

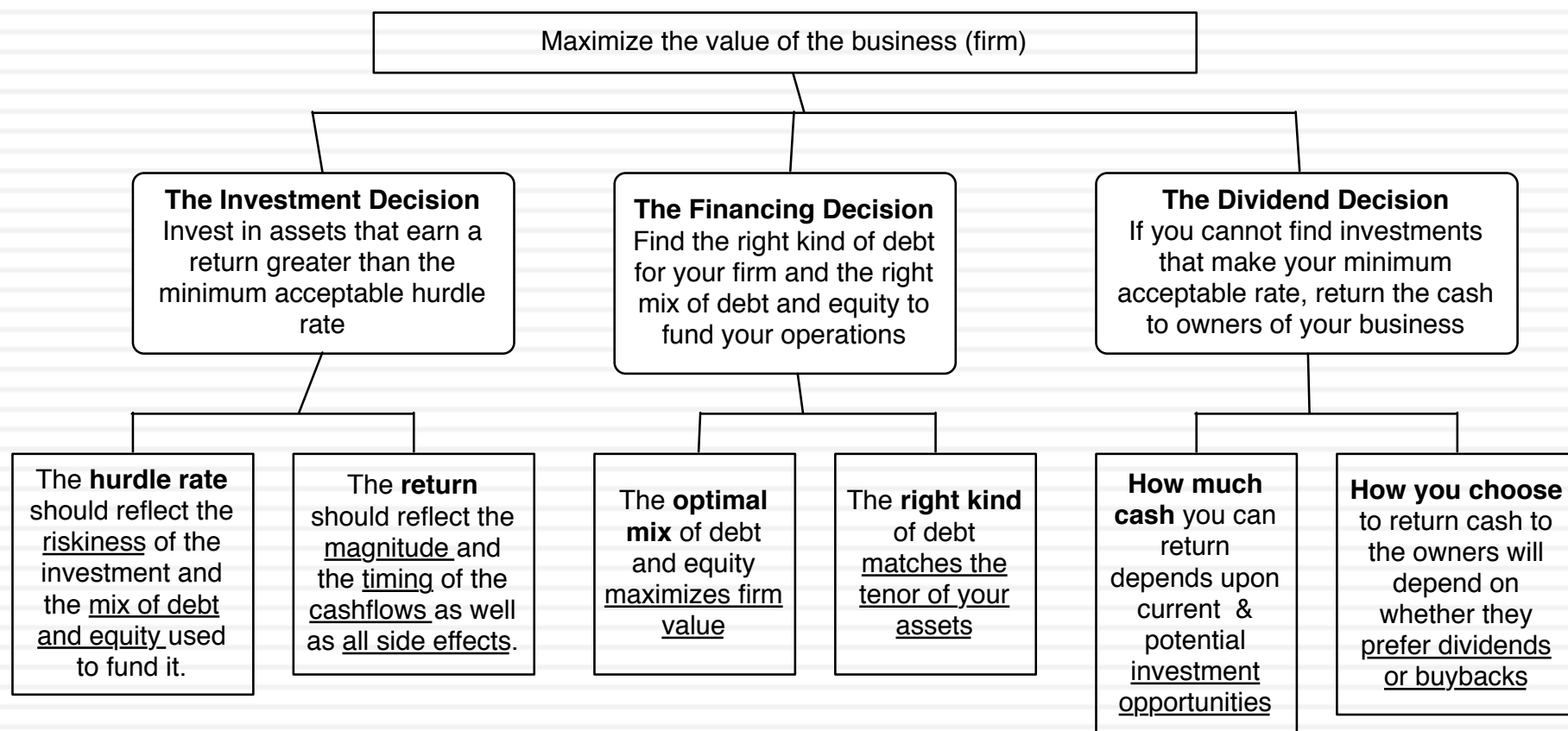


THE OBJECTIVE IN CORPORATE FINANCE

“If you don't know where you are going, it doesn't matter how you get there”

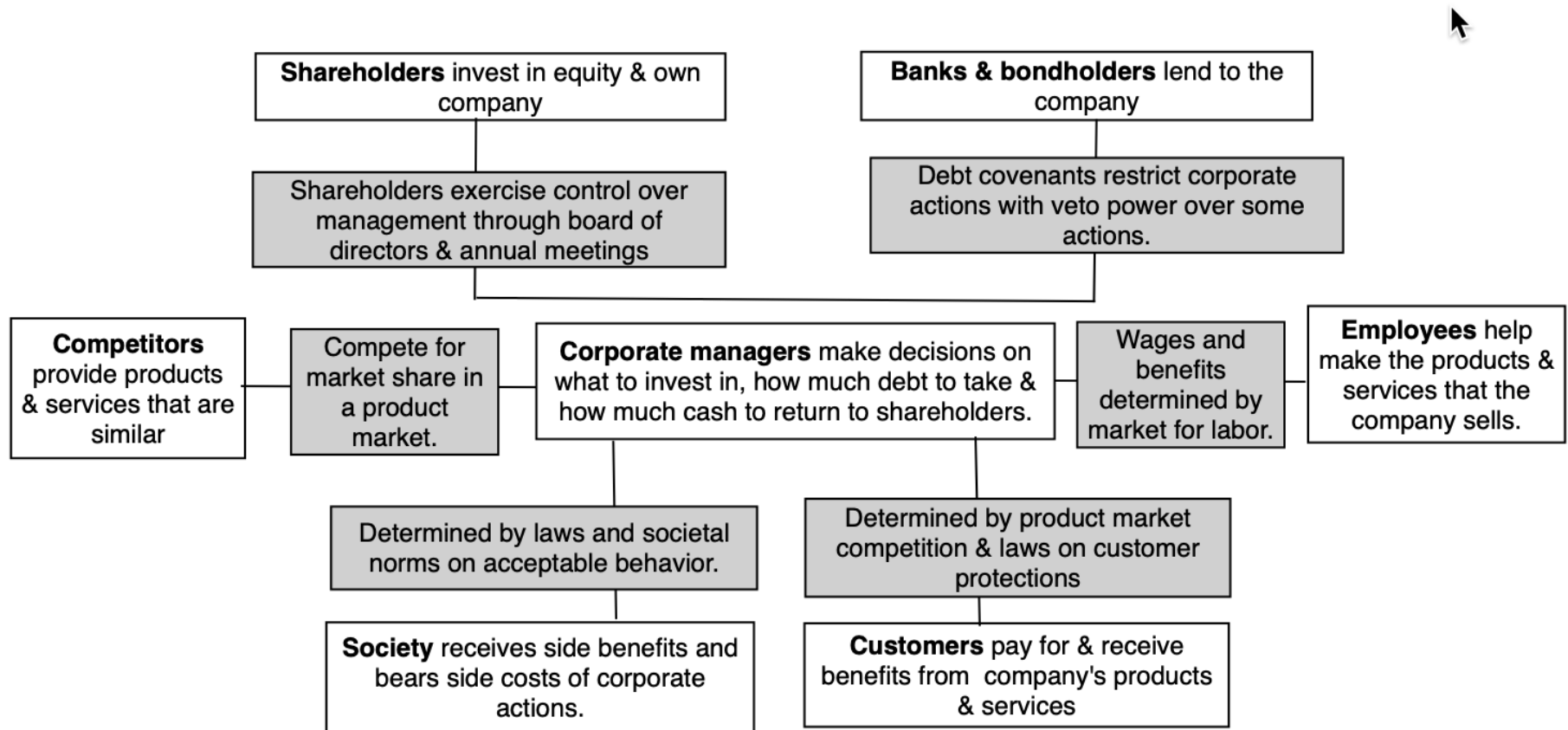
First Principles

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The Corporate Stakeholders

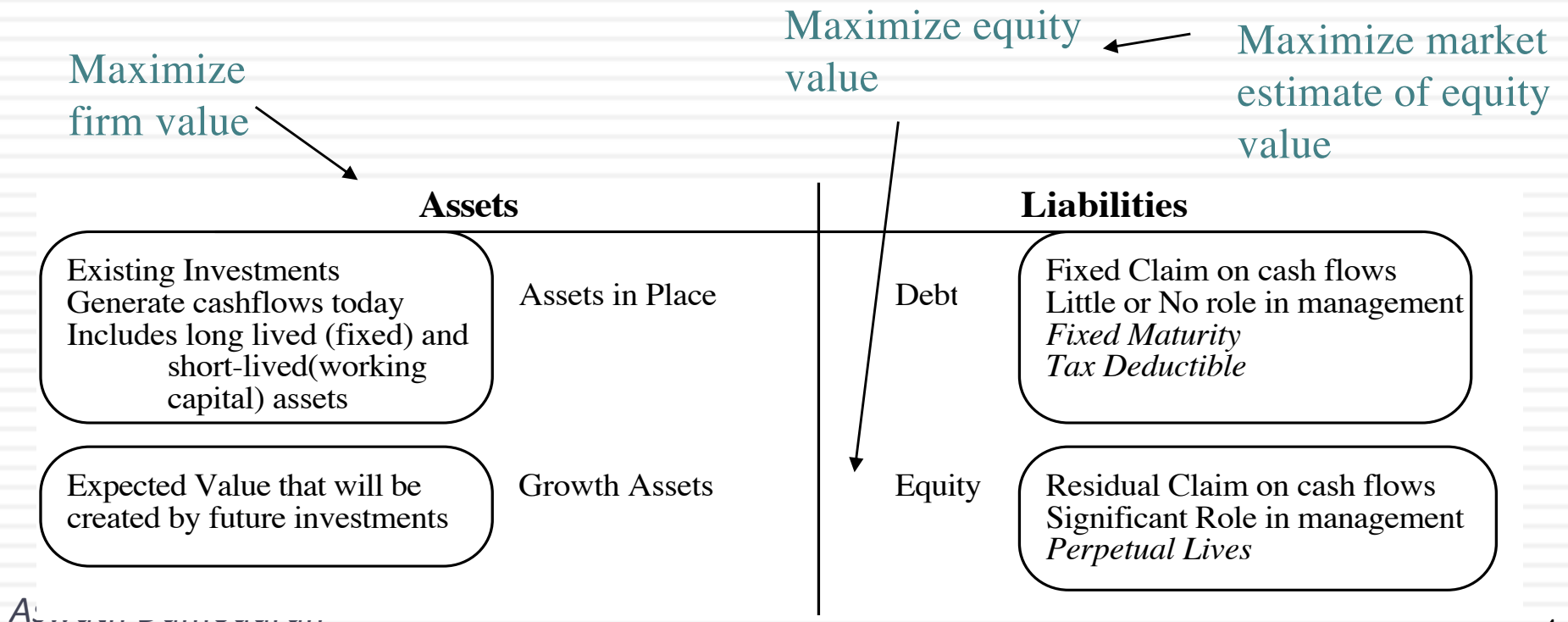
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The Objective in Decision Making

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- 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.



Why traditional corporate financial theory focuses on maximizing stockholder wealth.

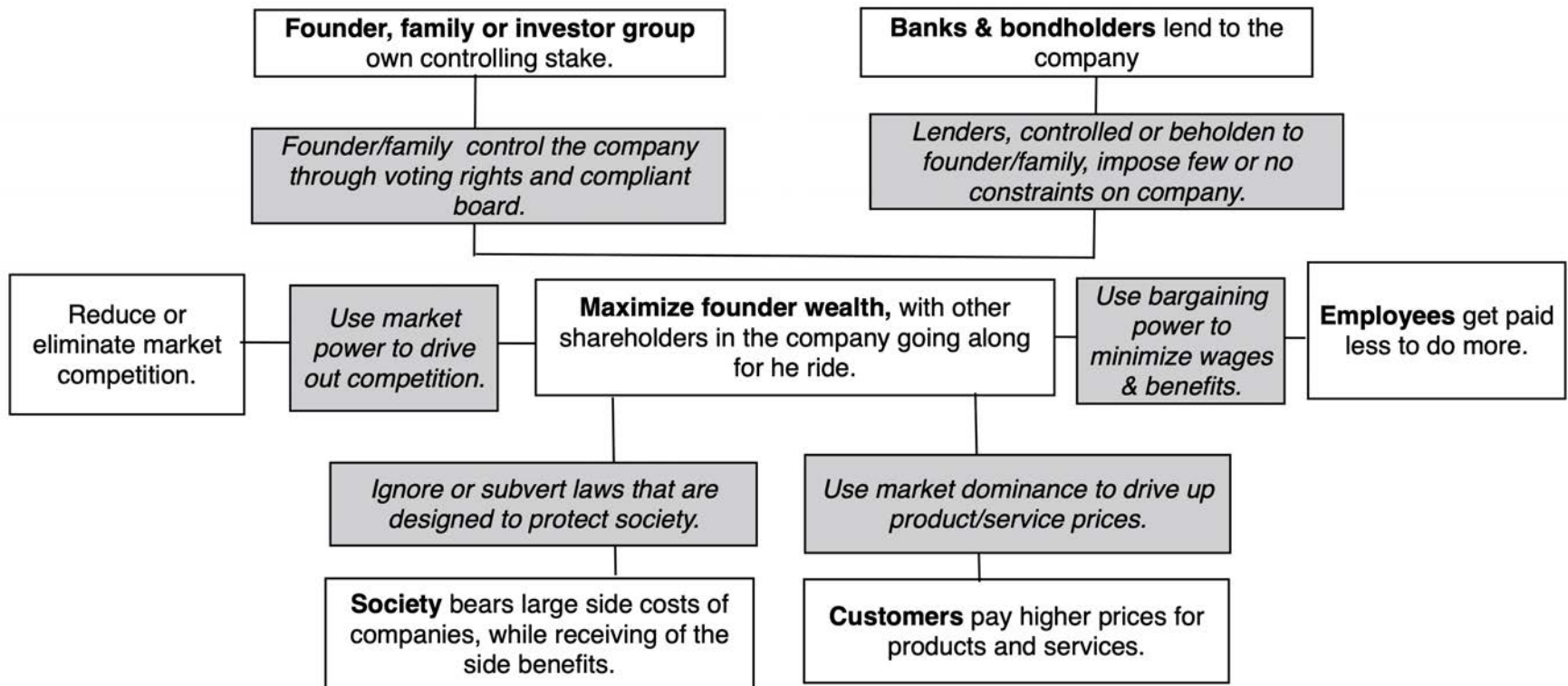
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- You can have only one objective, i.e., one interest group, whose interests get placed first.
 - Corporate finance picks shareholders because they have a residual claim, whereas every other claimholder has a contractual claim that they can negotiate 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

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Cutthroat Corporatism



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

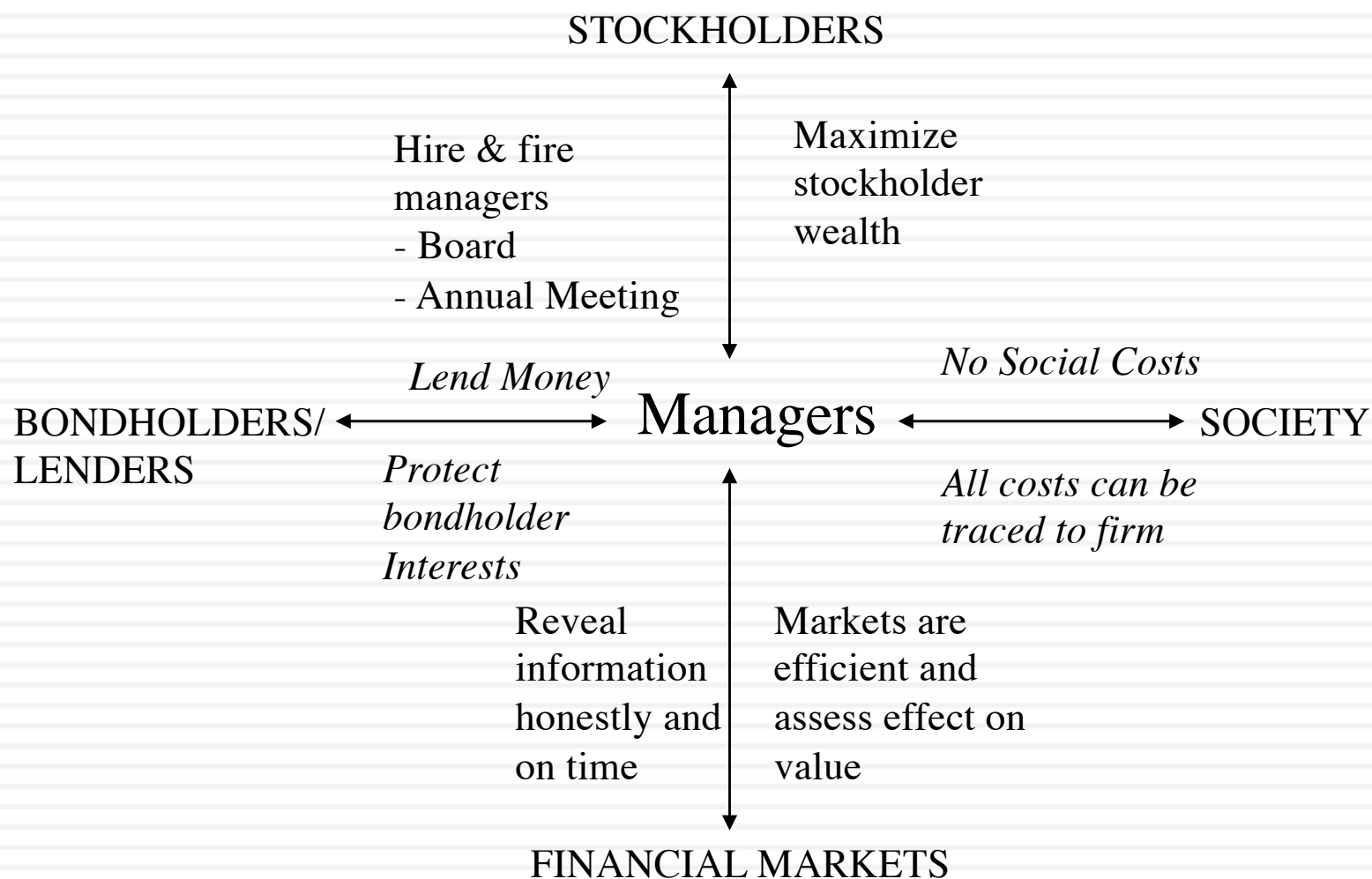
Real Choices or False Ones?

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- 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.

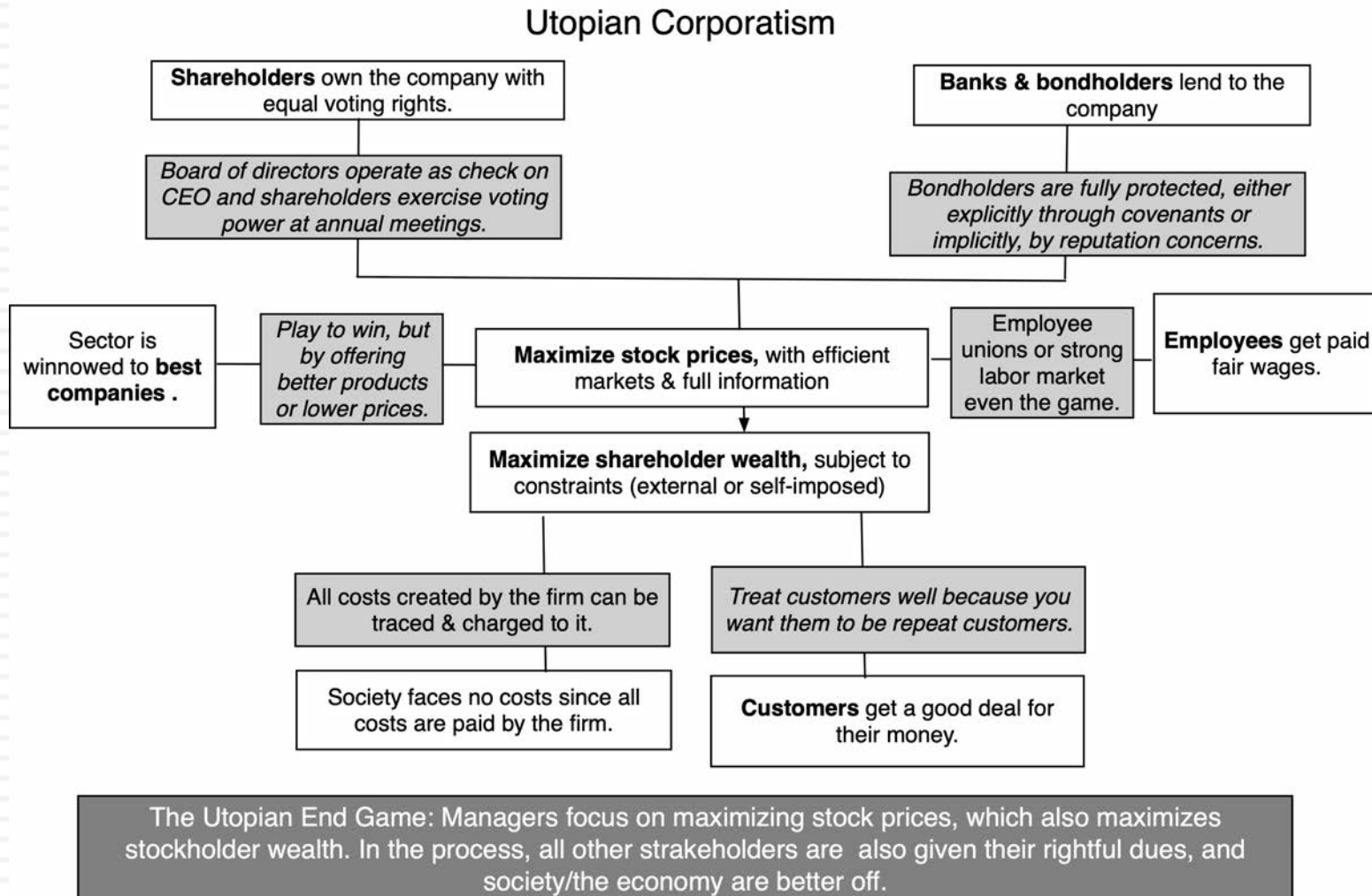
The Classical Objective Function

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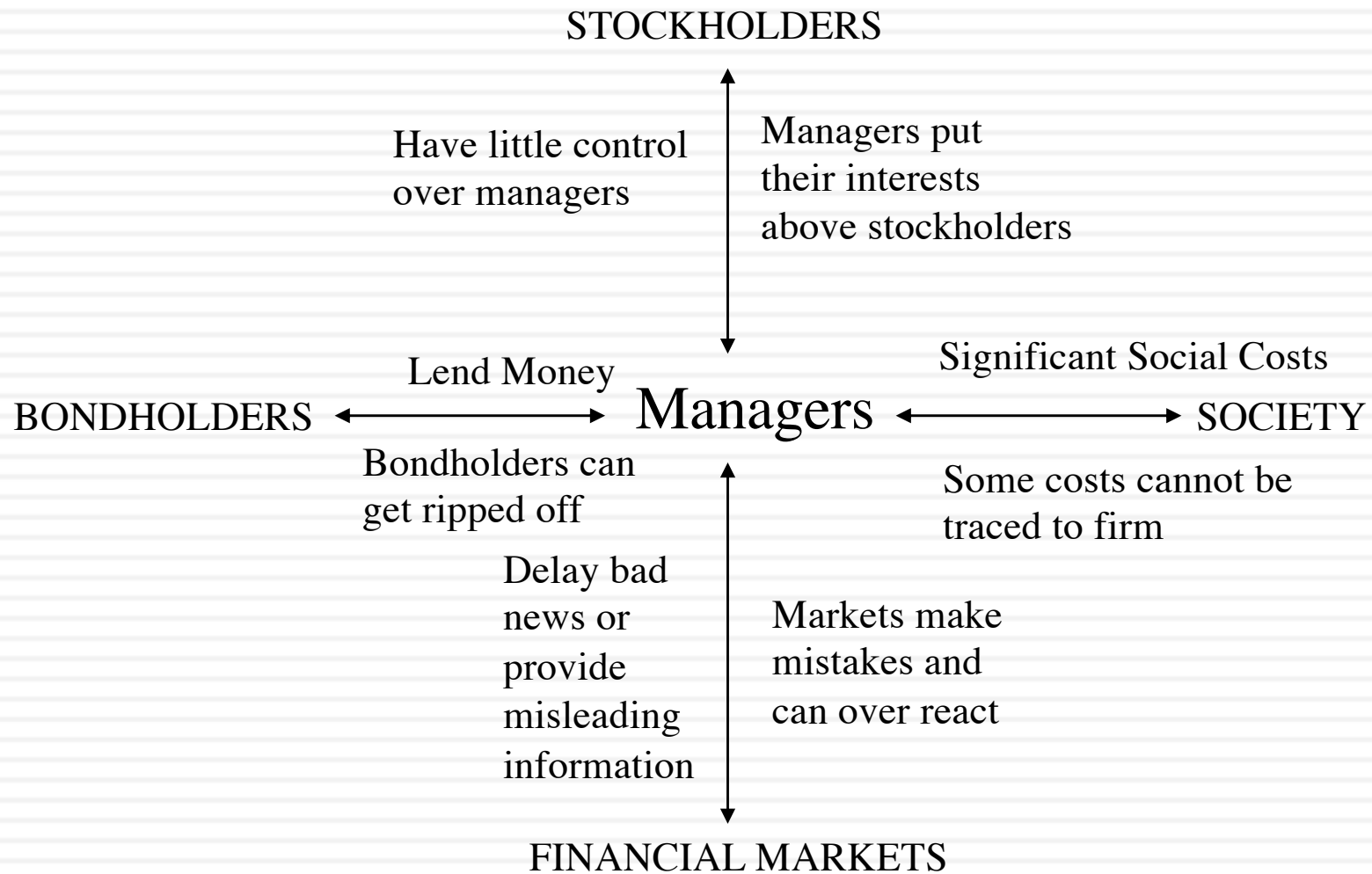
Utopian Corporatism

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What can go wrong?

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I. Stockholder Interests vs. Management Interests

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- 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.

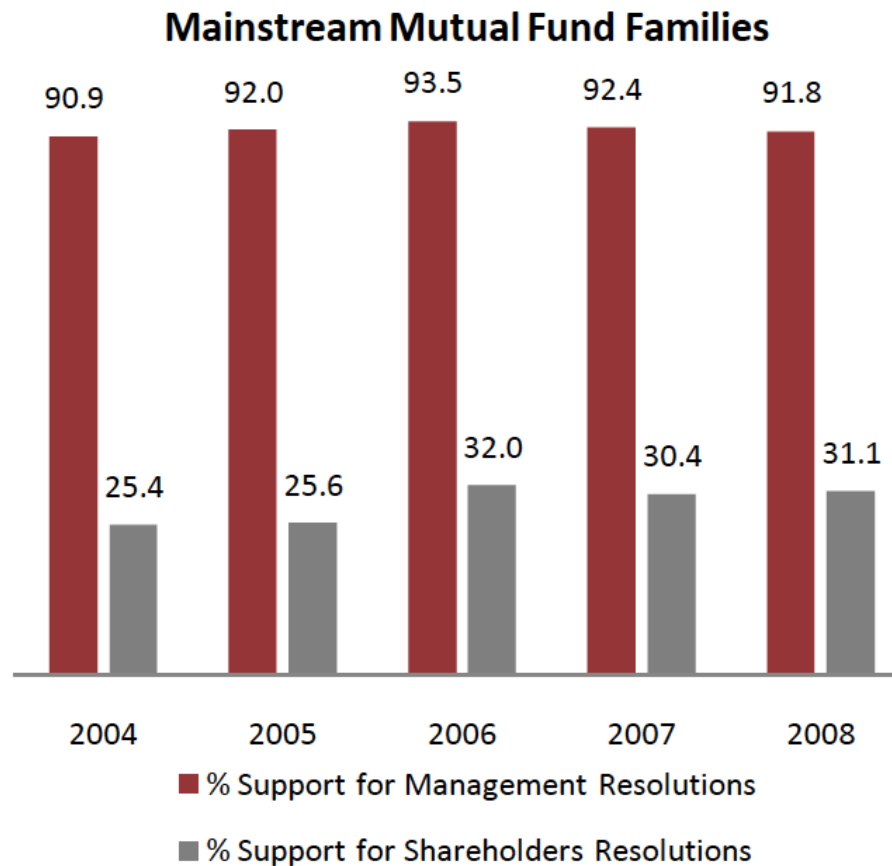
The Annual Meeting as a disciplinary venue

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- 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...

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The CEO often hand-picks directors..

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- 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..

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- 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.