

Restoring Confidence in Capital Markets

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Good evening Ladies and Gentlemen.

If I had been talking to you five years ago about capital markets, conventional wisdom would have had it that we were in very good shape.

The technology revolution was in full swing; huge amounts of capital were being poured into new businesses that were going to revolutionise whole industry sectors; and we were seeing the dawning of a glorious new market-driven era.

Today the shoe is on the other foot. We see company after company restructuring; many groaning under a huge weight of debt; and we have also seen a few spectacular implosions.

The function of capital markets is to allocate capital efficiently. History, from the tulip mania of the 17th century; through the South Sea bubble in the 18th century; to railway bonds in the 19th and what we can now see as the Internet Bubble of the 20th, shows us that there are periods when that doesn't happen.

Asset values rise rapidly on the back of ludicrous expectations of profit growth, only to burst, often amid a welter of fraud and manipulation. And the result is a suspicion of the market.

This time too the conventional wisdom seems to be that markets are often flawed, sometimes exploited by the unscrupulous and, occasionally, systematically rigged.

The result: a furious debate about accounting transparency, about corporate governance, and about conflicts of interest.

In the accounting world, the debate focuses on how companies represent their earnings to their shareholders. This is hardly surprising, given the use of off-balance-sheet entities to conceal risks and losses; the huge misstatements of earnings; and the propensity to use proforma statements to put the best 'spin' on performance.

A whole range of corporate governance issues have been under intense scrutiny around the world: consider Sarbanes Oxley in the US or the Higgs report in Britain. In emerging markets too, corporate governance is increasingly recognised as vital in securing investment flows, in Asia post-97, in China and in Russia, for example.

And we have all read about the problems of conflict of interest when banks provide advice on both sides of the shareholder-corporate relationship. So in New York and elsewhere, there is intricate debate on how to protect independence of research in the interests, especially, of retail investors.

These issues are important. There were clearly many excesses during the boom.

And a level playing field is a vital precondition of confidence in an effective market.

But I want to focus on one fundamental issue about recent events which has, perhaps, received less attention than it should in the debate. Because, necessary as accounting transparency, effective corporate governance and separation of interests undoubtedly are, they are not enough.

We need also to go to the heart of how companies set and implement their strategy. Let me explain.

At heart the issue is about companies having realistic strategies for growth.

Over the last decade, we saw industry sector after sector go for rapid growth. Not just the internet, not just the TMT sector, but right across the board. Maximising shareholder value was name of the game. That meant maximising growth, quarter on quarter, under relentless pressure from equity analysts.

Now, to make an obvious point, the price-to-earnings ratio acts as a proxy of investors'

furious debate

views of future earnings. If you buy at high and rising P/Es, it is because you expect a higher growth rate of earnings, unless you think the cost of capital is falling dramatically.

For most of the 20th century the average P/E of the US market was 14 or 15-to-one. But in the late 90s it rose sharply and by 1999, the ratio of US stock prices to corporate earnings was over 30-to-one. By 2000, the ratio on the NASDAQ was almost 100. For some stocks, of course, it was infinite.

So the P/Es at the end of the 90s implied very high expectations of growth in earnings to come.

To return the P/E to a more normal historical level implied growth in US corporate earnings of 14 or 15 per cent every year for a decade, compared to an S&P average of 6 per cent per year over the last fifty years. This would be way above the growth rate of GDP and is obviously unsustainable.

These high expectations of growth both encouraged and were encouraged by companies expanding through acquisition and/or moving into new business areas. The increasing popularity of the concept of shareholder value maximisation created intense pressure for management to deliver high returns. And whilst developed economies moved from higher to lower inflation, investor expectations remained fixated on double digit growth — anything less risked being punished as mediocre.

This created pressure that resulted in a huge M&A boom as companies looked for the transforming acquisition — despite the growing body of academic research that shows that at least half of all mergers actually destroy shareholder value, often catastrophically. I would estimate that only one in five works really well.

Acquisitions are very exciting, of course. A chief executive gets his picture on the cover of business magazines. And for all those who work on an acquisition, it's exciting — full of adrenaline, tactics, strategy, secret meetings, tight deadlines, media... it can be the time of your working life.

So acquisition can be a lot more fun than a relentless focus on customer service, costs and improving your business day-in, day-out; year-in, year-out.

But evidence has been accumulating which tells us how difficult it is to create real value.

Abraham Lincoln once said you can fool all of the people some of the time, some of the people all of the time, but you can't fool all of the people all of the time.

Well, here is a stock market corollary to Lincoln's saying. All sectors can grow faster than GDP some of the time, some sectors can grow faster all of the time, but all sectors can't grow faster all of the time.

In the 1990s people overlooked this. Company after company succumbed to the investment banker's stardust, started buying companies, often in different businesses or countries, and often overpaying in the process and taking on huge debt.

The cynic might say that it was amazing what you could get away with if you talked resolutely about EBITDA, and piled on the debt. As Warren Buffet said, 'don't count this, don't count that, just count what makes earnings fat'.

Between 1995 and 1999, US non-financial corporations' outstanding debt increased by almost 50 per cent. In 2001, leverage reached historic highs — in telecoms in particular, but in other sectors too.

The huge pressure for better returns also led management to look to new markets. For most companies in most sectors in developed markets, the chances are that growth prospects are reasonably limited. The market is mature, and it may also be highly regulated. Any growth comes the hard way, by doing better for your customers at a lower cost than your competition.

It was tempting, therefore, to look at pastures new. And that, again, is exactly what happened. The liberalisation of trade and investment regimes, advances in technology and the search for more efficient production and provision of services — all the factors that make up globalisation — meant that we saw unprecedented investment by companies in foreign ventures.

historic highs

As a result, global Foreign Direct Investment — FDI — has increased massively over the last two decades. Much of it is driven by investment by international corporations. Although China in particular has been a beneficiary, most of it has gone to developed countries. The major recipients are North America and Western Europe who have received around 70 per cent of total FDI inflows in recent years. Indeed, most of that investment has been between the EU countries and the US.

More than half of all United States FDI outflows goes to the European Union and the same applies for EU outflows to the US. So what we have is a pattern of European and American companies making large investments in America and Europe respectively.

I said that acquisitions are risky. And foreign acquisitions are even more so. I sometimes think that there is a trap here for many companies. If you are a European company investing in Asia, you are likely to be very aware of the cultural challenges that you face. But if the investment is between Europe and America, you are, perhaps, less likely to be aware of what can also be very real cultural differences, as some household names have discovered.

After the party comes the hangover.

We've seen the pain in the stock market. And FDI flows have reduced dramatically.

The US IPO market is at a thirty-year low. One commentator described the European IPO market for the first quarter of this year as 'effectively closed for business'.

There has been a shift in perception. Some old truths have come back into their own: cash is king, dividends matter.

Companies are now re-focusing on their core businesses; they are, to use the cliché, sticking to their knitting. The TMT companies are the obvious examples, but they are not the only ones. Companies are also paying down the debt they took on, disposing of non-core businesses, writing down goodwill and accepting — implicitly or explicitly — that growth may be lower.

Today we see financial transactions reduced

to their proper and normal status in life, which is to support of the core corporate business rather than to find the next transforming deal.

Capital markets should be seen as servants of a realistic corporate business strategy, not some magical device for transforming the world.

One consequence of this is that a long-term relationship with your financial service provider is ever more important. Building a business is a long-term process, and it is the financing partnership that is important, not any one deal.

The major responsibility here lies with management. Just because the investment bankers create the sweetshop doesn't mean that you have to buy the lollipop.

Management's job is to develop and implement realistic corporate business strategies, and it is vitally important not to over-promise and under-deliver.

None of this is to say that acquisition is never warranted. But there are five key tests whether an acquisition has the prospect of real success.

One. Is there a strategic case for the acquisition? Does it fit in with your core business?

Two. Can you realistically make the whole more than the sum of the parts?

Three. Is the price right? Can you create value for your shareholders? What is your 'walk away' price?

Four. Is the proposed financing prudent?

And probably hardest of all, but as important as all the rest:

Five. Is the chemistry right? The human fit is all important.

I would suggest that most conspicuous failures in acquisition strategy can be traced to a failure to pass one or more of these tests.

The overall message is a simple one, really. Well thought through and well-executed corporate strategy should be the driver. Then the capital markets will work perfectly effectively in support, over sustained periods.

unprecedented investment

Let capital markets into the driving seat, on the other hand, and a company risks disaster.

In 1936, the great economist John Maynard Keynes wrote:

‘Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done.’

Keynes’ words are as true now for our globalised 21st century capital markets as they ever were in Keynes’ own day.

Ladies and Gentlemen, thank you very much.

**well-executed
corporate strategy**