CORPORATE FINANCE B40.2302 LECTURE NOTES: PACKET 1

Aswath Damodaran

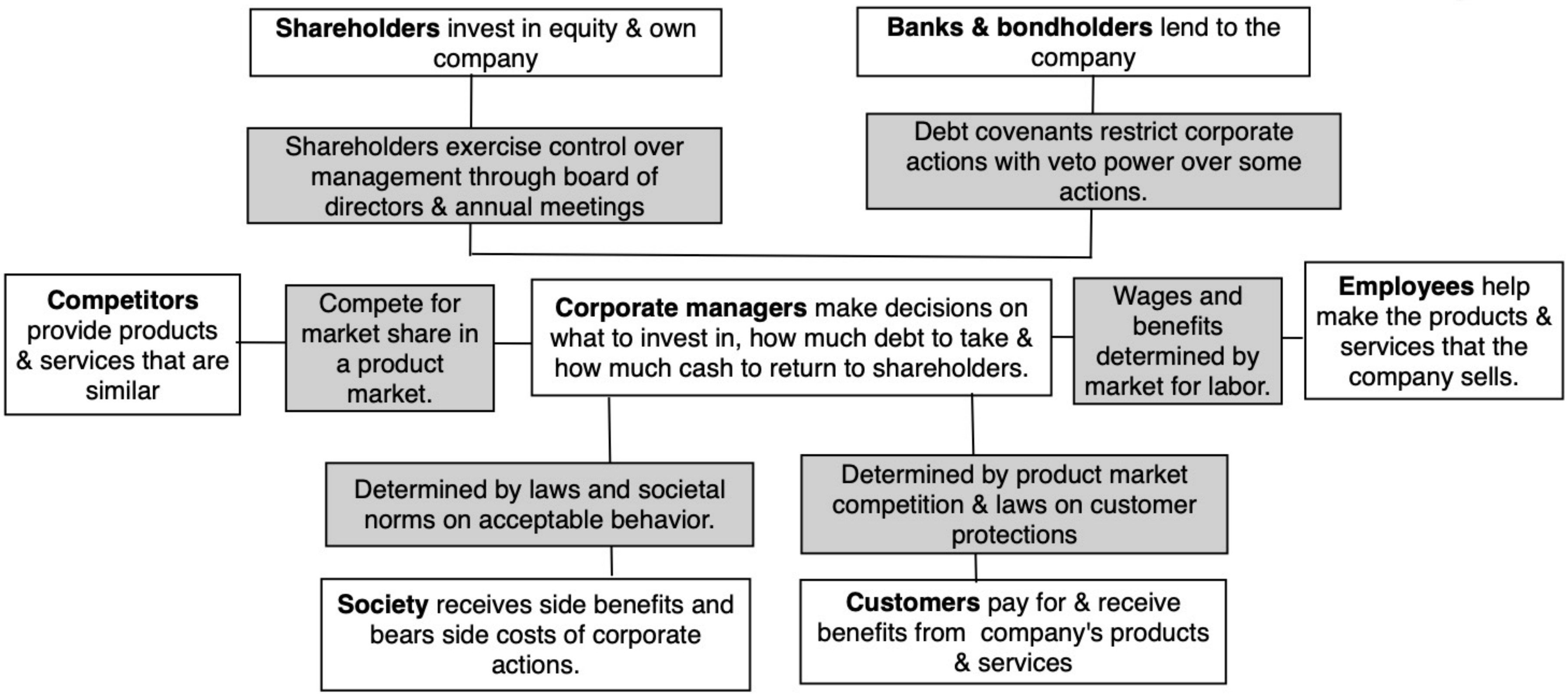
THE OBJECTIVE IN CORPORATE FINANCE

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

The End Game in Business?

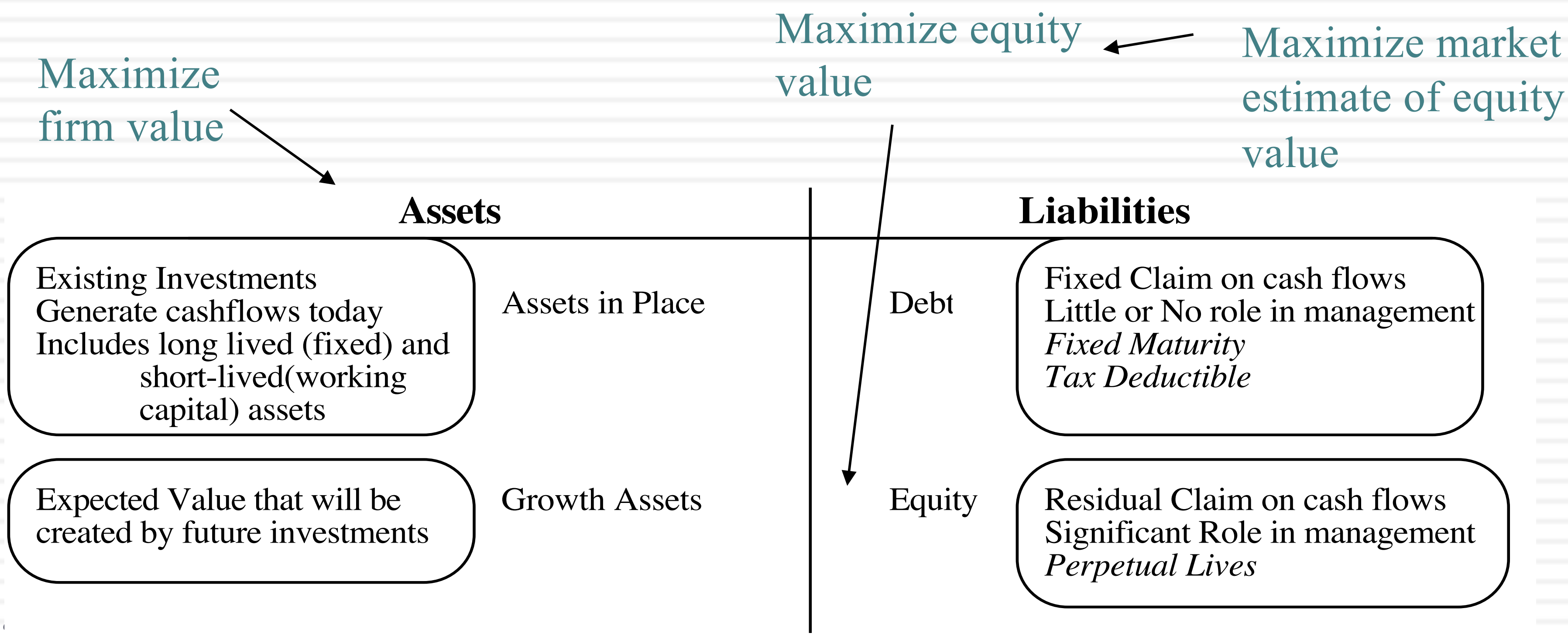
- Businesses have always struggled with mission statements. Put simply, what should the end game of a business?
  - The simplest and most pragmatic answer is that it is to sell products and services that customers want, while generating the most they can in profits for their owners, over the long term.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

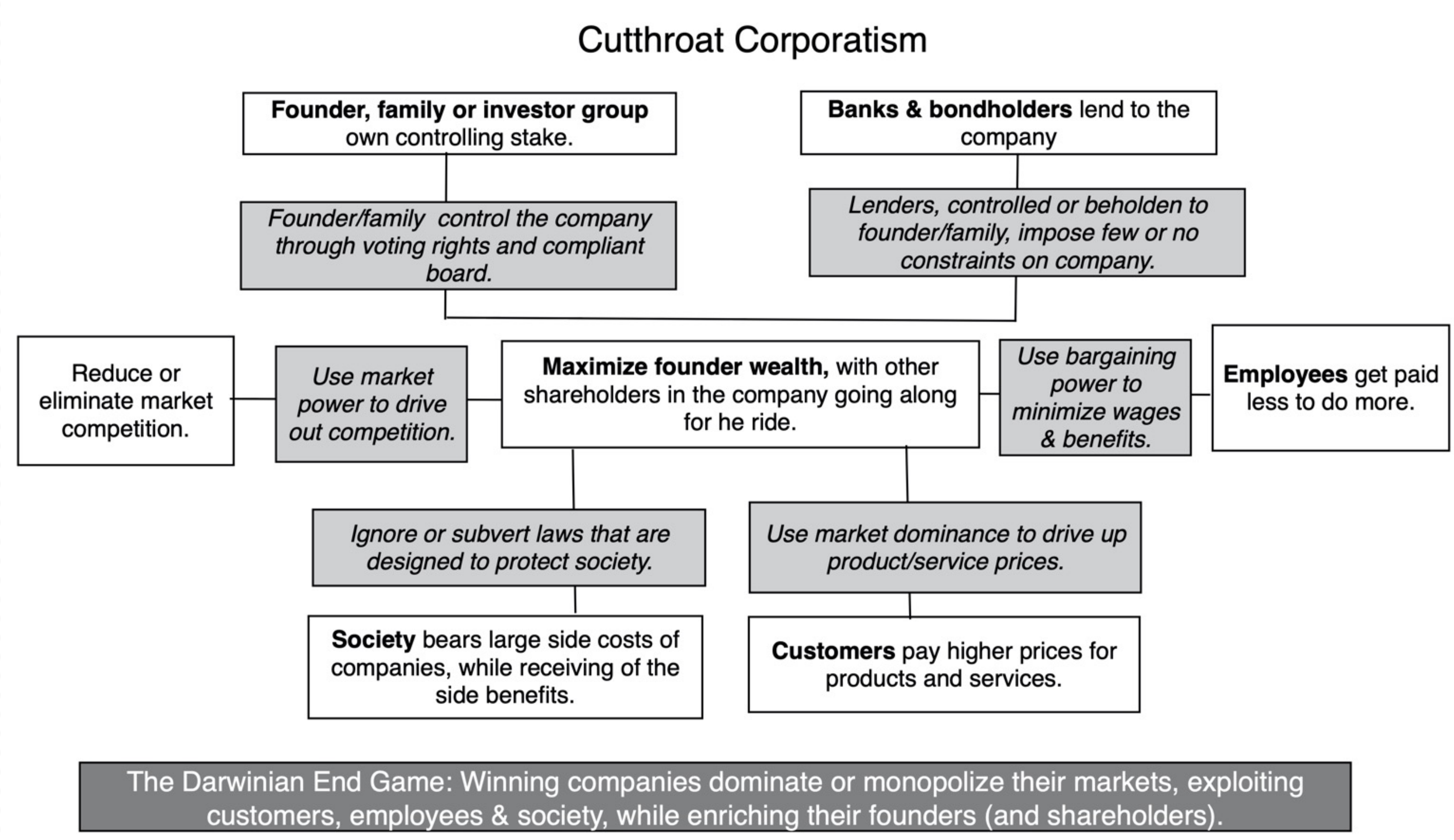
Maximize the value of the business (firm)

- **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.

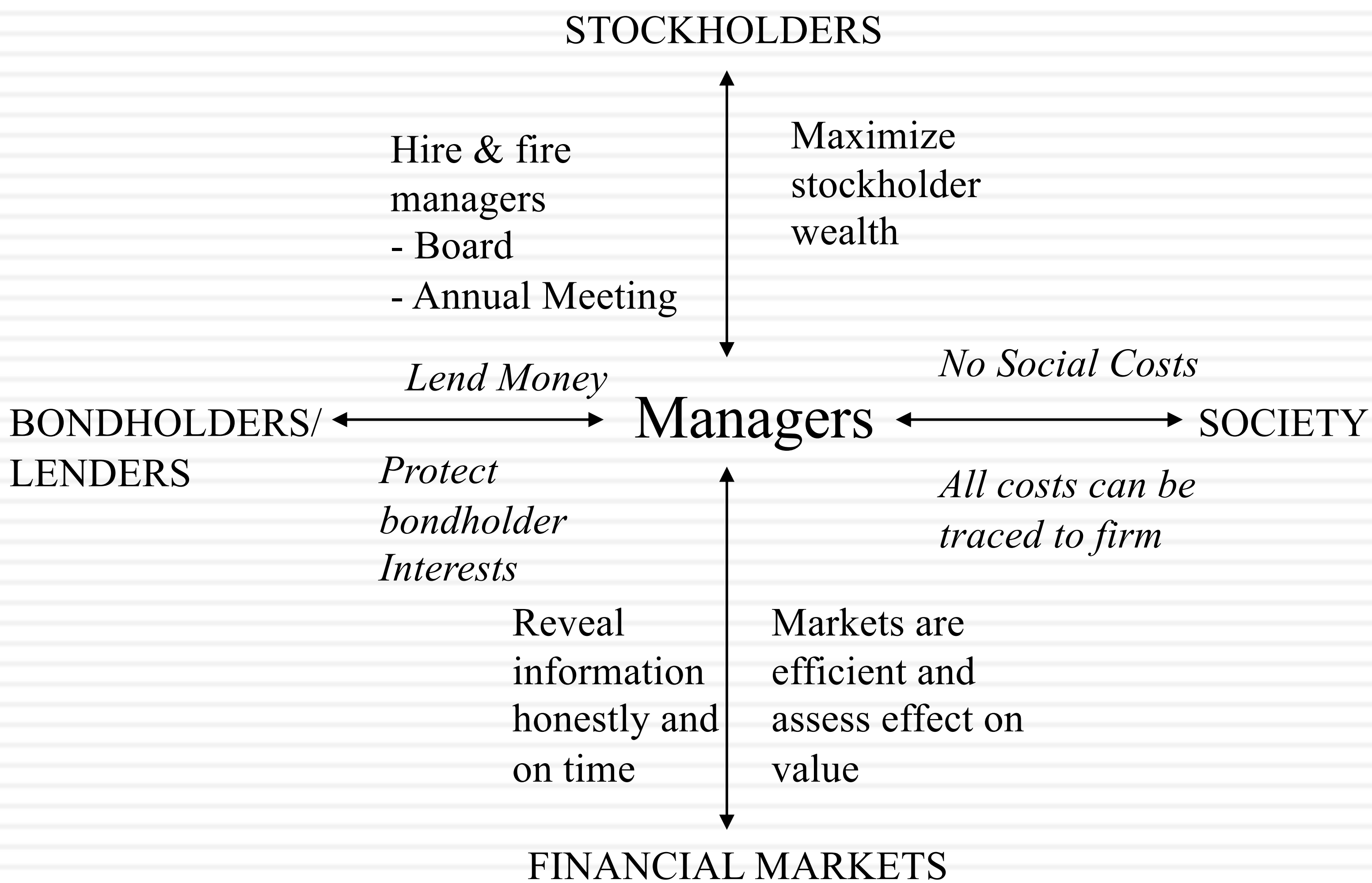
The Strawman Version: Cutthroat Corporatism



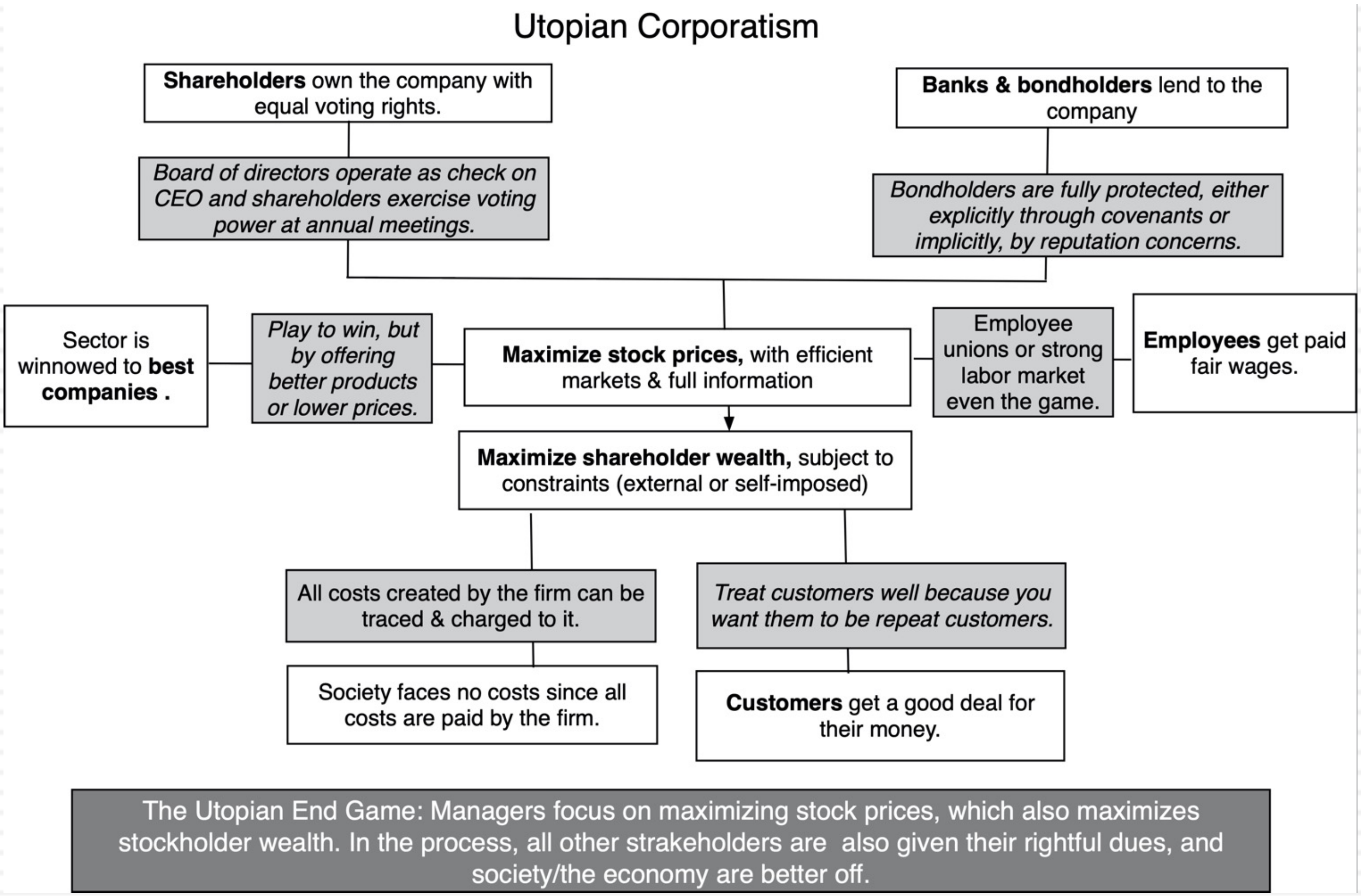
Real Choices or False Ones?

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

The Classical Objective Function



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.

Lend Money

BONDHOLDERS

Managers

Significant Social Costs

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

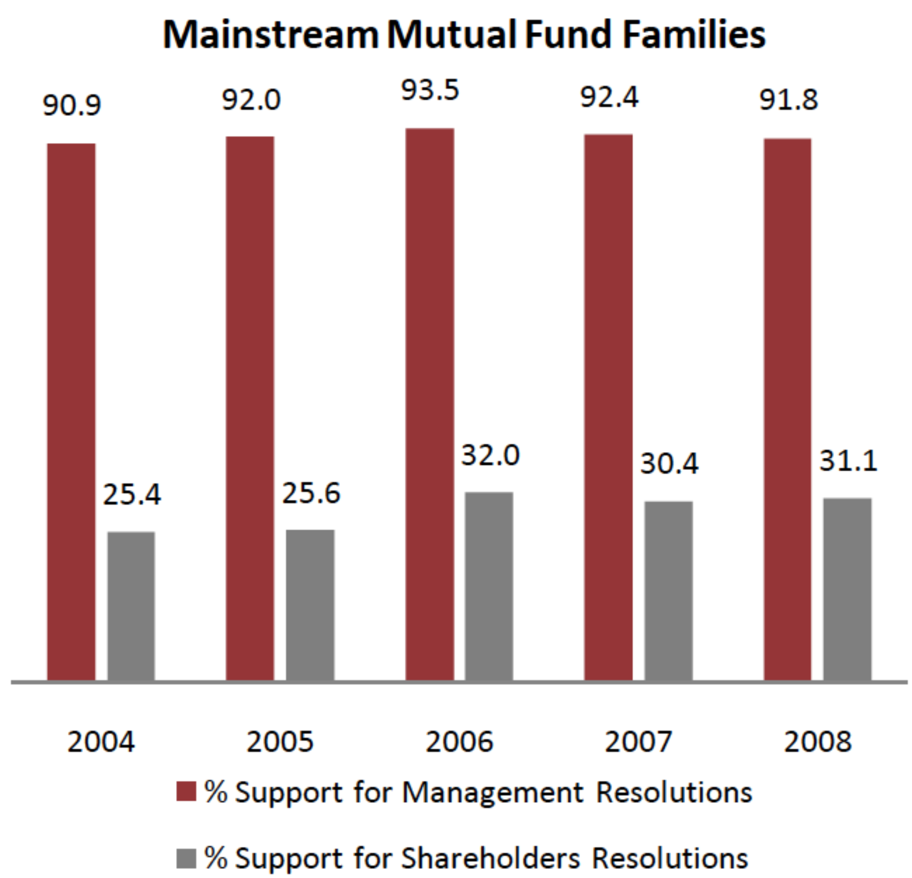
I. Stockholder Interests vs. Management Interests

- 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

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.