

# Loyalty Shares

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RESEARCH INITIATIVE  
Sovereign Wealth Funds

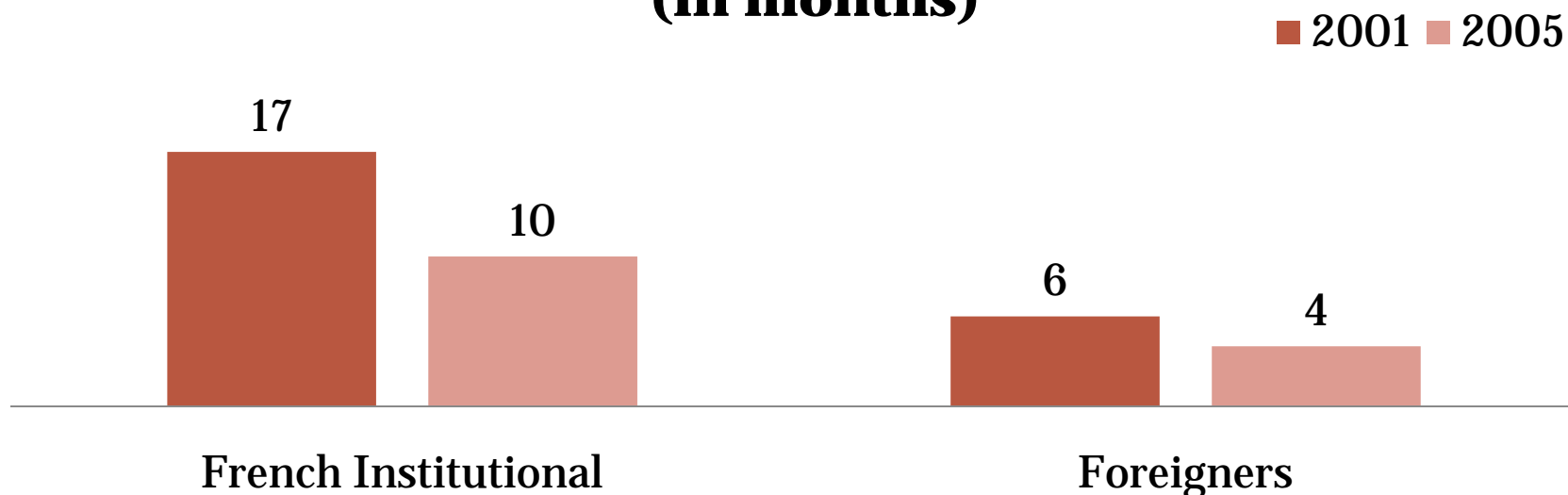
# Misalignment of Interests

- **Different time horizons among the different players:**
  - ✓ Long:
    - For the firms
    - For managers (with long term incentives)
  - ✓ Short: For Investors
- **One of the reasons: no specific reward for long term investors (dividends, voting rights)**
- **There is a need to align the interest of shareholders and managers toward a long term perspective.**

# Stock Turnover

- Average holding periods are quite short: in France
  - ✓ 10 months for domestic institutional shareholders
  - ✓ **4 months** for foreign institutional shareholders

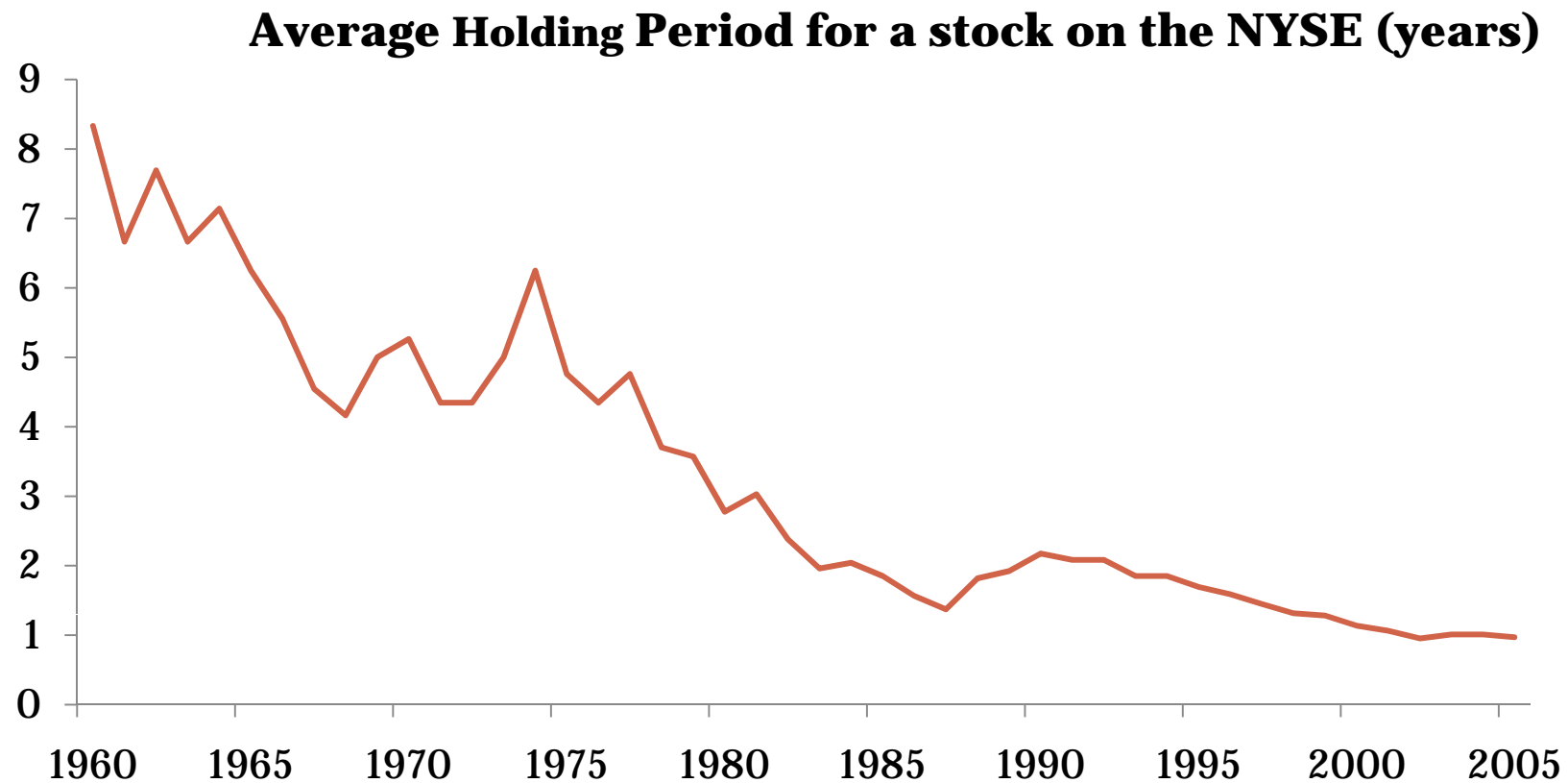
## Average Holding Period of French Stocks (in months)



Source : Banque de France

# An historical process also in the US

- The average holding period has been decreasing for 45 years:



Source: NYSE overview statistics

# Recognized Lack of Long Term Investors (prominent voices)

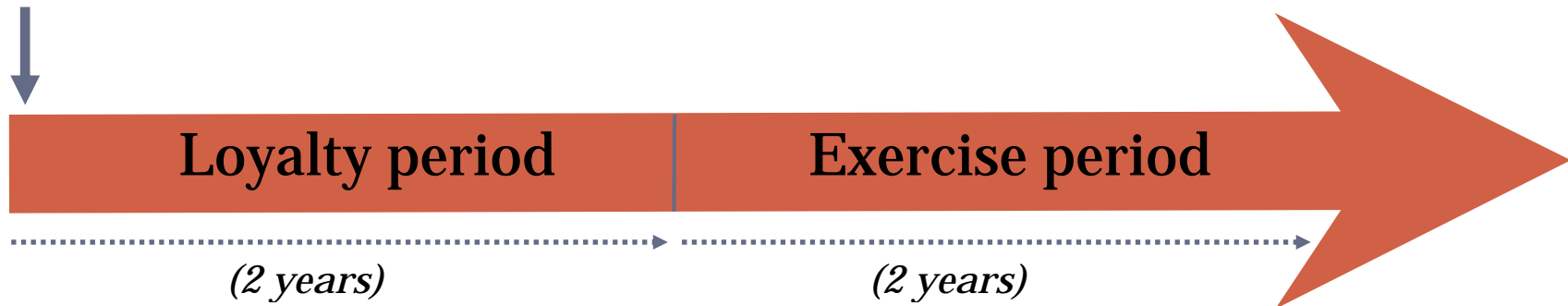
- *John Bogle: “In addition, policy makers ought to be considering structural changes that would enhance the role of investors and diminish the role of speculators.”*
  - ✓ Granting longer-term (two- to five-year holders of stock) extra voting rights and/or a higher dividend
  - ✓ Federal transfer tax 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
- *Warren Buffet: “Much success can be attributed to inactivity. Most investors cannot resist the temptation to constantly buy and sell.”*

# Existing Long Term Incentives

- Government incentives with reduced taxes for long term investment
- Longer term executive compensation (longer vesting periods, escrow accounts & clawback provisions)
- Company programs for shareholders:
  - ✓ Extra voting rights (France), extra shares (LLyod, Air Liquide, etc.), extra dividends (L'Oreal, etc)
  - ✓ Idea reduce frequency of reports? (from quarterly to semi annual: General Electric, Porsche,...)
- **... are not sufficient to properly align Long-Term goals of the company, managers and shareholders.**

# Loyalty Shares: principle and example

All shareholders  
are entitled to a  
*Loyalty Warrant*



The LT shareholders *having kept their shares for two years* → Warrant = 1

The ST shareholders *having sold their shares* → Warrant =  $\emptyset$

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

# Loyalty Shares: principle and example

Integrated in a previous example: **Michelin in 1991**

- Replacement of a *dividend payment* by a *warrant*
- Specifics:
  - ✓ Maturity: 4 years
  - ✓ Strike Price: FRF 200 (versus a share price at FRF115)
  - ✓ Parity:
    - 1 warrant granted per share
    - 10 warrants needed to subscribe one share
- Extra Warrant :
  - ✓ 1 for 1 classic warrant
  - ✓ 2 year Loyalty period
- The CEO of Michelin motivated the L-shares at the time by saying:  
*“Long-term oriented shareholders, who hold on to their shares during the difficult but critical time the company is facing [will thus be rewarded] “*



# Advantages of L-Shares

- Reward investors with a Long-Term orientation
- Reward monitoring of management
- Align shareholder and management objectives
- Refocus valuation on “*fundamental value*” and “*away from market sentiment*”

# Loyalty Shares: possible uses

- **Rewarding a Costly Monitoring**
- **Postponing a Costly Dividend**
- **Securing a Strategic Investor**
- **Facilitating a Share Issue**

# Loyalty Shares: characteristics and possible uses

- Warrants:
  - ✓ At/Out of the money;
  - ✓ Maturity that matches the loyalty/exceeds;
  - ✓ Strike price as a reference/average/lowest point observed;
- L Shares:
  - ✓ One shot;
  - ✓ At maturity roll-over;
  - ✓ Intermediary roll-over.
- Characteristics of L-share → important *signal* of company's *intentions and expectations*

	New L-Shares *	Existing L-Shares with a Warrant	
		One Shot	At Maturity roll-over
<b>Rewarding a Costly Monitoring</b>			✓
<b>Postponing a Costly Dividend</b>		✓	
<b>Securing a Strategic Investor</b>		✓	
<b>Facilitating a Share Issue</b>	✓	✓	

\* In the Case of an IPO

# Loyalty Shares: an example

## ***Terms of L-Shares***

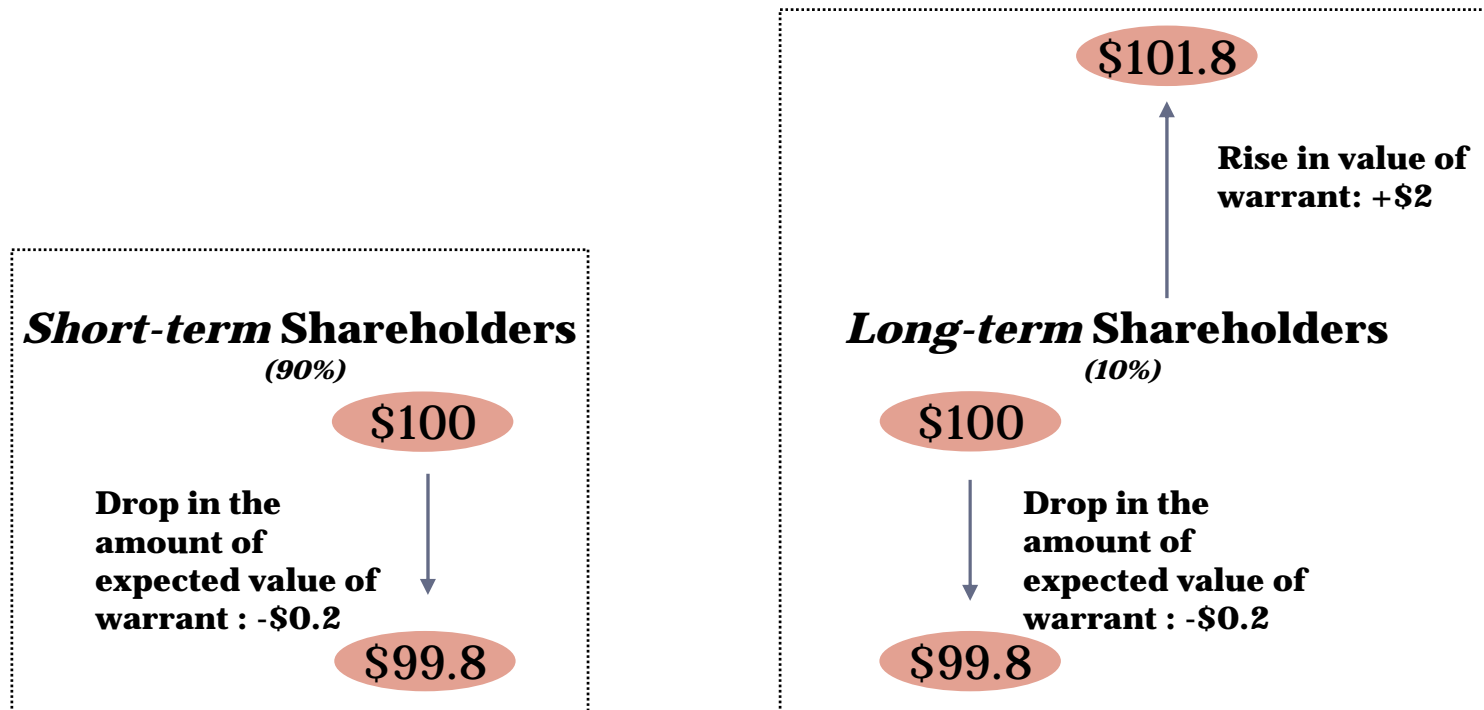
Maturity:	4 Years
Loyalty Period:	2 years
Strike:	At the Money
Parity:	10 for 1
Volatility:	27%
Div Yield:	1.75%
Interest rate:	2%
Price of the share:	\$100
Price (for LT shareholder):	\$2
Price (for ST shareholder):	\$0
Expected value:	\$0.20

## ***Capital Structure***

ST Shareholders:	90%
LT Shareholders:	10%

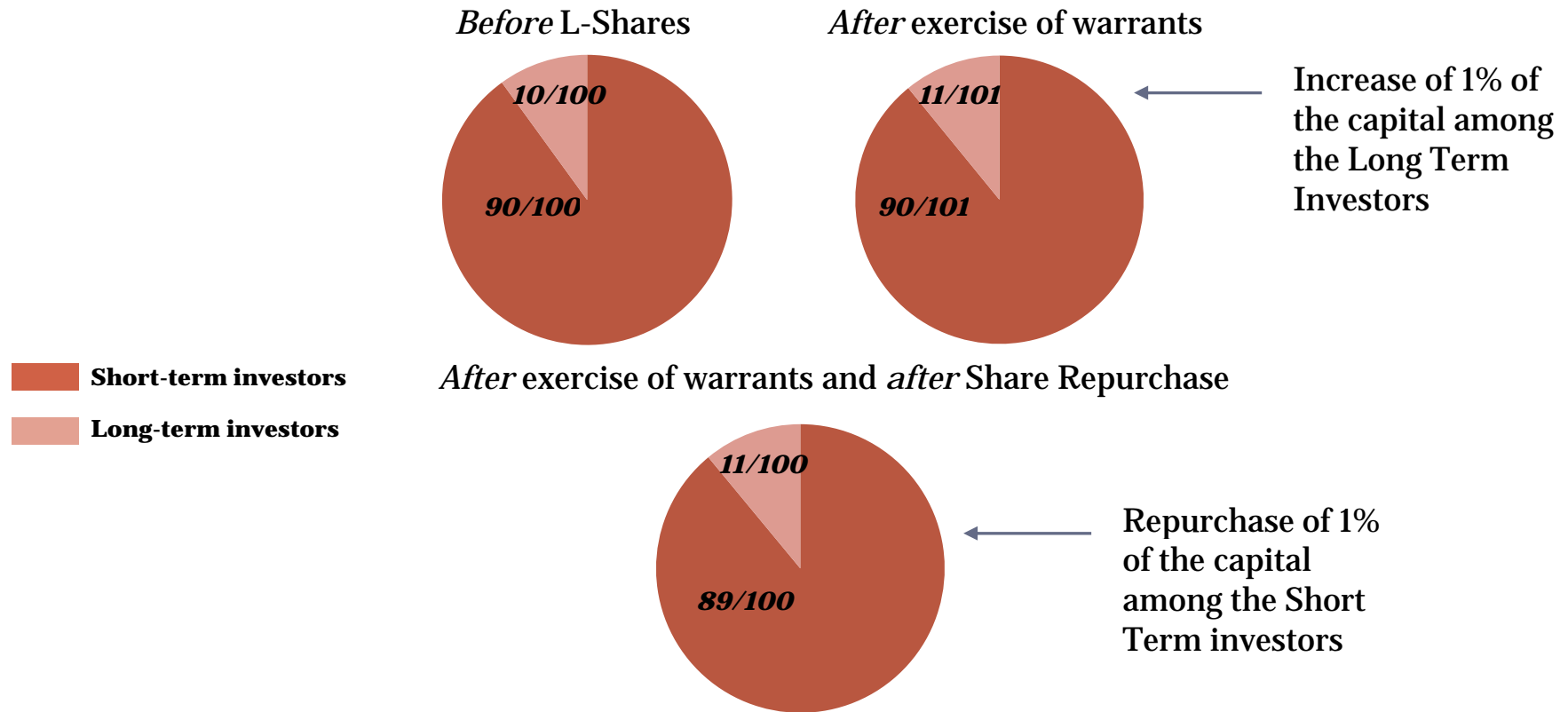
# Loyalty Shares: Effects on the Market

- Limited negative impact on stock price
- Wealth transfer from ST to LT shareholders



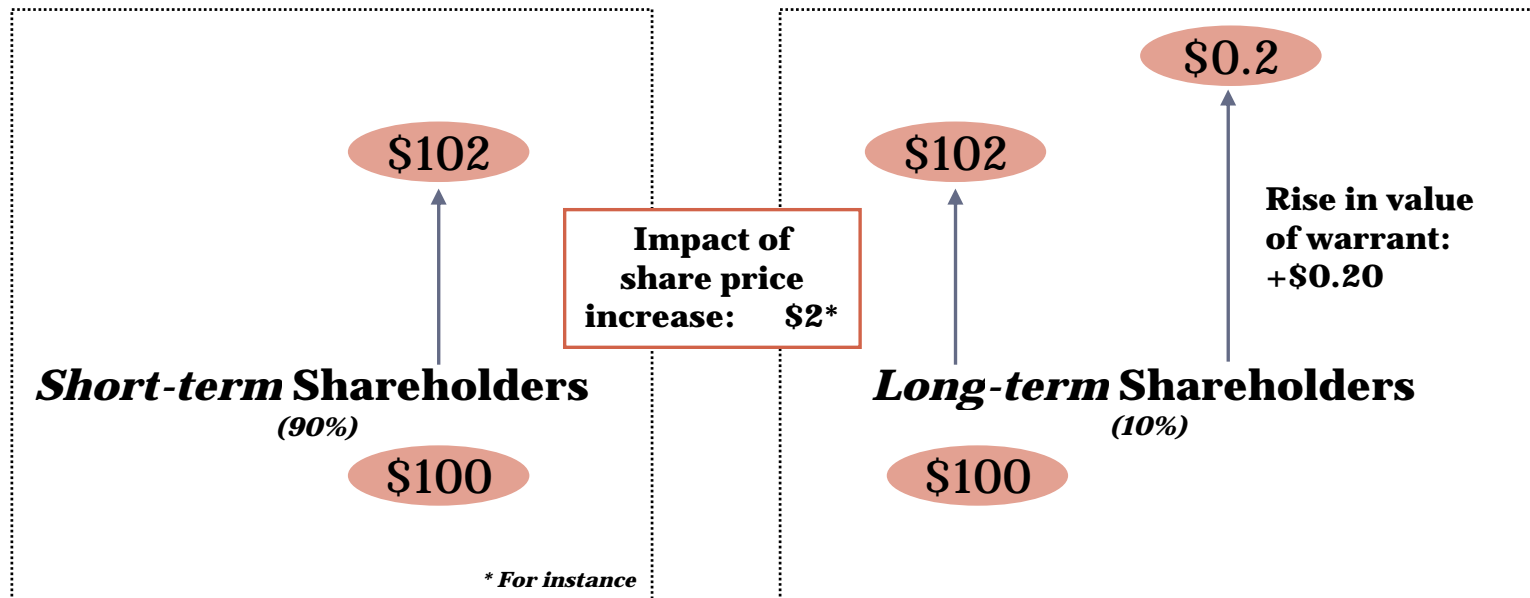
Mechanical transfer of wealth from ST to LT investors

# Loyalty Shares: Possible dilution of ownership & share repurchase programs



Correcting for dilution, the share buy back transfers the entire fraction of capital from the warrant to LT investors

# Loyalty Shares: a share buy back program with an increased impact for LT investors



	ST Investors	LT Investors	Stock-Option Holders
Dividend	+	+	
Share Buy Back	+	++	+

A way of aligning the interests of Long Term Investors with those of Stock-Option holders

# Loyalty Shares: other impacts on the market

- **Volatility:** The warrant should contribute to *reducing volatility* of the underlying after the loyalty period
- **Share borrowing cost:** The warrant should *increase the cost of borrowing shares* (during the Loyalty period):
  - ✓ LT investors are the main lenders of shares;
  - ✓ By lending their shares they would lose their warrants and require compensation for this loss



# Other Considerations

- **Pricing:**
  - ✓ **Classic:** Call Option Model (vesting + maturity, spot, strike, dividend, interest rates, implied volatility) \* Occurrence Probability <sup>(1)</sup>
  - ✓ **More sophisticated:** a down and out call option (\* Occurrence Probability)
  - ✓ **Novel effects of volatility:**
    - Volatility/turn-over of capital lowers value of the warrant;
    - Loyalty rewarded when volatility increases.
- **Tracking of shares:** Direct Registered Account or Administrated Registered Account
- **Mergers & Takeovers:** Allow an early exercise of the warrants

<sup>(1)</sup> Stable Capital/Total Float + Moving Capital/Total Float\* Max [100%-(Moving Capital Annual Roll-Over \* Loyalty Period), 0]

# Conclusion

	Extra Shares	Extra Voting Rights	Loyalty Shares	Tax Treatment	No Quarterly Results
<b>Impact on Liquidity</b>	Limited and only if increase	Limited	Limited and only if increase	Limited and only if increase	Limited
<b>Impact on Volatility</b>	No	No	Potentially reduces it	No	No
<b>Impact on Borrowing Cost</b>	No	No	Potentially increases it	No	No
<b>Sensitivity of the Incentive to the Market Conditions</b>	Yes	No	Yes	Yes	No
<b>Takes into Account the Volatility</b>	No	No	Yes	No	No
<b>Increases the Alignment with the Management</b>	No	No	Yes	No	No

- Loyalty shares bring about:
  - ✓ A more long-term orientation
  - ✓ Align shareholder interests with those of stock-option holders
  - ✓ But only if the share price does not drop significantly
- L-shares are a modest long-term incentive that will not disrupt the market.