

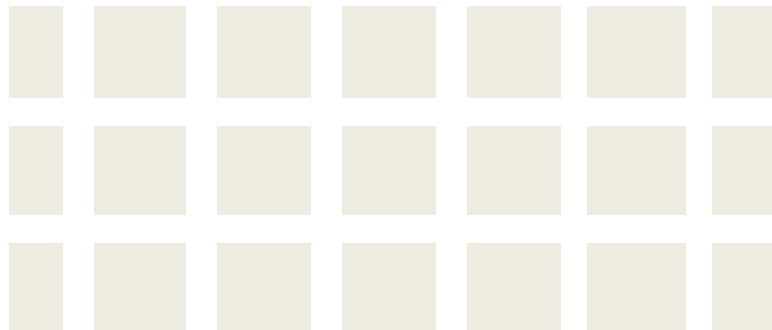


Sovereign Wealth Fund
RESEARCH INITIATIVE



LOYALTY-SHARES: REWARDING LONG-TERM

INVESTORS



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Seeking Long-term Investors

■ **Graham, Harvey and Rajgopal (2005)**

- **“More than three-fourths** of the surveyed executives **would give up economic value in exchange for smooth earnings** [...]
- Many executives feel that they are choosing a lesser evil by sacrificing long-term value to avoid short-term turmoil [...]
- Many managers would reject a positive NPV project in order to meet the analyst consensus estimate!

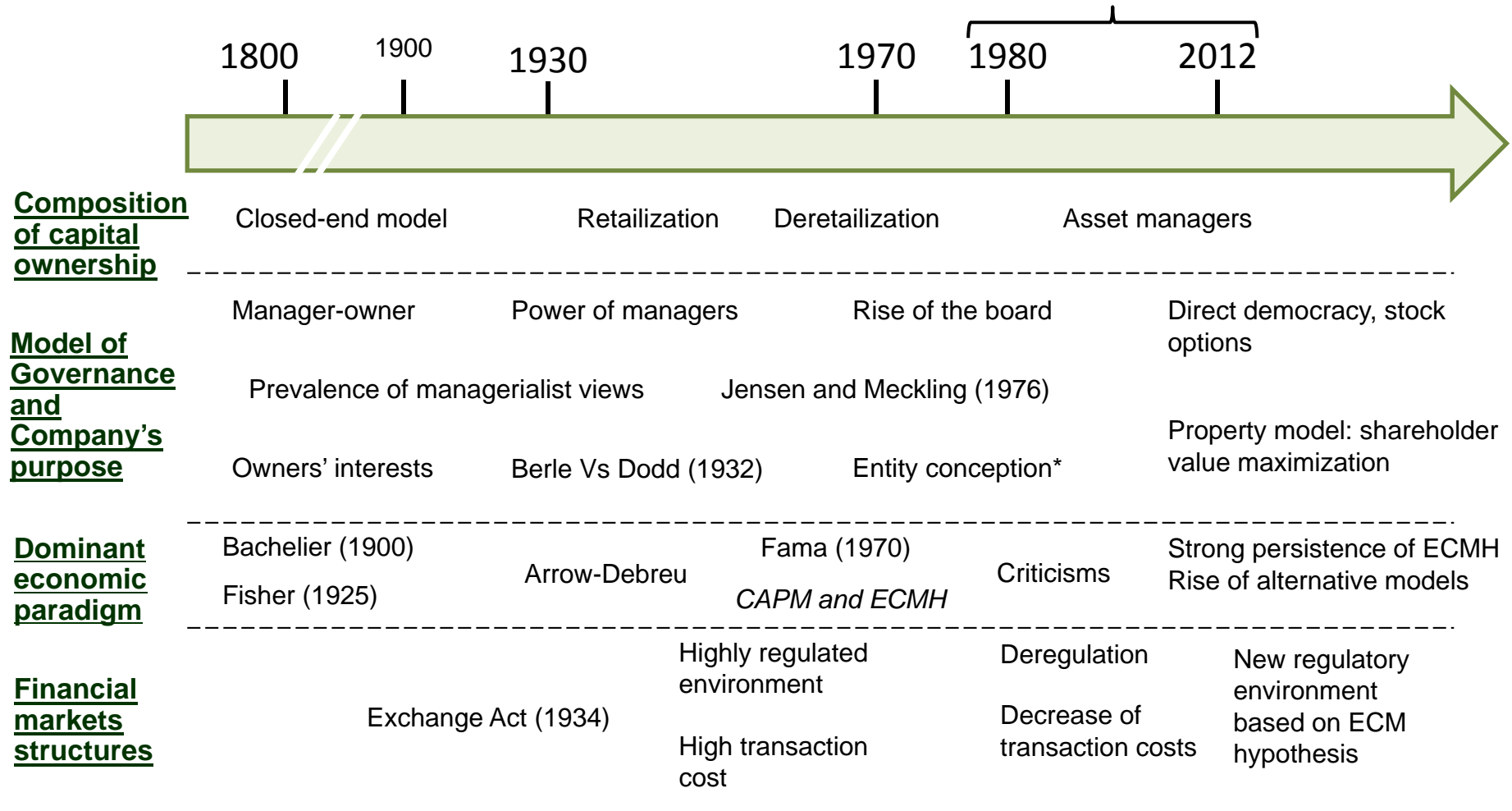
■ **John C. Bogle**

- “.... policy makers ought to be considering structural changes that would enhance the role of investors and diminish the role of speculators:”
 - **Granting longer-term (two- to five-year holders of stock) extra voting rights and/or a higher dividend;**
 - Federal transfer tax on securities transactions;
 - Or a tax on short-term realized capital gains (shares held for less than six months), applicable to taxable as well as tax-exempt investors such as IRAs.



Firm, Governance and Capital Markets

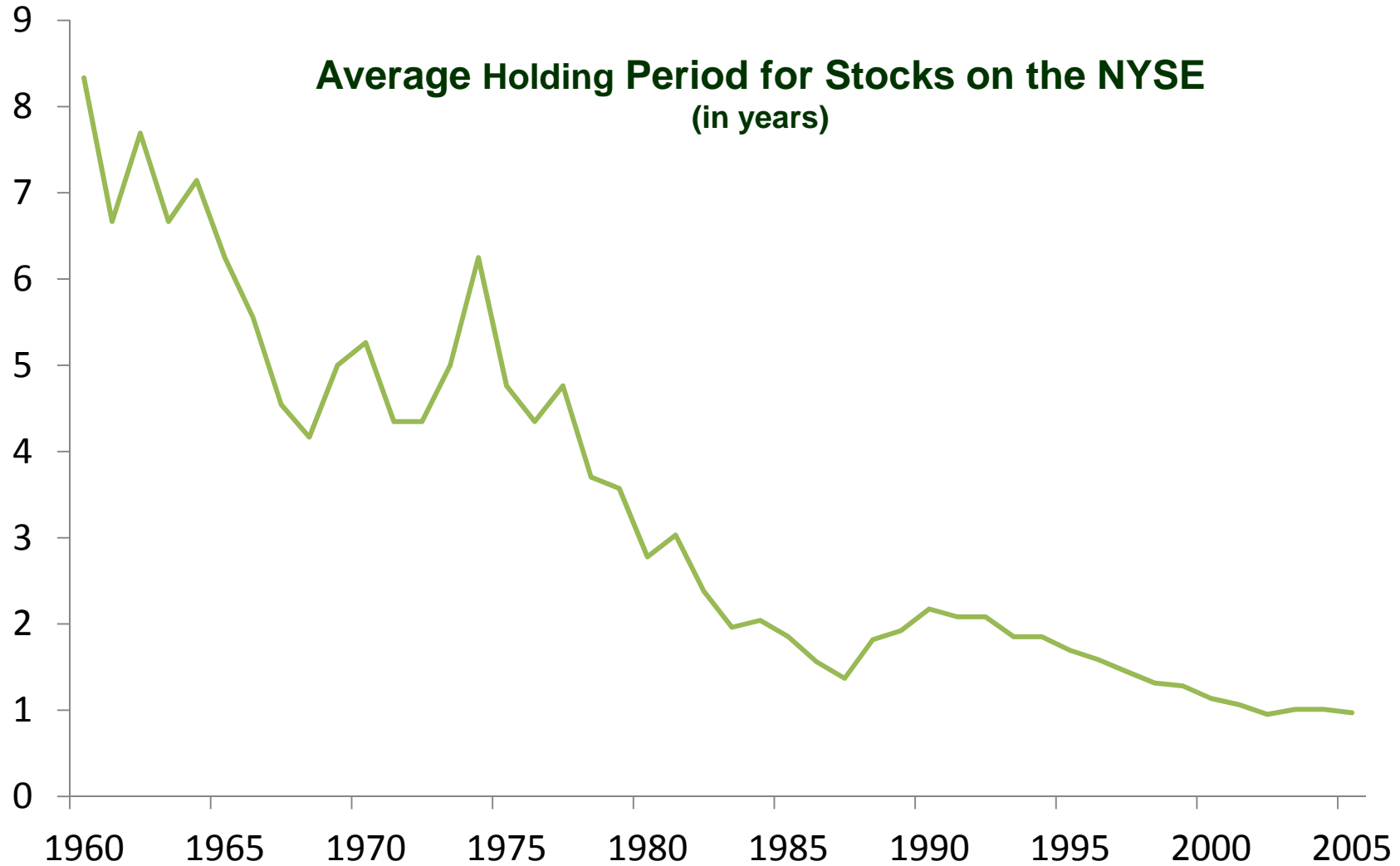
Emergence of a short-termist ecosystem



*Posits that the purpose of the corporation is the long-term wealth maximization for all corporate constituencies



Long-term Investors: the Missing Chain

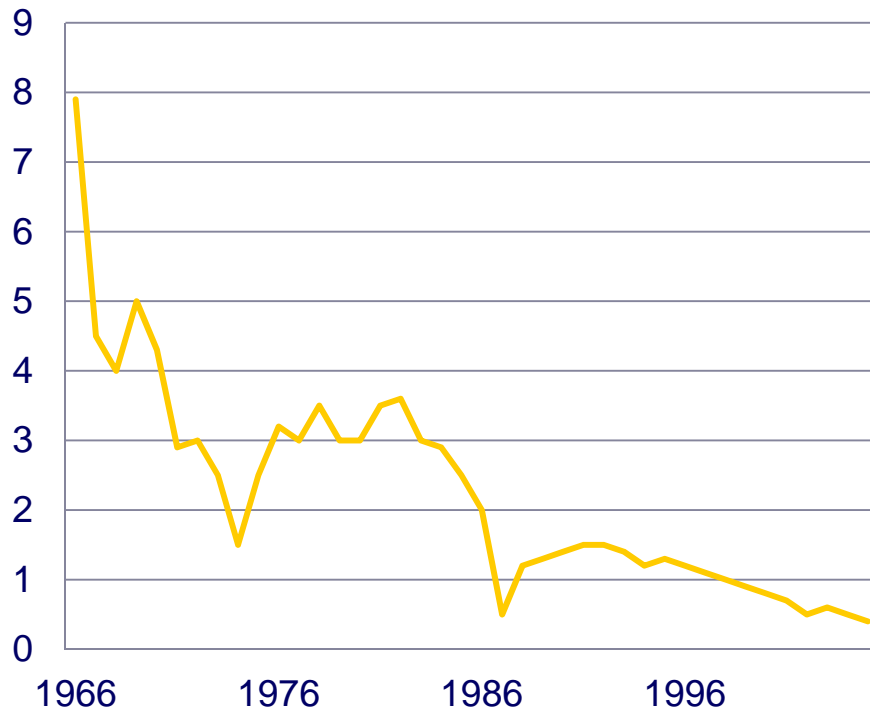


Source: NYSE overview statistics



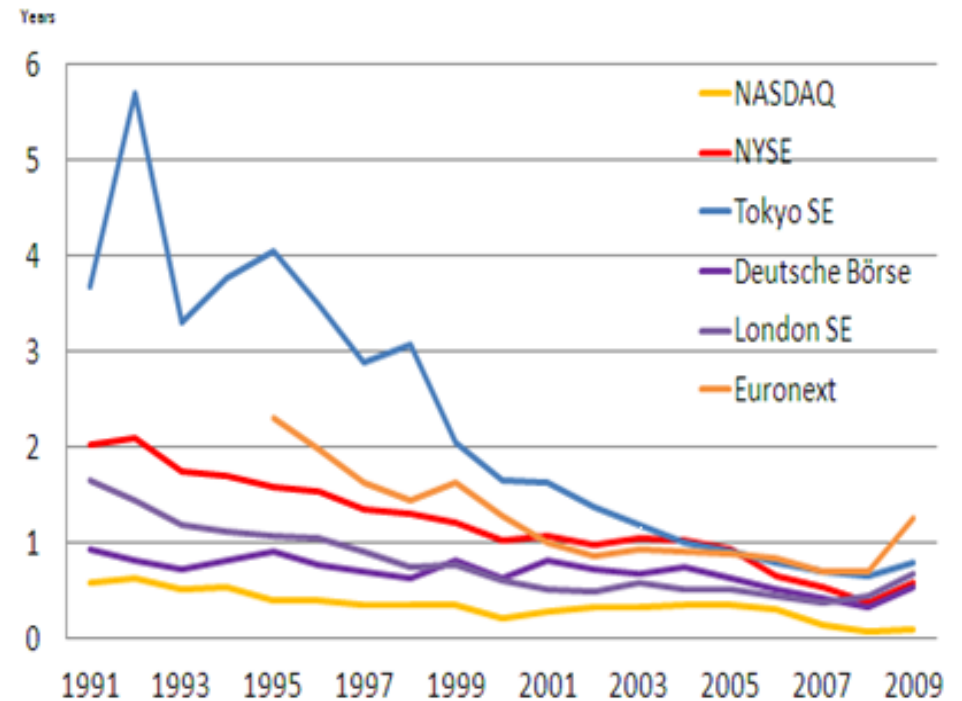
Holds True Across Major Exchanges

Average Holding Period for a stock on the FTSE (in years)



Source: London Stock Exchange

Average Holding Period in other major Stock Exchanges (in years)



Source: World Federation of Exchanges



Solutions to Enhance a Long-term Horizon (1/2)

■ Board of directors

- **Strengthen the stability of the boards:**
 - Lipton (2012): Protect the board against activists & short-term oriented shareholders;
 - Strine (2010): Limit reliance on proxy advisory firms unless they give voting advice based on a minimum holding period of 5 years.

■ Governance

- **Increase the independence of funds' management**
 - OECD (2009): Create an independent “governing body” to design and monitor the long-term strategy of the fund.

■ Management

- **End the default practice of issuing quarterly earnings guidance**
 - Al Gore & Blood (2012), Barton (2011).



Solutions to Enhance a Long-term Horizon (2/2)

■ Theory of the firm	<ul style="list-style-type: none">– Question the shareholder value principle<ul style="list-style-type: none">▪ Stout (2012): Emphasis on maximizing shareholder value induces a myopic behavior of managers and has harmful consequences for all stakeholders.
■ Investment practices	<ul style="list-style-type: none">– Embrace a long-term perspective when using models<ul style="list-style-type: none">▪ Fuster, Hebert & Laibson (2011): Abandon econometric models based on too recent references, under-estimating long-run mean-reversion.– Base investment strategies on fundamental values, meaning the present value of future cash flows<ul style="list-style-type: none">▪ Rappaport (2010): “Stock prices ultimately depend on a company’s ability to generate cash flow”.
■ Shareholders	<ul style="list-style-type: none">– Reward long-term shareholders<ul style="list-style-type: none">▪ Henry Jackson Initiative (2012), Al Gore & Blood (2012), Barton (2011), Aspen Institute (2009)



A Solution to Reward Long-term Investors

All shareholders are entitled to a *Loyalty Warrant*



The Long-term shareholders *having kept their shares for three years*



Warrant = 1

The Short-term shareholders *having sold their shares*



Warrant = \emptyset

Behavior of shareholders determines ownership (or not) of the warrants



Transfer of Value from Short-term to LT Investors

Terms of L-Shares

Maturity:	6 Years
Loyalty Period:	3 years
Strike:	At the Money
Parity:	10 for 1
Volatility:	24%
Div Yield:	2.0%
Interest rate:	2.0%
Price of the share:	\$100
Price (for LT shareholder):	\$2 ⁽¹⁾
Price (for ST shareholder):	\$0
Value for firm:	\$0.20

Capital Structure

ST Shareholders:	90%
LT Shareholders:	10%

(1) With a \$20 theoretical value for the call option



With Gains in a Few Hands



“Automatic” transfer of wealth from Short-term to Long-term investors.



A Reward for Other Actions

■ Rewarding Costly Monitoring	– Activist shareholders’ interventions benefit all shareholders but are costly and pay off only in the long run (e.g. Bolton & Von Thadden, 1998).
■ Postponing a Costly Dividend	– Granting L-Shares instead of dividends helps avoid the market sanction linked to a dividend cut (Michelin, 1991).
■ Securing a Strategic Investor	– Similar to Warren Buffet’s investment in Goldman Sachs or to some features of TARP investments.
■ Facilitating a Share Issue	– L-Shares to discourage “flipping” after an IPO.



Impacts on the Market

■ Pricing	<ul style="list-style-type: none">– Classic: Call Option Model (vesting + maturity, spot, strike, dividend, interest rates, implied volatility) * Occurrence Probability;– More sophisticated: a down and out call option (*Occurrence Probability).
■ Share borrowing costs	<ul style="list-style-type: none">– The warrant should increase the cost of borrowing shares (during the Loyalty period)<ul style="list-style-type: none">▪ Long-term investors are the main lenders of shares;▪ By lending their shares they would lose their warrants and require compensation for this loss.
■ Volatility	<ul style="list-style-type: none">– The warrant should contribute to reducing volatility of the underlying after the loyalty period<ul style="list-style-type: none">▪ Turnover of capital lowers value of the warrant;▪ Loyalty rewarded when volatility increases.
■ Mergers and takeovers	<ul style="list-style-type: none">– Allow for early exercise of the warrants.



L-Shares vs. Other Solutions

	Extra Share	Extra Voting Right	Extra Dividend	L-Warrants
Impact on Liquidity	Decrease <i>(if stock price rises)</i>	Decrease <i>(constant)</i>	Decrease <i>(constant)</i>	Increase ⁽¹⁾
Impact on Volatility	None	None	None	Decrease ⁽²⁾
Impact on Share Borrowing Cost	Limited <i>(only if stock price increases)</i>	Limited	Limited	Increase <i>(if stock price rises)</i>
Better alignment with management⁽³⁾	Limited	None	None	Yes
CEO “Retrenchment”	Limited	Possible	Limited	None

⁽¹⁾ Due to the hedging of traders

⁽²⁾ After the loyalty period

⁽³⁾ Assuming the management is entitled to stock options



L-Shares in the Press

- Published in the **Journal of Applied Corporate Finance**:
 - Peer-reviewed academic journal published by Wiley-Blackwell;
 - Edited by Donald H. Chew Jr., in collaboration with Columbia Business School.
- **Henry Jackson Initiative**, *Towards a More Inclusive Capitalism*, May 2012
- **World Economic Forum**, *Measurement, Governance and Long-term Investing*, March 2012
- **Al Gore and David Blood**, *Sustainable Capitalism*, February 2012
- **Wall Street Journal**,
 - *Loyalty Shares - It's a Long Story*, May 2011
 - *Here Comes the Slow-Stock Movement*, March 2013
- **Institutional Investor**, *Can Loyalty Shares Programs Help Build Long-term Value for Investors*, October 2012





Conclusion

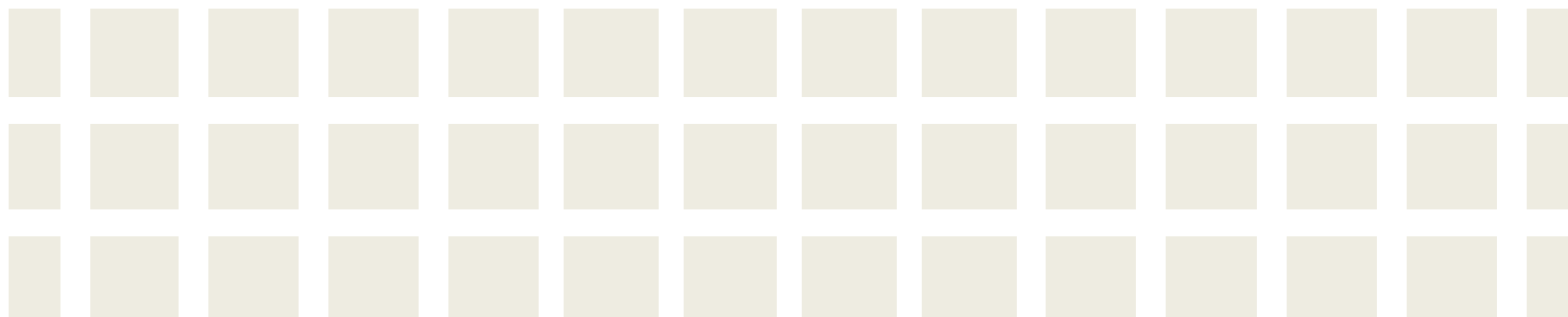
- 1. ESG factors / integrated reports are getting traction;**
- 2. It requires a long-term investment horizon;**
- 3. Companies need a right balance between short-term and long-term shareholders;**
- 4. L-Shares can contribute toward this re-balancing;**
- 5. They send a positive signal about the value of long-term investors.**



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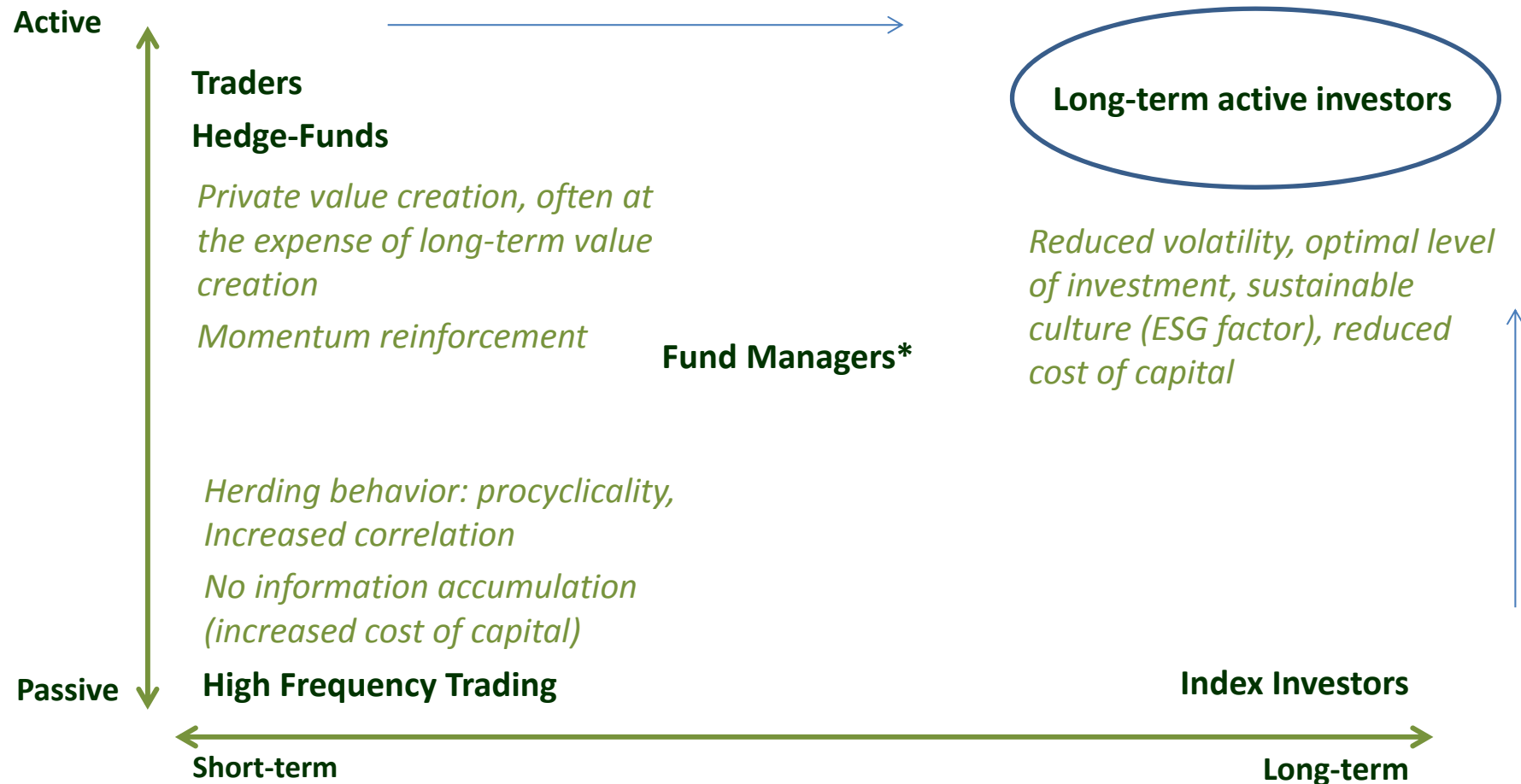


ANNEXES





Mapping Investors: Where are you located?

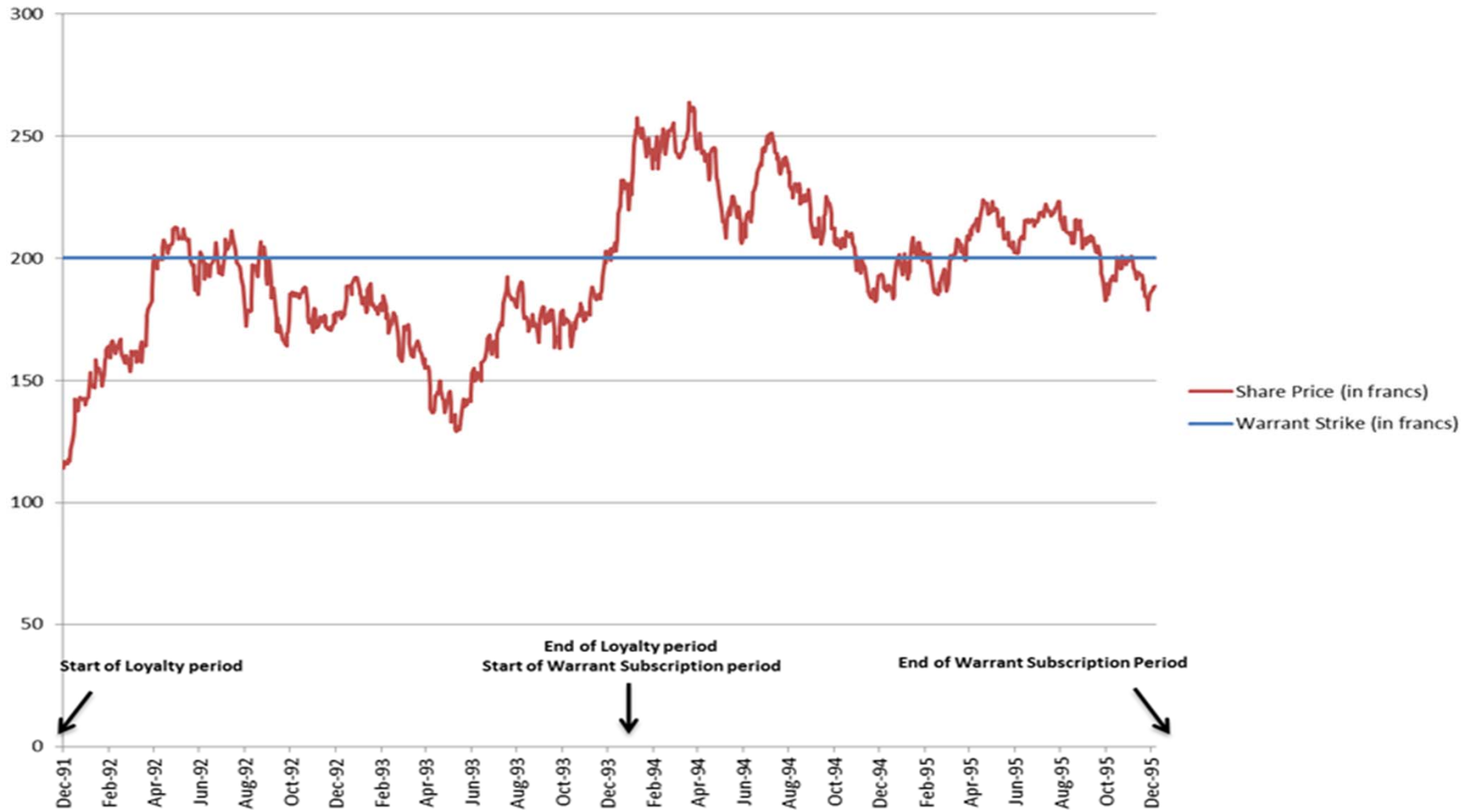


* Benchmarking investors are passive, as they have no incentive to pay for monitoring cost and prone to herd behavior.



The Michelin Case

Michelin Share Price and Warrant Strike





Possible returns for Long-term investors after 6 years

- Market Capitalization: \$ 50 bn
- Limited EPS Impact (<1%)
- Other Parameters unchanged

Annual growth (%)	5%	10%	15%	20%
Share price (\$)	134	177	231	299
Capital Gain on LT shares (M\$)	1,700	3,858	6,565	9,930
Additional Gain on L- warrants (M\$)	170	386	656	993



Two simple legal treatments of L-shares:

	French treatment	U.S. treatment
Corporate law environment	<ul style="list-style-type: none"> ✓ L-Shares as an issuance of warrants ⁽¹⁾: - <i>Issuance modalities defined by the board</i> 	<ul style="list-style-type: none"> ✓ L-Shares issued through a subscription rights offering ⁽³⁾: - <i>The board must show that the issue benefits shareholders</i>
Shareholder approval	<ul style="list-style-type: none"> ✓ Likely to be required 	<ul style="list-style-type: none"> ✓ Likely to be required
Tracking loyalty	<ul style="list-style-type: none"> ✓ Attribution of a new ISIN code, L-ISIN, to all L-Shares holders⁽²⁾: - <i>During the loyalty period, L-ISIN code reverts to a normal code if the shares are sold</i> - <i>At the end of the loyalty period, only L-ISIN code holders receive a warrant</i> 	<ul style="list-style-type: none"> ✓ Retain the services of a transfer agent to: - <i>Maintain a register of warrant holders</i> - <i>Ensure that no transfers are effected until the end of the holding period</i>

(1) Article L. 228-91 and following of the French Commercial Code

(2) To know shareholders' identity, the issuer can request them to become "registered shareholders" (either direct registered account or administrated registered account)

(3) Shareholders can subscribe for warrants by paying a minimal consideration (at least equal to the share par value: \$0.01 or \$0.001)



Possibility of arbitrage?

■ Hedging during the Loyalty Period?

- Traders will have to borrow shares mainly with long-term investors
- These long-term investors will ask for compensation as the lending of shares leads to a transfer of ownership and thus the disappearance of the warrant (1)
- The hedging price will therefore include the cost of the warrant

■ L-share platform?

- Over a limited fraction of shares outstanding: this provides a limited gain, shared among three players and this leads to reduced liquidity
- Over a large fraction of shares outstanding: high setup cost for an important structure to set up with a limited gain per share