This was the most influential article I wrote while I was in Spain. It was published in the weekend edition of Cinco Dias, which is like Barrons. It was widely circulated, and several of my colleagues at Instituto de Empresa used it in their classes. When I returned to Spain the following summer, several people mentioned the article to me, and said they had thought often of the points in the article.

This is one of the earliest statements of the shareholder value point of view in Spain. Managers in Europe are now adopting this point of view, in place of the stakeholder value point of view that dominated their thinking in the past.

Surfacing the Value: Steps to Raise Your Firm's Stock Price

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Spain's economic performance is consistently in the top rank of the industrial countries. In contrast, the Spanish stock market languishes at 9 times earnings. Spanish stocks, according to most international standards of value, are at bargain prices. The price-to-cash-flow ratio is 4,4 times.

There is a an explanation for the low prices of Spanish stocks, which goes beyond short-run explanations. It relates to a major difference in objectives between corporate managers and stock market investors.

Corporate managers in Spain try to maximize the long-term position of their companies. They work at improving asset quality, market share, and long-run profit margins. They do not focus on the price of the stock. They act as if the stock price will rise when the company is in some sense stronger. But their actions have not made their stock prices go up, as much as the strength of the companies would justify.

Stock market investors, in contrast, try to maximize the value of their portfolios in the short run. They try to be nimble traders, and their time horizon is much shorter than the time horizon of most Spanish corporate managers.

This profound difference in objectives can explain why the Spanish market never reaches levels of valuation consistent with Spain's rapid economic growth. The private market value of most Spanish companies rose sharply, but the stock market value of the companies did not rise as much. One reason is that stock market investors, even those few who still take a long-term view, do not feel that they will benefit in direct proportion to the increase in private market value of the companies. Improvements in company performance in Spain do not lead very quickly to sharp increases in dividends, share buybacks, LBOs, takeover battles where minority shareholders benefit greatly, or to any other immediate tangible payoff.

What can be done to bridge this gap in time horizons, and to make the objectives of managers and shareholders more congruent? Investors are not going to change. They will continue to have a short-term focus. Individuals who manage their own portfolios and professionals who manage other people's money will both continue to try to beat the market consistently. Obviously they cannot all succeed in doing this, but they will all try, and this will lead them to jump nervously from one stock to another. The vice of reacting to every wiggle on the chart, or to every side remark of economic policymakers, may intensify now that transactions costs are falling.

If investors are not going to change, corporate managers can respond in two ways. One is to keep doing what they are doing now, and rely on the good sense of the investment community to place a reasonable value on their companies' shares. This course of action will not reduce the volatility or undervaluation of their stock, but for some managers raising the stock price and keeping it high are not priority objectives. The other approach is to attempt to exercise more day-to-day influence over the stock price.

It may seem that managers can do very little to influence the day-to-day price of their companies' stock, but this is not true. Here are several specific actions that corporate managers can take which will raise and stabilize the stock price.

1. If cash flow permits, companies should repurchase shares in the open market and cancel them instead of holding them as treasury stock. This action will show that top managers feel the stock is a bargain. It will also take the shares out of weak hands. If the company's debt ratio is low, share repurchases will automatically raise the value of the remaining shares by reducing the total number of shares and by spreading the tax shield over fewer shares.

It will not work to repurchase shares and keep them in the treasury. Shares in the "autocartera" are correctly viewed as an overhang, which will be sold whenever the stock price rises. When the repurchased shares are canceled, there is no overhang.

2. Stop issuing share purchase rights with exercise prices more than 5% below the current market price of the stock. Rights offerings are seen as a threat, because in Spain the exercise price is usually as much as 20% below the current market price of the stock. There is good statistical evidence that investors view rights offerings negatively regardless of the size of the discount. Obviously the larger the discount the more the rights offering dilutes existing shareholders.

3. Stop issuing convertible bonds with conversion rights below the current market price of the stock. The practice of using such aggressive conversion clauses is like cramming more shares down the throats of existing shareholders: either they buy the convertible bond and covert it into shares at the earliest

opportunity, or they suffer dilution and sharply reduced upside potential.

Both rights offerings and Spanish-style convertible bonds have been major ways of raising equity capital for many years. Each one is viewed as a means of raising equity capital from investors who otherwise will not buy more stock. But both of these create a vicious circle: investors will not buy more stock because if the price goes up there will be a rights offering or a convertible bond issue. So stock prices remain low and the possibility of secondary offerings is limited. Because of the threat of dilution, investors refrain from buying stock in the first place, until the price is so absurdly low they can expect an adequate return even if there is dilution coming in the future.

Another reason for the heavy use of rights offerings and Spanish-style convertible bonds is that Spanish companies do not use much debt. During the Seventies and early Eighties the real aftertax cost of debt was very high, so Spanish companies avoided using it. To finance growth, the lesser evil was to raise equity. Since the stock market performed poorly during the period 1974 - 1983, investors correctly chose not to buy more stock except at bargain prices. This left management with no alternative but to sell stock at bargain prices, or to force existing shareholders to buy it by threatening them with dilution.

Faced with such negative incentives, investors bought shares, but continued to fear rights offerings and new issuance of convertible bonds.

In the Nineties, the real aftertax cost of debt is lower than before, and Spanish companies have started to use more of it. Yet investors continue to live in fear of rights offerings and convertible bond issues.

4. Increase use of debt up to prudent levels permitted by stability of cash flow. Some listed Spanish companies still have very low debt levels. This protects the company against bankruptcy, and makes the stock an extremely safe investment. Unfortunately, it also lowers the return on equity and raises the weighted cost of capital.

Higher levels of debt are now prudent because interest rates have fallen. Selling new shares to raise money, at the current level of stock prices, is more costly to the firm.

Using more debt has another benefit: it focuses management's attention on asset utilization, cash flow, and other matters of high priority to shareholders.

5. Sell idle or underutilized assets for cash and reallocate the money. If no internal use for it can be found which will pay a higher rate of return than the cost of equity, pay it out to

shareholders.

6. Transfer all real estate holdings to a separate profit center. Then use market rents as internal transfer prices. When these realistic transfer prices are in place, it will be easy to see which corporate activities really need all the space they are using, in the zones where they are using it. All users in the company who cannot justify paying the market price for the space they are using will ask to be relocated to less expensive space. The space which will be freed up can then be rented or sold.

7. If a company has two or more lines of business which are likely to be priced differently in the stock market, managers should consider seeking two or more separate listings for the different activities. For example, suppose there is a company which produces fertilizers and pharmaceuticals. The fertilizer business is worth 8 times earnings, and the pharmaceutical business is worth 18 times earnings. If the two businesses are traded under one consolidated stock market listing, investors will probably pay less for the combined entity than they would for the two businesses if they were traded separately. There are logical reasons for them to pay less even if they understand the situation perfectly. But the most likely outcome is that they will pay less because they will have a blurred and confused image of the company.

8. Sell divisions or lines of business which are not contributing to the core strategy of the company, or which drag down the average performance of the company. Investors will pay twice as much or more for a company which is growing rapidly. In the extreme, it often occurs that one division of a large company would have a higher value in the stock market than the entire company of which it is a part. Stock market investors have such a bias in favor of growth and glamour they they often, in effect, place a negative value on the unglamorous parts of a conglomerate.

9. Make part of managers' annual bonus dependent on the stock price. In Spain companies frequently pay annual bonuses to managers. These vary according to the performance of the company, as measured in terms of sales, profits, margins, market share, etc. The price performance of the company's stock is usually not one of the indicators used in calculating the bonus. If it were, managers would take a more direct personal interest in the price of the stock.

10. Introduce stock option plans for employees. Employees should be given options to purchase stock. They should be given an additional stock option every year. Each option should be valid for five years, and the exercise price should be the market price of the stock on the date the option is granted. Thus an employee should be given an option on January 1, 1993 to purchase 1000 shares of the company's stock at the market price which prevailed on Dec. 31, 1992. The employee could exercise this

option at any time up to Dec. 31, 1997. Then, on Jan. 1, 1994, the employee should be given another option to purchase another 1000 shares of stock at the price prevailing on Dec. 31, 1993. Each year the employee should be given another option covering an additional 1000 shares of stock. After several years, the employee would have bought stock in the company, and would hold options to acquire more stock.

Employees with that much vested interest in the stock price would take a much more intense personal interest in the company's success. And if the stock price were falling while the company was continuing to perform well, they might step in and buy shares.

After several more years, all top managers would have thousands of shares of the company's stock. Indeed a large fraction of their personal net worth would be in the form of stock in the company they manage. Their goals would automatically be more congruent with the goals of public stockholders.