# CORPORATE FINANCE
# B40.2302
# LECTURE NOTES: PACKET 1

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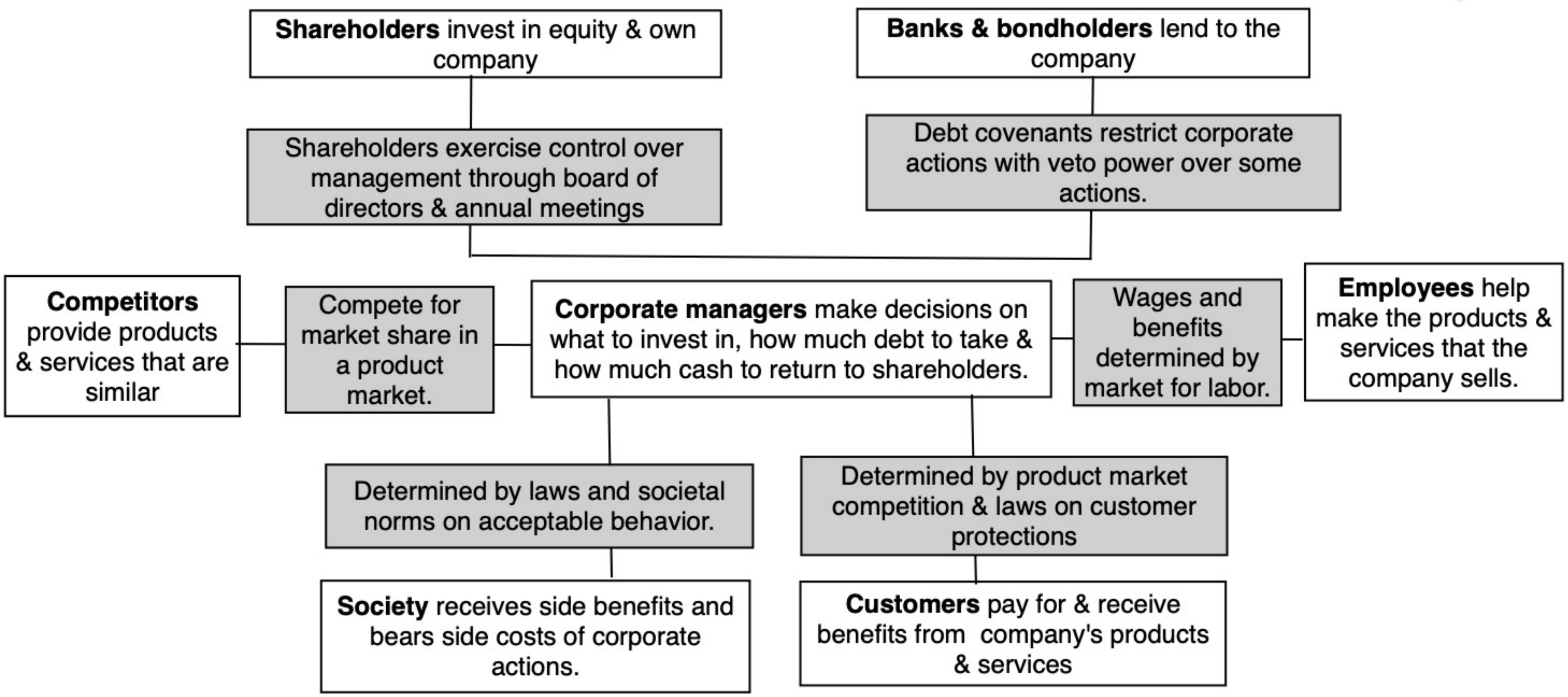
# THE OBJECTIVE IN CORPORATE FINANCE

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

# The End Game in Business?

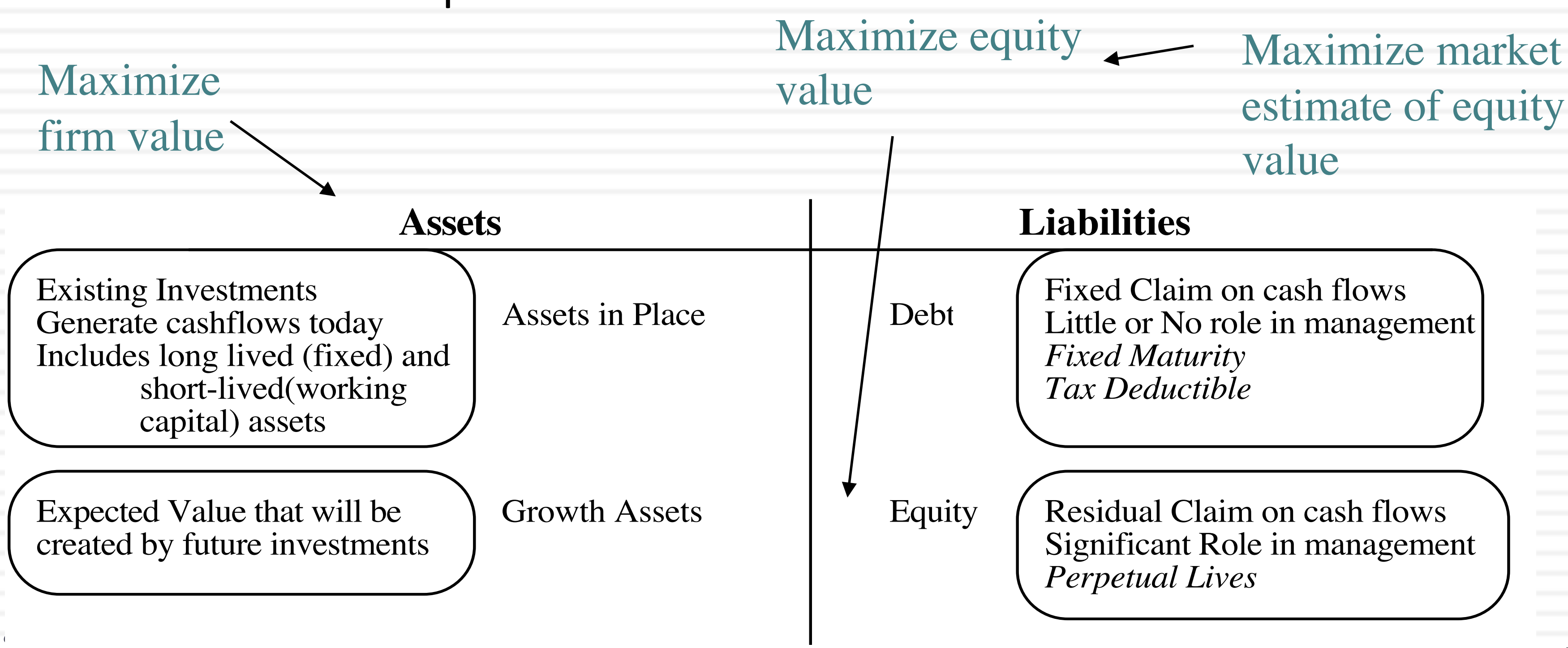
- Businesses have always struggled with mission statements. Put simply, what should the end game of a business?
  - The simplest and most pragmatic answer is that it is to sell products and services that customers want, while generating the most you can in profits for their owners, over the long term.
  - 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 business sustainability 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.



# 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

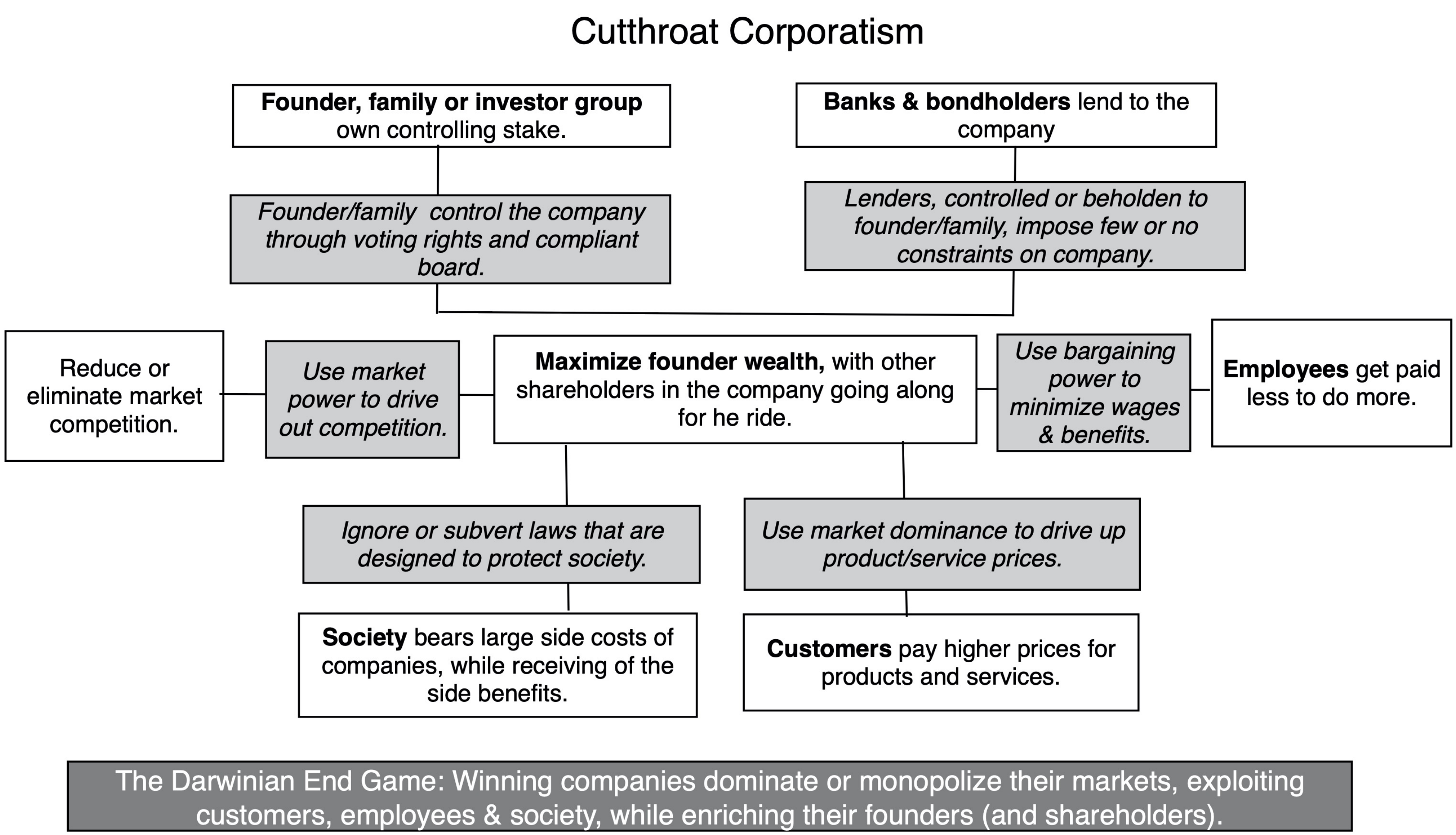
# Why traditional corporate financial theory focuses on maximizing stockholder wealth.



- 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



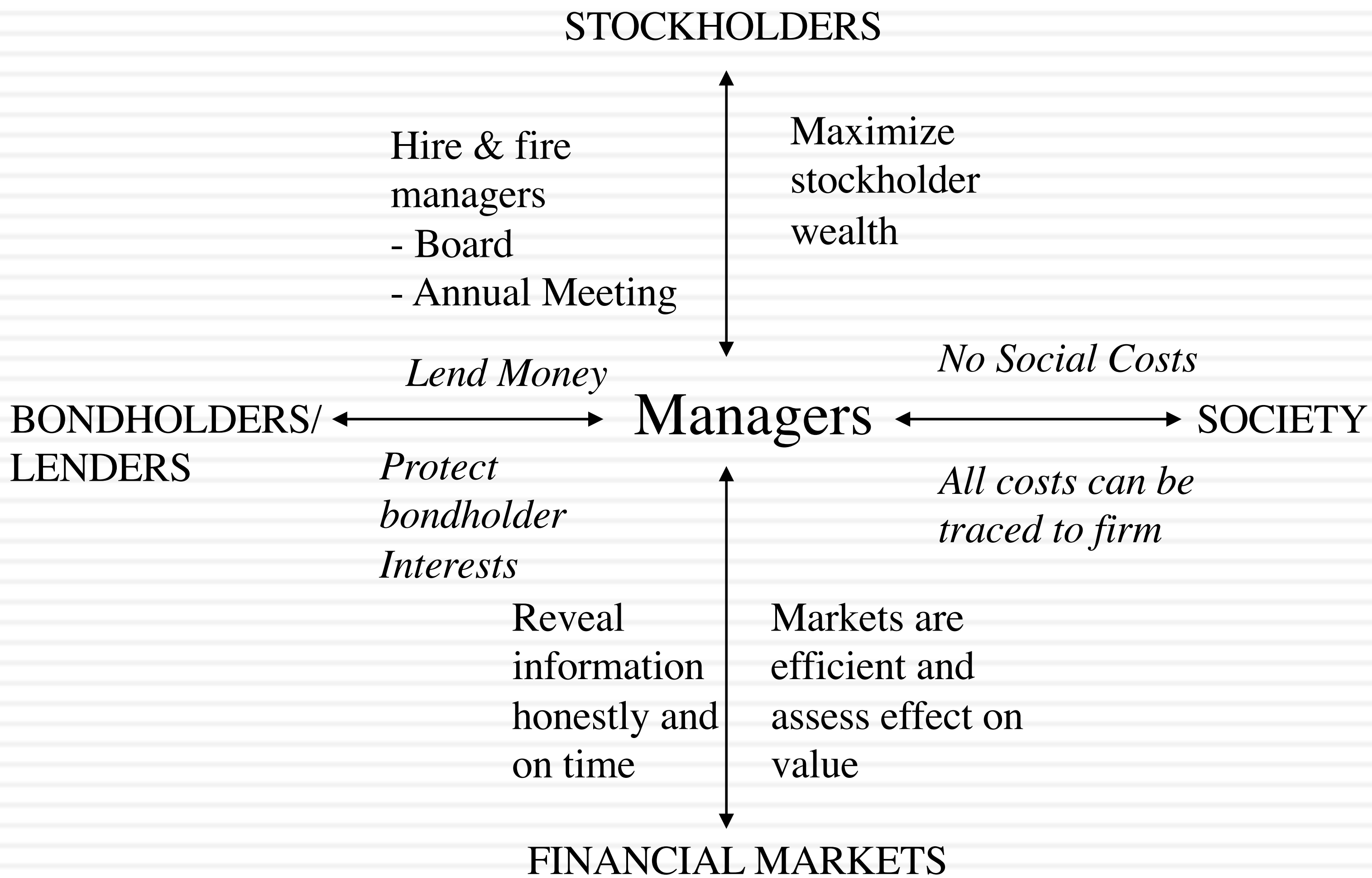


# Real Choices or False Ones?

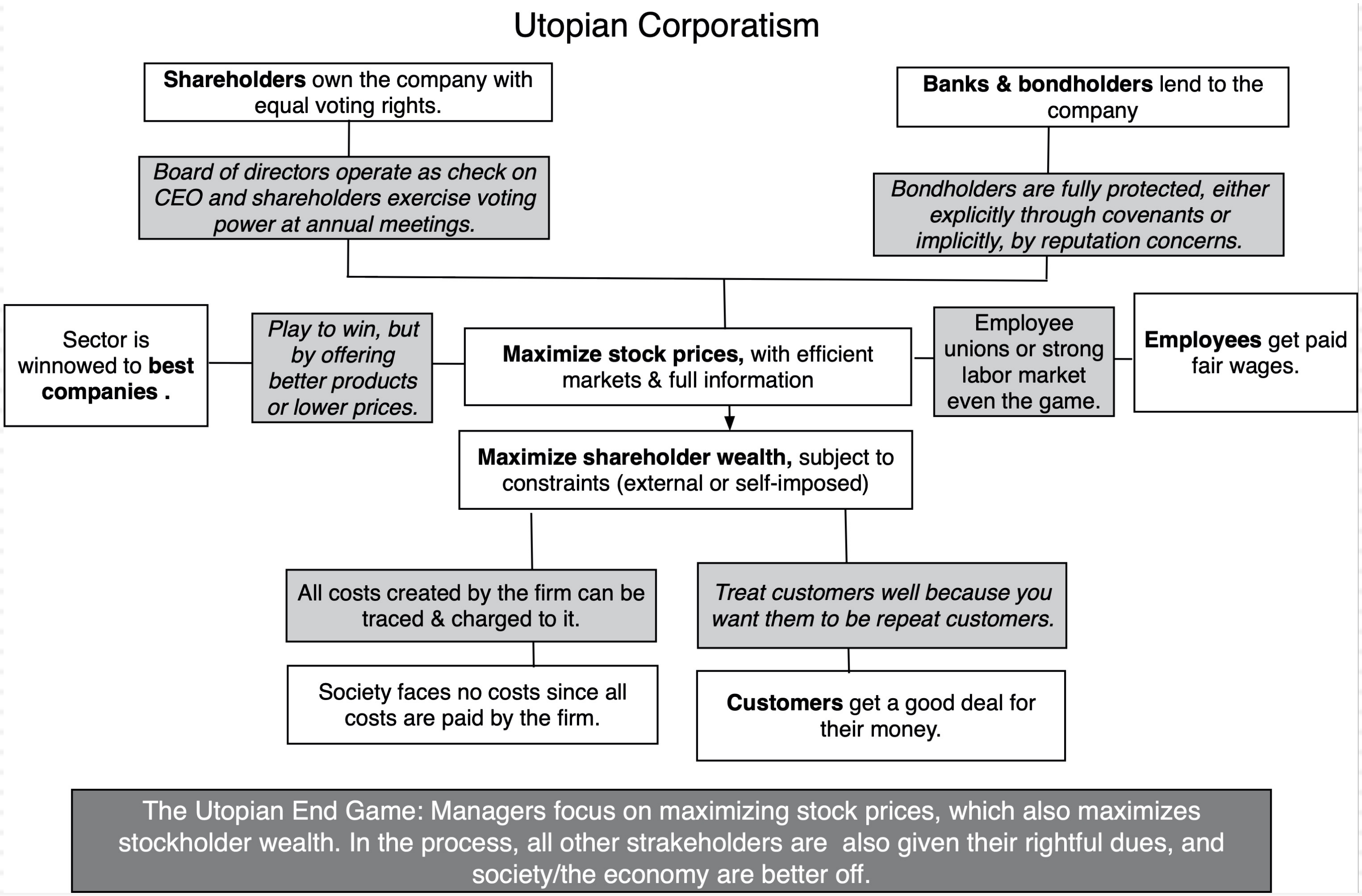


- Maximizing stock price is not incompatible with meeting employee needs/objectives. In particular:
  - Employees are often stockholders in many firms
  - Firms that maximize stock price generally are profitable firms that can afford to treat employees well.
- Maximizing stock price does not mean that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

# The Classical Objective Function



# Utopian Corporatism



# What can go wrong?



STOCKHOLDERS

Have little control over managers

Managers put their interests above stockholders

Lend Money

Significant Social Costs

BONDHOLDERS ⟷ **Managers** ⟷ SOCIETY

Bondholders can get ripped off

Some costs cannot be traced to firm

Delay bad news or provide misleading information

Markets make mistakes and can over react

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.

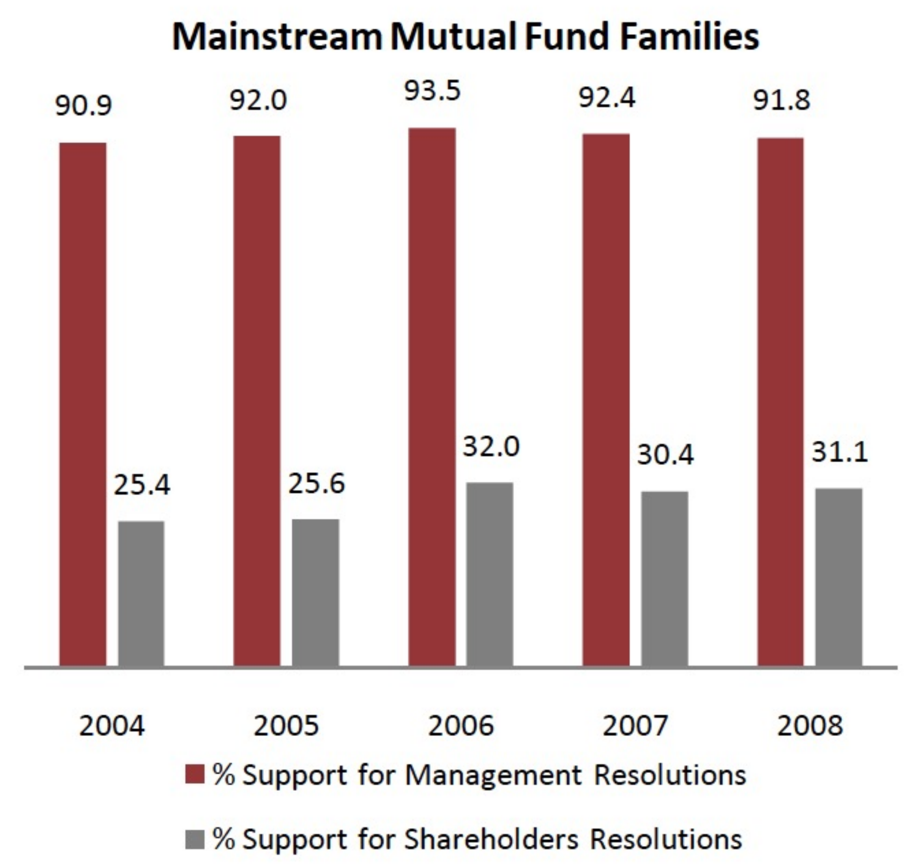
# The Annual Meeting as a disciplinary venue



- 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.
- 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…



- <u>CEOs pick directors</u>: 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.
- <u>Directors don't have big equity stakes</u>: 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).
- <u>And some directors are CEOs of other firms</u>: 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