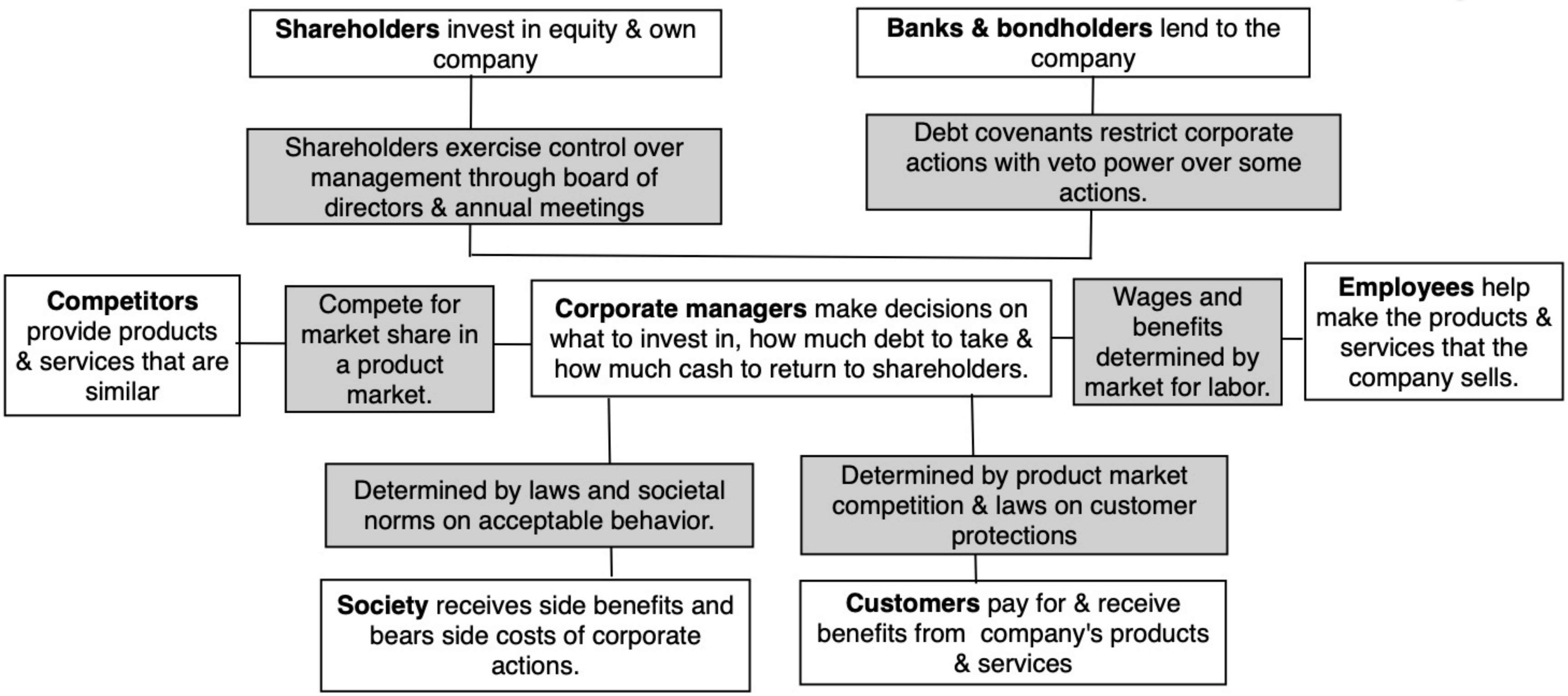
THE OBJECTIVE IN CORPORATE FINANCE

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

THE END GAME IN BUSINESS?

- Businesses have always struggled with mission statements. Put simply, what should the end game of a business?
  - The simplest and most pragmatic answer is that it is to sell products and services that customers want, while generating the most they can in profits for their owners, over the long term.
  - The pushback, often from non-business critics, has been that businesses should also serve society, not just minimizing social costs but also providing social benefits.
- In recent years, that pushback has found backing within business, with movements to expand business missions:
  - To put sustainability (climate? product? business?) first
  - To maximize the value to all stakeholders, not just owners
  - To incorporate environmental, social and governance goals

A BUSINESS HAS MANY STAKEHOLDERS…



IN RUNNING A BUSINESS, ONE OF THESE STAKEHOLDERS HAS TO BE GIVEN PRIMACY…

- 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.

Maximize firm value

Maximize equity value

Maximize market estimate of equity value

Assets		Liabilities	
Existing Investments Generate cashflows today Includes long lived (fixed) and short-lived(working capital) assets	Assets in Place	Debt	Fixed Claim on cash flows Little or No role in management *Fixed Maturity* *Tax Deductible*
Expected Value that will be created by future investments	Growth Assets	Equity	Residual Claim on cash flows Significant Role in management *Perpetual Lives*

GIVING CORPORATE FINANCE ITS FOCUS…

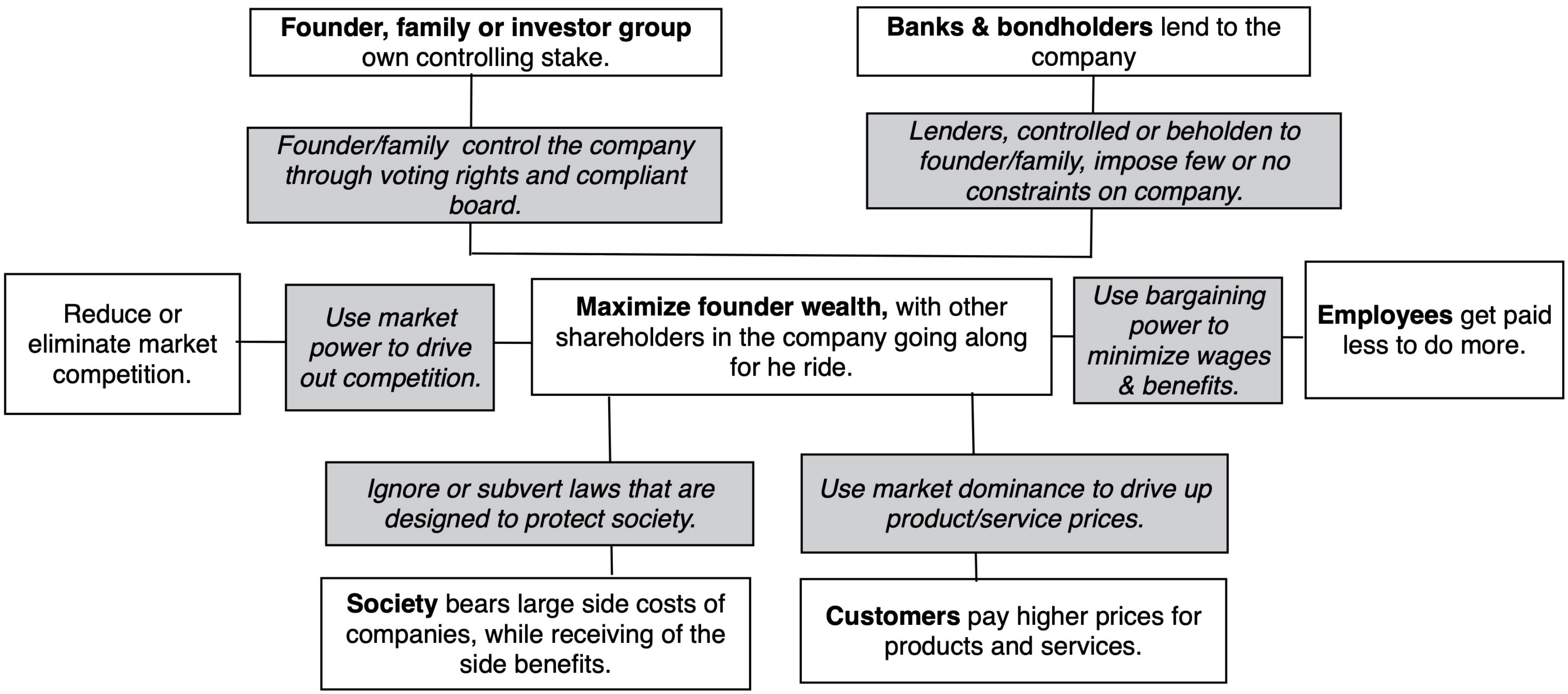
- Maximize the value of the business (firm)
  - **The Investment Decision** Invest in assets that earn a return greater than the minimum acceptable hurdle rate
    - The **hurdle rate** should reflect the riskiness of the investment and the mix of debt and equity used to fund it.
    - The **return** should reflect the magnitude and the timing of the cashflows as well as all side effects.
  - **The Financing Decision** Find the right kind of debt for your firm and the right mix of debt and equity to fund your operations
    - The **optimal mix** of debt and equity maximizes firm value
    - The **right kind** of debt matches the tenor of your assets
  - **The Dividend Decision** If you cannot find investments that make your minimum acceptable rate, return the cash to owners of your business
    - **How much cash** you can return depends upon current & potential investment opportunities
    - **How you choose** to return cash to the owners will depend on whether they prefer dividends or buybacks

WHY CORPORATE FINANCE FOCUSES ON MAXIMIZING STOCKHOLDER WEALTH.

- You can **have only one objective**, i.e., one interest group, whose interests get placed first.
  - Corporate finance picks shareholders because they have a residual claim, whereas every other claimholder has a contractual claim that they can negotiate to protect their interests.
- If the company is traded, **the stock price gets chosen** as the optimizing metric because:
  - Stock price is easily observable and constantly updated
  - If investors are rational, stock prices reflect the wisdom of decisions, short term and long term, instantaneously.

THE STRAWMAN VERSION: CUTTHROAT CORPORATISM

Cutthroat Corporatism



The Darwinian End Game: Winning companies dominate or monopolize their markets, exploiting customers, employees & society, while enriching their founders (and shareholders).

REAL CHOICES OR FALSE ONES?

- 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**. Companies that consistently flout social norms will find themselves losing business and facing regulation/targeted taxes.

THE CLASSICAL OBJECTIVE FUNCTION

STOCKHOLDERS

Hire & fire managers
- Board
- Annual Meeting

Maximize stockholder wealth

Lend Money

BONDHOLDERS/ LENDERS

Protect bondholder Interests

Managers

No Social Costs

SOCIETY

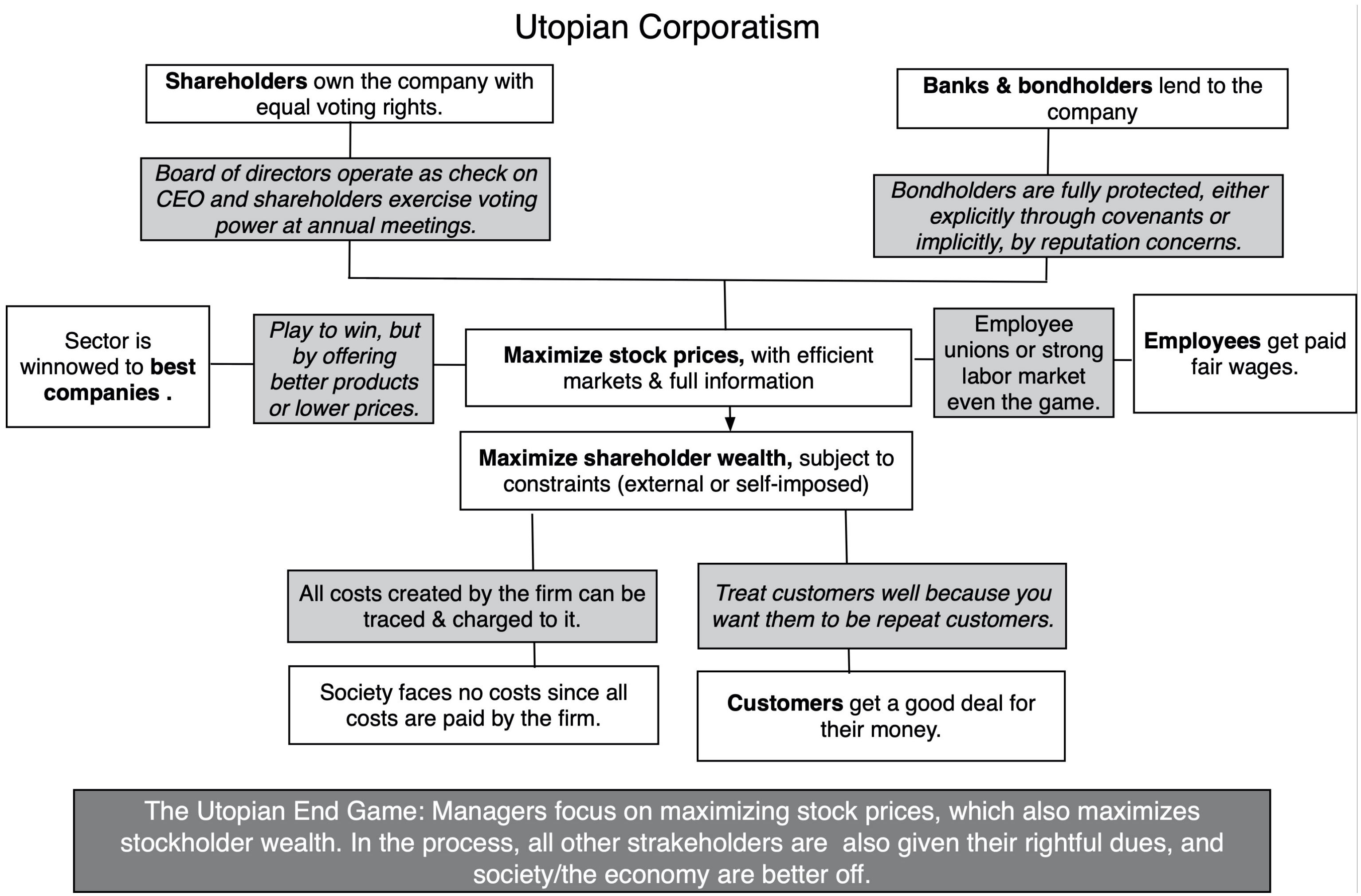
All costs can be traced to firm

Reveal information honestly and on time

Markets are efficient and assess effect on value

FINANCIAL MARKETS

UTOPIAN CORPORATISM



SO THIS IS WHAT CAN GO WRONG...

1. Annual meetings are too tightly scripted & controlled
2. Boards are rubber stamps for CEOs

STOCKHOLDERS

Have little control over managers

Managers put their interests above stockholders

Businesses create side costs and side benefits to society that cannot be traced back to the firm.

Significant Social Costs

Lend Money

BONDHOLDERS

Managers

SOCIETY

Bondholders can get ripped off

Some costs cannot be traced to firm

Covenants and lender protections provide only partial defense against shareholder overreach.

Delay bad news or provide misleading information

Markets make mistakes and can overreact

Markets are sometimes short term & oftentimes irrational.

FINANCIAL MARKETS

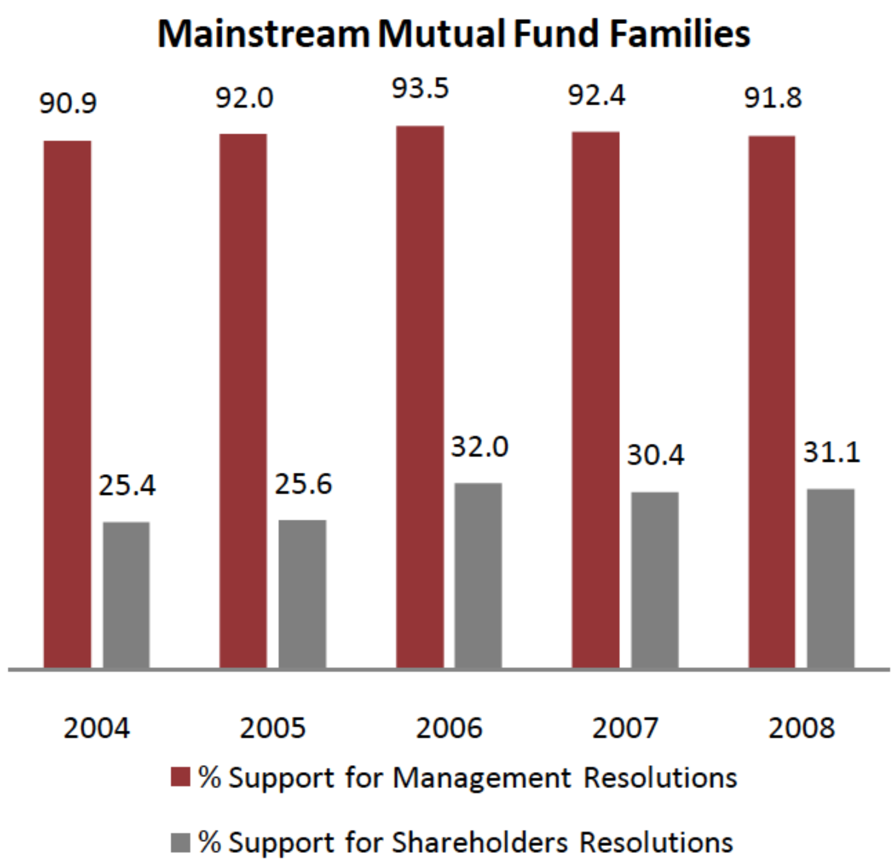
I. STOCKHOLDER INTERESTS VS. MANAGEMENT INTERESTS

- **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 also 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**, or do nothing, if they are passive investors (index funds)
- 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…



BOARDS OF DIRECTORS ARE OFTEN RUBBER STAMPS…

- **CEOs pick directors**: A 1992 survey by Korn/Ferry revealed that 74% of companies relied on recommendations from the CEO to come up with new directors and only 16% used an outside search firm. While that number has decreased in recent years, CEOs still determine who sits on their boards. While more companies have outsiders involved in picking directors now, CEOs exercise significant influence over the process.
- **Directors don't have big equity stakes**: Directors often hold only token stakes in their companies. 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).
- **And some directors are CEOs of other firms**: Many directors are themselves CEOs of other firms. Worse still, there are cases where CEOs sit on each other's boards.

AND LACK THE EXPERTISE (AND THE WILLINGNESS) TO ASK THE NECESSARY TOUGH QUESTIONS..

- **Robert's Rules of Order?** 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.
- **Be a team player?** The search for consensus overwhelms any attempts at confrontation.
- **The CEO as authority figure**: 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.

THE WORST BOARD EVER? 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

					BOARD PERFORMANCE POLL				GOVERNANCE GUIDELINE ANALYSIS		
BW RANK	OVERALL SCORE	SURVEY SCORE	ANALYSIS SCORE	DETAILS	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

DISNEY'S BOARD OF DIRECTORS IN 2023

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.
- Is there tangible evidence that your board acts independently of management?
  - **Check news stories** to see if there are actions that the CEO has wanted to take that the board has stopped him or her from taking or at least slowed him or her down.

SO, WHAT NEXT? WHEN THE CAT IS IDLE, THE MICE WILL PLAY ....

- 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.

No stockholder approval **needed…. Stockholder Approval needed**

MANAGERIAL SELF INTEREST OR STOCKHOLDER WEALTH? OVERPAYING ON TAKEOVERS!

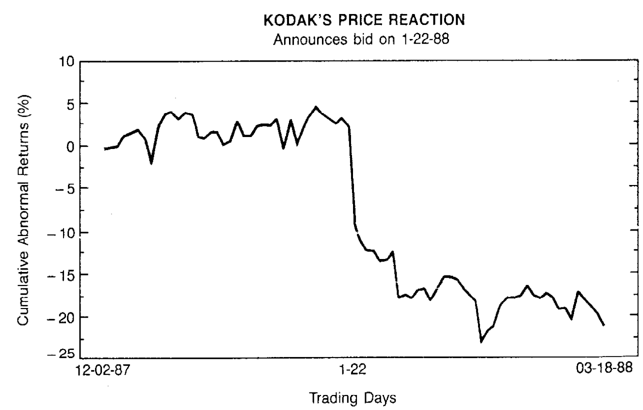
- The quickest and perhaps the most decisive way to impoverish stockholders is to **overpay on a takeover**.
- The stockholders in acquiring firms do not seem to share the enthusiasm of the managers in these firms. **Stock prices of bidding firms decline on the takeover announcements a significant proportion 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 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!!!!

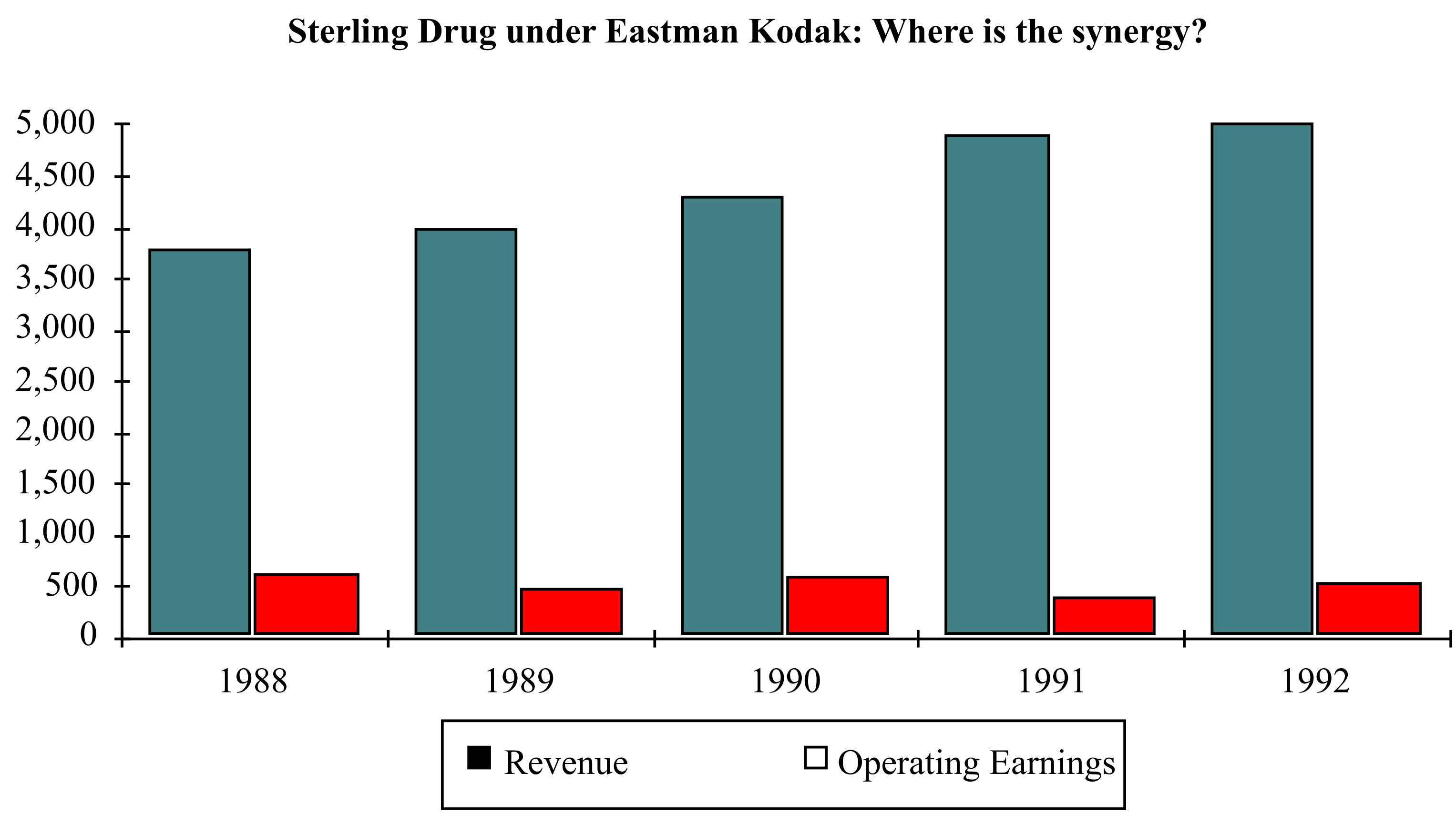


Kodak's market reaction indicates that investors expected no synergies:

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

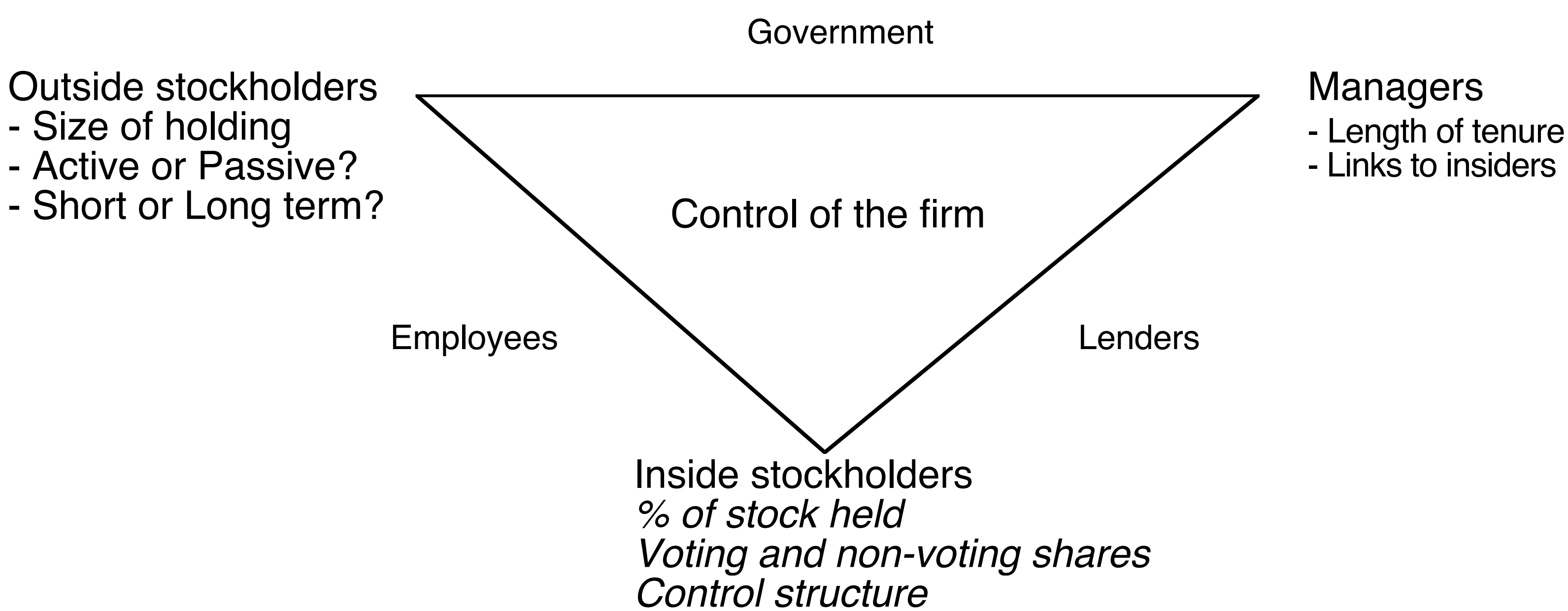


KODAK SAYS DRUG UNIT IS NOT FOR SALE … BUT…

- 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.

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

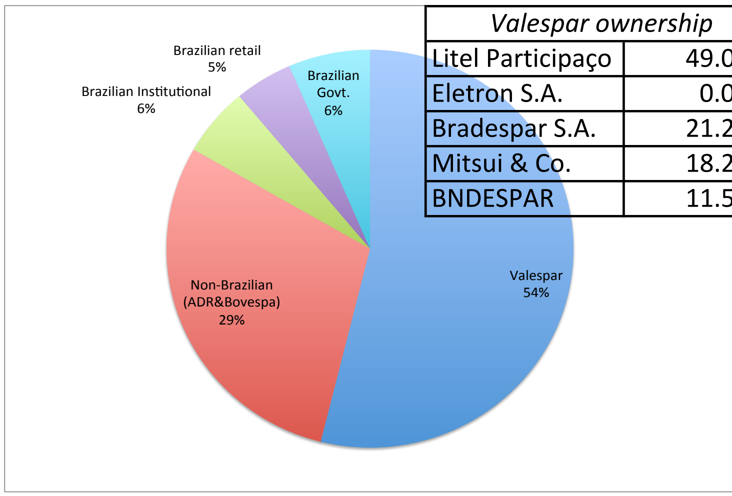
00118965@224-000 **HOLDINGS SEARCH** CUSIP 25468710

DIS US DISNEY (WALT) CO Page 1 / 100

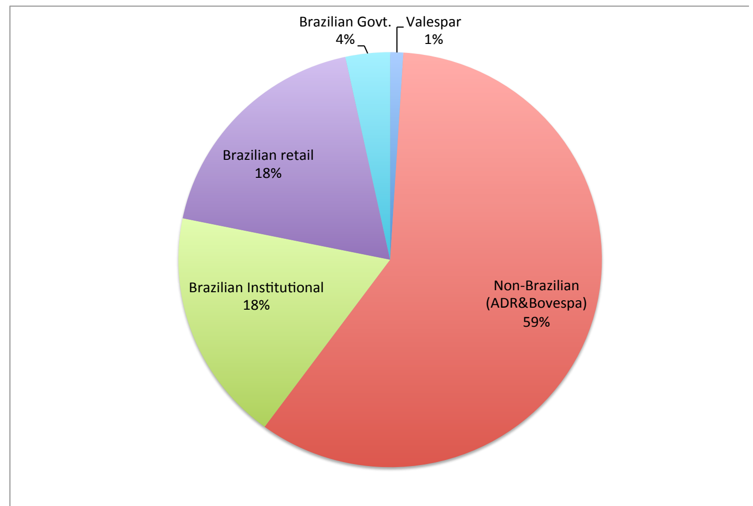
	Holder name	Portfolio Name	Source	Held	Percent Outstd	Latest Change	Filing Date
	1 BARCLAYS GLOBAL	BARCLAYS BANK PLC	13F	83,630M	4.095	1,750M	09/02
*	2 CITIGROUP INC	CITIGROUP INCORPORAT	13F	62,857M	3.078	4,811M	09/02
*	3 FIDELITY MANAGEM	FIDELITY MANAGEMENT	13F	56,125M	2.748	5,992M	09/02
	4 STATE STREET	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>.

CASE 2: VOTING VERSUS NON-VOTING SHARES & GOLDEN SHARES: VALE



Valespar ownership	
Litel Participaço	49.00%
Eletron S.A.	0.03%
Bradespar S.A.	21.21%
Mitsui & Co.	18.24%
BNDESPAR	11.51%



Golden (veto) shares owned by Brazilian govt

Common (voting) shares
3,172 million

Preferred (non-voting)
1,933 million

Vale Equity

Vale has eleven members on its board of directors, ten of whom were nominated by Valespar and the board was chaired by Don Conrado, the CEO of Valepar.

CASE 3: CROSS AND PYRAMID HOLDINGS
TATA MOTOR'S TOP STOCKHOLDERS IN 2013

TTMT IN Equity | 25) Settings | 99) Feedback | Holdings: Current

Tata Motors Ltd | ISIN INE155A01022

1) Current | 2) Historical | 3) Matrix | 4) Ownership | 5) Transactions | 6) Options

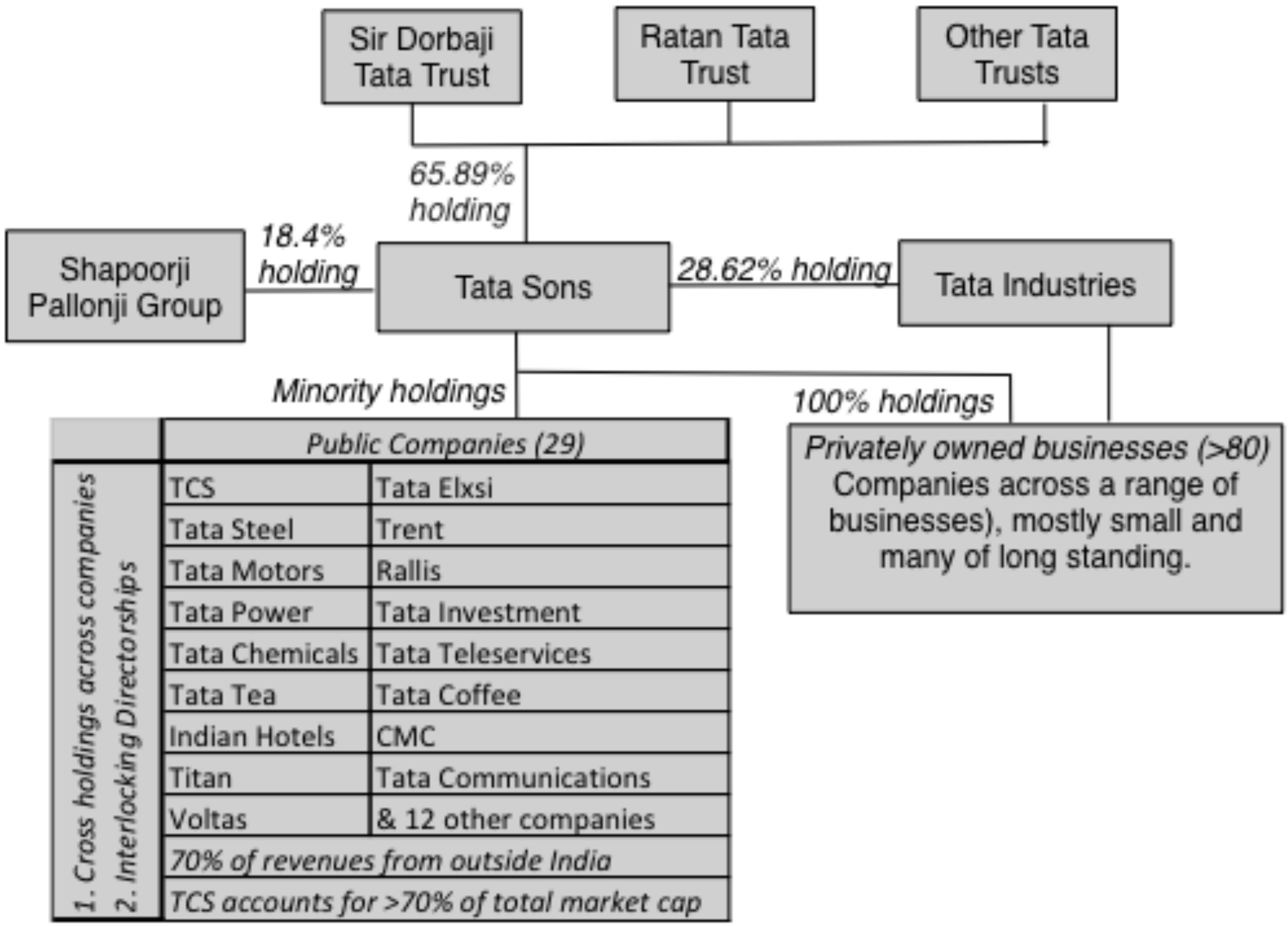
Search Name -- | 21) Save | 22) Delete | 3) Saved Search | 24) Refine Search

Text Search | Holder Group: All Holders | 20) Export

	Holder Name	Portfolio Name	Source	Opt	Amt Held	% Out	Latest Chg	File Dt
			All Sources	All				
1.	TATA SONS LTD	n/a	Co File		702,333,345	26.07	0	09/30/13
2.	CITIBANK NA	n/a	20F		446,246,135	16.56	0	06/30/12
3.	LIFE INSURANCE CORP OF I	n/a	Co File		168,754,477	6.26	-119,728,333	09/30/13
4.	TATA STEEL LTD	n/a	Co File		147,810,695	5.49	0	09/30/13
5.	CAPITAL GROUP COMPANIES	n/a	ULT-AGG		97,689,911	3.63	-877,871	09/30/13
6.	TATA INDUSTRIES LTD	n/a	Co File		68,436,485	2.54	0	09/30/13
7.	VANGUARD GROUP INC	n/a	ULT-AGG		41,285,983	1.53	4,535,434	09/30/13
8.	PRUDENTIAL PLC	n/a	ULT-AGG		34,080,063	1.26	147,814	09/30/13
9.	GIC PRIVATE LIMITED	n/a	ULT-AGG		30,428,428	1.13	0	09/30/13
10.	WILLIAM BLAIR & COMPANY L	WILLIAM BLAIR & COMP	13F		30,093,943	1.12	3,997,149	06/30/13
11.	JPMORGAN CHASE & CO	n/a	ULT-AGG		24,918,852	0.92	-2,157,750	08/31/13
12.	SCHRODER INVESTMENT MGM	Multiple Portfolios	MF-AGG		19,136,665	0.71	2,578,904	06/30/13
13.	BLACKROCK	n/a	ULT-AGG		14,100,725	0.52	-265,173	10/31/13
14.	NORGES BANK	Multiple Portfolios	MF-AGG		10,762,579	0.40	0	12/31/12
15.	T ROWE PRICE ASSOCIATES	Multiple Portfolios	MF-AGG		10,056,366	0.37	324,353	09/30/13
16.	TATA INVESTMENT CORP LTD	n/a	Co File		10,025,000	0.37	0	09/30/13
17.	SBI LIFE INSURANCE CO LTD	Multiple Portfolios	MF-AGG		9,256,170	0.34	-151,323	09/30/13
18.	ALLIANZ ASSET MANAGEMENT	n/a	ULT-AGG		8,129,923	0.30	2,071,551	09/30/13

% Out 76.19 | Zoom 100%

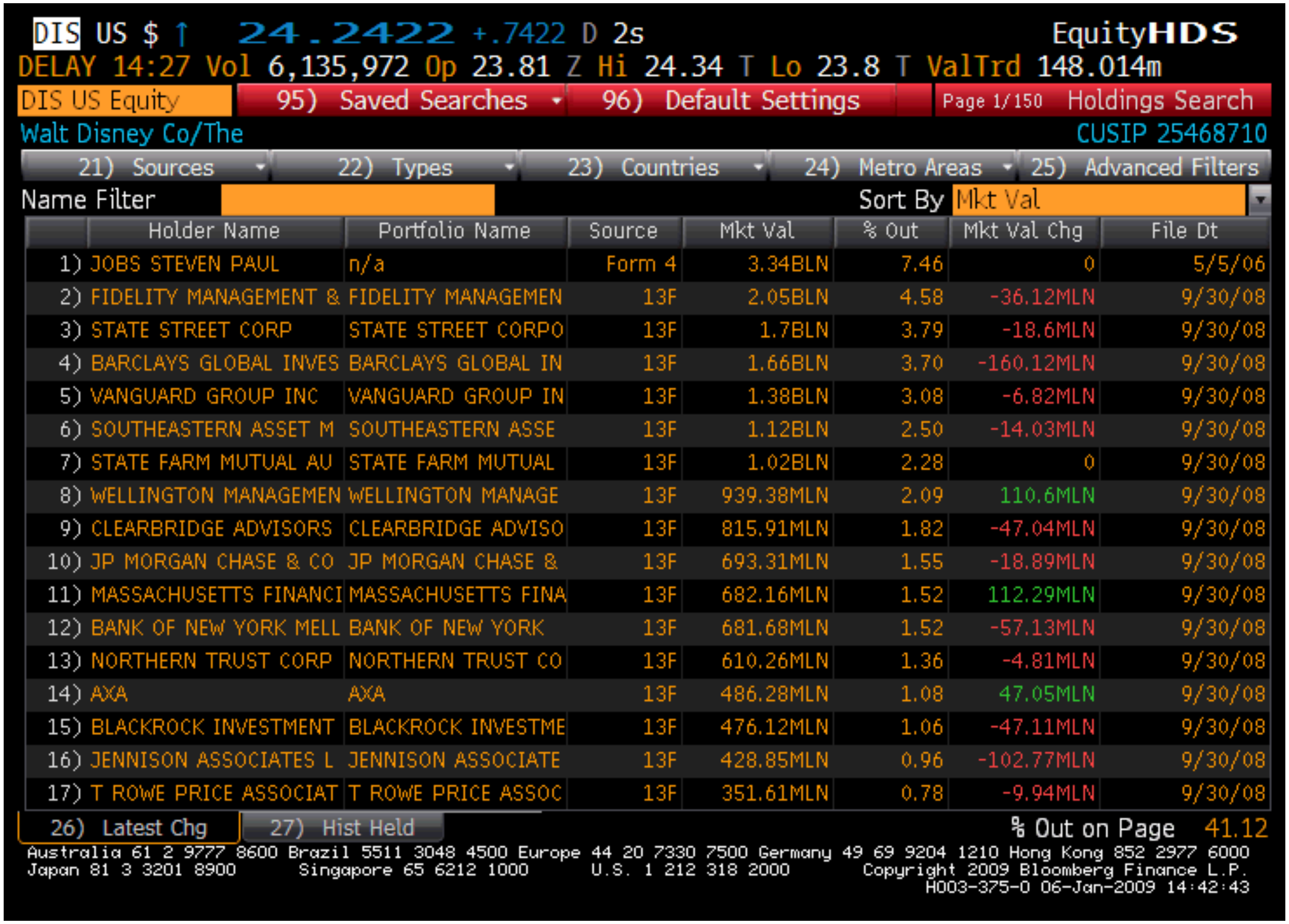
BUT IT IS A BENEVOLENT FAMILY!



CASE 4: LEGAL RIGHTS AND CORPORATE STRUCTURES: BAIDU

- **The Board**: The company has six directors, one of whom is Robin Li, who is the founder/CEO of Baidu. Mr. Li also owns a majority stake of Class B shares, which have ten times the voting rights of Class A shares, granting him effective control of the company.
- **The structure**: Baidu is a Chinese company, but it is incorporated in the Cayman Islands, its primary stock listing is on the NASDAQ and the listed company is structured as a shell company, to get around Chinese government restrictions of foreign investors holding shares in Chinese corporations.
- **The legal system**: Baidu's operating counterpart in China is structured as a Variable Interest Entity (VIE), and it is unclear how much legal power the shareholders in the shell company have to enforce changes at the VIE.

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
Australia 61 2 9777 8600 Brazil 5511 3048 4500 Europe 44 20 7330 7500 Germany 49 69 9204 1210 Hong Kong 852 2977 6000
Japan 81 3 3201 8900 Singapore 65 6212 1000 U.S. 1 212 318 2000 Copyright 2009 Bloomberg Finance L.P.
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II. Stockholders' Objectives vs. Bondholders' Objectives

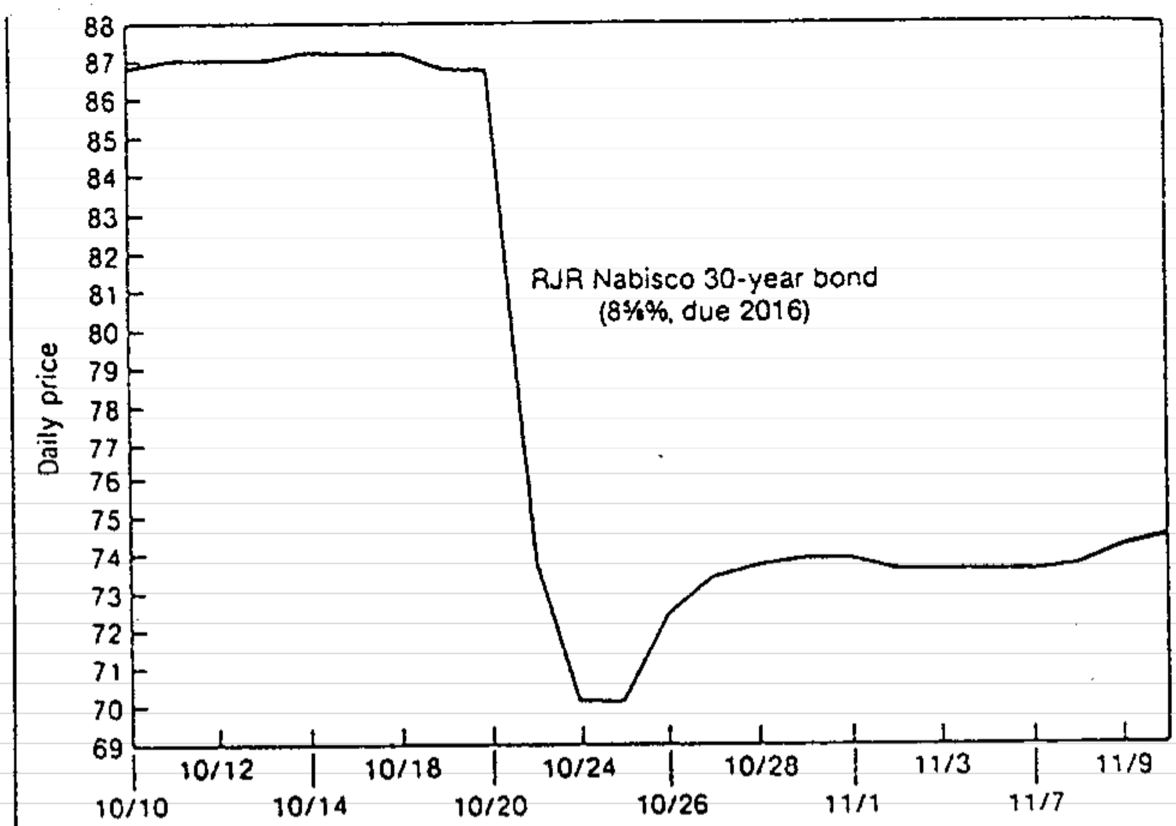
- **In theory**: There is no conflict of interests between stockholders and bondholders.
- **In practice**: Stockholders and bondholders have different objectives. Bondholders are concerned most about safety and ensuring that they get paid their claims. Stockholders are more likely to think about upside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

EXAMPLES OF THE CONFLICT..

- **A dividend/buyback surge**: 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.
- **Risk shifting**: When a firm takes riskier projects than those agreed to at the outset, lenders are hurt. 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



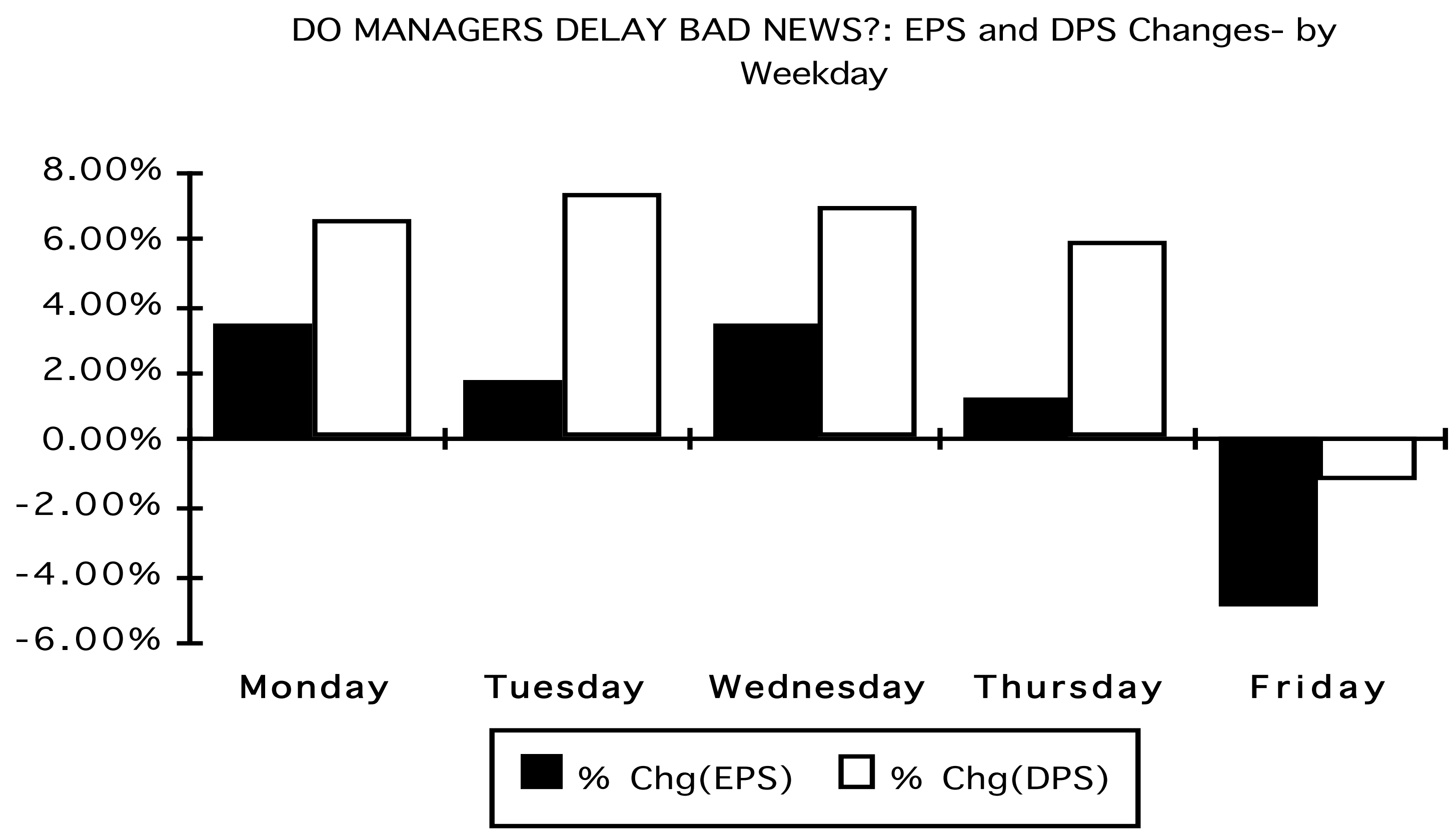
III. Firms and Financial Markets

- **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 management (timing and spin):** Information (especially negative) is sometimes suppressed or delayed by managers seeking a better time to release it. When the information is released, firms find ways to "spin" or "frame" it to put themselves in the best possible light.
- **Outright fraud:** 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..

- **Investor irrationality**: The base argument is that investors are irrational, and prices often move for no 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.
- Manifestations of irrationality
  - **Reaction to news**: Some believe that investors overreact to news, both good and bad. Others believe that investors sometimes under react to big news stories.
  - **An insider conspiracy**: Financial markets are manipulated by insiders; Prices do not have any relationship to value.
  - **Short termism**: Investors are short-sighted, and do not consider the long-term implications of actions taken by the firm

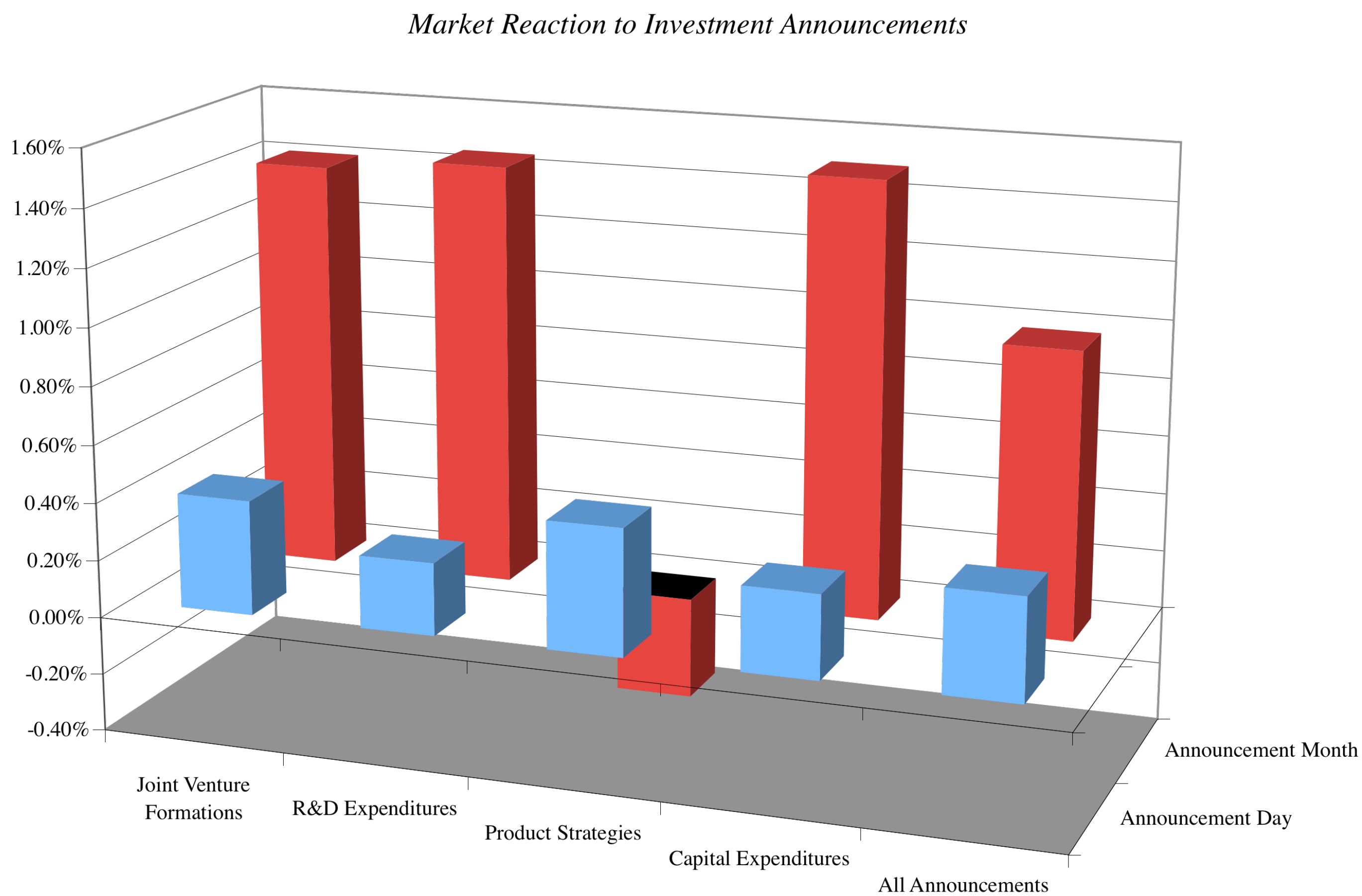
ARE MARKETS SHORT SIGHTED AND TOO FOCUSED ON THE NEAR TERM? WHAT DO YOU THINK?

- 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 COUNTER (ALBEIT NOT CONCLUSIVE) EVIDENCE THAT THEY ARE NOT..

- **Value of young firms**: 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?
- **Current earnings vs Future growth**: 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
- **Market reaction to investments**: 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?

- **Markets are the problem**: 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.
- **The counter**: There are two counter arguments that can be offered:
  - The 2008 crisis illustrates 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) was 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 marketplace. 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 (externalities).
  - 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 ..

- **Cannot know the unknown**: 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)
- **Eyes of the beholder**: They are 'person-specific', since different decision makers can look at the same social cost and weight them very differently.
- **Decision paralysis**: 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?
  a. Yes
  b. No
- If yes, would you tell your stockholders and let them vote on the issue?
  a. Yes
  b. No
- If no, how would you respond to a stockholder query on why you were not living up to your social responsibilities?

PUT SIMPLY, TRADITIONAL CORPORATE FINANCIAL THEORY BREAKS DOWN WHEN …

- **Managerial self-interest drives decision making**: The interests/objectives of the decision makers in the firm conflict with the interests of stockholders.
- **Debt holders are unprotected**: Bondholders (Lenders) are not protected against expropriation by stockholders.
- **Markets are inefficient and prices don’t reflect value**: Financial markets do not operate efficiently, and stock prices do not reflect the underlying value of the firm.
- **Businesses create large side costs for society (externalities):** Significant social costs can be created as a by-product of stock price maximization.

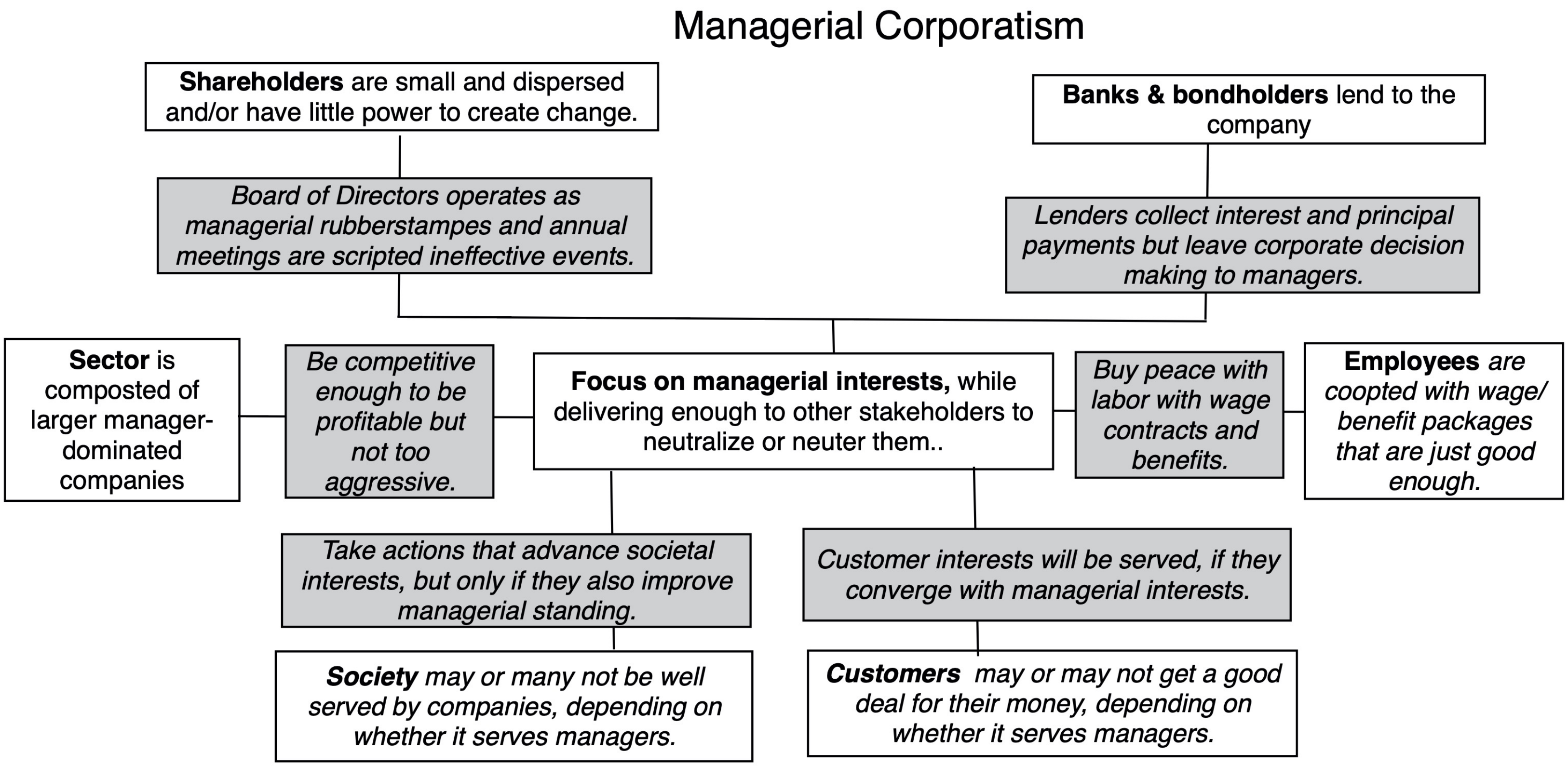
WHEN TRADITIONAL CORPORATE FINANCIAL THEORY BREAKS DOWN, THE SOLUTION IS:

- **A non stockholder-based governance system**: To choose a different mechanism for corporate governance, i.e, assign the responsibility for monitoring managers to someone other than stockholders.
- **A better objective than maximizing stock prices?** To choose a different objective for the firm, either by shifting to a different metric or stakeholder group(s).
- **Maximize stock prices but minimize side costs**: 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

I. AN ALTERNATIVE CORPORATE GOVERNANCE SYSTEM

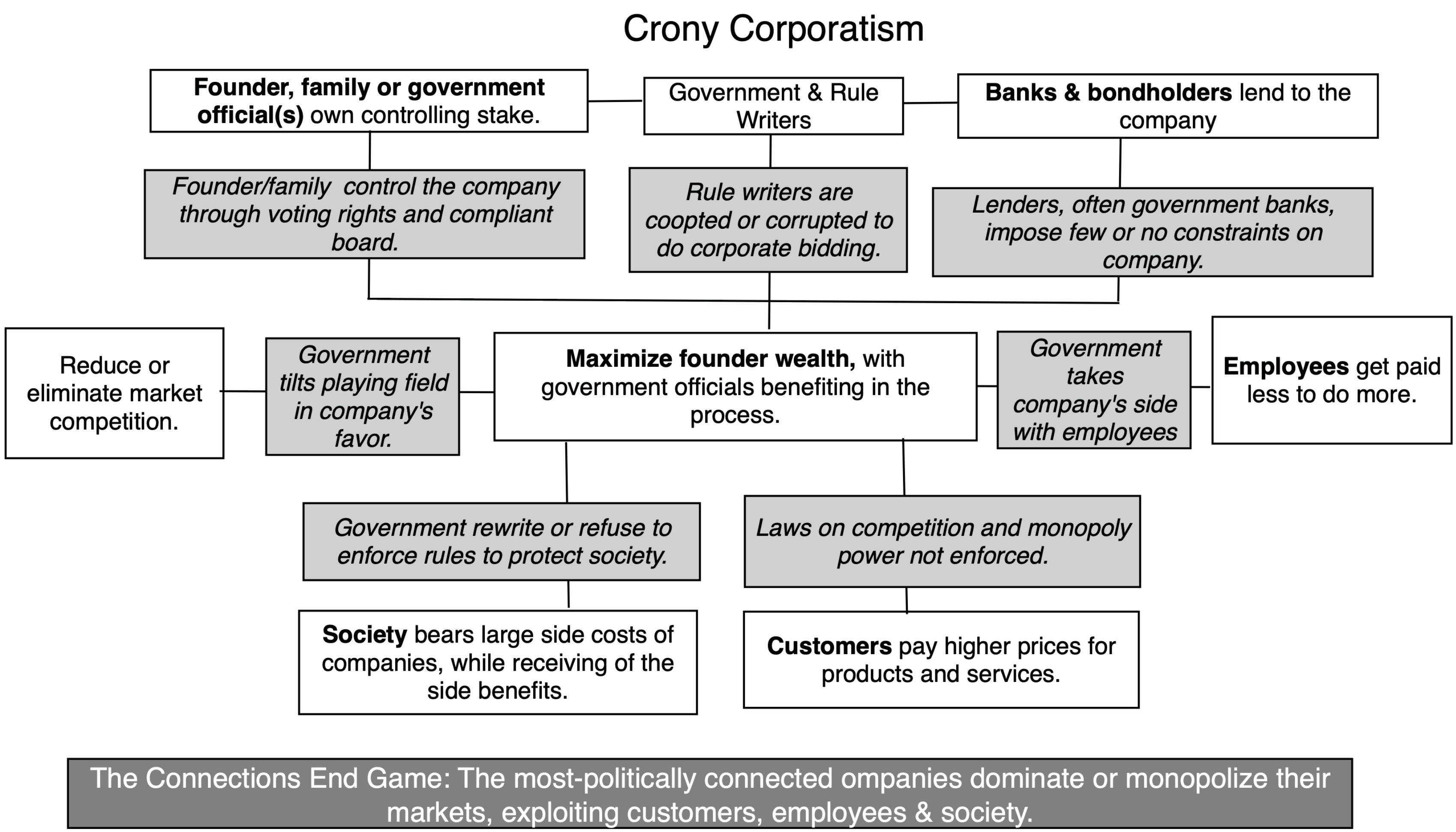
- **Germany and Japan** developed a different mechanism for corporate governance, based upon corporate cross holdings.
  - In Germany, the banks form the core of this system.
  - In Japan, it is the keiretsus
  - Other Asian countries have modeled their system after Japan, with family companies forming 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.

ONE END GAME: MANAGERIAL CORPORATISM



The Managerial End Game: The surviving companies are the ones that find a way to keep managers happy (either economically or with side benefits) with other stakeholders' interests being served well or badly depending on whether they converge with managerial interests.

A SKEWED VERSION: CRONY CORPORATISM



IIA. Choose a Different Metric to Maximize

- 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

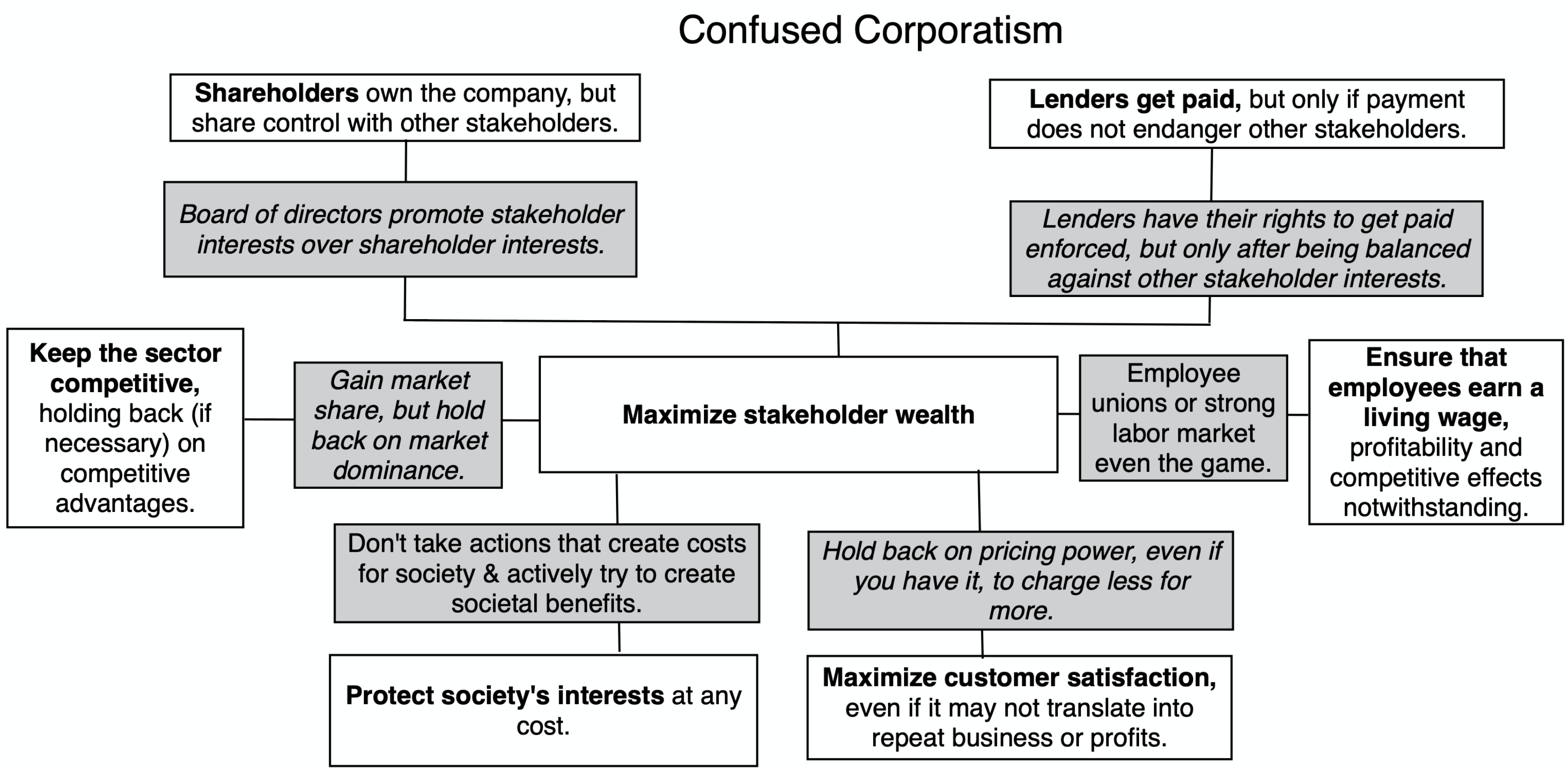
IIB. MAXIMIZE STAKEHOLDER WEALTH

- **A fairness argument**: To the extent that shareholder wealth maximization seems to, at least at first sight, put all other stakeholders in the back seat, it seems unfair.
- **An Easy Fix?** The logical response seems to be stakeholder wealth maximization, where the collective wealth of all stakeholders is maximized. That is the promise of stakeholder wealth maximization.
- **Protective response**: As corporations have found themselves losing the battle for public opinions, many CEOs and even some institutional investors seem to have bought into this idea.

THE BUSINESS ROUNDTABLE'S MESSAGE..

- While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders. We commit to:
  - **Delivering value to our customers**. We will further the tradition of American companies leading the way in meeting or exceeding customer expectations.
  - **Investing in our employees**. This starts with compensating them fairly and providing important benefits. It also includes supporting them through training and education that help develop new skills for a rapidly changing world. We foster diversity and inclusion, dignity and respect.
  - **Dealing fairly and ethically with our suppliers**. We are dedicated to serving as good partners to the other companies, large and small, that help us meet our missions.
  - **Supporting the communities in which we work**. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.
  - **Generating long-term value for shareholders**, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders

CONFUSED CORPORATISM

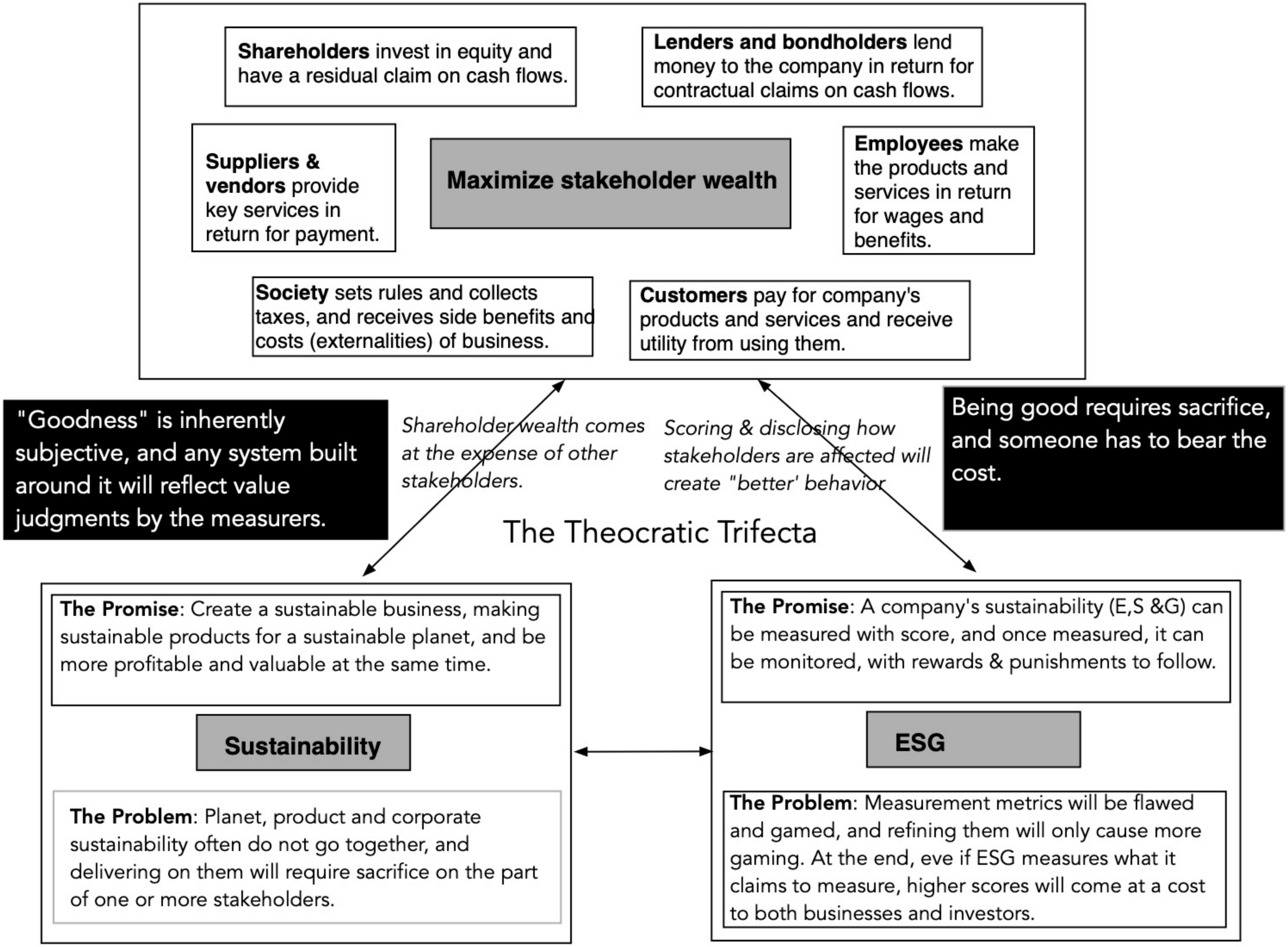


The Confused End Game: In the attempt to serve all stakeholders, none will be served, and there will be no accountabiity for managers, leading to companies that are less competitive and efficient.

IF CONFUSED CORPORATISM SOUNDS LIKE A GOOD DEAL, SOME CAUTIONARY NOTES..

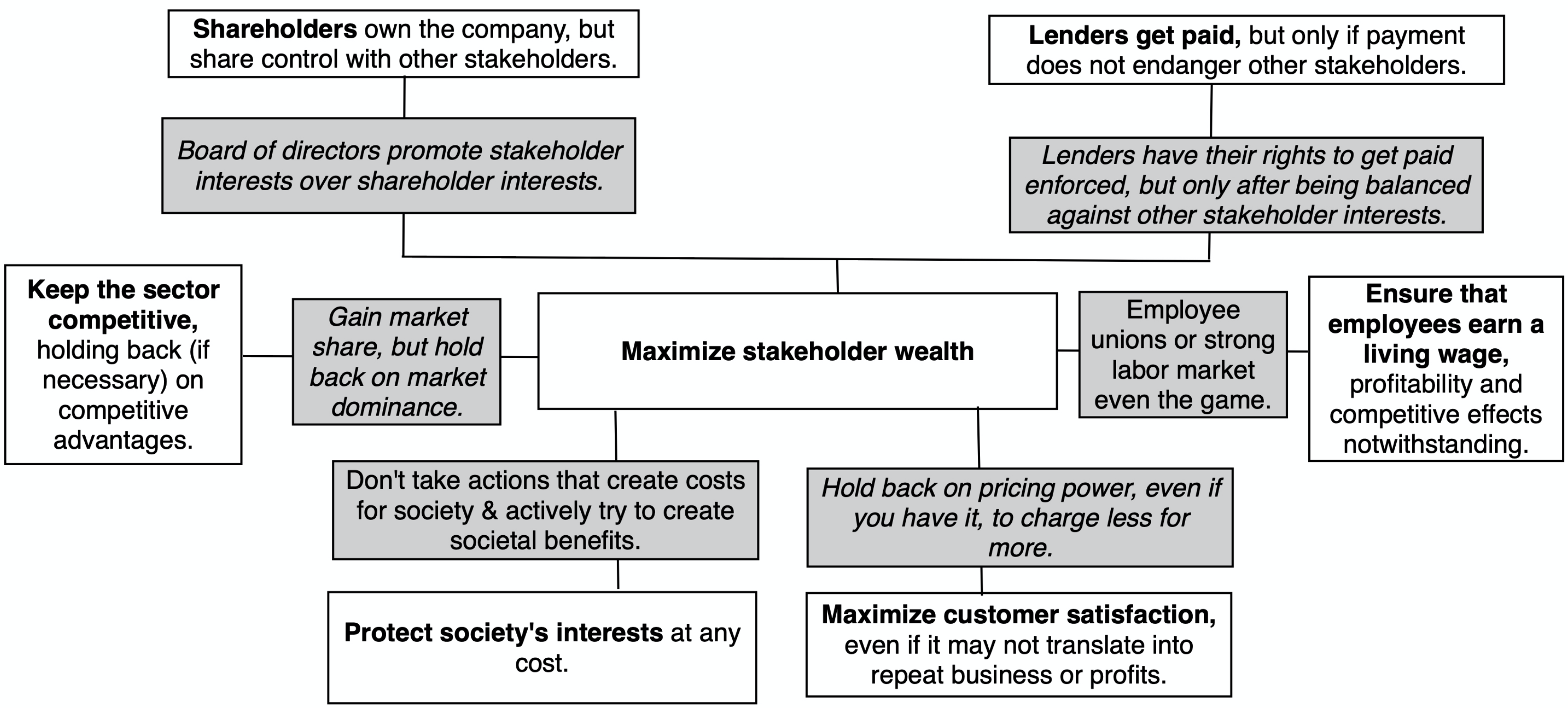
- **Government-owned companies**: The managers of these companies were given a laundry list of objectives, resembling in large part the listing of stakeholder objectives, and told to deliver on them all. The end results were some of the most inefficient companies on the face of the earth, with every stakeholder group feeling ill-served in the process.
- **US research universities**: These entities lack a central focus, where whose interests dominate and why shifts, depending on who you talk to and when. The end result is not just economically inefficient operations, capable of running a deficit no matter how much tuition is collection, but one where every stakeholder group feels aggrieved.

The Theocratic Trifecta



CONFUSED CORPORATISM (STAKEHOLDER WEALTH MAXIMIZATION)

Confused Corporatism



The Confused End Game: In the attempt to serve all stakeholders, none will be served, and there will be no accountabiity for managers, leading to companies that are less competitive and efficient.

SUSTAINABILITY: OF WHAT?

- **Planet sustainability**, measuring how our actions, as consumers and businesses, affect the planet, and our collective welfare and well being. This, of course, covers everything from climate change to health care to income inequality.
- **Product sustainability,** measuring how long a product or service from a business can be used effectively, before becoming useless or waste. In a throw-away world, where planned obsolescence seems to be built into every product or service, there are consumers and governments who care about product sustainability, albeit for different reasons.
- **Business or corporate sustainability**, measuring the life of a business or company, and actions that can extend or constrict that life.

WHAT DOES A CSO DO?

CSO Role Model	*Role/Tasks*	*Training/Preparation for job*
1. Yoda	Providing vision and guidance to the companies they worked at, about the social effects of their actions, and doing so with a long-term perspective. In short, they have a better perspective than the rest of us on how the company and society would evolve over time, and advice the company on the actions that it would need to take to match that evolution.	Born brilliant and spent a decade up in a cave in the Himalayas, acquiring "wisdom" or Jedi training from Obi-wan Kenobi.
2. Jiminy Cricket	Act as corporate consciences, reminding the companies that they work for of the social effects of their actions, hoping that it prompts them to change their ways. Like Jiminy Cricket, they are usually ignored and get little glory, even in hindsight.	A past life as a pastor or a priest, with clearly defined lines between good and bad and a talent for evoking guilt.
3. PR (Mad Man)	Marketing fronts for companies, with the job of taking actions that could not remotely be argued as being good for the planet and selling them as such and stepping up during "crises" and finding someone else to blame for corporate actions.	A job in public relations, preferably working for a politician, with skills in spinning the facts.
4. Embalmer	Ensure that the company will live longer, perhaps even forever, even if it is not in the best interests of any of the stakeholders, that they should, or the planet.	Strategic consulting, preferably at a big-name consulting firm, with a matrix to guide you.

THE ESG PROMISES: MEASURABLE AND CAKE FOR ALL, WITH NO CALORIES!

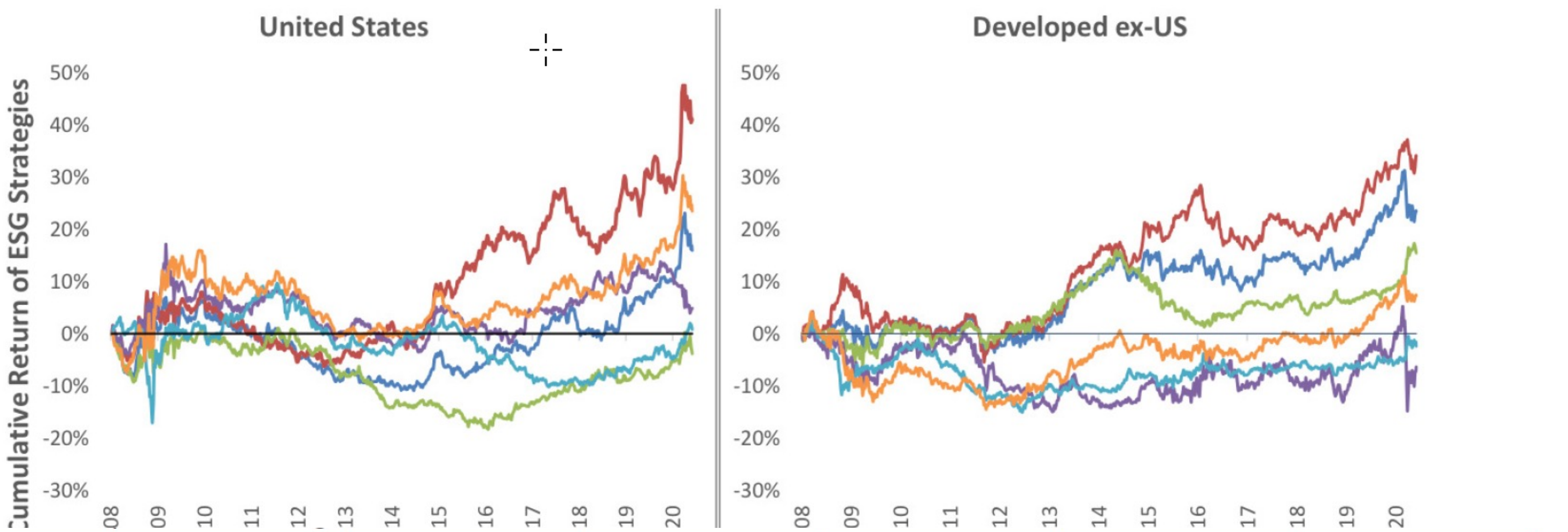
- It is measurable: Much as ESG advocates try to claim it is not about scores, it is undeniable that its growth in use has come from the scoring.
- It is good for value: For companies, the promise is that being "good" will generate higher profits for the company, at least in the long term, with lower risk, and thus make them more valuable.
- It is good for investors: For investors in these companies, the promise is that investing in "good" companies will generate higher returns than investing in "bad" or middling companies.
- It is good for society: For society, the promise is that not only would good companies help fight problems directly related to ESG, like climate change and low wages, but also counter more general problems like income inequality and healthcare crises.

ESG: THE CONTRA CASE

- **ESG is difficult (if not impossible) to measure, since goodness is in the eyes of the beholder and changes over time.** Not surprisingly, this results in (a) significant disagreements on ESG scores for the same company across different services and (b) changes in the score for a company across time from the same service.
- **The notion that increasing ESG always increases value is absurd**. It can increase value at some companies, smaller and serving niche markets (Patagonia, REI), decrease value at others (where being good costs you with no revenue gain, which is true for the vast majority of companies that spend money on ESG) or do nothing for value.
- **The notion that investing in high ESG companies will earn you alpha, risk-adjusted returns that exceed what you make, is the epitome of the "have your cake and eat it too" sales pitch** that has led ESG to where it is today. In reality, doing good will cost you, and you have to be okay with it.
- The fallback that even if ESG is not good for companies or investors, it should be pursued, because it is **good for society is also questionable**. You would be hard pressed to find a single ESG dimension where we are better off now than we were 20 years ago, when ESG was created.

THE PROBLEM WITH ESG RESEARCH: ACCIDENTAL ALPHAS!

Exhibit 3: Cumulative Returns of ESG Strategies



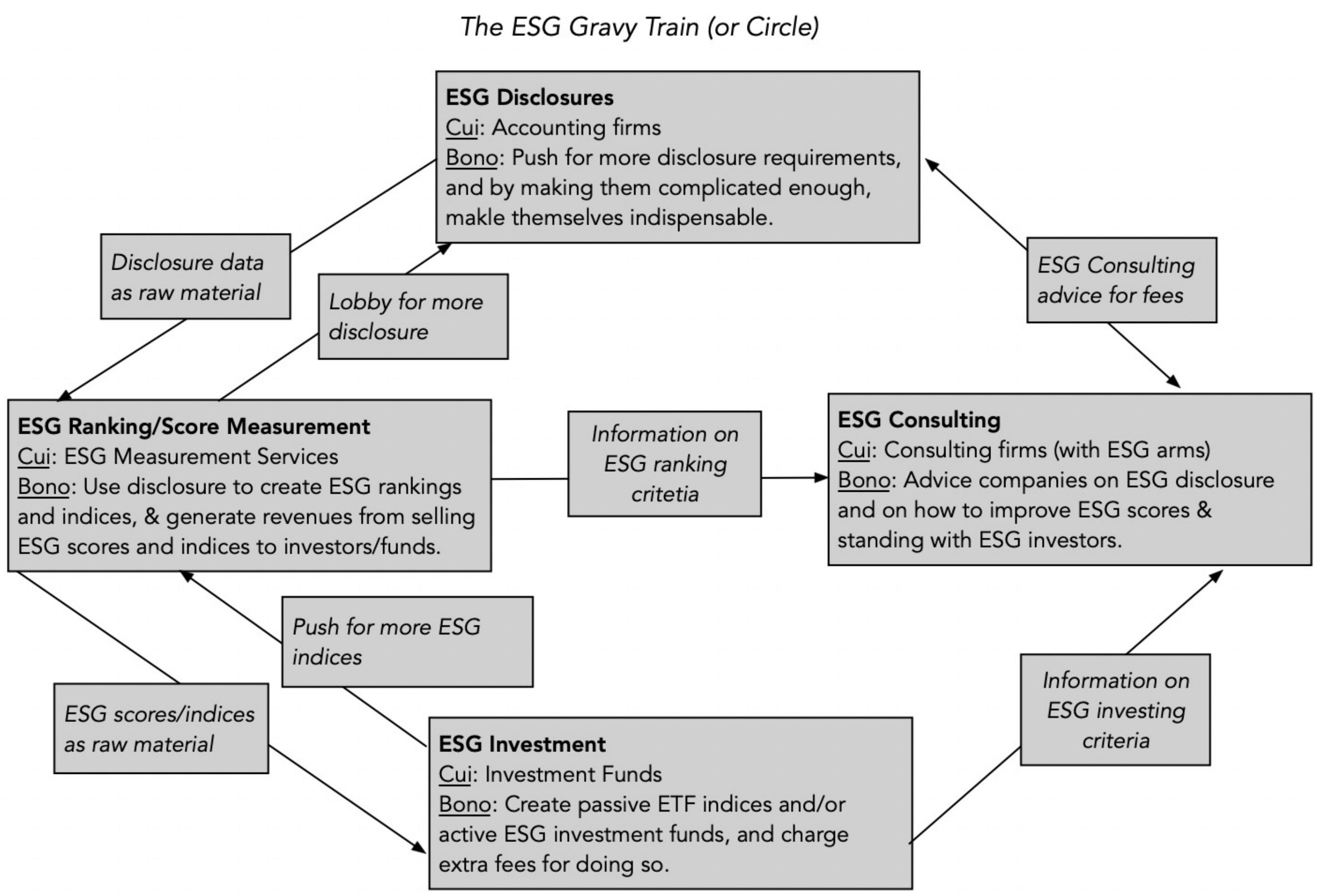
Jan 2008 - Jun 2020	ESG		E		S		G		ESG Momentum		Combination	
Geographic Universe	US	Dev ex-US	US	Dev ex-US	US	Dev ex-US	US	Dev ex-US	US	Dev ex-US	US	Dev ex-US
Ann. Return	1.29%	1.63%	2.89%	2.43%	-0.23%	1.07%	0.45%	-0.85%	0.15%	-0.26%	1.92%	0.48%
t-statistic	0.85	0.90	1.71	1.59	-0.05	0.70	0.40	-0.05	0.19	-0.11	1.23	0.36
CAPM Alpha	2.57%	1.63%	3.99%	2.43%	0.54%	1.08%	1.30%	-0.52%	0.06%	-0.14%	2.84%	0.53%
t-statistic	1.55	1.05	2.28	1.68	0.35	0.79	0.84	-0.23	0.04	-0.12	1.62	0.37
7 Factor Alpha	-0.33%	1.31%	0.96%	1.95%	-1.17%	1.95%	-0.22%	-1.75%	0.00%	0.86%	0.96%	0.52%
t-statistic	-0.24	0.85	0.68	1.43	-0.84	1.43	-0.16	-0.78	0.00	0.73	0.59	0.36

Source: Honey, I shrunk the ESG alpha

AND THE SOCIETAL BENEFITS ARE ILLUSORY

- There are some who argue that even if ESG is bad for companies and investors, it is good for society, because companies will treat their customers and employees better, while catering to their local communities.
- There are three fundamental flaws:
  - **Greenwashing**: ESG allows companies to sound good, while not doing good, and that it will allow for posturing and public relation ploys that do little to advance public good.
  - **Outsourcing goodness**: It makes the CEOs the arbiters of goodness and badness.
  - **Behind the curtain**: Pressuring companies to invest in the good and divest themselves or avoid the bad may only push bad behavior to less observable and monitored parts of the economy.

SO WHY IS ESG STILL BEING SOLD? CUI BONO? (WHO BENEFITS?)



III. 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 can lead to a much more active market for corporate control.
  - stockholders taking advantage of bondholders can lead to bondholders and lenders protecting themselves better.
  - firms revealing incorrect or delayed information to markets can lead to markets becoming more "skeptical" and "punitive"
  - firms creating social costs can lead to more regulations, as well as investor and customer backlashes.

MARKET DISCIPLINE AS SELF-CORRECTION

1. Activist investors make their presence felt.
2. Threat of hostile acquisitions

STOCKHOLDERS

Have little control over managers

Managers put their interests above stockholders

1. Laws and regulations restricting behavior.
2. Customers, employees & investors abandon firm.

Lend Money

BONDHOLDERS ⟷ **Managers** ⟷ SOCIETY

Bondholders can get ripped off

Significant Social Costs

Some costs cannot be traced to firm

Delay bad news or provide misleading information

Markets make mistakes and can overreact

Bondholders design new debt and write in fresh protections against stockholder actions.

The truth eventually comes out and markets mete out decisive punishment.

FINANCIAL MARKETS

1. The Stockholder Backlash

- **Vocal stockholders, armed with more information and new powers**: At annual meetings, stockholders have taken to expressing their displeasure with incumbent management by voting against their compensation contracts or their board of directors.
- **Shareholders become more receptive to activist investor campaigns**: Activist investors (individuals and institutions) target companies where shareholders are unhappy with the status quo and push for change.
- **Hostile acquisitions**: There is nothing that focuses management minds more than the threat of a hostile acquisition. 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

DISNEY: EISNER'S RISE & FALL FROM GRACE

- In his early years at Disney, Michael Eisner **brought about long-delayed changes in the company** and put it on the path to being an entertainment giant that it is today. His success allowed him to consolidate power and the boards that he created were increasingly captive ones.
- In 1996, Eisner **spearheaded the push to buy ABC and the board rubberstamped his decision**, as they had with other major decisions.
  - In the years following, the **company ran into problems** both on its ABC acquisition and on its other operations and stockholders started to get restive, especially as the stock price halved between 1998 and 2002.
  - In 2003, Roy Disney and Stanley Gold **resigned from the Disney board**, arguing against Eisner's autocratic style.
- In early 2004, **Comcast made a hostile bid for Disney** and later in the year, 43% of Disney shareholders withheld their votes for Eisner's reelection to the board of directors. Following that vote, the board of directors at Disney voted unanimously to elect George Mitchell as the Chair of the board, replacing Eisner, who vowed to stay on as CEO.

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... IGER'S ENTRY AND A NEW AGE DAWNS?

A New CEO

A Better Board?

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

And a plan for transition..

In 2011, Iger announced his intent to step down as CEO in 2015 to allow a successor to be groomed.

BUT AS A CEO'S TENURE LENGTHENS, DOES CORPORATE GOVERNANCE SUFFER?

- In 2011, the board voted to reinstate Iger as chair of the board in 2011, reversing a decision made to separate the CEO and Chair positions after the Eisner years.
- There were signs of restiveness among Disney's stockholders, especially those interested in corporate governance.
  - Activist investors (CalSTRS) started making noise and Institutional Shareholder Services (ISS), which gauges corporate governance at companies, raised red flags about compensation and board monitoring at Disney.
  - Shareholder votes challenging management became more common.

IGER'S NON-EXIT, THE DOMINO EFFECT AND A RESOLUTION?

- In 2015 but Disney's board convinced Iger to stay on as CEO for an extra year, for the "the good of the company".
  - In 2016, Thomas Staggs who was considered heir apparent to Iger left Disney. Others who were considered potential CEOs also left.
  - In 2017, Disney acquired Fox and announced that Iger's term would be extended to 2019 (and perhaps beyond) because his stewardship was essential for the merger to work.
- In February 2020, Iger stepped down as CEO (but stayed on as Exec Chair until Dec 2021), and Bob Chapek, head of Disney Theme Parks, took his place. Disney's stock price dropped about 8% in the immediate aftermath.

ACTIVISTS COME FOR DISNEY…

February 2020
Iger steps down and the board names Bob Chapek as successor

October 2020
Chapek announces major restructuring, with Disney Plus taking center stage.

2020-22
Disney Plus is a hit, in terms of subscribers, but with huge content costs.

September 2022
Dan Loeb targets Disney, [ushing for spin off of ESPN & reining in of content costs.

November 2022
Disney reports annual numbers for 2022, missing on revenue and earnings.

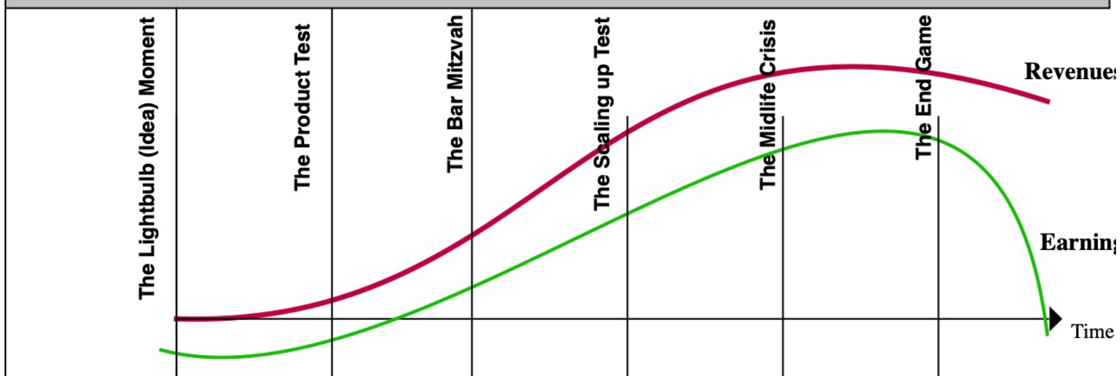
In January 2023, Nelson Peltz goes public with his demand for a seat on Disney's board and a push for costs controls (especially at Disney+)

Time: January 2020 - January 2023

In **November 2022**, Bob Iger returned to the firm as CEO, replacing Bob Chapek as CEO and firing Kareem Daniel from his position at the top of the media & distribution business.

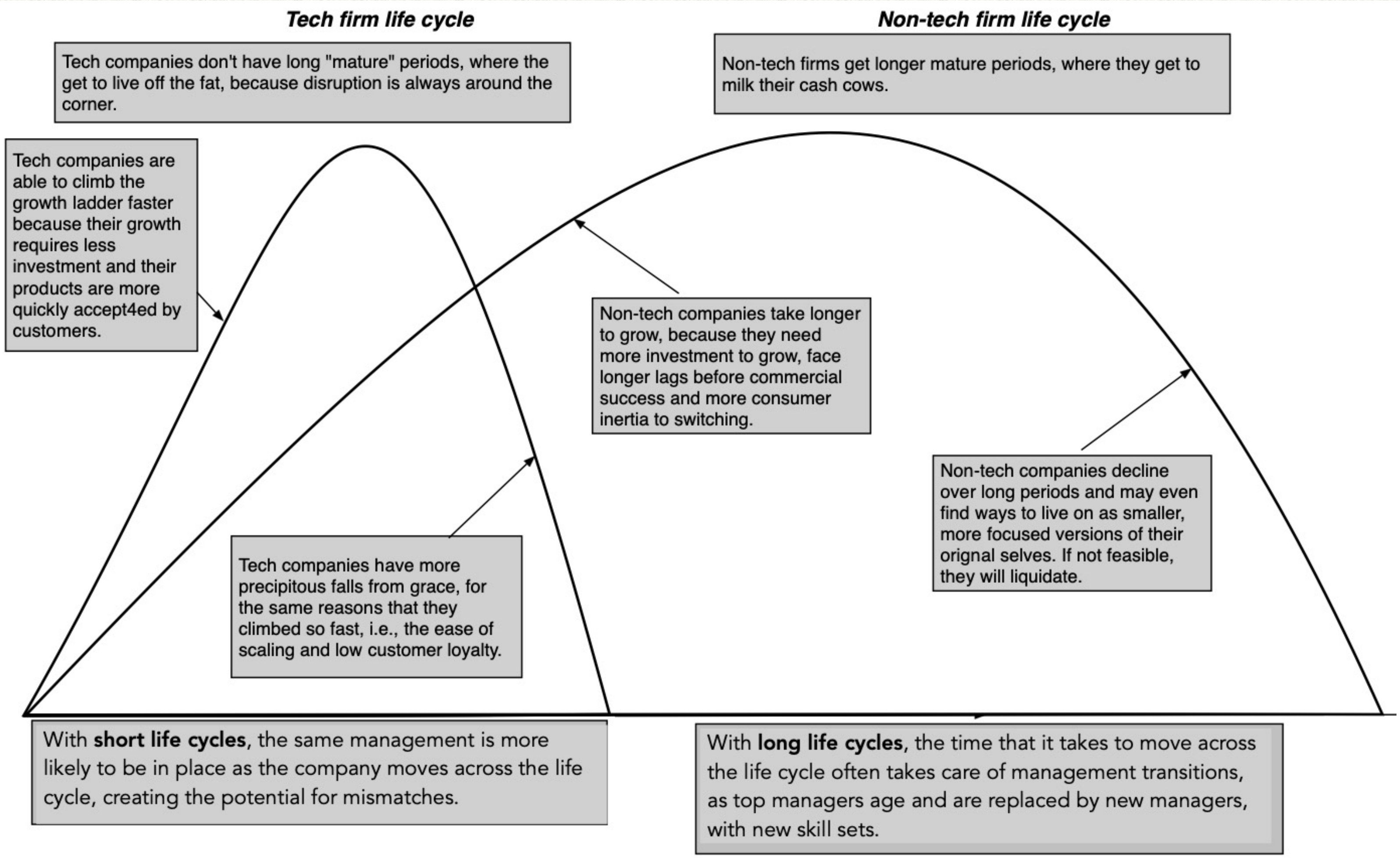
A LIFE CYCLE VIEW OF CEOS

The Corporate Life Cycle: The "Right" CEO

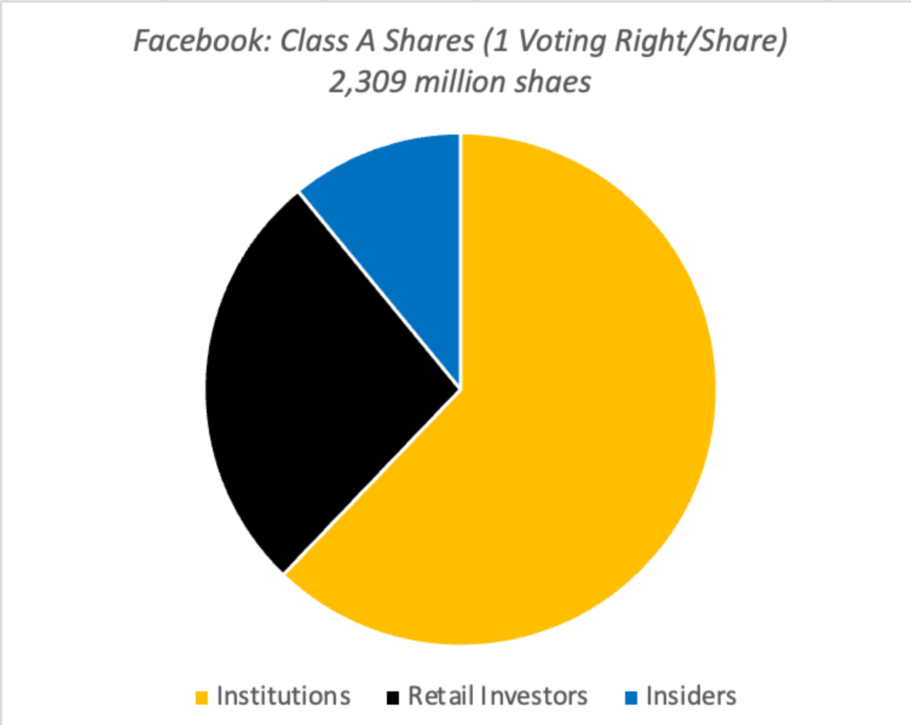


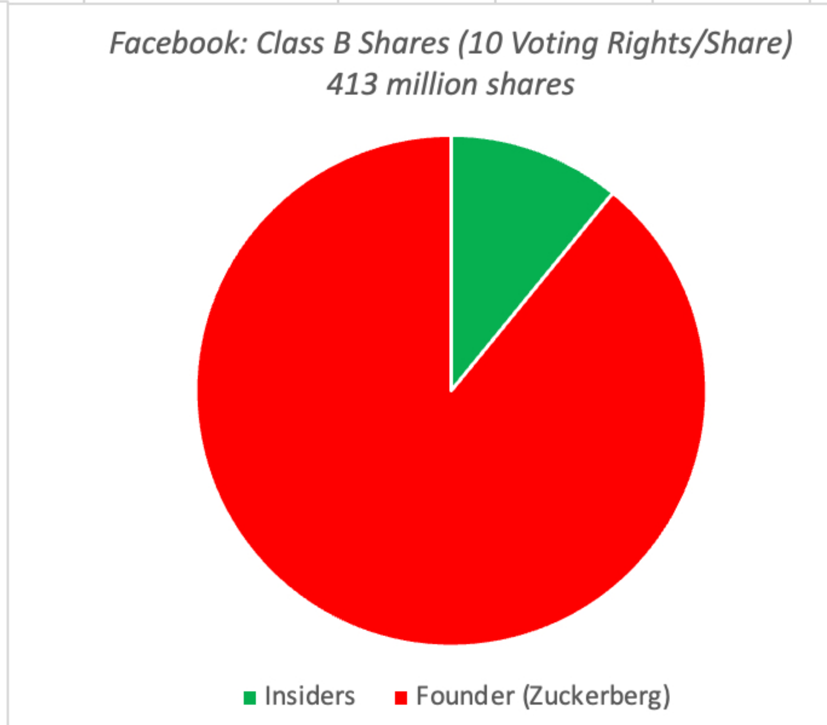
Lifecycle stage	Start-up	Young Growth	High Growth	Mature Growth	Mature Stable	Decline
Management's Importance	Critical, in selling vision & creating business model		Decreases as firm matures, and more so in macro businesses			Significant, since denial or desperation can be costly.
Management role in narrative/ numbers	Visionary/Story Teller	Stay consistent with words & actions	Deliver numbers to back up story	Keep narrative in sync with numbers	Adjust your narrative to reflect where you are in the life cycle.	Act your age (in terms of narrative & choices)
Management key function	Sell a vision (story) to investors and employees	Build a business model to deliver on vision	Scale up the business model	Extend the business model into new maarkets	Defend the business model against competitors	Scale down the business model
The Right CEO	**Steve, the Visionary**	**Paula, the Pragmatist**	**Bob, the Builder**	**Oscar, the Opportunist**	**Donna, the Defender**	**Larry, the Liquidator**

THE COMPRESSED TECH LIFE CYCLE



CORPORATE GOVERNANCE AT TECH FIRMS: THE FACEBOOK EXAMPLE





	% of shares	% of voting rights
Institutions	52.72%	22.29%
Retail Investors	22.83%	9.65%
Insiders (no Zuckerberg)	10.93%	10.92%
Zuckerberg	13.52%	57.14%

2. 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.

3. THE FINANCIAL MARKET RESPONSE

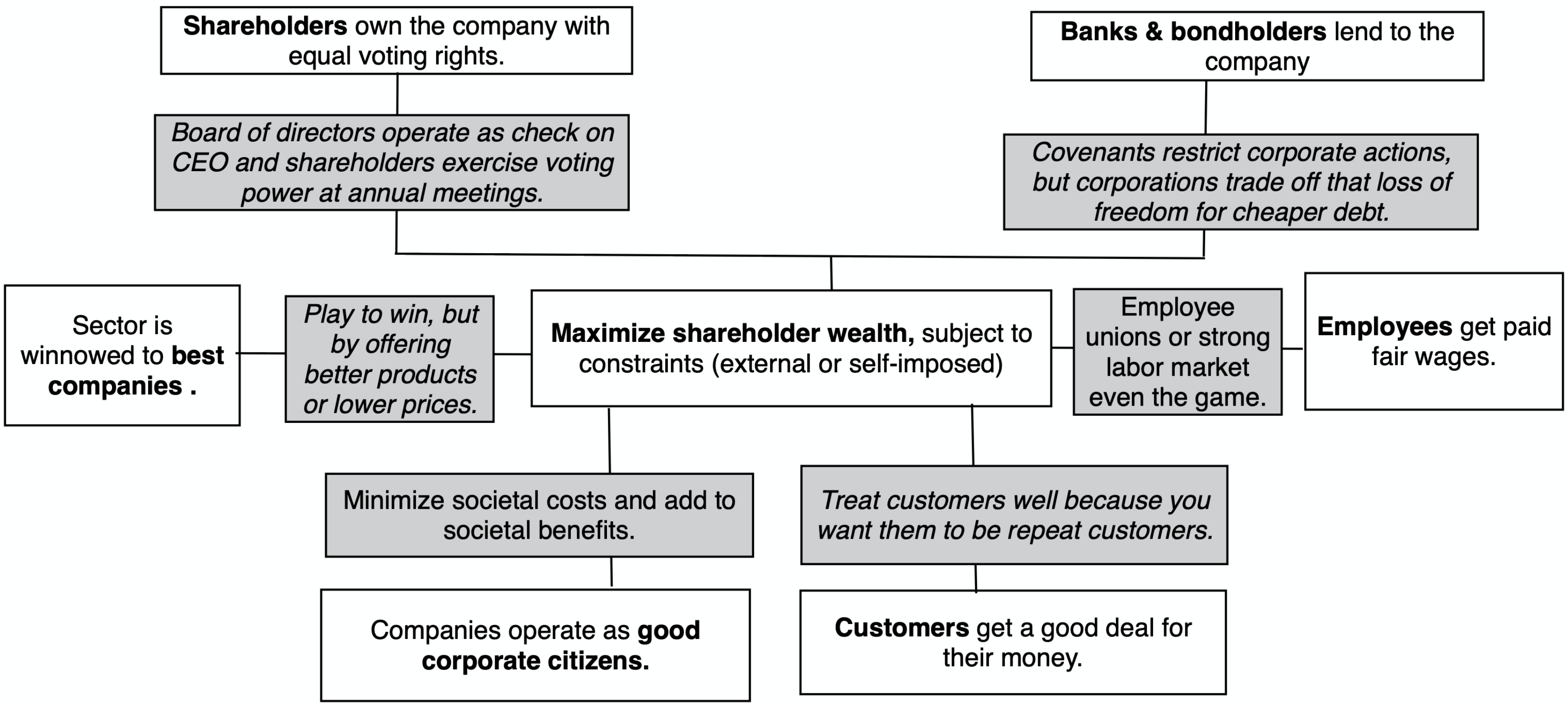
- Companies can mislead investors for long periods, leading stock prices away from value and skewing capital allocation across firms. (Firms that mislead have access to more capital than they should…)
  - Analysts, for the most part, seem to be ineffective at uncovering these "problems", sometimes because of tunnel vision and sometimes because of biases.
  - As investor access to information improves, it is becoming much more difficult for firms to control when and how information gets out to markets.
  - If there are ways of trading on over valuation, the payoff to uncovering negative information about companies rises, and there will be an incentive on the part of investors to uncover the truth.
- No matter what, the truth eventually does come out, and when it does:
  - The punishment is not only quick, but it is savage. Stock prices drop, as markets reset.
  - The management of the company loses credibility making it difficult for the company to find its way back to health.

4. 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.
- Even if governments and regulators do not act, a company that deliberately flouts societal norms and acquires a reputation as a bad company can pay a price:
  - 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 customers and revenues.
  - These firms may have trouble holding on to employees
  - Investors may choose not to invest in stocks of firms that they view as socially irresponsible and lenders may be reluctant to lend money to the firm.
  - If this seems like a back-handed argument for ESG, it is, but it is a very restrictive one where the advice to companies it to not be bad (rather than to be good).

CONSTRAINED CORPORATISM

Constrained Corporatism



The Constrained End Game: The winner companies are the ones that find a way to maximize shareholder wealth, while being good corporate citizens, protecting employee interests and delivering good value to customers.

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)