moneybox

Martha the Oracle

Four years ago, Martha Stewart warned her shareholders what could happen to her. They didn't listen.

By Daniel Gross

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Martha Stewart's indictment yesterday on charges of securities fraud and obstruction of justice didn't much surprise shareholders. The stock of her company, Martha Stewart Omnimedia, barely budged on the news—remaining in the $9-a-share dungeon where it's been imprisoned since the ImClone scandal broke last summer.

Omnimedia's distress is a vivid case study in the perils of a cult of personality stock. Its decline will go down as one of the rare instances in which the voluminous "risk factors" enumerated in a company's prospectus—worries that are usually ignored—precisely telegraphed the fate that would befall shareholders. Even in predicting her firm's crippling, it turns out Martha was a meticulous planner.

The risk-factors section of every prospectus is an exercise in ass-covering. Written largely in boilerplate, it warns investors of all the things that could go wrong and hurt the value of the stock they're about to buy. Habitual prospectus readers encounter roughly the same language in the IPOs of retailers, manufacturers, and Internet companies. "Our revenues and income could decline due to general economic trends and declines in consumer spending;" or "since our stock has not been publicly traded before this offering, the price of our stock may be subject to wide fluctuations." (These are drawn from Martha Stewart Omnimedia's). They warn of generic issues: competition, pricing pressures, etc. In effect, companies issuing stock are asking the public to look beyond all these problems—risk factors generally run on for several pages—and put their money down. The subtext: If any of this comes to pass, don't bother trying to sue. You knew what might happen.

While it's hard to argue against disclosure, these risk factors are generally of dubious value to investors. Professionals coast right past them to get to the juicy numbers on operations. And few investors make decisions to buy, or not buy, into an IPO because of what they see in the risk factors.

What's more, the lethal risk factor that ends up destroying a company is rarely one of those listed in the prospectus. In the early '90s, for example, prospectuses vaguely mentioned threats posed by technology. But not a single prospectus suggested the rise of the Internet would upset tried-and-true business models. Fiber-optic company Global Crossing warned that it might not be able to sell capacity on its network, but it didn't warn that mammoth stock sales by founder and chairman Gary Winnick, combined with serious accounting questions, would destroy investor confidence. And HealthSouth never warned shareholders that a group of executives might conspire to cook the books and falsify profits.

But Martha knew. Here are some passages a passage from the risk factors section of Omnimedia's 1999 prospectus:

> We are highly dependent upon our founder, Chairman and Chief ExecutiveOfficer, Martha Stewart. Martha Stewart's talents, efforts, personality and leadership have been, and continue to be, critical to our success. The diminution or loss of the services of Martha Stewart, and any negative market or industry perception arising from that diminution or loss, would have a material adverse effect on our business. While our other key executives have substantial experience and have made significant contributions to our business, Martha Stewart remains the personification of our brands as well as our senior executive and primary creative force. ...

> Our success depends on our brands and their value. Our business would be adversely affected if: Martha Stewart's public image or reputation were to be tarnished. ...
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> Martha Stewart, as well as her name, her image and the trademarks and other intellectual property rights relating to these, are integral to our marketing efforts and form the core of our brand name. Our continued success and the value of our brand name therefore depends, to a large degree, on the reputation of Martha Stewart.

The company didn't regard this as mere boilerplate, either. In the prospectus, management pointed out that it had purchased a $67 million life-insurance policy and a $55 million disability policy on its founder and guiding light. The company couldn't short its own stock, so it bought financial instruments—in this case, insurance policies—that would pay off if Martha could no longer function as an effective CEO. Or so they thought.

Since she neither became disabled nor died, the shareholders can't collect. And besides, the cost to the company of her damaged reputation is far more than those insurance policies. The stock of Martha Stewart Omnimedia has fallen by half since the ImClone scandal broke last June: Her shareholders have lost about $500 million. But they can't say Martha didn't warn them.

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