Finance 702

Assignment 1

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Contents

1 Brand & Franchise Analysis

1.1 Brand Name & Organisation Specific Assets

A brand name is classified as an organisation specific asset. Asset Specificity is the degree an object or person of value can be readily adapted for other purposes. Levels of specificity determine the flexibility and usefulness for assets across multiple situations and purposes. A brand name identifies the franchisor's organisation as distinct from competitors. Brand names are considered indefinite intangible assets as they stay with the entity for the duration of their operating period and are not physical by nature. Brand names (e.g. McDonalds, Taco Bell etc.) are highly specific as aren't interchangeable for many purposes or situations. Their purpose is to label the franchisor organisation with contractual agreements enabling the franchisees/lessees to use the brand name. These contractual agreements between franchisors and franchisees/lessees require the franchisees/lessees to use highly specific assets which are of value to the franchisor in the form of brand name(s). Subsequently, brand names can be viewed as specific assets to an organisation (Investopedia, 2021).

1.2 Benefits of Franchising

The dichotomy between outlet ownership retention and leasing to franchisees/lessees for a franchisor is interesting. Franchising is another form of product distribution. The ability to achieve potential benefits associated with large scale e.g. brand name development while utilizing local profit incentives and retailing efforts rationalise the decision to franchise. Three factors define franchising: Firstly, distribution of goods and services associated with the franchisor's trademark. Secondly, exercise of significant control over, or giving of significant assistant to, the franchisee by the franchisor. Lastly, payment to the franchisor by the franchisee. These factors inform the benefits on either side of the dichotomy (Klein, 1995).

1.2.1 Retention of Ownership

There are several benefits a franchiser receives from the retention of ownership for some outlets that use the brand. Firstly, a franchisor may utilize economies of scale to increase profits when outlets are densely located in a geographic area. For example, several McDonalds outlets within close proximity may generate cost savings from shared distribution networks and proximity to dispatch centres in high-density urban areas (Tokyo, New York, Auckland etc.) In this instance, a franchisor has greater control over the quality of staff employed in the outlets. Although franchising enables greater access to talent, the franchisor would have greater control over who the outlets hire, ability to build a better community amongst outlets and ability to innovate.

1.2.2 Leasing Brand Name

Conversely, there are benefits to leasing brand names out to franchisees or lessees. Franchising enables the franchisor to further build their brand without managing the daily operations of each outlet. The franchisor may be able to have greater access to capital and expand at a higher rate with lower growth risk as each outlet is managed by the outlet operator. Additionally, they collect royalties and initial franchise payments with lower risk as the initial capital investment in opening the outlet is fronted by the outlet operator. The franchisor still has the ability to exercise control over the franchisees/lessees through a franchise contract. Contributions made by the franchisee/lessee may contribute to funding brand improvements, product R&D, training and/or corporate functions. The franchisor may also have greater access to talent who they can monitor in franchisee/lessee outlets and transfer to corporate functions if needed.

1.3 Failures in Corporate Governance by RFG

1.3.1 Introduction to Retail Food Group (RFG)

Retail Food Group (ASX: RFG) is a global beverage and food company headquartered in Queensland, Australia. The company is Australia's largest multi-brand retail food and beverage franchise owner. They also roast and supply high quality coffee products (Retail Food Group, 2021). Their brands include: Donut King, Brumby's Bakery, The Coffee Guy, Michel's Patisserie, Gloria Jean's, Di Bella, Crust, Pizza Capers and Cafe2U. These brands serve over 17 million Australian customers annually, recording more than 70 million customer transactions in 2020. Their core focus is supporting the success of franchise partners and improving profitability. Interestingly, their home page outlines three provisions to franchisees: training facilities, product innovation and on-going support. These provisions will be relevant further in our discussion.

1.3.2 Background on Corporate Governance & Case

Corporate Governance is a system of rules, practises and policies dictating the managerial responsibilities and operational oversight of the board of directors. Three principles underpin Corporate Governance: Accountability, Transparency and Security (Corporate Finance Institute, 2021). These factors inform the assessment of RFG's corporate governance failure. For background, RFG was accused by the franchisees operating Michel's Patisserie, Brumby's Bakery, Donut King and Gloria Jean's brand for false, deceptive and misleading conduct during the sale of stores to franchisee owners. The ACCC alleged RFG's action were unconscionable as critical financial information was withheld during the sale or licensing of 42 unprofitable stores. The ACCC's investigation ramped up after the Australian Securities and Investment Commission (ASIC) scrutinized RFG on a lack of transparency for investors but subsequently escaped enforcement (Maskiell, 2020).

1.3.3 Failure of Corporate Governance

Firstly, the Board of Directors failed to upheld satisfactory levels of transparency regarding the profitability in the sale or licensing of 42 stores. Each participant in the franchise community is entitled to accurate information related to the goals, strategy and performance of the franchise. Deceiving franchisees on the financial outcomes on the outlet enables the franchisor to shift default risk to outlet manages while collecting royalties and capital injections from the sale of stores. An article in the Australian Financial Review highlights RFG suffered an $88 million AUS loss, forecast the closure of 200 stores and the financial devastation incurred by store owners dreaming of owning a small business (Ferguson, 2018). This is a clear violation in good corporate governance. Secondly, their was no clear system in place to manage or support financially-distressed stores. Good corporate governance should provide frameworks to manage cost cutting exercises to support distressed stores. Franchisees were left to fend for themselves rather than RFG rolling out cost cutting plans and financial support plans to the franchisees. Thirdly, corporate governance should ensure RFG operates ethically with high standards of integrity. The allegations of insider trading, tax avoidance, breaches of consumer law, market disclosure and valuation violations by RFG and it's directors indicate otherwise. These allegations inform unethical behaviour and the poor corporate governance. Directors failed to take accountability for their responsibilities. RFG failed to provide satisfactory supply arrangements and good quality products to two Michel's Patisserie franchisees in Townsville, leading to a breach in consumer law (Maskiell, 2020). These are basic provisions expected from franchisors and should be specified in a franchise contract. This is another example of a failure in corporate governance. Subsequently, RFG failed multiple times to practise good corporate governance, leading to the destruction of value.

2 Long/Short-selling & Corporate Governance

2.1 Definition of Hedge Funds

Hedge funds are a form of investment vehicle and are usually identified by four characteristics. Firstly, they are privately organised, pooling capital from several parties. Secondly, professional investment managers administer the fund. They are incentivised by performance-based compensation and significant carry in the fund. Thirdly, they are inaccessible to the public. Lastly, they operate externally to securities regulation and registration requirements. A hedge fund is managed by general partners (GP) who manage limited partners' (LP) investments in the fund. LPs make passive investments with little to no control in the fund's operations. Hedge funds typically charge a 2% annual fee and 20% performance fee on the fund's annual return. They raise capital through private offerings and pursue multiple, complex investment strategies in public and private markets to generate returns for investors (BRAV, JIANG, PARTNOY, and THOMAS, 2008). Two examples of investment strategies deployed by hedge funds are long positions and short selling. Short selling is a strategy to bet against a securities performance. This strategy capitalises on an expectation the security will fall in value and may be used as a hedge to the mitigate downside risk of a long position in a similar security. A portfolio manager borrows the security, immediate sells it on the market and buys the security back later at a lower price to generate a return. A long position is a strategy to bet on a securities performance, capitalising on the expectation the security will rise in value. A portfolio manager buys the security, holds as the price rises, then sells at a higher price to generate returns for investors.

2.2 Impact of Hedge Funds

Good corporate governance maximises operational efficiencies and returns for stakeholders. Corporate governance is defined in section 1.3.2. Existing literature and articles suggest hedge fund activity does influence organisations.

2.3 J Capital and Nearmap Analysis

The incident involving J Capital exemplifies how hedge fund's engagement in short selling activities can unethically affect value. J Capital published comments related to layoffs, discounting to artificially lift margins, failures to monetise products in the US market and the cost advantages of competitors. Subsequently, Nearmap shares slid 7% in response to the research, destroying value for Nearmap's shareholders before the execution of a trading halt. Nearmap produced an ASX release falsifying the claims made on the following areas by J Capital: sales strategy, churn, pricing, technology, capture efficiencies, AI, pushpin and accounting practises (Nearmap, 2021). Additionally, several equity analysts criticised the research, emphasising a $3 price target, stating US market performance was priced in and the layoff accusations were overblown (Kruger, 2021). However, J Capital created an opportunity to capitalise on the falling share price and exit their short positions to generate returns. In this example, J Capital destroyed value for Nearmap shareholders. However, Nearmap's board were quick to react and provide evidence falsifying the claims made by J Capital. They exemplified good corporate governance in reassuring shareholders J Capital was acting unethically.

2.4 BHP & Elliot Management Analysis

Elliot Management, who represent Elliot Funds, prepared a presentation to the directors of BHP Billiton Plc and BHP Billiton Limited on how to increase shareholder value through recommending the BHP Shareholder Value Unlock Plan. Elliot Management identified three key initiatives for management to implement to unlock value for shareholders. Firstly, unify BHP under into a single Australian-headquartered and Australian tex resident listed company. Secondly, demerge and separately list BHP's US petroleum business to monetise intrinsic value. Lastly, adopt a policy of consistent and optimal capital return to BHP's shareholders. The demerger, accretion value from buybacks and franking credits from buybacks would unlock $15 billion, $20 billion and $11 billion in enterprise value respectively. The implementation of the plan recommended unlocks a total $46 billion (USD) in enterprise value (Elliot Management, 2021). This plan is validated by FTI Consulting report on the incumbent management's oversight preventing the realisation of approximately $40 billion (USD) in value (FTI Consulting, 2021). Elliot Management, on behalf of Elliot Funds, provided recommendations to improve corporate governance and increase long-term shareholder value to create value. This case study shows hedge funds who engage in long positions can hold director's accountable, encourage good corporate governance and create value.

2.5 Activist Hedge Funds

Activist hedge funds have a role to play in ensuring good corporate governance. One paper analysed hedge fund activism documenting the heterogeneity in hedge fund objectives and tactics, showing how tactics relate to target firm responses. The paper finds positive market reactions to hedge fund intervention is consistent with improved post-intervention target performance, the effect of interventions on CEO remuneration and turnover, and changes in payout policy. The findings were consistent with informed shareholder monitoring can reduce agency costs at target firms. Most importantly, the paper found hedge fund activism generates value on average from both the activist's credible commitment to intervention and conviction to follow through on their commitments (BRAV et al., 2008). Recently, ExxonMobil faced scrutiny for it's energy strategy. Engine No. 1, an activist investment group, nominated four qualified potential board members to improve governance and reposition the organisation to achieve sustainable, long term value for shareholders. The company recently appointed two new board members, one who cofounded an investment firm focussing on increasing shareholder value and promoting sound ESG practises, in efforts to improve corporate governance (Engine No. 1, 2021). These articles exemplify the role activist hedge funds, who engage in long and short selling activities, play in forcing better corporate governance and create long term shareholder returns.

2.6 Positional Dichotomy: Short vs Long

J Capital, BHP Billiton and activist hedge funds and their action taking positions in an entity show evidence of changes in corporate governance, long-term shareholder returns and value. The directionality of change depends on the position. Short positioning would incentivise poor corporate governance and the destruction of long-term shareholder value from the perspective of the hedge fund. Investors hedging against a firm's success may give unethical recommendations or slander the organisation to drive down perceived value and generate returns as seen with J Capital and Nearmap. It was fortunate Nearmap's board and executive team took swift action to mitigate the damage. Alternatively, long positioning incentivises hedge funds to influence good corporate governance and generate long term shareholder returns as there is more to gain from the upside of improved performance. This was shown through the BHP example and literature on activist hedge funds. In conclusion, hedge funds will take a position in alignment with their investment thesis, own corporate governance and likelihood to generate returns. Whether the involvement of hedge funds leads to better corporate governance and improved long-term shareholder returns depends on their influence, market conditions, thesis and the resolve of the incumbent board of directors.

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