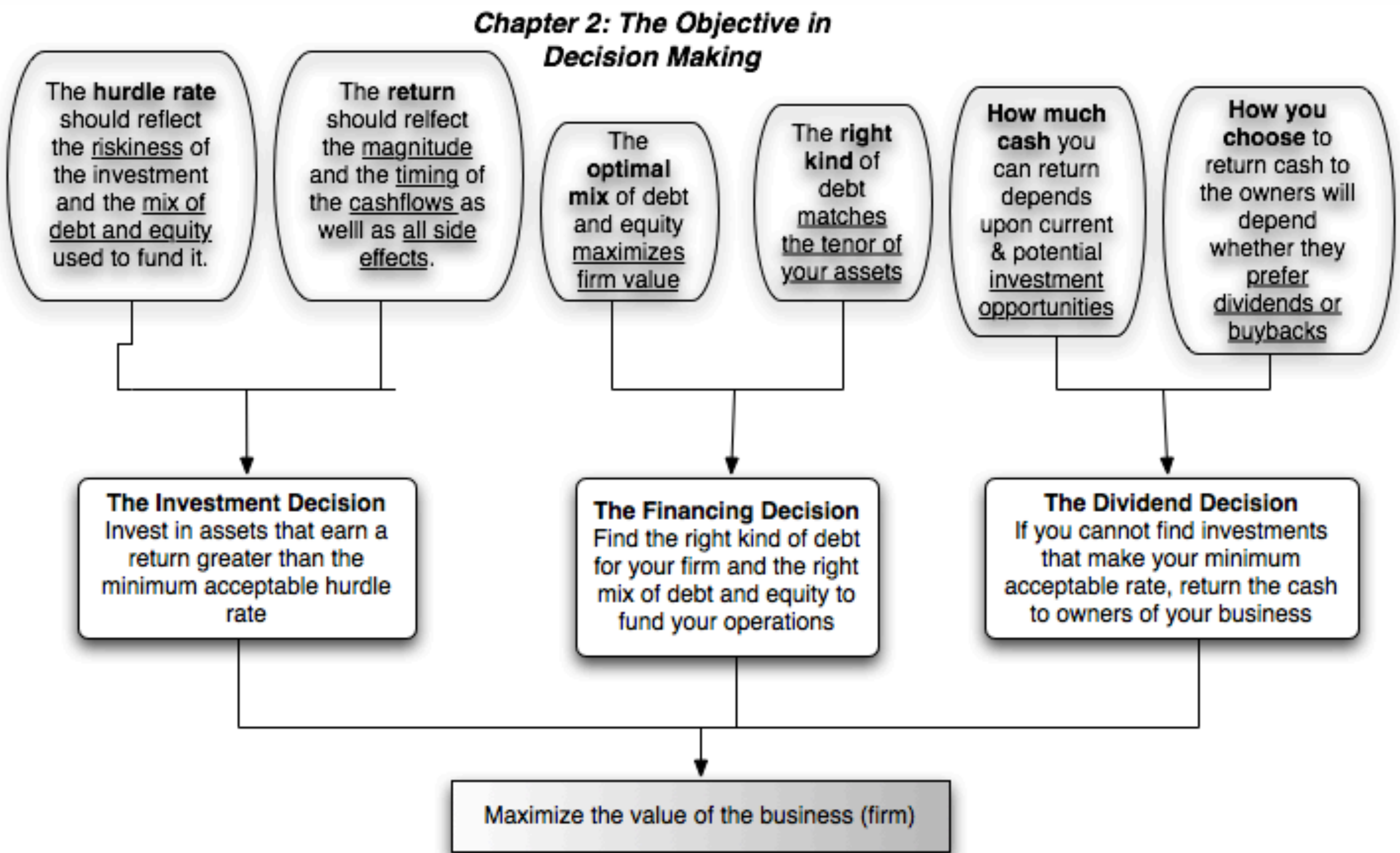
THE OBJECTIVE IN CORPORATE FINANCE

"If you don't know where you are going, it does'nt matter how you get there"

First Principles

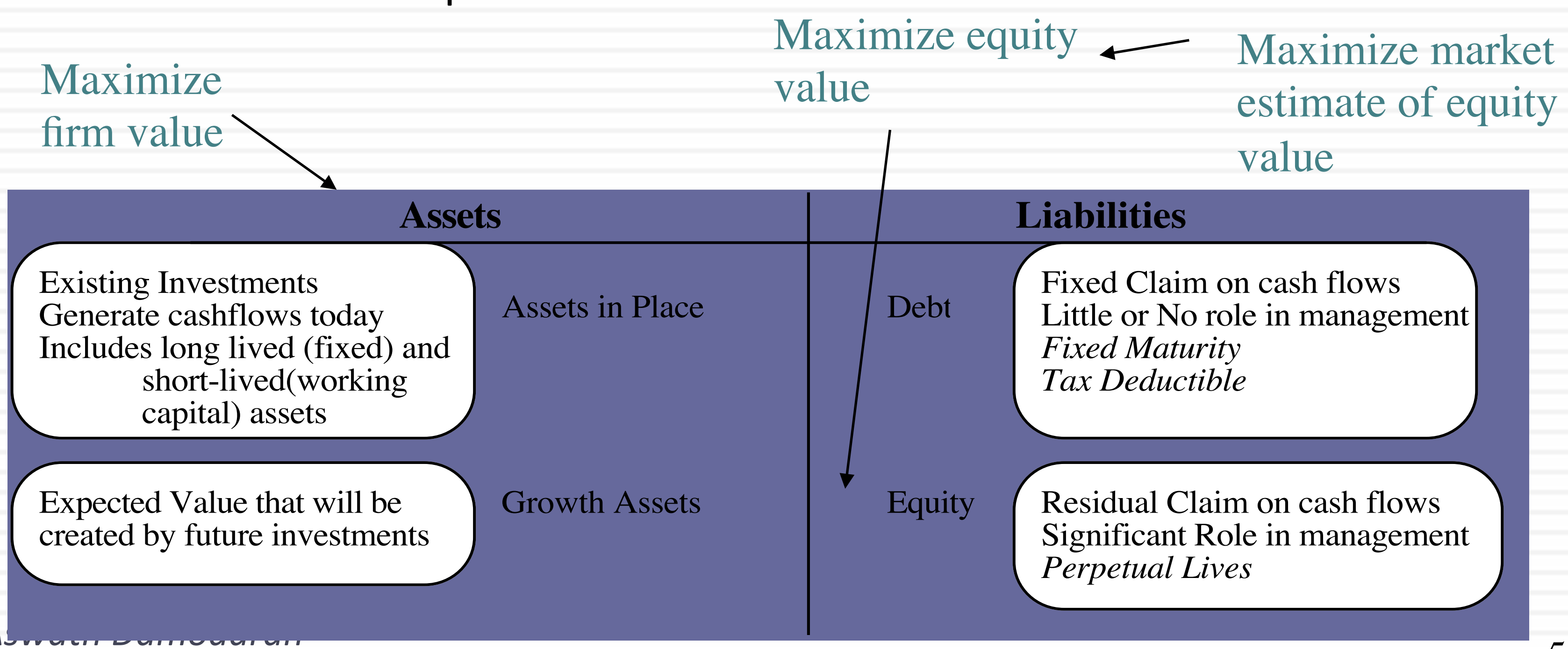


The Classical Viewpoint

- Van Horne: "In this book, we assume that the objective of the firm is to maximize its value to its stockholders"
- Brealey & Myers: "Success is usually judged by value: Shareholders are made better off by any decision which increases the value of their stake in the firm... The secret of success in financial management is to increase value."
- Copeland & Weston: The most important theme is that the objective of the firm is to maximize the wealth of its stockholders."
- Brigham and Gapenski: Throughout this book we operate on the assumption that the management's primary goal is stockholder wealth maximization which translates into maximizing the price of the common stock.

The Objective in Decision Making

- In traditional corporate finance, the objective in decision making is to maximize the value of the firm.
- A narrower objective is to maximize stockholder wealth. When the stock is traded and markets are viewed to be efficient, the objective is to maximize the stock price.



Maximizing Stock Prices is too "narrow" an objective: A preliminary response

- Maximizing stock price is not incompatible with meeting employee needs/objectives. In particular:
  - - Employees are often stockholders in many firms
  - - Firms that maximize stock price generally are profitable firms that can afford to treat employees well.
- Maximizing stock price does not mean that customers are not critical to success. In most businesses, keeping customers happy is the route to stock price maximization.
- Maximizing stock price does not imply that a company has to be a social outlaw.

Why traditional corporate financial theory focuses on maximizing stockholder wealth.

- Stock price is easily observable and constantly updated (unlike other measures of performance, which may not be as easily observable, and certainly not updated as frequently).
- If investors are rational (are they?), stock prices reflect the wisdom of decisions, short term and long term, instantaneously.
- The objective of stock price performance provides some very elegant theory on:
  - Allocating resources across scarce uses (which investments to take and which ones to reject)
  - how to finance these investments
  - how much to pay in dividends

The Classical Objective Function

STOCKHOLDERS

Hire & fire managers
- Board
- Annual Meeting

Maximize stockholder wealth

Lend Money

BONDHOLDERS/ LENDERS ⟷ Managers ⟷ SOCIETY

No Social Costs

Protect bondholder Interests

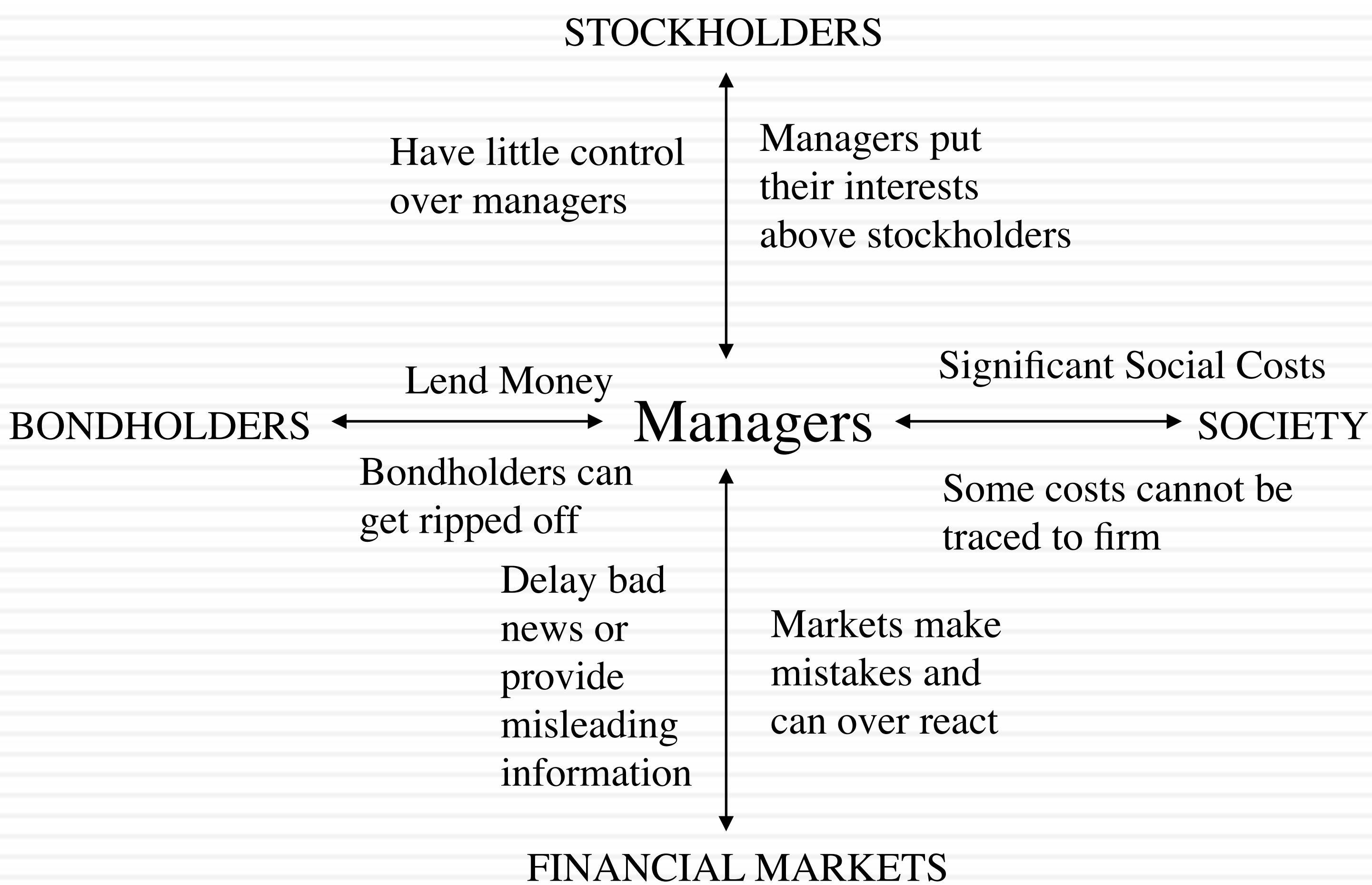
All costs can be traced to firm

Reveal information honestly and on time

Markets are efficient and assess effect on value

FINANCIAL MARKETS

What can go wrong?



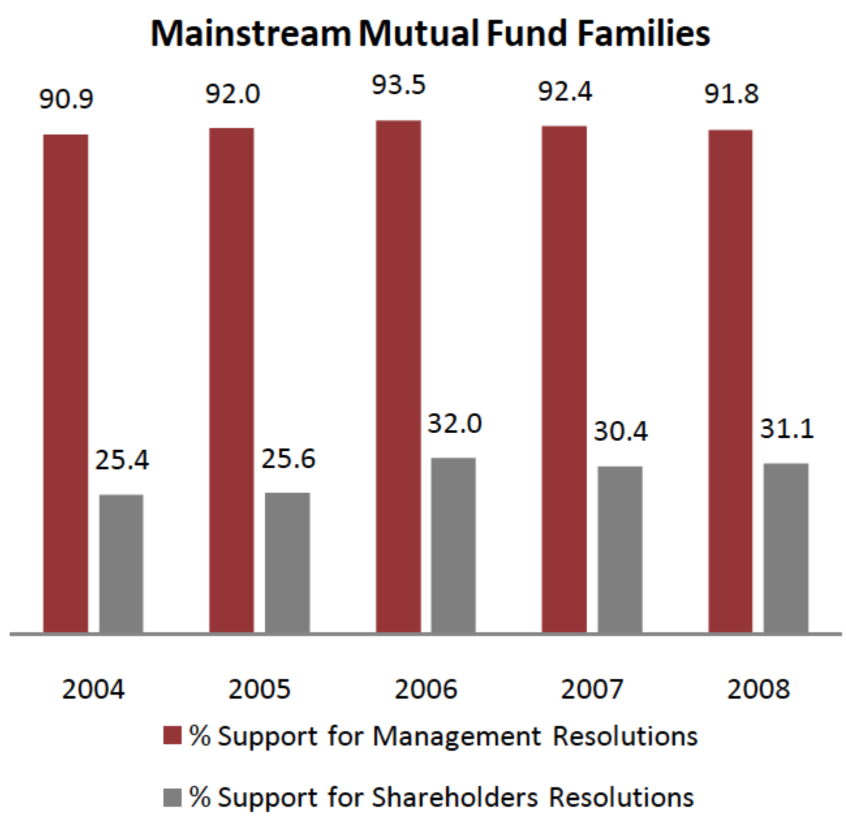
I. Stockholder Interests vs. Management Interests

- In theory: The stockholders have significant control over management. The two mechanisms for disciplining management are the annual meeting and the board of directors. Specifically, we assume that
  - Stockholders who are dissatisfied with managers can not only express their disapproval at the annual meeting, but can use their voting power at the meeting to keep managers in check.
  - The board of directors plays its true role of representing stockholders and acting as a check on management.
- In Practice: Neither mechanism is as effective in disciplining management as theory posits.

The Annual Meeting as a disciplinary venue

- The power of stockholders to act at annual meetings is diluted by three factors
  - Most small stockholders do not go to meetings because the cost of going to the meeting exceeds the value of their holdings.
  - Incumbent management starts off with a clear advantage when it comes to the exercise of proxies. Proxies that are not voted becomes votes for incumbent management.
  - For large stockholders, the path of least resistance, when confronted by managers that they do not like, is to vote with their feet.
- Annual meetings are also tightly scripted and controlled events, making it difficult for outsiders and rebels to bring up issues that are not to the management's liking.

And institutional investors go along with incumbent managers…



Board of Directors as a disciplinary mechanism

- In 2010, the median board member at a Fortune 500 company was paid $212,512, with 54% coming in stock and the remaining 46% in cash. If a board member is a non-executive chair, he or she receives about $150,000 more in compensation.
- A board member works, on average, about 227.5 hours a year (and that is being generous), or 4.4 hours a week, according to the National Associate of Corporate Directors. Of this, about 24 hours a year are for board meetings.
- Many directors serve on three or more boards, and some are full time chief executives of other companies.

The CEO often hand-picks directors..

- A 1992 survey by Korn/Ferry revealed that 74% of companies relied on recommendations from the CEO to come up with new directors; Only 16% used an outside search firm. While that number has changed in recent years, CEOs still determine who sits on their boards. While more companies have outsiders involved in picking directors now, CEOs still exercise significant influence over the process.
- Directors often hold only token stakes in their companies. The Korn/Ferry survey found that 5% of all directors in 1992 owned less than five shares in their firms. Most directors in companies today still receive more compensation as directors than they gain from their stockholdings. While share ownership is up among directors today, they usually get these shares from the firm (rather than buy them).
- Many directors are themselves CEOs of other firms. Worse still, there are cases where CEOs sit on each other's boards.

Directors lack the expertise (and the willingness) to ask the necessary tough questions..

- In most boards, the CEO continues to be the chair. Not surprisingly, the CEO sets the agenda, chairs the meeting and controls the information provided to directors.
- The search for consensus overwhelms any attempts at confrontation.
- Studies of social psychology have noted that loyalty is hardwired into human behavior. While this loyalty is an important tool in building up organizations, it can also lead people to suppress internal ethical standards if they conflict with loyalty to an authority figure. In a board meeting, the CEO generally becomes the authority figure.

Who's on Board? The Disney Experience - 1997

Reveta F. Bowers 1,5
Head of School
Center for Early Education

Roy E . Disney 3
Vice Chairman
The Walt Disney Company

Michael D. Eisner 3
Chairman and Chief Executive Officer
The Walt Disney Company

Stanley P. Gold 4,5
President and Chief Executive Officer
Shamrock Holdings, Inc.

Sanford M. Litvack
Senior Executive Vice President
and Chief of Corporate Operations
The Walt Disney Company

Ignacio E. Lozano, Jr. 1,2,4
Editor-in-Chief, LA OPINION

George J. Mitchell 5
Special Counsel
Verner, Liipfert, Bernard, McPherson
and Hand

Thomas S. Murphy
Former Chairman
Capital Cities/ABC, Inc.

Richard A. Nunis
Chairman
Walt Disney Attractions

Leo J. O'Donovan, S.J.
President
Georgetown University

Michael S. Ovitz 3
President
The Walt Disney Company

Sidney Poitier 2,4
Chief Executive Officer
Verdon-Cedric Productions

Irwin E. Russell 2,4
Attorney at Law

Robert A.M. Stern
Senior Partner Productions

E. Cardon Walker 1
Former Chairman and Chief Executive Officer
The Walt Disney Company

Raymond L. Watson 1,2,3
Vice Chairman
The Irvine Company

Gary L. Wilson 5
Co-Chairman
Northwest Airlines Corporation

1 Member of Audit Review Committee
2 Member of Compensation Committee
3 Member of Executive Committee
4 Member of Executive Performance Plan Committee
5 Member of Nominating Committee

The Calpers Tests for Independent Boards

- Calpers, the California Employees Pension fund, suggested three tests in 1997 of an independent board
  - Are a majority of the directors outside directors?
  - Is the chairman of the board independent of the company (and not the CEO of the company)?
  - Are the compensation and audit committees composed entirely of outsiders?
- Disney was the only S&P 500 company to fail all three tests.

Business Week piles on… The Worst Boards in 1997..

THE WORST BOARDS OF DIRECTORS

BW RANK	OVERALL SCORE	SURVEY SCORE	ANALYSIS SCORE	DETAILS	BOARD PERFORMANCE POLL				GOVERNANCE GUIDELINE ANALYSIS		
					SHAREHOLDER ACCOUNTABILITY	BOARD QUALITY	BOARD INDEPENDENCE	CORPORATE PERFORMANCE	SHAREHOLDER ACCOUNTABILITY	BOARD QUALITY	BOARD INDEPENDENCE
1. DISNEY	10.3	1.8	8.5	Investors decry board for conflicts; many directors own little if any stock	3.3	4.3	2.0	5.8	–0.4	2.8	2.2
2. AT&T	10.9	–16.6	27.5	Investors scorn board for failing to control succession, not ousting CEO	3.0	4.2	3.5	2.8	2.0	5.2	7.4
3. H.J. HEINZ	15.4	–1.1	16.5	Longtime CEO dominates insider-filled board; resists investor calls for change	2.8	3.7	2.0	4.7	4.4	6.0	1.4
4. ARCHER DANIELS MIDLAND	16.8	–12.2	29.0	Board changes fail to satisfy investors, who say directors still lack independence	2.3	2.1	1.3	3.5	5.6	7.6	5.0
5. DOW JONES	21.1	1.6	19.5	Investors disenchanted with performance; weakest attendance record of any board	2.6	4.6	2.8	2.6	6.0	0.0	5.8
6. DILLARD'S	22.0	5.0	17.0	Board loaded with insiders; lacks an outsider with retail expertise or CEO	2.0	3.0	2.0	3.5	6.4	3.2	2.0
7. ROLLINS INTERNATIONAL	22.7	1.7	21.0	Board dominated by family members and insiders; lacks nominating panel	1.0	1.0	0.0	2.0	4.0	7.6	4.4
8. OCCIDENTAL PETROLEUM	24.0	–1.5	25.5	Investors outraged over $95 million payout to CEO by cozy, aging board	1.3	2.0	1.1	2.0	2.8	6.0	5.8
9. OGDEN	27.2	4.2	23.0	Board has three consultants and a lawyer who do business with company	2.0	1.5	2.0	2.5	2.0	8.4	4.0
10. MAXXAM	28.3	4.3	24.5	Tiny board with little business experience dominated by CEO	1.5	2.0	1.0	3.5	3.6	2.0	6.0

Application Test: Who's on board?

- Look at the board of directors for your firm.
  - How many of the directors are inside directors (Employees of the firm, ex-managers)?
  - Is there any information on how independent the directors in the firm are from the managers?
- Are there any external measures of the quality of corporate governance of your firm?
  - Yahoo! Finance now reports on a corporate governance score for firms, where it ranks firms against the rest of the market and against their sectors.

So, what next? When the cat is idle, the mice will play ....

No stockholder approval needed….. Stockholder Approval needed

- When managers do not fear stockholders, they will often put their interests over stockholder interests
  - Greenmail: The (managers of) target of a hostile takeover buy out the potential acquirer's existing stake, at a price much greater than the price paid by the raider, in return for the signing of a 'standstill' agreement.
  - Golden Parachutes: Provisions in employment contracts, that allows for the payment of a lump-sum or cash flows over a period, if managers covered by these contracts lose their jobs in a takeover.
  - Poison Pills: A security, the rights or cashflows on which are triggered by an outside event, generally a hostile takeover, is called a poison pill.
  - ~~Shark~~ Repellents: Anti-takeover amendments are also aimed at dissuading hostile takeovers, but differ on one very important count. They require the assent of stockholders to be instituted.
  - Overpaying on takeovers: Acquisitions often are driven by management interests rather than stockholder interests.

Overpaying on takeovers

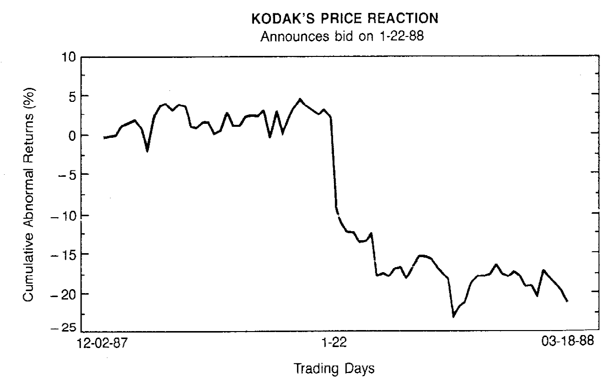
- The quickest and perhaps the most decisive way to impoverish stockholders is to overpay on a takeover.
- The stockholders in acquiring firms do not seem to share the enthusiasm of the managers in these firms. Stock prices of bidding firms decline on the takeover announcements a significant proportion of the time.
- Many mergers do not work, as evidenced by a number of measures.
  - The profitability of merged firms relative to their peer groups, does not increase significantly after mergers.
  - An even more damning indictment is that a large number of mergers are reversed within a few years, which is a clear admission that the acquisitions did not work.

A case study in value destruction: Eastman Kodak & Sterling Drugs

Kodak enters bidding war

- In late 1987, Eastman Kodak entered into a bidding war with Hoffman La Roche for Sterling Drugs, a pharmaceutical company.
- The bidding war started with Sterling Drugs trading at about $40/share.
- At $72/share, Hoffman dropped out of the bidding war, but Kodak kept bidding.
- At $89.50/share, Kodak won and claimed potential synergies explained the premium.

Kodak wins!!!!

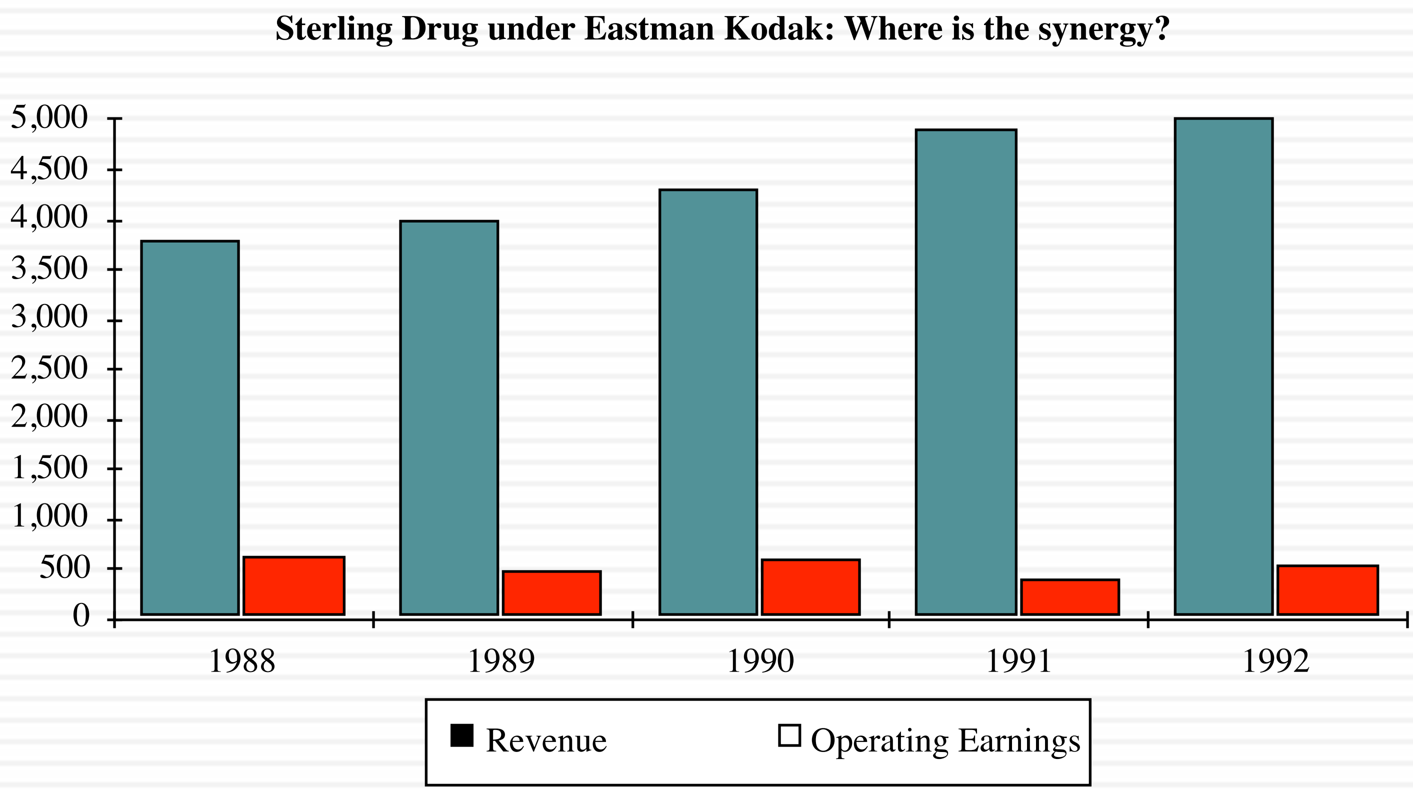


Kodak's market reaction indicates that investors expected no synergies:

Kodak's bid =	$5.1 billion
Sterling's market value 30 days prior to announcement =	3.0 billion
Premium bid	$2.1 billion
Decrease in Kodak's market value =	$2.2 billion

SOURCE: The Alcar Group, Inc.

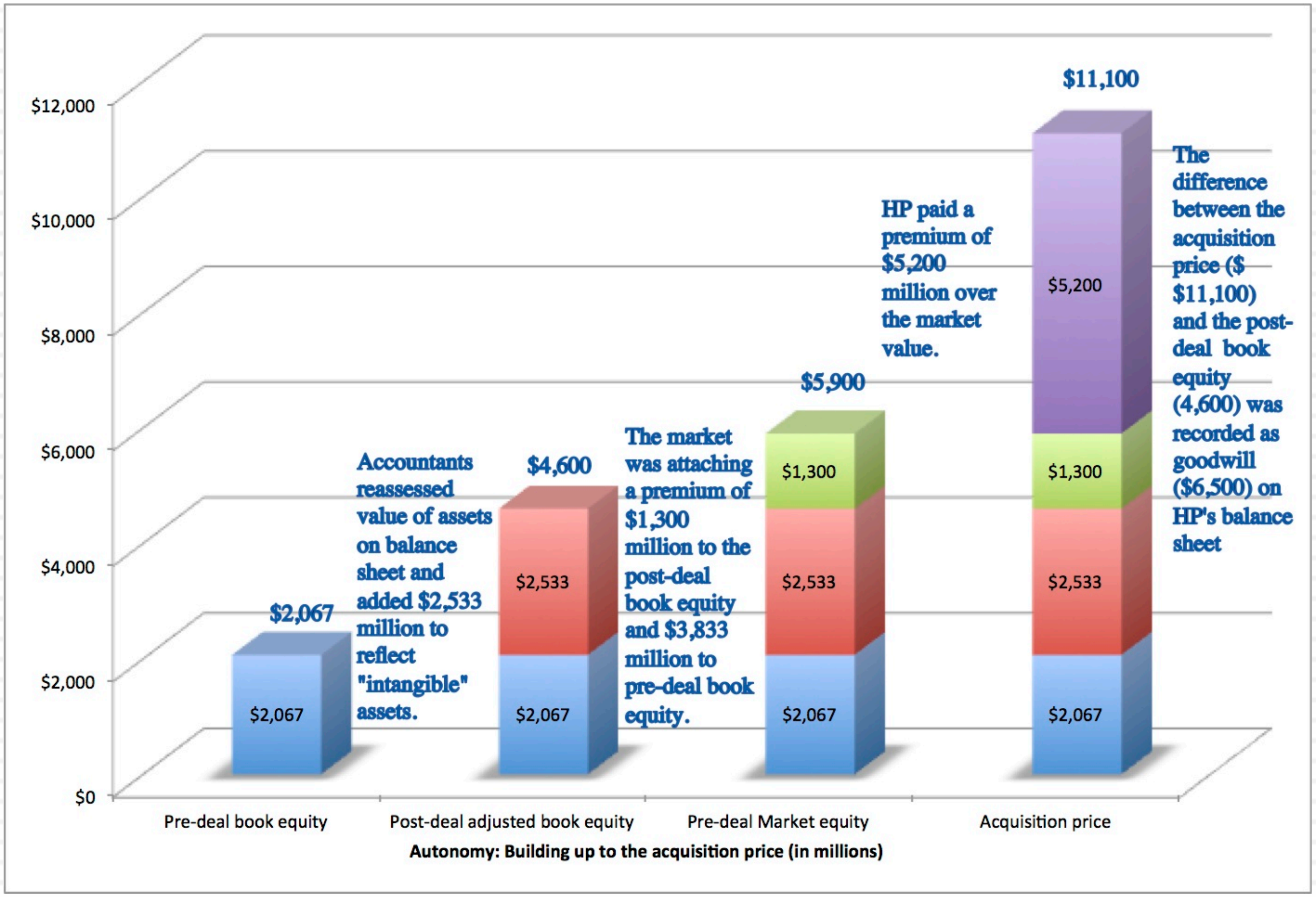
Earnings and Revenues at Sterling Drugs



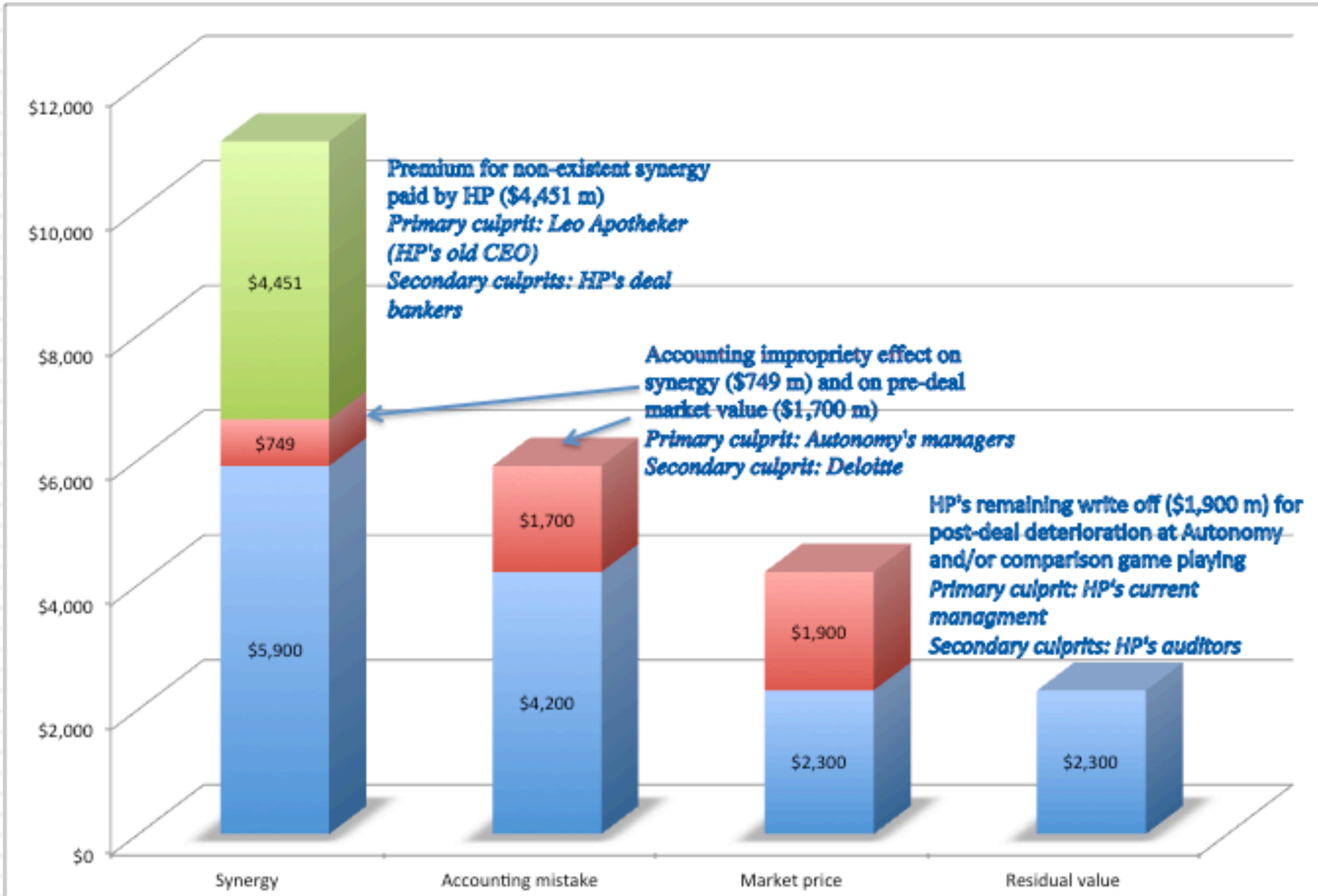
Kodak Says Drug Unit Is Not for Sale … but…

- An article in the NY Times in August of 1993 suggested that Kodak was eager to shed its drug unit.
  - In response, Eastman Kodak officials say they have no plans to sell Kodak's Sterling Winthrop drug unit.
  - Louis Mattis, Chairman of Sterling Winthrop, dismissed the rumors as "massive speculation, which flies in the face of the stated intent of Kodak that it is committed to be in the health business."
- A few months later…Taking a stride out of the drug business, Eastman Kodak said that the Sanofi Group, a French pharmaceutical company, agreed to buy the prescription drug business of Sterling Winthrop for $1.68 billion.
  - Shares of Eastman Kodak rose 75 cents yesterday, closing at $47.50 on the New York Stock Exchange.
  - Samuel D. Isaly an analyst , said the announcement was "very good for Sanofi and very good for Kodak."
  - "When the divestitures are complete, Kodak will be entirely focused on imaging," said George M. C. Fisher, the company's chief executive.
  - The rest of the Sterling Winthrop was sold to Smithkline for $2.9 billion.

The connection to corporate governance: HP buys Autonomy… and explains the premium

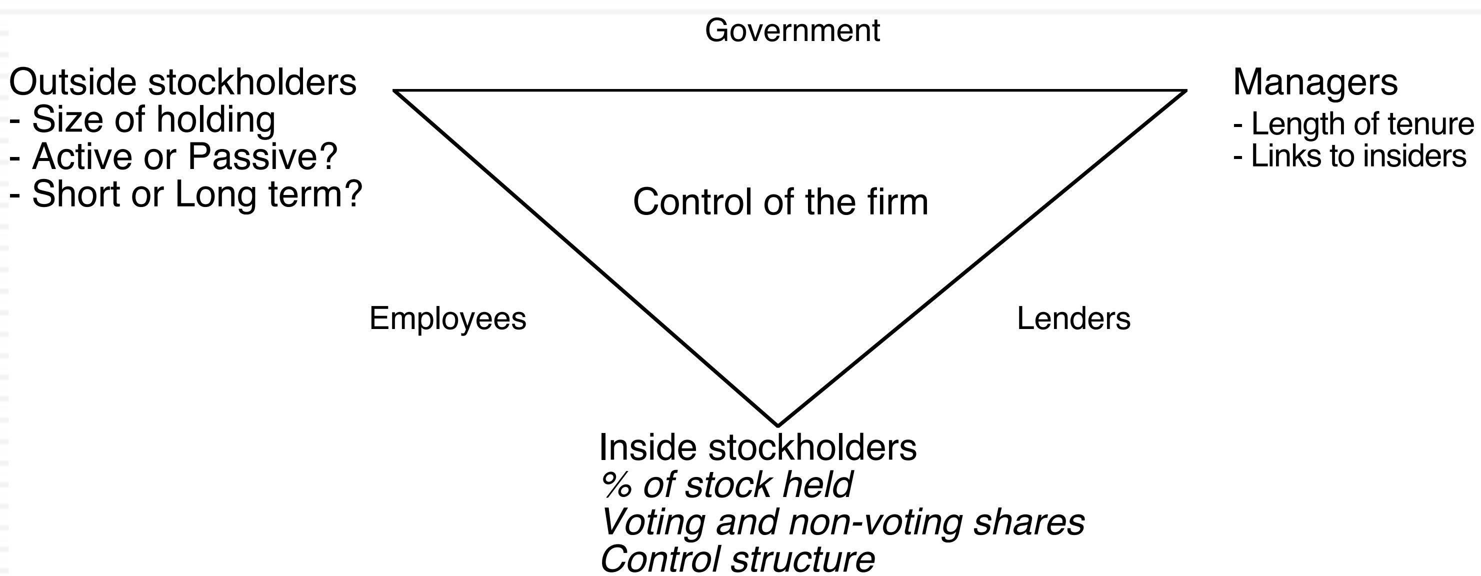


A year later… HP admits a mistake…and explains it…



Application Test: Who owns/runs your firm?

- Look at: Bloomberg printout HDS for your firm
- Who are the top stockholders in your firm?
- What are the potential conflicts of interests that you see emerging from this stockholding structure?



Case 1: Splintering of Stockholders
Disney's top stockholders in 2003

<HELP> for explanation. dgp Equity HDS

Enter #<GO> to select aggregate portfolio and see detailed information

0011B9658224-000 **HOLDINGS SEARCH** CUSIP 25468710

DIS US DISNEY (WALT) CO Page 1 / 100

	Holder name	Portfolio Name	Source	Held	Percent Outstd	Latest Change	Filing Date
	1) BARCLAYS GLOBAL	BARCLAYS BANK PLC	13F	83,630M	4.095	1,750M	09/02
*	2) CITIGROUP INC	CITIGROUP INCORPORAT	13F	62,857M	3.078	4,811M	09/02
*	3) FIDELITY MANAGEM	FIDELITY MANAGEMENT	13F	56,125M	2.748	5,992M	09/02
	4) STATE STREET	STATE STREET CORPORA	13F	54,635M	2.675	2,239M	09/02
*	5) SOUTHEASTRN ASST	SOUTHEASTERN ASSET M	13F	47,333M	2.318	14,604M	09/02
	6) ST FARM MU AUTO	STATE FARM MUTUAL AU	13F	41,938M	2.054	120,599	09/02
	7) VANGUARD GROUP	VANGUARD GROUP INC	13F	34,721M	1.700	-83,839	09/02
	8) MELLON BANK N A	MELLON BANK CORP	13F	32,693M	1.601	957,489	09/02
	9) PUTNAM INVEST	PUTNAM INVESTMENT MA	13F	28,153M	1.379	-11,468M	09/02
	10) LORD ABBETT & CO	LORD ABBETT & CO	13F	24,541M	1.202	5,385M	09/02
	11) MONTAG CALDWELL	MONTAG & CALDWELL IN	13F	24,466M	1.198	-11,373M	09/02
	12) DEUTSCHE BANK AK	DEUTSCHE BANK AG	13F	23,239M	1.138	-5,002M	09/02
	13) MORGAN STANLEY	MORGAN STANLEY	13F	19,655M	0.962	3,482M	09/02
	14) PRICE T ROWE	T ROWE PRICE ASSOCIA	13F	19,133M	0.937	2,925M	09/02
	15) ROY EDWARD DISNE	n/a	PROXY	17,547M	0.859	-126,710	12/01
	16) AXA FINANCIAL	ALLIANCE CAPITAL MAN	13F	14,283M	0.699	69,353	09/02
	17) JP MORGAN CHASE	JP MORGAN CHASE & CO	13F	14,209M	0.696	-462,791	09/02
	Sub-totals for current page:			599,159M	29.340		

* Money market directory info available. Select portfolio, then hit IP<GO>.

Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 920410
Hong Kong 852 2977 6000 Japan 81 3 3201 8900 Singapore 65 212 1000 U.S. 1 212 318 2000

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Bloomberg PROFESSIONAL

Case 2: Voting versus Non-voting Shares: Aracruz

- Aracruz Cellulose, like most Brazilian companies, had multiple classes of shares.
  - The common shares had all of the voting rights and were held by incumbent management, lenders to the company and the Brazilian government.
  - Outside investors held the non-voting shares, which were called preferred shares, and had no say in the election of the board of directors. At the end of 2002,
- Aracruz was managed by a board of seven directors, composed primarily of representatives of those who own the common (voting) shares, and an executive board, composed of three managers of the company.

Case 3: Cross and Pyramid Holdings
Tata Chemical's top stockholders in 2008

<HELP> for explanation. EquityHDS
As of Apr29 DELAYED Vol 502,362 Op 165 B Hi 172 S Lo 165 B
TTCH IN Equity | 94) Matrix | 95) Searches | 96) Actions | Page 1/11 Holdings Search
Tata Chemicals Ltd ISIN INE092A01019
21) Sources | 22) Types | 23) Countries | 24) Metro Areas | 25) Advanced Filters
Name Filter | Sort By Amount Held

Holder Name	Portfolio Name	Source	Amt Held	% Out	Latest Chg	File Dt
1) TATA SONS LTD	n/a	Co File	33,534,323	14.26	0	12/31/08
2) LIFE INSURANCE CORP O	n/a	Co File	27,537,984	11.71	6,856,922	12/31/08
3) TATA INVESTMENT CORP	n/a	Co File	16,000,001	6.80	-390,000	12/31/08
4) TATA TEA LTD	n/a	Co File	15,385,522	6.54	0	12/31/08
5) NEW INDIA ASSURANCE C	n/a	Co File	6,060,895	2.58	0	12/31/08
6) HINDUSTAN LEVER LTD	n/a	Co File	5,032,000	2.14	0	12/31/08
7) GENERAL INSURANCE CO	n/a	Co File	4,996,262	2.12	6,000	12/31/08
8) UNITED INDIA INSURANC	n/a	Co File	2,668,047	1.13	20,000	12/31/08
9) NATIONAL INSURANCE C	n/a	Co File	2,373,302	1.01	0	12/31/08
10) TEMPLETON ASSET MGMT	TEMPLETON INDIA EQ	MF-IND	2,363,937	1.01	163,937	3/31/09
11) TEMPLETON ASSET MGMT	FRANKLIN INDIA FLEX	MF-IND	1,503,761	0.64	0	3/31/09
12) SBI FUNDS MANAGEMENT	SBI MAGNUM SECTOR	MF-IND	1,473,989	0.63	156,222	3/31/09
13) M&G INVESTMENT MANA	M&G INV (1)-SOUTH	UT-UK	1,451,251	0.62	-383,000	12/31/08
14) EWART INVESTMENTS LT	n/a	Co File	1,369,290	0.58	0	12/31/08
15) TEMPLETON MANAGEMEN	TEMPLETON EMERGIN	MF-CAN	1,078,000	0.46	539,000	12/31/08
16) TEMPLETON ASSET MGMT	TEMPLETON INDIA G	MF-IND	1,054,645	0.45	554,645	3/31/09
17) BIRLA SUN LIFE ASSET M	BIRLA SUN LIFE SPEC	MF-IND	1,050,000	0.45	0	2/28/09

26) Latest Chg | 27) Hist Held | % Out on Page 53.12

Things change.. Disney's top stockholders in 2009

DIS US $ ↑ 24.2422 +.7422 D 2s EquityHDS
DELAY 14:27 Vol 6,135,972 Op 23.81 Z Hi 24.34 T Lo 23.8 T ValTrd 148.014m
DIS US Equity 95) Saved Searches 96) Default Settings Page 1/150 Holdings Search
Walt Disney Co/The CUSIP 25468710
21) Sources 22) Types 23) Countries 24) Metro Areas 25) Advanced Filters
Name Filter Sort By Mkt Val

	Holder Name	Portfolio Name	Source	Mkt Val	% Out	Mkt Val Chg	File Dt
1)	JOBS STEVEN PAUL	n/a	Form 4	3.34BLN	7.46	0	5/5/06
2)	FIDELITY MANAGEMENT &	FIDELITY MANAGEMEN	13F	2.05BLN	4.58	-36.12MLN	9/30/08
3)	STATE STREET CORP	STATE STREET CORPO	13F	1.7BLN	3.79	-18.6MLN	9/30/08
4)	BARCLAYS GLOBAL INVES	BARCLAYS GLOBAL IN	13F	1.66BLN	3.70	-160.12MLN	9/30/08
5)	VANGUARD GROUP INC	VANGUARD GROUP IN	13F	1.38BLN	3.08	-6.82MLN	9/30/08
6)	SOUTHEASTERN ASSET M	SOUTHEASTERN ASSE	13F	1.12BLN	2.50	-14.03MLN	9/30/08
7)	STATE FARM MUTUAL AU	STATE FARM MUTUAL	13F	1.02BLN	2.28	0	9/30/08
8)	WELLINGTON MANAGEMEN	WELLINGTON MANAGE	13F	939.38MLN	2.09	110.6MLN	9/30/08
9)	CLEARBRIDGE ADVISORS	CLEARBRIDGE ADVISO	13F	815.91MLN	1.82	-47.04MLN	9/30/08
10)	JP MORGAN CHASE & CO	JP MORGAN CHASE &	13F	693.31MLN	1.55	-18.89MLN	9/30/08
11)	MASSACHUSETTS FINANCI	MASSACHUSETTS FINA	13F	682.16MLN	1.52	112.29MLN	9/30/08
12)	BANK OF NEW YORK MELL	BANK OF NEW YORK	13F	681.68MLN	1.52	-57.13MLN	9/30/08
13)	NORTHERN TRUST CORP	NORTHERN TRUST CO	13F	610.26MLN	1.36	-4.81MLN	9/30/08
14)	AXA	AXA	13F	486.28MLN	1.08	47.05MLN	9/30/08
15)	BLACKROCK INVESTMENT	BLACKROCK INVESTME	13F	476.12MLN	1.06	-47.11MLN	9/30/08
16)	JENNISON ASSOCIATES L	JENNISON ASSOCIATE	13F	428.85MLN	0.96	-102.77MLN	9/30/08
17)	T ROWE PRICE ASSOCIAT	T ROWE PRICE ASSOC	13F	351.61MLN	0.78	-9.94MLN	9/30/08

26) Latest Chg 27) Hist Held % Out on Page 41.12

II. Stockholders' objectives vs. Bondholders' objectives

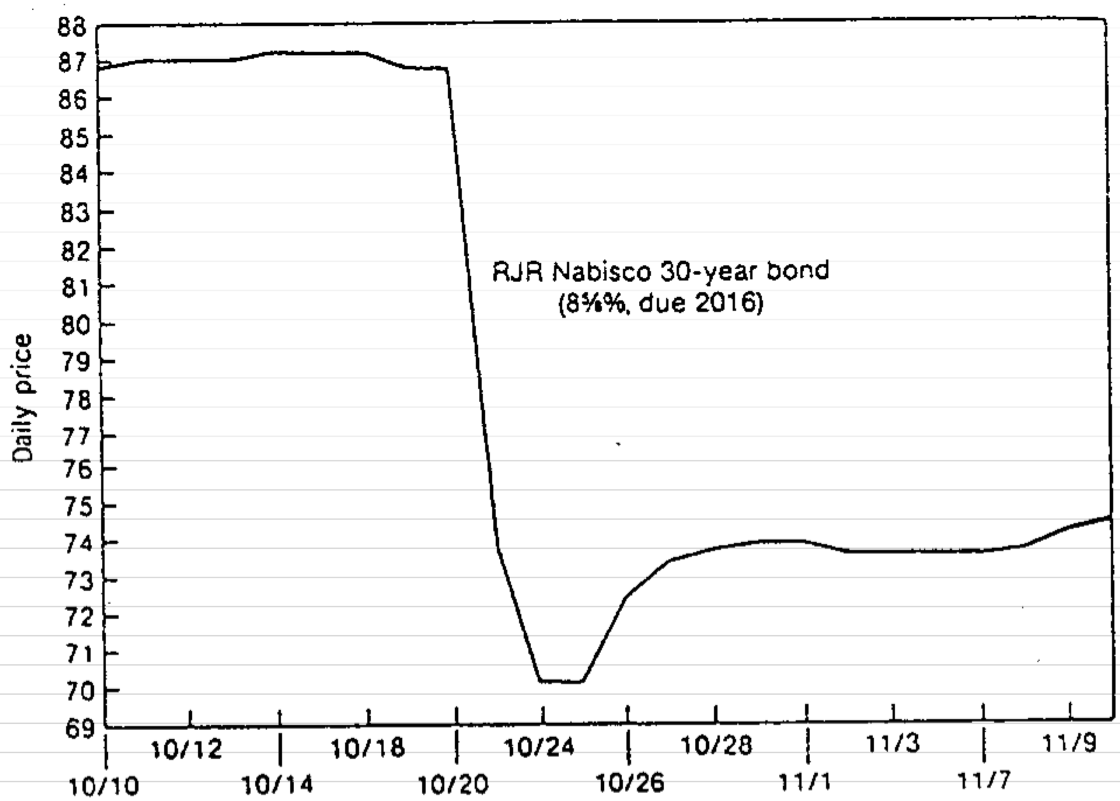
- In theory: there is no conflict of interests between stockholders and bondholders.
- In practice: Stockholder and bondholders have different objectives. Bondholders are concerned most about safety and ensuring that they get paid their claims. Stockholders are more likely to think about upside potential

Examples of the conflict..

- Increasing dividends significantly: When firms pay cash out as dividends, lenders to the firm are hurt and stockholders may be helped. This is because the firm becomes riskier without the cash.
- Taking riskier projects than those agreed to at the outset: Lenders base interest rates on their perceptions of how risky a firm's investments are. If stockholders then take on riskier investments, lenders will be hurt.
- Borrowing more on the same assets: If lenders do not protect themselves, a firm can borrow more money and make all existing lenders worse off.

An Extreme Example: Unprotected Lenders?

RJR Nabisco's Bonds Sink Following Announcement of the Leveraged Buyout



Aswath Damodaran

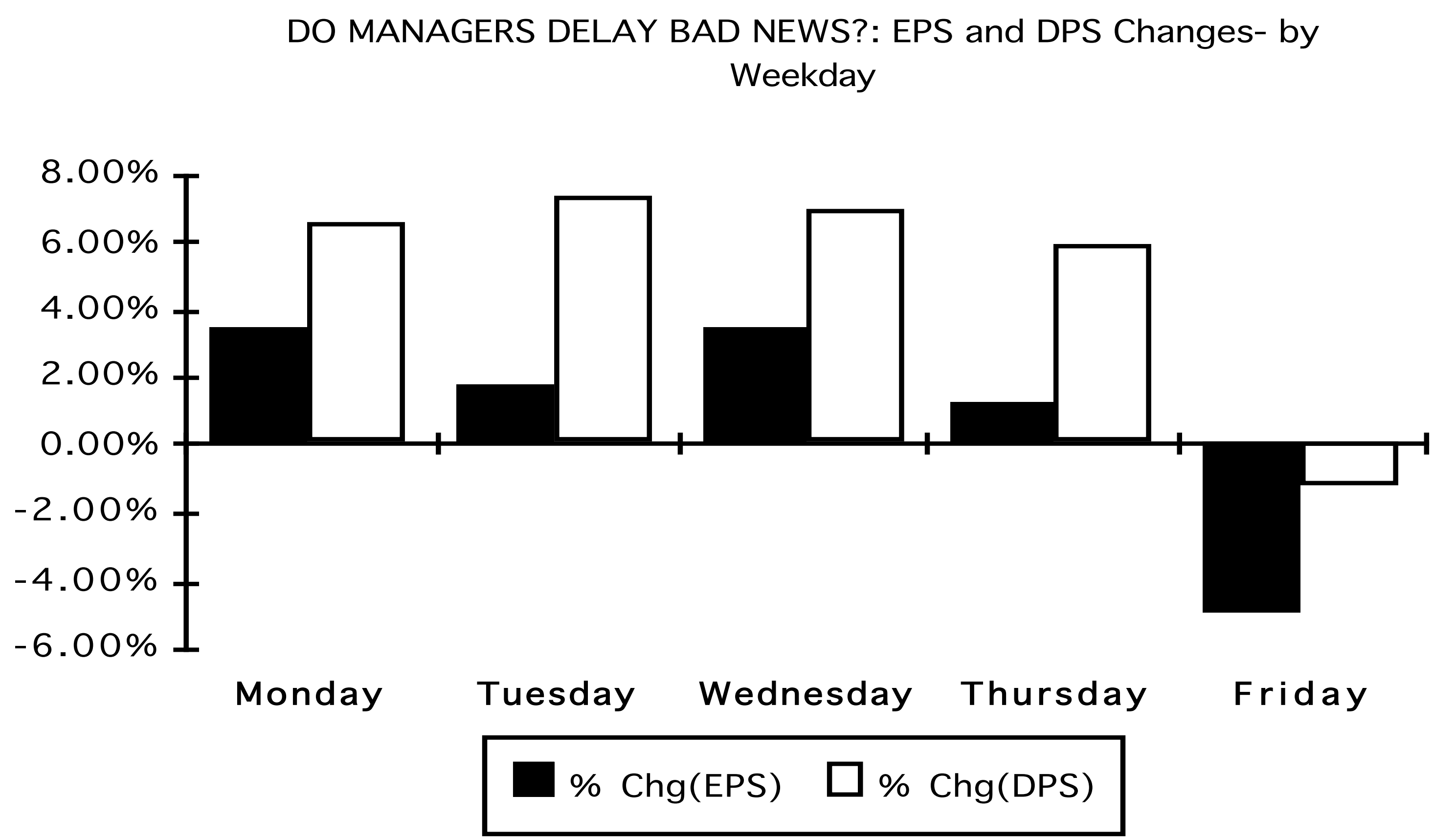
III. Firms and Financial Markets

- In theory: Financial markets are efficient. Managers convey information honestly and and in a timely manner to financial markets, and financial markets make reasoned judgments of the effects of this information on 'true value'. As a consequence-
  - A company that invests in good long term projects will be rewarded.
  - Short term accounting gimmicks will not lead to increases in market value.
  - Stock price performance is a good measure of company performance.
- In practice: There are some holes in the 'Efficient Markets' assumption.

Managers control the release of information to the general public

- Information (especially negative) is sometimes suppressed or delayed by managers seeking a better time to release it.
- In some cases, firms release intentionally misleading information about their current conditions and future prospects to financial markets.

Evidence that managers delay bad news?



Some critiques of market efficiency..

Investors are irrational and prices often move for not reason at all. As a consequence, prices are much more volatile than justified by the underlying fundamentals. Earnings and dividends are much less volatile than stock prices.

- Investors overreact to news, both good and bad.
- Financial markets are manipulated by insiders; Prices do not have any relationship to value.
- Investors are short-sighted, and do not consider the long-term implications of actions taken by the firm

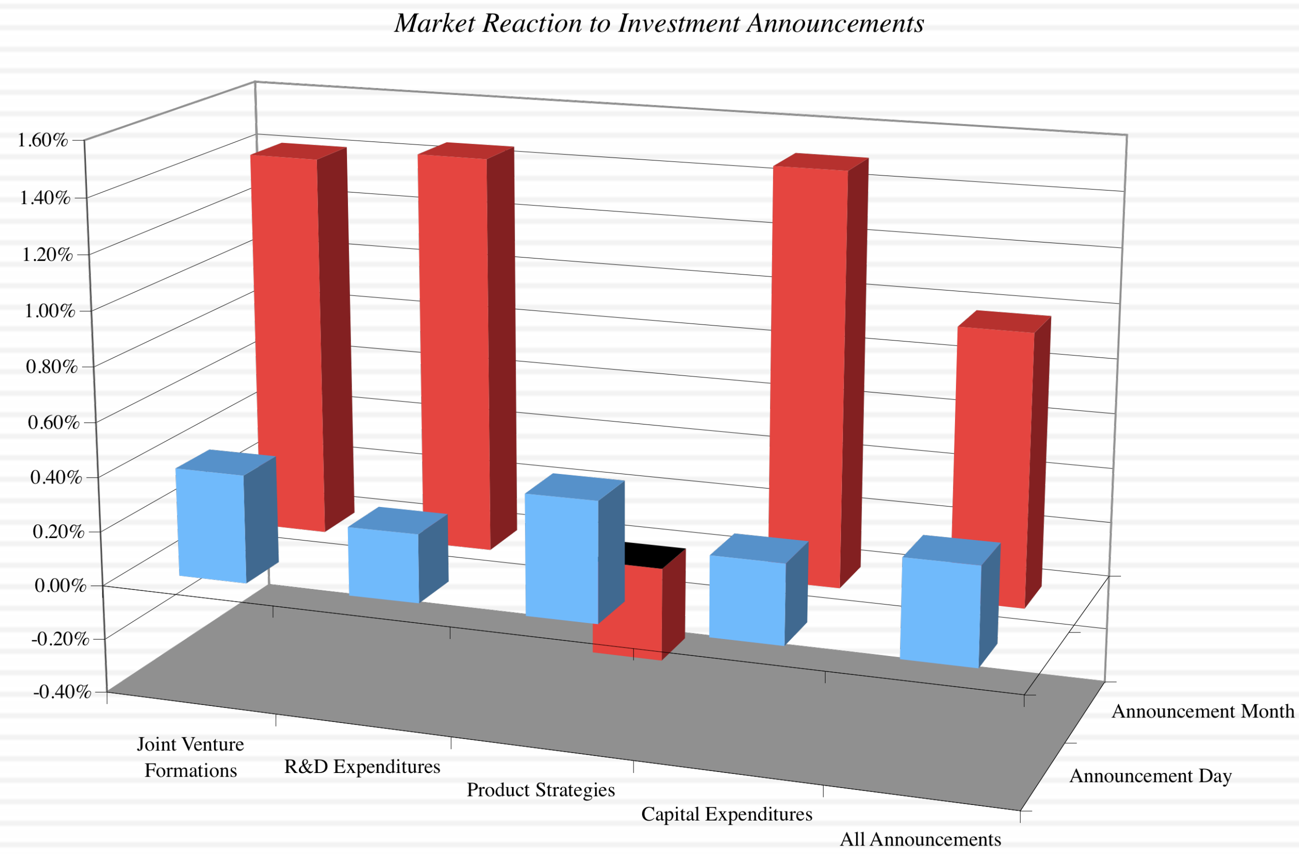
Are Markets Short term?

- Focusing on market prices will lead companies towards short term decisions at the expense of long term value.
  a. I agree with the statement
  b. I do not agree with this statement
- Allowing managers to make decisions without having to worry about the effect on market prices will lead to better long term decisions.
  a. I agree with this statement
  b. I do not agree with this statement
- Neither managers nor markets are trustworthy. Regulations/laws should be written that force firms to make long term decisions.
  a. I agree with this statement
  b. I do not agree with this statement

Are Markets short term? Some evidence that they are not..

- There are hundreds of start-up and small firms, with no earnings expected in the near future, that raise money on financial markets. Why would a myopic market that cares only about short term earnings attach high prices to these firms?
- If the evidence suggests anything, it is that markets do not value current earnings and cashflows enough and value future earnings and cashflows too much. After all, studies suggest that low PE stocks are under priced relative to high PE stocks
- The market response to research and development and investment expenditures is generally positive.

If markets are so short term, why do they react to big investments (that potentially lower short term earnings) so positively?



But what about market crises?

- Many critics of markets point to market bubbles and crises as evidence that markets do not work. For instance, the market turmoil between September and December 2008 is pointed to as backing for the statement that free markets are the source of the problem and not the solution.
- There are two counter arguments that can be offered:
  - The events of the last quarter of 2008 illustrate that we are more dependent on functioning, liquid markets, with risk taking investors, than ever before in history. As we saw, no government or other entity (bank, Buffett) is big enough to step in and save the day.
  - The firms that caused the market collapse (banks, investment banks) were among the most regulated businesses in the market place. If anything, their failures can be traced to their attempts to take advantage of regulatory loopholes (badly designed insurance programs… capital measurements that miss risky assets, especially derivatives)

IV. Firms and Society

- In theory: All costs and benefits associated with a firm's decisions can be traced back to the firm.
- In practice: Financial decisions can create social costs and benefits.
  - A social cost or benefit is a cost or benefit that accrues to society as a whole and not to the firm making the decision.
    - Environmental costs (pollution, health costs, etc..)
    - Quality of Life' costs (traffic, housing, safety, etc.)
  - Examples of social benefits include:
    - creating employment in areas with high unemployment
    - supporting development in inner cities
    - creating access to goods in areas where such access does not exist

Social Costs and Benefits are difficult to quantify because ..

- They might not be known at the time of the decision. In other words, a firm may think that it is delivering a product that enhances society, at the time it delivers the product but discover afterwards that there are very large costs. (Asbestos was a wonderful product, when it was devised, light and easy to work with… It is only after decades that the health consequences came to light)
- They are 'person-specific', since different decision makers can look at the same social cost and weight them very differently.
- They can be paralyzing if carried to extremes.

A test of your social consciousness: Put your money where you mouth is...

- Assume that you work for Disney and that you have an opportunity to open a store in an inner-city neighborhood. The store is expected to lose about a million dollars a year, but it will create much-needed employment in the area, and may help revitalize it.
- Would you open the store?
  - Yes
  - No
- If yes, would you tell your stockholders and let them vote on the issue?
  - Yes
  - No
- If no, how would you respond to a stockholder query on why you were not living up to your social responsibilities?

So this is what can go wrong...

STOCKHOLDERS

Have little control over managers

Managers put their interests above stockholders

BONDHOLDERS

Lend Money

Bondholders can get ripped off

Managers

Significant Social Costs

SOCIETY

Some costs cannot be traced to firm

Delay bad news or provide misleading information

Markets make mistakes and can over react

FINANCIAL MARKETS

Traditional corporate financial theory breaks down when ...

- The interests/objectives of the decision makers in the firm conflict with the interests of stockholders.
- Bondholders (Lenders) are not protected against expropriation by stockholders.
- Financial markets do not operate efficiently, and stock prices do not reflect the underlying value of the firm.
- Significant social costs can be created as a by-product of stock price maximization.

When traditional corporate financial theory breaks down, the solution is:

- To choose a different mechanism for corporate governance, i.e, assign the responsibility for monitoring managers to someone other than stockholders.
- To choose a different objective for the firm.
- To maximize stock price, but reduce the potential for conflict and breakdown:
  - Making managers (decision makers) and employees into stockholders
  - Protect lenders from expropriation
  - By providing information honestly and promptly to financial markets
  - Minimize social costs

An Alternative Corporate Governance System

- Germany and Japan developed a different mechanism for corporate governance, based upon corporate cross holdings.
  - In Germany, the banks form the core of this system.
  - In Japan, it is the keiretsus
  - Other Asian countries have modeled their system after Japan, with family companies forming the core of the new corporate families
- At their best, the most efficient firms in the group work at bringing the less efficient firms up to par. They provide a corporate welfare system that makes for a more stable corporate structure
- At their worst, the least efficient and poorly run firms in the group pull down the most efficient and best run firms down. The nature of the cross holdings makes its very difficult for outsiders (including investors in these firms) to figure out how well or badly the group is doing.

Choose a Different Objective Function

- Firms can always focus on a different objective function. Examples would include
  - maximizing earnings
  - maximizing revenues
  - maximizing firm size
  - maximizing market share
  - maximizing EVA
- The key thing to remember is that these are intermediate objective functions.
  - To the degree that they are correlated with the long term health and value of the company, they work well.
  - To the degree that they do not, the firm can end up with a disaster

Maximize Stock Price, subject to ..

- The strength of the stock price maximization objective function is its internal self correction mechanism. Excesses on any of the linkages lead, if unregulated, to counter actions which reduce or eliminate these excesses
- In the context of our discussion,
  - managers taking advantage of stockholders has led to a much more active market for corporate control.
  - stockholders taking advantage of bondholders has led to bondholders protecting themselves at the time of the issue.
  - firms revealing incorrect or delayed information to markets has led to markets becoming more "skeptical" and "punitive"
  - firms creating social costs has led to more regulations, as well as investor and customer backlashes.

The Stockholder Backlash

- Activist Institutional investors such as Calpers and the Lens Funds have become much more active in monitoring companies that they invest in and demanding changes in the way in which business is done. They have been joined by private equity funds like KKR and Blackstone.
- Individuals like Carl Icahn specialize in taking large positions in companies which they feel need to change their ways (Blockbuster, Time Warner and Motorola) and push for change
- At annual meetings, stockholders have taken to expressing their displeasure with incumbent management by voting against their compensation contracts or their board of directors

The Hostile Acquisition Threat

- The typical target firm in a hostile takeover has
  - a return on equity almost 5% lower than its peer group
  - had a stock that has significantly under performed the peer group over the previous 2 years
  - has managers who hold little or no stock in the firm
- In other words, the best defense against a hostile takeover is to run your firm well and earn good returns for your stockholders
- Conversely, when you do not allow hostile takeovers, this is the firm that you are most likely protecting (and not a well run or well managed firm)

In response, boards are becoming more independent…

- Boards have become smaller over time. The median size of a board of directors has decreased from 16 to 20 in the 1970s to between 9 and 11 in 1998. The smaller boards are less unwieldy and more effective than the larger boards.
- There are fewer insiders on the board. In contrast to the 6 or more insiders that many boards had in the 1970s, only two directors in most boards in 1998 were insiders.
- Directors are increasingly compensated with stock and options in the company, instead of cash. In 1973, only 4% of directors received compensation in the form of stock or options, whereas 78% did so in 1998.
- More directors are identified and selected by a nominating committee rather than being chosen by the CEO of the firm. In 1998, 75% of boards had nominating committees; the comparable statistic in 1973 was 2%.

Eisner's concession: Disney's Board in 2003

Board Members	*Occupation*
Reveta Bowers	Head of school for the Center for Early Education,
John Bryson	CEO and Chairman of Con Edison
Roy Disney	Head of Disney Animation
Michael Eisner	CEO of Disney
Judith Estrin	CEO of Packet Design (an internet company)
Stanley Gold	CEO of Shamrock Holdings
Robert Iger	Chief Operating Officer, Disney
Monica Lozano	Chief Operation Officer, La Opinion (Spanish newspaper)
George Mitchell	Chairman of law firm (Verner, Liipfert, et al.)
Thomas S. Murphy	Ex-CEO, Capital Cities ABC
Leo O'Donovan	Professor of Theology, Georgetown University
Sidney Poitier	Actor, Writer and Director
Robert A.M. Stern	Senior Partner of Robert A.M. Stern Architects of New York
Andrea L. Van de Kamp	Chairman of Sotheby's West Coast
Raymond L. Watson	Chairman of Irvine Company (a real estate corporation)
Gary L. Wilson	Chairman of the board, Northwest Airlines.

Changes in corporate governance at Disney

- Required at least two executive sessions of the board, without the CEO or other members of management present, each year.
- Created the position of non-management presiding director, and appointed Senator George Mitchell to lead those executive sessions and assist in setting the work agenda of the board.
- Adopted a new and more rigorous definition of director independence.
- Required that a substantial majority of the board be comprised of directors meeting the new independence standards.
- Provided for a reduction in committee size and the rotation of committee and chairmanship assignments among independent directors.
- Added new provisions for management succession planning and evaluations of both management and board performance
- Provided for enhanced continuing education and training for board members.

Eisner’s exit… and a new age dawns? Disney’s board in 2008

Board Members	*Occupation*
John E. Pepper, Jr. (Chairman)	Retired Chairman and CEO, Procter & Gamble Co.
Susan E. Arnold	President, Global Business Units, Procter & Gamble Co.
John E. Bryson	Retired Chairman and CEO, Edison International
John S. Chen	Chairman,, CEO & President, Sybase, Inc.
Judith L. Estrin	CEO, JLabs, LLC.
Robert A. Iger	CEO, Disney
Steven P. Jobs	CEO, Apple
Fred Langhammer	Chairman, Global Affairs, The Estee Lauder Companies
Aylwin B. Lewis	President and CEO, Potbelly Sandwich Works
Monica Lozano	Publisher and CEO, La Opinion
Robert W. Matschullat	Retired Vice Chairman and CFO, The Seagram Co.
Orin C. Smith	Retired President and CEO, Starbucks Corporation

What about legislation?

- Every corporate scandal creates impetus for a legislative response. The scandals at Enron and WorldCom laid the groundwork for Sarbanes-Oxley.
- You cannot legislate good corporate governance.
  - The costs of meeting legal requirements often exceed the benefits
  - Laws always have unintended consequences
  - In general, laws tend to be blunderbusses that penalize good companies more than they punish the bad companies.

Is there a payoff to better corporate governance?

- In the most comprehensive study of the effect of corporate governance on value, a governance index was created for each of 1500 firms based upon 24 distinct corporate governance provisions.
  - Buying stocks that had the strongest investor protections while simultaneously selling shares with the weakest protections generated an annual excess return of 8.5%.
  - Every one point increase in the index towards fewer investor protections decreased market value by 8.9% in 1999
  - Firms that scored high in investor protections also had higher profits, higher sales growth and made fewer acquisitions.
- The link between the composition of the board of directors and firm value is weak. Smaller boards do tend to be more effective.
- On a purely anecdotal basis, a common theme at problem companies and is an ineffective board that fails to ask tough questions of an imperial CEO.

The Bondholders' Defense Against Stockholder Excesses

- More restrictive covenants on investment, financing and dividend policy have been incorporated into both private lending agreements and into bond issues, to prevent future "Nabiscos".
- New types of bonds have been created to explicitly protect bondholders against sudden increases in leverage or other actions that increase lender risk substantially. Two examples of such bonds
  - Puttable Bonds, where the bondholder can put the bond back to the firm and get face value, if the firm takes actions that hurt bondholders
  - Ratings Sensitive Notes, where the interest rate on the notes adjusts to that appropriate for the rating of the firm
- More hybrid bonds (with an equity component, usually in the form of a conversion option or warrant) have been used. This allows bondholders to become equity investors, if they feel it is in their best interests to do so.

The Financial Market Response

- While analysts are more likely still to issue buy rather than sell recommendations, the payoff to uncovering negative news about a firm is large enough that such news is eagerly sought and quickly revealed (at least to a limited group of investors).
- As investor access to information improves, it is becoming much more difficult for firms to control when and how information gets out to markets.
- As option trading has become more common, it has become much easier to trade on bad news. In the process, it is revealed to the rest of the market.
- When firms mislead markets, the punishment is not only quick but it is savage.

The Societal Response

- If firms consistently flout societal norms and create large social costs, the governmental response (especially in a democracy) is for laws and regulations to be passed against such behavior.
- For firms catering to a more socially conscious clientele, the failure to meet societal norms (even if it is legal) can lead to loss of business and value.
- Finally, investors may choose not to invest in stocks of firms that they view as socially irresponsible.

The Counter Reaction

STOCKHOLDERS

1. More activist investors
2. Hostile takeovers

Managers of poorly run firms are put on notice.

Protect themselves

Corporate Good Citizen Constraints

BONDHOLDERS ⟷ **Managers** ⟷ SOCIETY

1. Covenants
2. New Types

1. More laws
2. Investor/Customer Backlash

Firms are punished for misleading markets

Investors and analysts become more skeptical

FINANCIAL MARKETS

So what do you think?

- At this point in time, the following statement best describes where I stand in terms of the right objective function for decision making in a business
  - Maximize stock price, with no constraints
  - Maximize stock price, with constraints on being a good social citizen.
  - Maximize stockholder wealth, with good citizen constraints, and hope/pray that the market catches up with you.
  - Maximize profits or profitability
  - Maximize earnings growth
  - Maximize market share
  - Maximize revenues
  - Maximize social good
  - None of the above

The Modified Objective Function

- For publicly traded firms in reasonably efficient markets, where bondholders (lenders) are protected:
  - Maximize Stock Price: This will also maximize firm value
- For publicly traded firms in inefficient markets, where bondholders are protected:
  - Maximize stockholder wealth: This will also maximize firm value, but might not maximize the stock price
- For publicly traded firms in inefficient markets, where bondholders are not fully protected
  - Maximize firm value, though stockholder wealth and stock prices may not be maximized at the same point.
- For private firms, maximize stockholder wealth (if lenders are protected) or firm value (if they are not)