For BCE shareholders, conversion to a trust is the logical step

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Over the years, BCE Inc. shareholders have not had much to smile about with regards to the company, its management and the return on their investment. As the new year dawns, can BCE make any changes to its structure to unlock shareholder value?

Yes, if that change involves converting to an income trust.

BCE is Canada's largest communications company and the owner of Bell Canada and Bell Mobility, as well as having interests in Aliant, CGI Group Inc. and Bell Globemedia, which includes Sympatico, CTV and The Globe and Mail.

Over the years, BCE has ventured into a number of unsuccessful acquisitions and partnerships including real estate, pipelines and international telecommunications, some of which filed for bankruptcy protection and were written off, while others were divested (usually at a loss) after shareholder pressure.

A few weeks ago, BCE said it will reduce its stake in Bell Globemedia, which it acquired for $2.3-billion in 2000, to 20 per cent from about 70 per cent. BCE is expected to raise about $1.3-billion in cash, with its remaining 20-per-cent interest in Bell Globemedia estimated to be worth about $300-million.

Once again, BCE bought high and sold low. Particularly over the past five years, BCE has severely underperformed the S&P/TSX composite index and the S&P 500. And all this despite BCE generating — and being forecast to generate — significant free cash flows per share.

As free cash flows are the cash flows that remain in the company after all operating expenses, interest to service debt, taxes and capital investments have been paid, BCE has had and will continue to have surplus or excess funds even after paying dividends. Such excess funds belong to shareholders and could potentially be paid to shareholders. Since the company has not generated a satisfactory return on its equity, it may make a lot of sense for BCE to pay its shareholders all its free cash flows rather than only about half.

However, BCE has another reason to convert, and it has to do with the resolution of principle-agent problems.

As owners, shareholders hire managers to develop and manage a company's corporate strategy and capital investments. Management is supposed to act on the behalf of the shareholders and in the shareholders' interest, but this relationship gives rise to conflicts of interest. While managers are supposed to act on the behalf of shareholders, they in fact often act on their own behalf in an attempt to maximize their own wealth.

One way to do this is empire building, the sometimes self-serving actions taken by management to maximize the size of a company, not market value, since size often determines managers' compensation.

Warren Buffett hit the nail on the head in 1984 when he wrote: “Many corporations that consistently show good returns, both on equity and on overall incremental capital, have, indeed, employed a large portion of their retained earnings on an economically unattractive, even disastrous basis. Their marvellous core business, however, whose earnings grow year after year, camouflage repeated failures in capital allocation elsewhere (usually involving high-priced acquisitions that have inherently mediocre economics). In such cases, shareholders would be far better off if earnings were retained only to expand the high return businesses, with the balance paid in dividends.”

BCE fits this bill.

For companies such as BCE, free cash flows must be paid out to shareholders if it is to maximize its share value. However, the payout of cash reduces the resources under management's control. Moreover, withholding funds from shareholders reduces the likelihood of the company having to go to the markets to raise funds and prevents the firm's monitoring by capital markets.

An income trust, by virtue of the fact that it commits management to distributing all expected free cash flows to investors, will not only increase the payout to investors, but will also reduce the risk of management entrenchment and investor exploitation, thus leading to an even higher valuation.