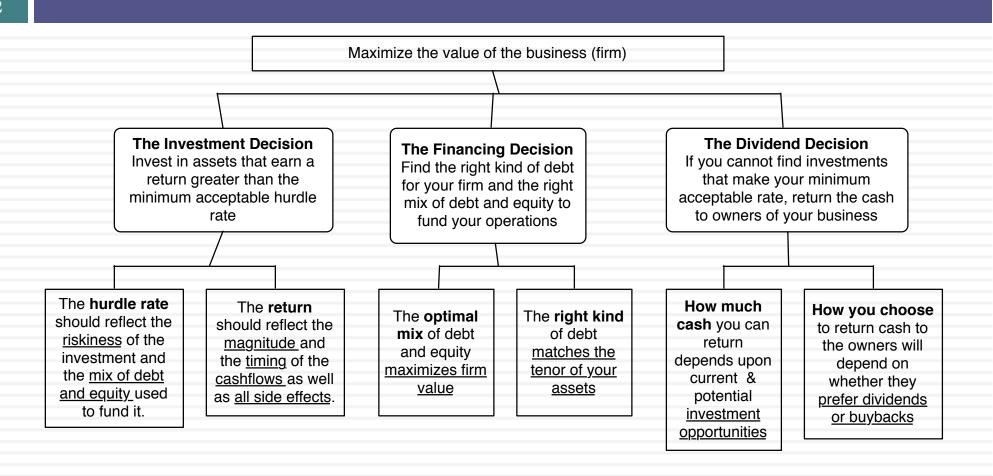
CORPORATE FINANCE B40.2302

LECTURE NOTES: PACKET 1

Aswath Damodaran

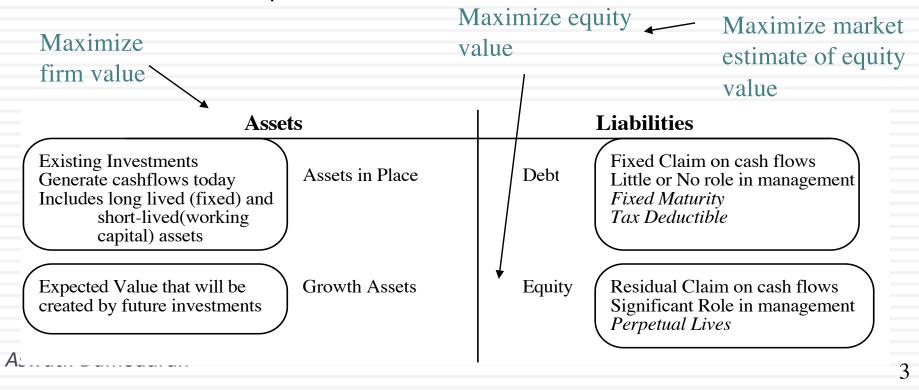
THE OBJECTIVE IN CORPORATE FINANCE

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



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

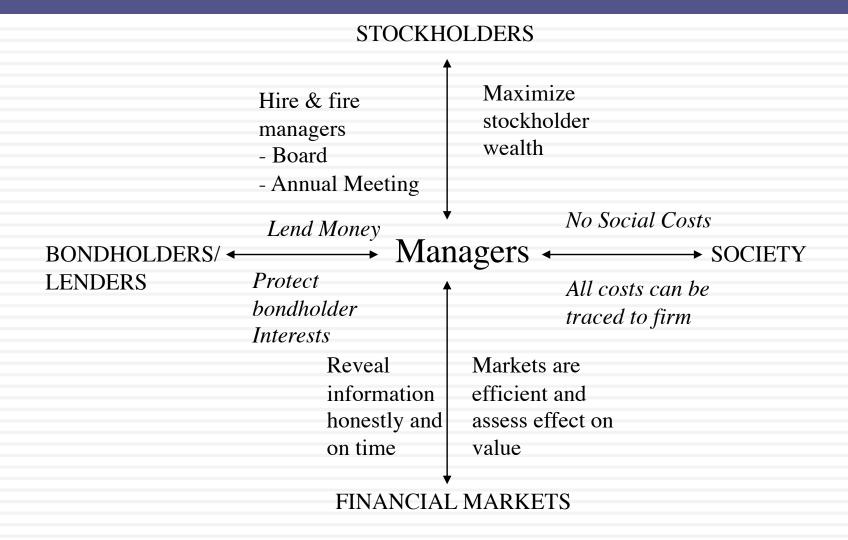
- Maximizing stock price is not incompatible with meeting employee needs/objectives. In particular:
 - Employees are often stockholders in many firms
 - Firms that maximize stock price generally are profitable firms that can afford to treat employees well.
- Maximizing stock price does not mean that 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.

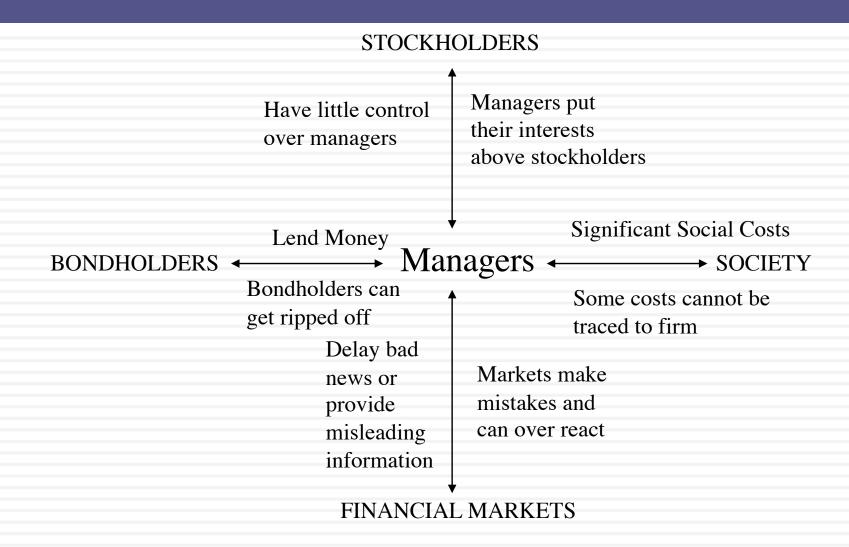
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- Stock price is easily observable and constantly updated (unlike other measures of performance, which may not be as easily observable, and certainly not updated as frequently).
- If investors are rational (are they?), stock prices reflect the wisdom 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



What can go wrong?



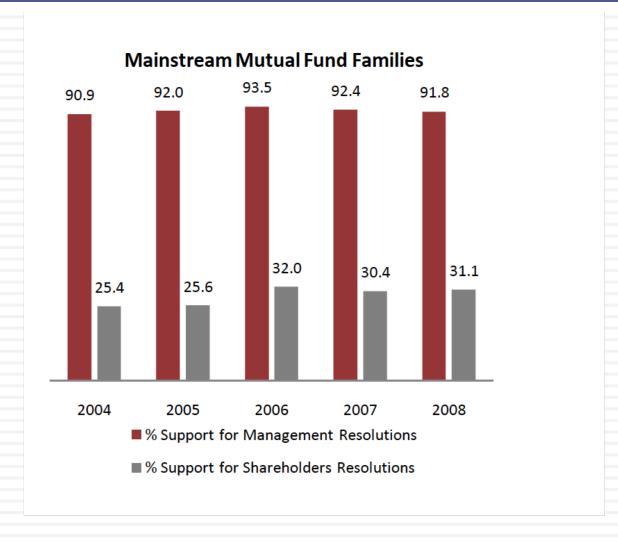
I. Stockholder Interests vs. Management Interests

- 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

- Directors are paid well: 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 was a non-executive chair, he or she received about \$150,000 more in compensation.
- Spend more time on their directorial duties than they used to: A board member worked, 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. Those numbers are up from what they were a decade ago.
- Even those hours are not very productive: While the time spent on being a director has gone up, a significant portion of that time was spent on making sure that they are legally protected (regulations & lawsuits).
- And they have many loyalties: Many directors serve on three or more boards, and some are full time chief executives of other companies.

The CEO often hand-picks directors...

- 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 changed 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.

Directors 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

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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...

EW BANK					DOARD PERFORMANCE POLL				GOVERNANCE GUIDELINE ANALYSIS		
	OVERALL SCORE	SURNEY SCORE	ANALYSIS SCORE	DETAILS	SHAREHOLDER ACCOUNTABILITY	BOARD	BOARD INDEPENDENCE	CORPORATE PERFORMANCE	SHAREHOLDER ACCOUNTABILITY	DIRAUD YTIJAUD	BOARD INDEPENDEN
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