November 2016

Expensive Recalls

Over the last few years, product recalls have dominated news cycles. Whether it was faulty car parts or contaminated peanut butter, recalls have affected consumers and businesses everywhere. Given that many companies that have undergone a recall are large entities, the full financial impact of recalls may be unclear. Let's take a look at some of the most prominent product recalls of the past decade and their massive financial ramifications.

Samsung – 2016
After 35 reported incidents of their Galaxy Note 7 smartphones catching fire, Samsung decided to recall every single Galaxy Note 7 it had manufactured. Despite the recall, more than 50 additional reports have been filed in the United States regarding the phone's exploding batteries. According to an article by the Wall Street Journal, analysts speculate that the recall might cost Samsung over $4 billion in recall expenses and lost sales. Samsung boasted approximately $22 billion operating profit in 2014, with total current assets of nearly $110 billion.

Pfizer Inc - 2005
Stemming from "illegally marketing" Bextra and three other drugs, Pfizer paid a total $2.3 billion in civil and criminal settlements. Pfizer's violations included employees distributing off-label information about the drug and destroying documentation regarding the medication's side effects. At the recommendation of the FDA, Pfizer recalled Bextra in 2005. Pfizer had a net profit of $8 billion in 2005.

Takata Corporation - 2016
In July 2016, 14 different automakers were forced to begin a recall of approximately 100 million vehicles equipped with faulty Takata frontal airbags that caused 11 deaths and over 150 injuries. The recall was deemed "the largest and most complex safety recall in U.S. history" by the National Highway Traffic Safety Administration. Estimates from March 2016 say the recall could cost Takata as much as $24 billion; in 2014, Takata had a net profit of just $107 million.

Volkswagen - 2015
In 2015, Volkswagen had to recall 11 million cars across the globe after news surfaced that its cars used software that circumvented emissions tests. Once the software returned to normal, some vehicles were found to emit nitrogen oxide 40 times higher than the U.S. limit. In the United States alone, Volkswagen is slated to pay $15 billion to settle claims, and must buy back or fix all affected vehicles by the end of 2018. Internationally, Volkswagen is reported to be paying an additional $5 billion. Volkswagen had a net income of more than $3 billion in both 2013 and 2014.

Toyota - 2009
Toyota was forced to recall 7.5 million vehicles after dozens of reports regarding "sudden unintended acceleration." In some cases, accelerator pedals got stuck underneath floor mats; other reports stated that the pedals would jam and get stuck upon acceleration. Toyota agreed to pay $1.2 billion to avoid legal prosecution in the case and ultimately recalled over 8 million affected vehicles. According to a Forbes article from 2010, estimated total cost of the recall process, including loss of sales, was an additional $2 billion. In fiscal year 2010, Toyota had a net income of $506 million.

Peter Pan Peanut Butter – 2007
ConAgra's Peter Pan peanut butter was linked to cases of salmonella in the United States. This forced a recall of every Peter Pan peanut butter made after 2004. Though no deaths were reported, at least 600 people got salmonella because of the contaminated peanut butter. According to a press release from ConAgra from 2015, the company has spent $275 million in structural upgrades and other precautions to prevent future issues. Additionally, ConAgra was ordered to pay more than $11 million in legal fees and forfeitures to the federal government. In 2007, ConAgra posted a net income of $765 million.

the market at a glance

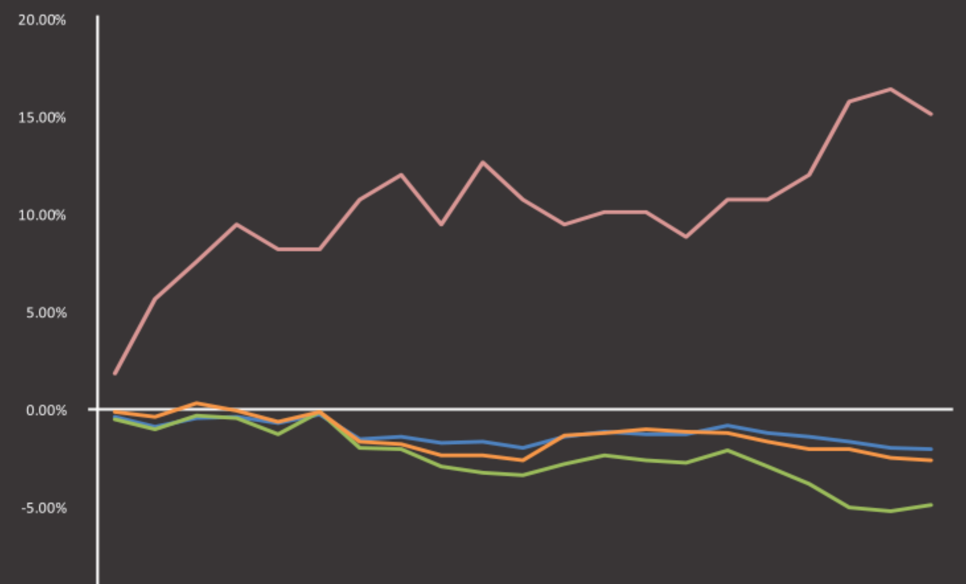
October

U.S. Large Cap
(S&P 500)
2,126.15 (-1.94%) ▼

U.S. Mid/Small
(Russell 2000)
1,191.39 (-4.81%) ▼

International Large
(NYSE International 100)
4,762.01 (-2.54%) ▼

U.S. Treasuries
(U.S. 10-Year Treasury Yield Rate)
1.84 (15.00%) ▲



Past performance is no guarantee of future results. Indices are unmanaged and cannot be invested into directly.

The market in action

- The Department of Labor announces the economy added 156,000 jobs in the month of September. The modest job growth was enough to lure more discouraged workers back into the job market, causing the official unemployment rate to increase slightly to 5.0 percent.
- Multiple major banks in Europe release plans to cut a combined 20,000 jobs over the next few years as ultra-low and negative interest rates in the Eurozone hurt profitability. Dutch and German banking giants ING and Commerzbank plan for the largest downsizing, shedding 5,800 and 9,600 positions, respectively.
- The Social Security Administration announces a 0.3 percent cost of living adjustment (COLA) to social security benefits for 2017—its smallest increase ever. Although an improvement from the 2016 figures, when no COLA was made, the average monthly retirement benefit will only see a $3.92 increase.
- Bass Pro Shops reaches a deal to acquire Cabela's Incorporated for $5.5B. The deal will unite the two outdoor equipment retailers and aims to avoid sales competition as the two companies expand into each other's regional territories.
- Following three years of joint investigation, the IRS and the U.S. Department of Justice arrest a total of 56 individuals and indict 5 call centers in India for running tax scams that stole a total of $300M from over 15,000 U.S. taxpayers.
- Bankrate reports that out-of-network ATM fees have climbed for their tenth consecutive year, reaching an average cost of $4.57 per transaction. The increasing rates are attributed to the steadily declining use of ATMs (and cash) by consumers.
- In a landmark event for self-driving vehicles, a loaded semi-truck equipped with an autonomous driving system drives itself for 120 miles in Colorado. While limited highway driving only, the test proved autonomous technology could be used to enhance the quality and safety of work for America's three million professional truck drivers.
- Newell Brands Inc. streamlines its business operations by selling its tools division to Stanley Black & Decker Inc. for $1.95B. The sale will put the tool accessory brands Irwin and Lenox under Black & Decker's holdings.

The Shareholder's Dilemma

In September of last year, automaker Volkswagen (VW) got into serious trouble when U.S. regulators announced that they had discovered that several of the company's diesel engines were designed to cheat emission tests. The scandal led to millions of dollars in vehicle refunds and a massive $14.7 billion settlement with the U.S. government (smaller fines were also issued in some other countries.)

Not surprisingly, many VW shareholders were not happy about the scandal. The company managers broke the law and incurred some hefty fines; the fines lowered the company's value and caused share prices to fall; decreasing share prices meant that many VW investors lost a lot of money.

And whenever someone loses a lot of other people's money, lawsuits usually follow.

In the year following the disclosure of the scandal, over 1,000 lawsuits had been filed by investors seeking more than $9 billion in damages (i.e. falling share prices). In essence, investors want VW to pay them for losses caused by their illicit operations.

At first glance, this seems like a sensible to way for people to get some value from a company that lost money to illegal activities. But is it really? Shareholders are the company's owners. Every dollar VW is forced to pay in lawsuits is a dollar that shareholders no longer own through the company. Investors are essentially suing the business for their own money.

While it's possible that VW has insurance policies that will cover some of the damages if the lawsuits are successful, suing still appears to be an inefficient strategy. Corporate lawsuits typically generate a lot of legal fees and create bad press for a company. Additionally, a loss of working capital could make it difficult for VW to invest in the technologies it needs to continue being a dominant automaker. By the end of the lawsuits, it is highly likely that more value will be taken from VW than will be collected by investors.

So why bother suing?

Since the damage to a company's market value is distributed among all shares, lawsuits are more efficient when fewer shares are involved. If VW were sued over losses on a single share, the small settlement would be divided among hundreds of millions of shares—likely causing no change to the stock price. However, if lawsuits involve many shares, the payouts would start to lower prices. At that point, all shareholders begin to lose more value, but only the ones filing lawsuits are getting any of it back. This creates an incentive for more shareholders to start suing, so they too can capture some of the money lost to lawsuits.

Are lawsuits the right approach? Ideally, no investors would sue and no value would be lost to lawyers or bad publicity. Unfortunately, as soon as some investors start suing, the remaining need to do the same—even if they don't want to—or risk suffering larger losses. And even if no one else has sued, investors may still feel compelled to prepare their lawsuit because they think others will. This obligation can be particularly strong for fund and pension managers who must protect their clients' money or risk losing their own jobs.

It is typically assumed that shareholders want what is best for their companies and their fellow investors. However, the VW scandal is good reminder that investors are individuals that ultimately act in their own self-interests. Even though a group of investors may reach the same decision, it doesn't mean it is a coordinated strategy. Collectively, suing VW may end up being a terrible decision for its investors; but, individually, it may be their only sensible choice.

LIBERTY
ASSET MANAGEMENT, INC.

6725 Kingery Hwy Willowbrook, IL 60527
Tel: 630.789.9653 | Fax: 630.734.1471
www.libertyassetmgt.com