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Unequal Proposition

By FRANK K. MARTIN

ON GEORGE ORWELL'S *ANIMAL FARM*, all animals were equal, only some were more equal than others. On some American corporate farms, the founding family is given special power in the form of more votes than other shareholders. But at media company Emmis Communications (ticker: EMMS), management seems to have scored privileges that are in a class of their own -- and which may have negative implications for firm valuation.

For comparison's sake, look first at Dow Jones, publisher of *Barron's* and The Wall Street Journal. DJ is one of several newspaper companies that entrusted its founding family with a class of shares having 10 votes each, while ordinary investors have one vote per share. Family shareholders were presumed to hold the company's longer-term interests and its newspapers' editorial independence in special regard, having received it as a legacy from their ancestor, Clarence Barron. More broadly, creation of two classes of stock has been intended as a mechanism to protect shareholders from manager misconduct by giving a certain shareholder class, most commonly founding-family members who aren't active company officers, greater power over management.

Now let's look at Emmis, an Indianapolis-based broadcasting empire with prime assets in New York, Chicago and Los Angeles, to see what happens when management itself obtains a privileged class of shares when it's not entirely clear that its purpose is to perpetuate and protect editorial independence.

Emmis generated $387 million in revenue for the year ended Feb. 28, 2006, down from $618 million in revenue in the prior year owing to the sale of most of the company's television stations.

And now Jeff Smulyan, 58, the company's CEO, wishes to buy in the shares he does not own.

In an April 18 conference call regarding fourth-quarter earnings, Smulyan exuded: "I'm remarkably upbeat in spite of the market, which clearly doesn't look very good." Regarding private-market values for radio stations, Smulyan said, "The reality is, what we are seeing is mid-teens valuation for really good asset holdings everybody agrees we had the best assets in the business." Wall Street apparently wasn't convinced, as Smulyan also mentioned the need to "invest" in several of their properties in order to remain competitive. The shares swooned from $15 to $12 the day of the conference call. Three weeks later, Smulyan filed an offer with the Securities and Exchange Commission to take Emmis private at 15.25 a share.

Martin Capital Management, of which I am managing partner, is a registered investment adviser that has filed a 13D indicating beneficial ownership of 7.2% of Emmis' total outstanding shares. Martin Capital is a long-term investor and its average cost for Emmis shares is in close proximity to the proposed offering price.

Many analysts make the assumption that managerial equity ownership helps align the interests of the manager and public shareholders. The outsiders know they have little power, but they are comforted in the belief that fair-minded managers, honorably feathering their own nests, will feather the nests of public shareholders, as well. There are many roads to Rome: Stock options, a flawed shortcut to aligning the interests of managers and outside shareholders, are pervasive in Corporate America.

The dual-class voting structure doesn't even attempt to justify its existence as an "alignment of interests." It's all about the concentration of control for various and sundry purposes, some praiseworthy, some not. At Emmis, the CEO owns 13.7% of the company shares, but controls 60.4% of their votes by virtue of his exclusive ownership of the superior Class B shares, having 10 votes each.

Although he cannot use his supervoting shares in a going-private transaction such as the one he has proposed, he has told the other shareholders he will use his power to block any other transaction.

The board of directors is responsible for this imbalance. The Emmis compensation committee has continued to lavishly and exclusively grant Smulyan stock options for Class B shares. Were it not for the fact that the 1.5 million vested options he holds are deep underwater, he would have 66.7% of the votes.

The board has also entrenched itself. In February 2000 the Articles of Incorporation were amended to provide that directors cannot be removed without an 80% vote of shareholders. Further, the directors can't fire the CEO.

SCHOLARLY STUDIES of dual-class firms suggest that the separation of voting and cash-flow ownership may significantly reduce a company's valuation.

"Increases in inside ownership of votes decreases firm value" according to a Harvard Business School study using data from 1994 to 2001. "This is consistent with an entrenchment effect of voting ownership: The more control that the insiders have, the more they can pursue strategies that are at the expense of outside shareholders. Our results appear to be able to separately identify an incentive effect associated with insider ownership of cash flow rights and an entrenchment effect associated with insider ownership of voting rights."

To be sure, managers cannot perform their work and gain the benefit of any incentives without some form of control over the organization. But all share-owning managers are subject to moral temptations. The CEO's actions cannot be directly observed by the shareholders, so there's increased risk of questionable or unethical behavior by a CEO who may profit more fully than outsiders or avoid the full consequences of problems caused by his actions.

The proposal by the Emmis CEO to take the company private at 15.25 may be just such a case of the CEO benefiting from mismanagement. Since Emmis came public in 1994, Smulyan has had absolute power to direct the destiny of the company. Over the past 10 years, while an index of broadcasting stocks and the Standard & Poor's 500 index have both doubled, the share price of Emmis fell by 50%, until the stock upticked on the Smulyan proposed offer.

At times during that decade, though, the stock enjoyed some favor on Wall Street, and the company took advantage of it. Since 1998 the company has sold 27.2 million shares in four offerings at a weighted average price of $26.23 for total proceeds of $713 million. This, we note, comfortably exceeds the value of the CEO's proposed offer.

If Smulyan is as adroit in picking an opportunistic price at which to buy those shares back as he was in selling them to the public in the first place, he might consider starting a hedge fund on the strength of that long-term record.

Assuming a formal offer is forthcoming, investors will find themselves the hapless victims of a classic Catch-22-type paradox. If they vote against the offer because they believe that the highest and best price for all shareholders -- based on relative economic interest -- is well above 15.25, and they prevail, they will remain hostage to a potentially capricious CEO whose loyalty to the outside shareholders must be considered questionable and whose dual-class voting power assures that he will maintain in absolute control. Or they can reluctantly vote for a proposal they consider unfair, perhaps rationalizing the decision with the argument that "at least I'll know the extent of my loss."

THERE IS ANOTHER alternative. Because of the pall cast over the ordinary shares of Emmis by the offer under consideration and Smulyan's supervoting shares, the sum of this broadcast company's separate parts, untarnished by the corporate character if they were sold as individual stations or groups of stations, would surely be greater than the corporate whole. Intentionally or otherwise, the CEO, by making an offer for the company himself, has effectively put Emmis in play. He has made it clear, however, that he and his voting power will not entertain any higher offers.

In an SEC filing, Smulyan defended the "fairness" of his offer as a 13.6% premium to the stock price at the close of the previous day. But three weeks earlier, he had implicitly valued the company at a "mid-teens" multiple of cash flow. Furthermore, his proposal letter to the board, trumpeting a $1.4 billion enterprise value, doesn't take into account the value of discontinued assets either sold or for sale, which should be netted against the debt in any calculation of enterprise value. Since he made his offer, the sale of discontinued operating assets has added $310 million to the company's coffers, and there are two more discontinued television stations.

At a "mid-teens" multiple of 15, with adjusted trailing broadcast cash flow (including a minor contribution from publishing assets) of about $125 million, the enterprise value of Emmis is closer to $1.9 billion and the value of the equity much greater than the current market cap of $582 million.

After reducing the enterprise value by the remaining debt (net of cash and an estimate of the value of discontinued assets held for sale) and preferred stock outstanding, the per-share break-up value for shareholders is closer to 30 than 15, before consideration of taxes and other expenses Emmis might incur in liquidating the properties.

THAT, THE OUTSIDE shareholders might argue, is a difference worth fussing about.

At this juncture, however, the outside shareholders' recourse of last resort is the hope that the Emmis directors somehow will assume their fiduciary duty to all shareholders -- fairly and equitably.

The directors -- who notably include the lead outside director, Susan Bayh, wife of Indiana Sen. Evan Bayh -- owe duties of care and loyalty to the corporation and its shareholders. These duties require the directors to act in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances, and in a manner they reasonably believe to be in the best interest of the corporation and its shareholders.

The board has given one not-very-encouraging sign that its members recognize the importance of its assignment. While a time frame for a decision has not yet been set, the board did vote on June 28 to pay an extra $50,000 to each of the three directors serving on a special committee to evaluate Smulyan's offer, one of whom is presumably "lead director" Susan Bayh. While several of Emmis' "expert" outside board members could render an informed opinion of the fairness of the offer on the back of an envelope, we remain perplexed about the necessity to spend shareholder money to hire two high-profile investment banks to render a "fairness opinion" and to induce the members of the special committee to be especially conscientious with a $50,000 stipend. Ruse is a word that might come to mind to some observers.

Is there any reason to think the directors will defend the outside shareholders from their CEO? It may depend on how much public heat is applied to them.

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