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Shareholder class actions

Residual Income Method

Abstract

In 2016, the Supreme Court of New South Wales held that shareholders in HIH were able to prove causation by establishing that the price of shares they acquired was inflated by the misleading statements of the company.

In this article, Axiom outline a valuation methodology (the Residual Income Method ("RIM")) that has been used to undertake an assessment of the market's expectation of earnings and thereby assess whether a share price was inflated by the non-disclosure of earnings expectations.

The RIM can be used to provide a market-based assessment of expected earnings

Introduction

Where a company issues correcting disclosure, the loss claimed by the shareholders is typically represented by the fall in the share price that occurred following the correcting disclosure (modified for movements in the market as a whole). The loss claimed in this scenario typically being assessed by reference to an 'Event Study'.

Where the company does not issue correcting disclosure, the task is more complicated. To assess whether shareholders have suffered a loss, it is necessary to assess the market's expectation of earnings.

If the market's expectations of earnings were greater than the earnings that the company should have announced but did not, the share price may be said to have been inflated, meaning that shareholders may have paid too much to acquire their shares.

The focus of this article is to address how one may go about assessing the market's expectation of earnings.

Overview of the RIM

In a previous article, Axiom outlined the building blocks of the RIM and established that the RIM is similar to, and as robust as, a valuation prepared using the discounted cash flow method.

The conventional use to which the RIM is put, is to assess the fundamental value of a business or to calculate the value of the shares in a business.

The RIM is an established and robust valuation methodology

When applied in this manner, the key inputs in the RIM are:

- The expected level of earnings;
- A discount rate;
- A rate of growth in earnings; and
- The reported book value of net assets.

Using these inputs, the valuer calculates the value of the business and/or the shares in the business.

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Re-arranging the RIM equation – solving for earnings

Whilst the conventional use of the RIM is to assess the fundamental value of a business, it is accepted that, just as any algebraic equation can be re-arranged, the RIM valuation equation can be re-arranged such that rather than 'solving' for the share price, the valuer can 'solve' for the market's expectation of earnings.

Where market-based / indirect causation forms the basis of a shareholder claim, it is necessary to determine the market's expectations of earnings; it is only if the market's expectations were greater than the earnings that should have been announced that shareholders can be said to have paid an inflated price for their shares and, therefore, have suffered a loss as a result of the non-disclosure.

It is uncontroversial that the value of a business reflects the present value of the future earnings of that business.

It follows, therefore, that a company's traded share price reflects the market's expectation of the earnings of that company.

As such, where a company trades on a stock exchange, the valuer can re-arrange the RIM equation so that the traded share price is used to 'solve' for the market's expectation of earnings. Thus, the known variable (the traded share price) is used to ascertain the unknown variable (the market's expectation of earnings).

A re-arranged RIM equation enables the valuer to use the traded share price to 'solve' for the market's expectation of earnings

To illustrate, a decline in a company's traded share price results in a decline in the company's market value. Because the traded share price is a reflection of the present value of future earnings, the decline in the share price reflects a decline in the market's expectation of earnings.

By utilising the traded share price as a determinant of the market's expectation of earnings, the market's expectation of earnings are ascertained directly by reference to the value the market places on the company.

Given that market expectations are central to claims founded on market-based / indirect causation, Axiom considers that the re-arranged RIM equation is a compelling means of ascertaining the market's expectations of earnings as, at all times, this method is centered on the value placed on the company by the market.

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Illustrative example

By way of example, a company previously announced current-year expected earnings of $500 million and subsequently became aware that earnings would instead be $300 million. The company does not, however, announce this revised earnings guidance. Prima facie, one might consider that the share price traded at an inflated level.

However, if the market's expectation of the company's current year earnings was not the announced $500 million but rather $250 million (reflecting scepticism held by the market regarding the initial forecast issued by the company), then it cannot be said that the share price traded at an inflated level as the market had already priced-in a lower level of earnings.

In this instance, shareholders cannot be said to have suffered a loss as the market's expectations of earnings were lower than the earnings guidance that the company should have announced.

This example illustrates that being able to assess the market's expectations of earnings is critical in determining whether a loss has been suffered.

If the market's expectation of earnings are lower than the company's guidance, shareholders have suffered no loss

Conclusion

A shareholder claim based on market-based / indirect causation relies upon market expectations.

The share price of a listed company reflects the market's expectations of earnings (both current and future) accounting for the risk associated with achieving those earnings.

By re-arranging the RIM equation, the market's expectation of the company's prospects (as reflected in the traded share price) can be utilised to calculate the market's expectation of earnings.

It is the shortfall, if any, between the market's expectations of earnings and the earnings that the company should have announced that will assist in determining whether the shares in the company were inflated by any non-disclosure, and therefore whether shareholders can be said to have suffered a loss.

As the re-arranged RIM is based on the traded share price and assesses the market's expectations of earnings directly by reference to the value placed on the company by the market, the RIM is a compelling tool by which market expectations of earnings can be assessed.