before VEP is introduced, therefore, the total dividend payment is going to reduce and to some extent, the pressure for increasing dividend level can be relieved a bit. Moreover, the effect of cash option is similar to that of share buyback, the number of new shares outstanding will reduce; thus, earnings per share will increase and it can increase the overall demand for Ford’s share, which will benefit share price in the long run.

If shareholders elect stock option, they can increase voting power and exercise more control over the company. Also, as we discussed in the cash option, share price will increase, so, shareholders will benefit a lot from holding more new Ford shares.

As for the combination of cash and new shares, shareholders can take part of their money out of the stock to make other profitable investment, and they can also maintain their interest in the company. On
Value Enhancement Plan

the one hand, they can enjoy tax efficiency by paying tax of capital gains for cash received, on the other hand, they can enjoy the profit when share price increases and they can have a say in the firm.

VEP is better than cash dividend in terms of tax effect, and compared with share repurchase, it meets shareholders’ need to remain or increase control of the company. Therefore, based on the analysis, Ford should go ahead with VEP.

Alternatives?

Cash Dividends

Paying dividends attracts a certain clientele of investors.

Dividend payments provide important signals regarding the strength or quality of the firm’s present and future cash flows.

Some investors prefer the certainty of dividend payments to the possibility of substantially higher future capital gains.

*Tax implications of Dividends - Dividends from stocks are taxable, as are any capital gains they generate.*

Ford Family prefers Dividends

Share Repurchases

Share repurchase means a company buys its shares back from the market or from those shareholders who are willing to tender such shares.

- Repurchases have also been found to signal favorable information

- Share repurchase reduces the number of shares outstanding (i.e. supply), it increases earnings per share and tends to elevate the market value of the remaining shares.

*Offers flexibility* - this gives the company a better opportunity to optimize investments. This flexibility can be used to increase repurchases when stock prices are low.

*Tax implications for Stock Repurchase - there are much lower personal taxes that result from share repurchases relative to dividends.*

Ford Family does not want to lose Voting Power.
Value Enhancement Plan

What Problems are the VEP Designed to Solve?

**Increase Share Value and Performance of Company** - A recapitalization plan would enhance and increase the value of Ford’s share in the market. They also believe that the re-capitalization would align the interests of the Shareholders and the Owners in a way that would further improve the performance of the company.

**Company Control** – Another goal of the VEP is to reduce the conflict between the Ford Family, who does not want to lose voting power, and the Shareholders who want to receive cash distribution.

**Concentrated Focus** - It was expected that this spin-off would further help Visteon create its own customer base that would be separate from the client base of Ford.

Other Advantages of the VEP

Tax Efficiency
Investment Opportunities
No Bearing of Losses
Reduce Dividend Payment

Conclusion

One important aspect of investing is the understanding of when a particular stock is no longer doing the things that caused you to invest in it in the first place. Ford shares are dropping in value.

This VEP appears to be a strategy put in place with an obvious biased towards Ford Family.

Therefore, given everything that has been highlighted, as a shareholder after considering the tax liability due on cash income, also considering that Ford had stated that the cash would be tax as capital gain and not dividend, we would option to receive cash instead of shares, pay the required taxes and seek better investments for the remaining cash. Our decision would be based on the potential risk of losing a significant portion or all of my investment versus regaining some of my investment as cash and paying either a high rate of income tax or the capital gains rate as stated by Ford.

Ford family member will choose stock option because they want to expand their control in the firm. By supporting VEP, their 40% voting power remains unchanged but their equity in the firm decreases from 5% to 3.6%. If they elect stock option, they hold more common shares, and their voting power is beyond 40%. Since it has been mentioned that liquidity for the family
Value Enhancement Plan

members was a major concern due to real estate disputes, divorce settlements etc., the cash would also be welcome as they could be used to settle current settlements due. The share price would be expected to rise, yielding a higher return post the VEP being implemented; hence those could be liquidated when required as well.

Institutional investors, such as TIAA-Cref and the Calpers would choose combination of cash and shares. It's obvious that VEP favors Ford family members and dilutes institutional investors' voting power, so it's hard for them to compete with Ford family members in terms of control even if they reinvest all the $20 cash to buy new Common shares. In this sense, combination of cash and new share is a better choice for them. They can get part of their investment out of Ford stock for good opportunities somewhere else; meanwhile, they can remain interest in Ford.

As an institutional investor, a lot would depend on the taxation rules being applied for that company. Pension funds like TIAA- Cref and the Calpers would prefer cash for two reasons. Firstly, pension funds always need to have a strong position of liquidity. Since pensions of their clients need to be given out rapidly and regularly, a strong cash balance is a pre-requisite for a pension fund to perform properly. Secondly, a pensions fund’s income is not taxed. For other institutional investors, the choice could depend heavily on the way they are taxed for non-operating income. The VEP mentions that the cash dividend would be taxed like a capital gain, but only if the stake in the company was less than 1% and it had no control over corporate affairs. Larger institutions would presumably have large stakes and hence prefer additional shares to save on tax.

Regular outsider shareholder doesn't care about voting power. The purpose of their investment is profit. So, if I was one of them, I would go for cash option, because I would think Ford can't find profitable projects and there are few growth opportunities. By getting money back, I can make good use of it by myself.

As in investor, the cash dividend v/s the issue of more shares is a highly debatable matter. Some would argue that the announcement of a large cash dividend can be a bad thing as it means that future growth of the company is low and there are no further investable opportunities, hence preferring a cash dividend. However Ford’s management have also announced the spin off of Visteon, a subsidiary of Ford. This can give the market a positive sign of growth and confidence in the future. It might then seem that a growth investor would benefit with a payout of shares and the short term investor would prefer the cash pay out as the cash dividend would be treated as a capital gain as far as tax was concerned. However keeping in mind the company’s record of dividend pay outs, a sudden surge of payout due to the VEP, would signal that growth opportunities are indeed scarce and the company has no better alternative than to distribute the excess cash to shareholders. A $20 payout for each share held as stock or cash is a massive change from the $0.50 currently being paid every quarter for each share held. As a result, it is more likely that the jump signifies that growth opportunities are limited for the future, and hence an individual investor would prefer a cash dividend.