MSc Marketing Management

Pre-course Fall 2007

Corporate Management

Session 4.
Corporate Governance

Why do we need an objective?

An objective specifies <u>what a decision maker is trying to accomplish</u> and by so doing, provides <u>measures</u> that can be used to choose between alternatives.

Why do we need a unique objective?

- Allows for systematic decision making
- A theory developed around multiple objectives of equal weight will create quandaries when it comes to making decisions.

Characteristics of a good objective function

It is *clear and unambiguous*

It comes with a *clear and timely measure* that can be used to evaluate the success or failure of decisions.

It *does not create costs for other entities or groups* that erase firm-specific benefits and leave society worse off overall.

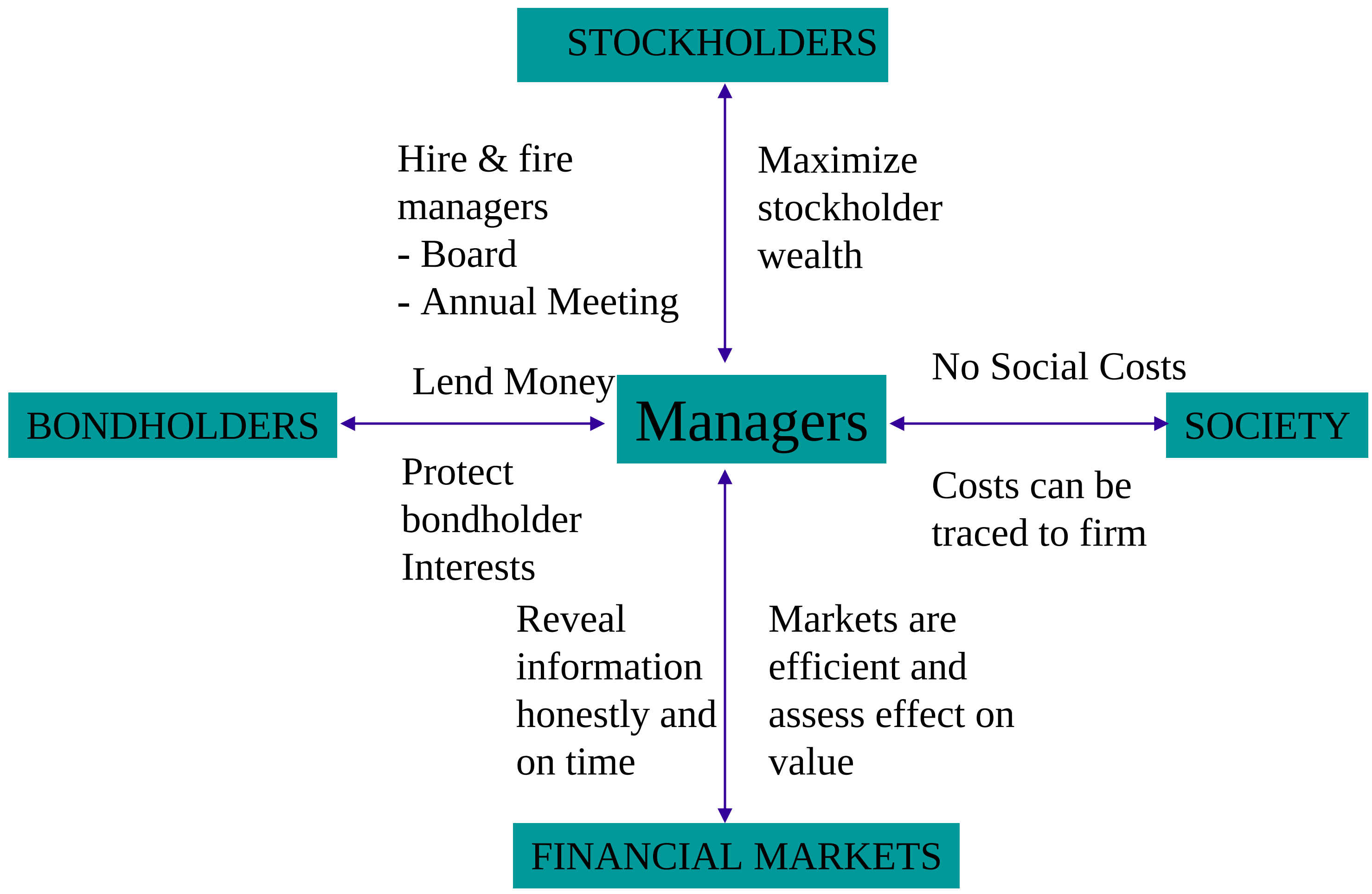
In theory, what serves as a good objective for us?

When the stock is traded and markets are viewed to be efficient, the objective is to maximize the stock price (and firm value).

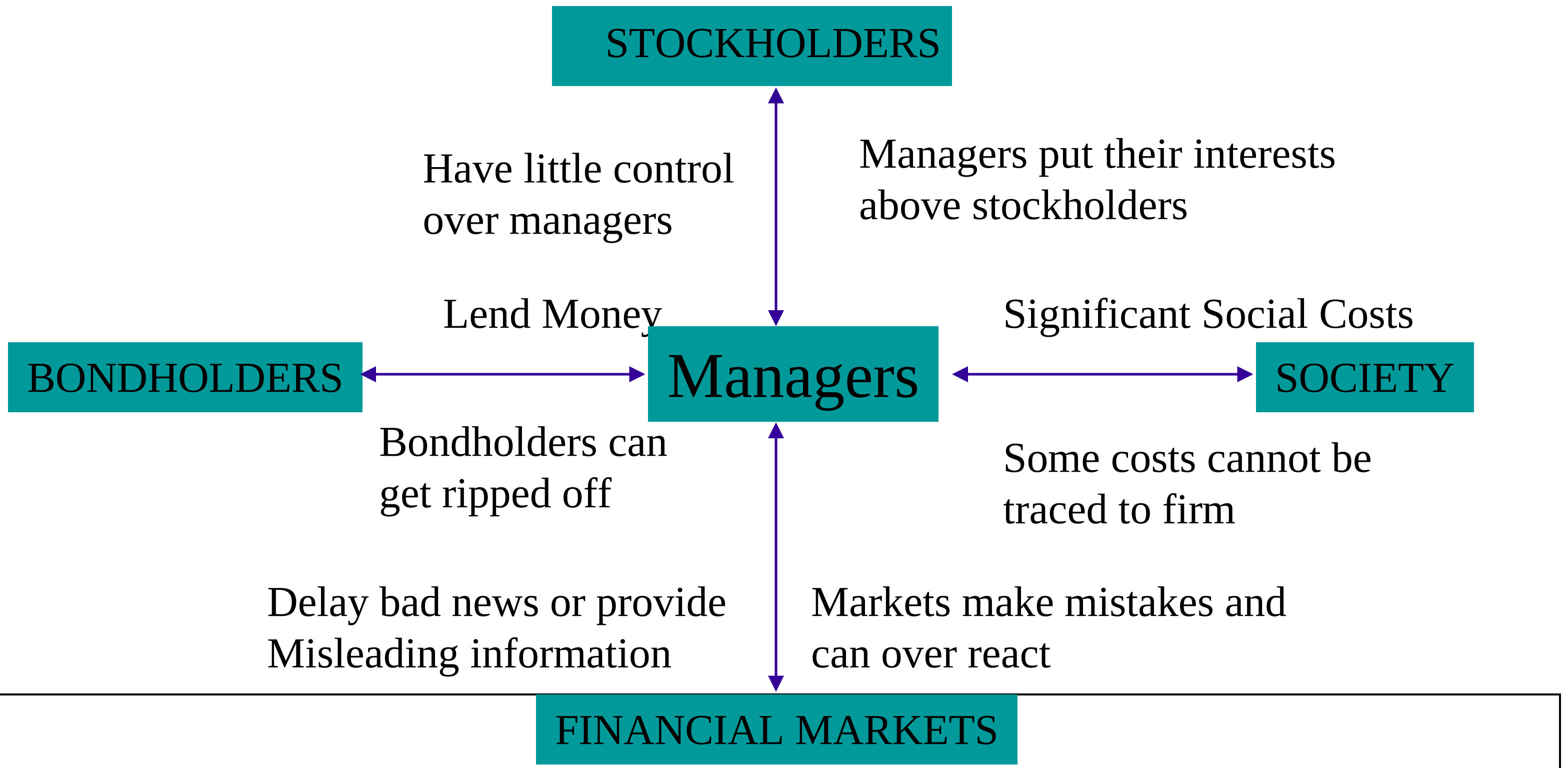
Why?

- It is easily observable
- constantly updated
- If investors are rational, it reflects the wisdom of decisions, short term and long term, instantaneously.
- It is a real measure of stockholder wealth, since stockholders *can sell their stock and receive the price now*.

The classical objective function



We don’t live in a Utopian world



<u>Agency costs</u> refer to the conflict of interest that arise between the different parties and thus make parties act in a manner that is inconsistent with stock price maximization.

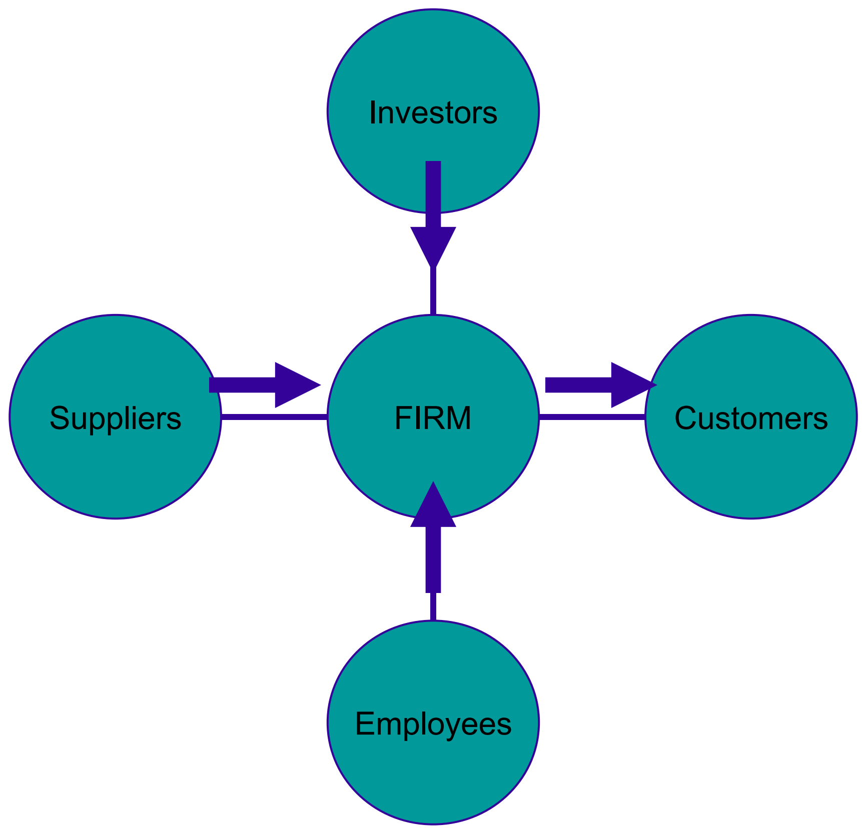
What is Corporate Governance? Definitions

"Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment." (Shleifer and Vishny, 1997)

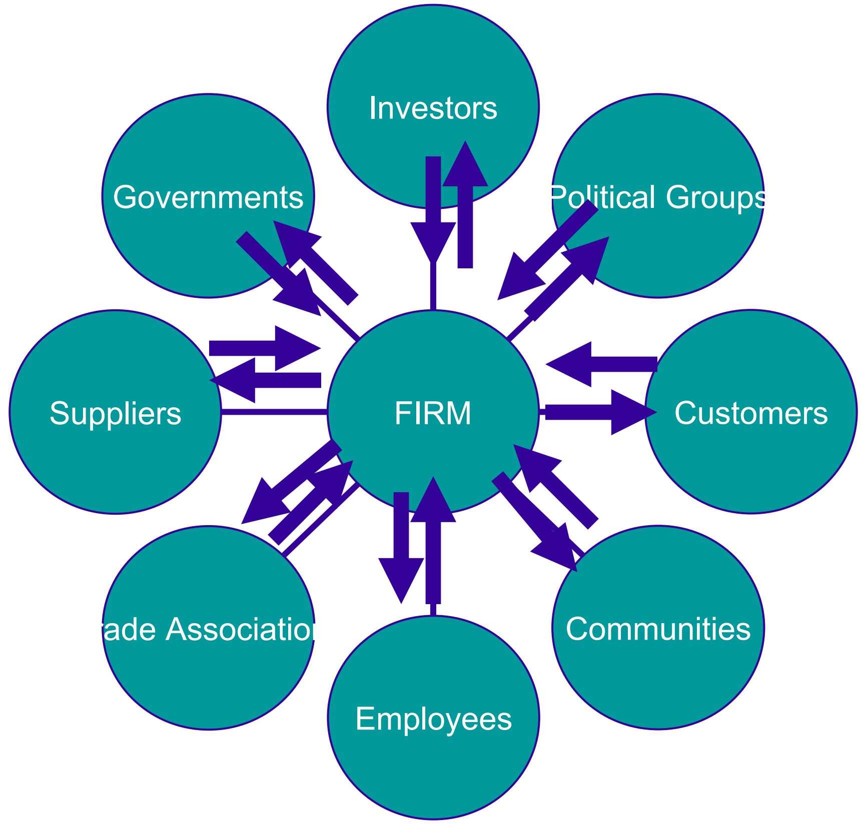
"The relationship between various participants in determining the direction and performance of corporations." (Monks and Minow, 1995)

"Entire network of formal and informal relations involving the corporate sector and society in general." (Keasey and Wright, 1997)

Input-Output Model



Stakeholder Model



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Principal-Agent Model

Owner hires manager to run firm

Firm's performance, Π, depends on

- manager's effort *e*
- chance variable ε, determined after *e* chosen

$\Pi = g(e, \varepsilon)$

Manager's effort observed only by him, and owner doesn't observe ε

- Contract with managerial compensation *I* as function of effort is unenforceable

Principal-Agent Model

Manager utility *U* depends positively on compensation *I*, negatively on effort *e*

Trade-off between incentives and risk sharing

$I = F + b(\Pi)$

High-powered incentives: make *I* sensitive to Π (low F, high *b*)

Low-powered incentives: make *I* insensitive to Π (high F, low *b*)

Agency Costs

Monitoring costs

Bonding costs

Residual loss

Owner tries to minimize these costs

Complete Contracting World

Manager's incentive scheme can depend on what happened previously

Specify when manager is replaced

Specify when assets bought and sold

Specify when employment to rise or fall

No residual decisions, so no need for governance structure

Contracting Costs

Thinking about all the contingencies that can occur

Negotiating with others about plans

Writing down plans in such a way that they can be enforced by a 3rd party in event of dispute

Since contracting costs are high, parties write incomplete contracts

Incomplete Contracts

Future actions specified only partly or not at all

May be renegotiated as new information arrives

May be legal disputes to the extent that the initial contract is ambiguous

Governance Structure Needed When

Contract is incomplete

Agency problems are present

Governance Structure allocates residual rights of control over the firm's nonhuman assets – the right to decide how assets used, given that the usage is not specified in the initial contract

Corporate Governance Mechanisms

Incentive-based managerial compensation

Corporate boards

Large shareholders

Stock market

Market for corporate control

Debt holders

Managerial labor market

Product market competition

Stakeholder Model

Shareholder wealth maximization should not be the only objective of the firm – should balance the objectives of various stakeholders

More equitable model?

More socially efficient?

Bridging Gap Between Principal/Agent and Stakeholder Models: The Moral Business Strategy

- Voluntary adoption of shared values (honesty and integrity; don't lie, cheat or steal) can be good for the economy and a good business strategy
  - Good agents in principal/agent relationships because don't require expensive monitoring
  - Good sellers of resources because don't misrepresent value of resources, reducing buyer search and monitoring costs
  - Good buyers of specialized resources – will not hold up sellers
  - Good team members, because will not shirk or free ride on work of others

The Moral Business Strategy

Moral firms must choose partners carefully to ensure that desired benefits are obtained – avoid opportunistic and potentially opportunistic partners

The Moral Business Strategy

Firms contracting with stakeholders on basis of mutual trust and cooperation should have competitive advantage over other firms

- Lower monitoring costs, bonding costs, search costs, warranty costs, and residual losses
- Benefits are shared between firm and stakeholders

"Moral" Behavior Through Enlightened Self-Interest

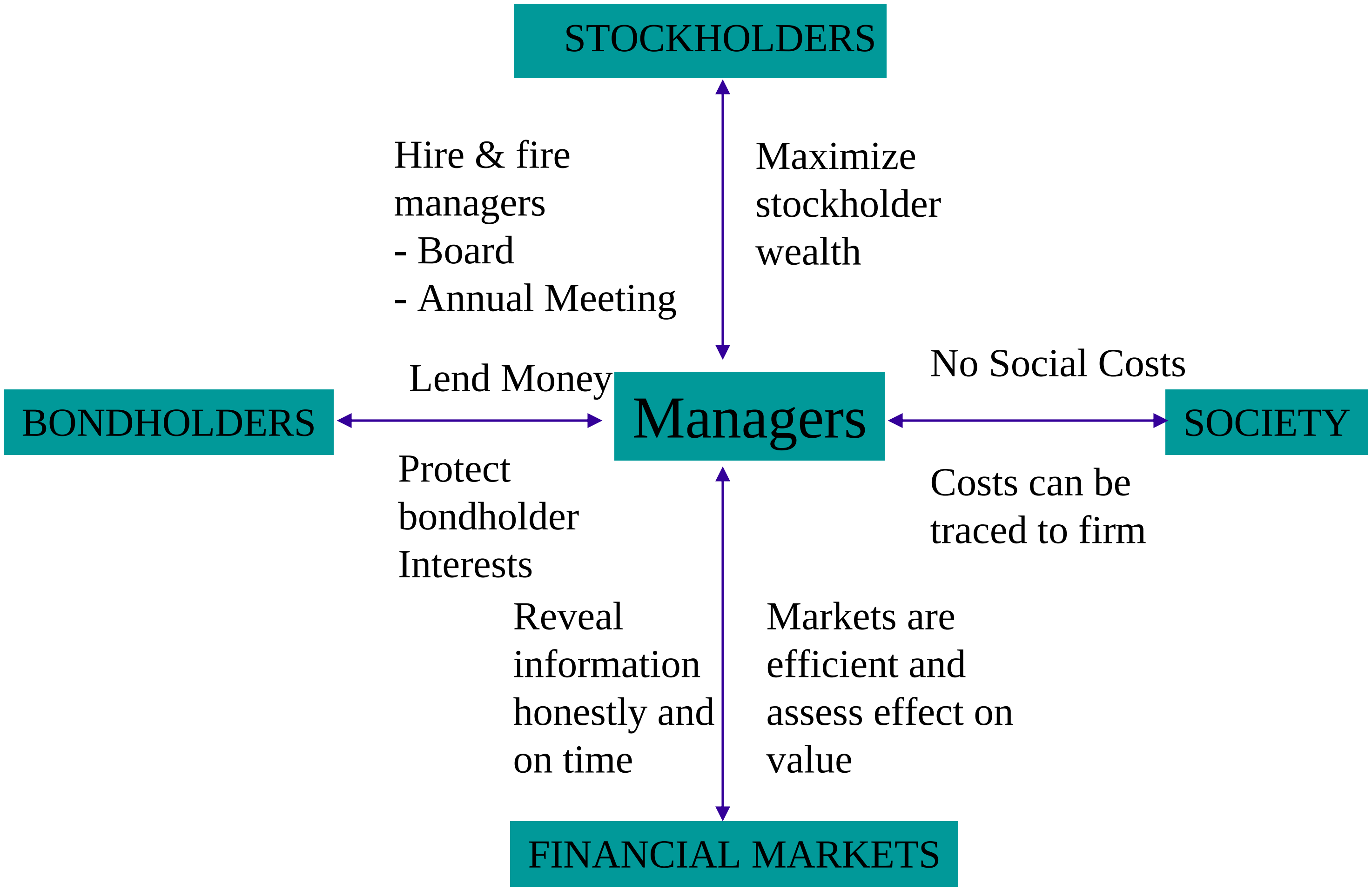
Prisoner's Dilemma game

- single play leads to noncooperative bad outcome
- repeat play can lead to cooperative good outcome – cooperate as long as other player cooperates – develop reputation

“Moral” Behavior Through Enlightened Self-Interest

- Limited effectiveness when contracting relationships do not involve repeated, regular interactions with the same parties
- Mutually cooperative solutions may be slow to evolve, so opportunists may decide that short-term gain larger than long-term one

The classical objective function



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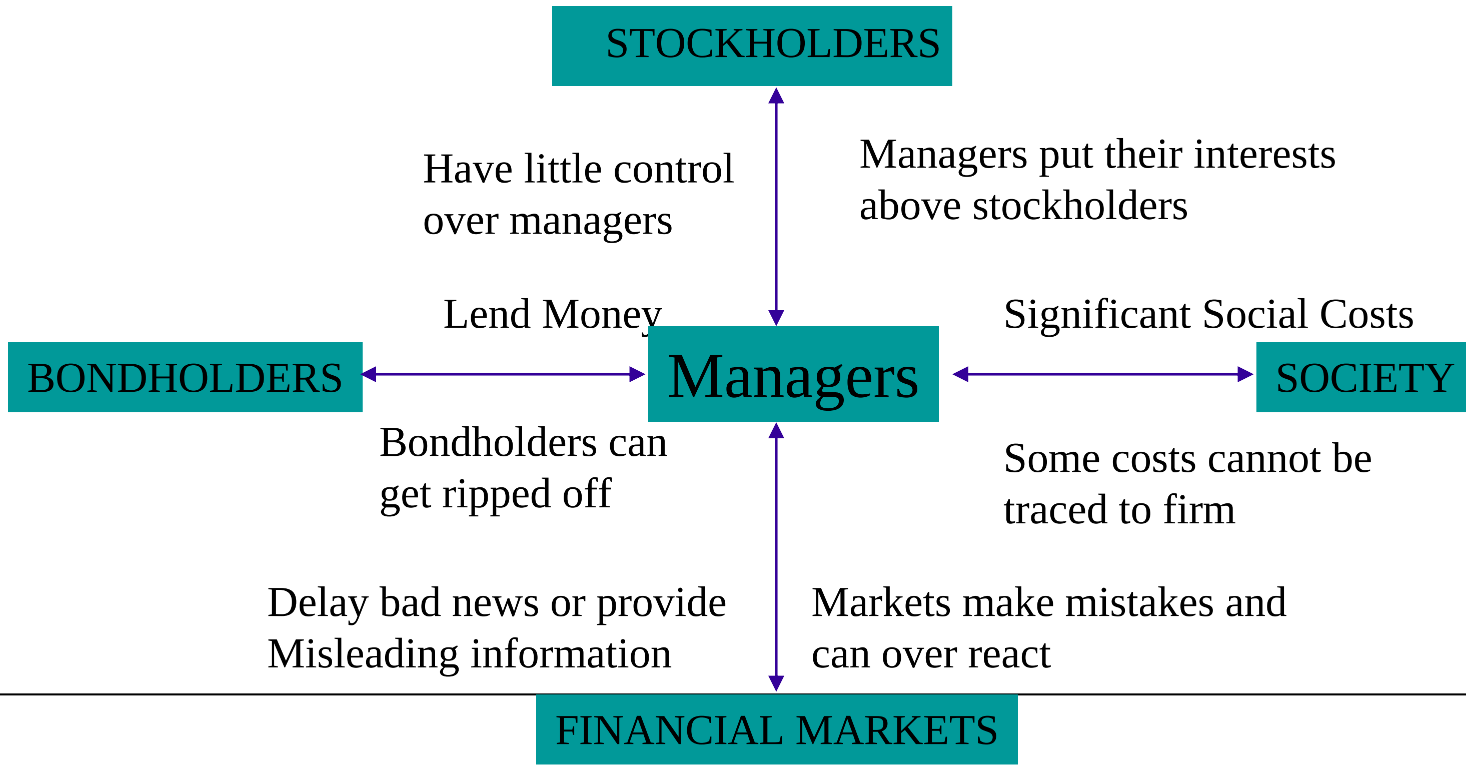

<u>Agency costs</u> refer to the conflict of interest that arise between the different parties and thus make parties act in a manner that is inconsistent with stock price maximization.

I. Stockholder vs. Management

Theory

- The stockholders have significant control over management.
- The mechanisms for disciplining management are the annual meeting and the board of directors.

Practice

- Most small stockholders do not attend meetings
- Incumbent management starts off with a clear advantage when it comes to the exercising of proxies.
- For large stockholders, sometimes, when confronted by managers that they do not like, is to vote with their feet.

Stakeholder Conflicts

Employee layoffs, pay cuts, pension cuts

- Hurt current employees in short run
- Hurt community in short run
- Increase profit in short run
- May reduce effort of remaining employees, hurt ability to recruit talented employees
- If labor costs not minimized, firm could eventually be forced out of business

Stakeholder Conflicts

Switch to lower-cost supplier

- Hurts current supplier and its stakeholders
- Increases profit in short run
- May harm relations with other suppliers
- If cost of supplies not minimized, firm could eventually be forced out of business

Stakeholder Conflicts

Environmental pollution

- Hurts community
- Cheaper, polluting technology raises profit in short run
- May damage firm's reputation, and sales could fall if customers care about environment

Bottom line: taking nonshareholder stakeholders into account can often be consistent with shareholder wealth maximization

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The problem with the board of directors

The board of directors is the body that oversees the management of a publicly traded firm.

The board of directors are *supposed* to represent the shareholders and discipline and guide management if necessary. Historically, however,

- most directors in the past were hand-picked by CEOs
- many have insufficient knowledge of the business
- at times, management is too heavily represented on the board
- there may be insufficient interest or motivation for the directors to take an active role
- some boards are too large to be effective in administration

Visible managerial actions that provide no benefit to the shareholders

- **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.
- **Overpaying on takeovers.** This transfers wealth from the stockholders of the acquiring firm to those of the acquired firm. How would we know? Look at market reactions to takeover bids.
- **Perks**: Benefits provided to the CEO and management.

Dennis Koslowski's (TYCO) faux pas…

In 1992, Dennis indicated that.. Perks such as country-club memberships and executive dining rooms are taboo

Early 2000s revelations of asset embezzlement

- $17,100 traveling toilet box
- $15,000 dog umbrella stand
- $16.8 million apartment on Fifth Avenue
- $3 million in renovations
- $11 million in furnishings
- $7 million apartment on Park Avenue for his former wife.
- A $72,000 fee to Germán Frers, a yacht maker
- A $6,300 sewing basket
- A $6,000 shower curtain
- $5,960 for two sets of sheets
- A $2,900 set of coat hangers
- A $2,200 gilt metal wastebasket
- A $1,650 notebook
- and a $445 pincushion (sewing, to store pins)

II. Stockholder vs. Bondholder

Theory

- There is no conflict of interest between stockholders and bondholders.

Practice

- Stockholders may maximize their wealth at the expense of bondholders by:
  - Taking riskier projects than those agreed to at the outset.
  - 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.

III. Firms and Financial Markets

Theory

- Financial markets are efficient.
- Managers convey information honestly and truthfully to financial markets
- Financial markets make reasoned judgments of 'true value'.

Practice

- Management suppress information
- Management delay the releasing of bad news
- Management sometimes reveal fraudulent information
- Some argue that markets are short-sighted
- Analyst recommendations are not always unbiased

Are markets short-sighted and thus inefficient? Some evidence that they are not..

There are hundreds of start-up and small firms, with no earnings expected in the near future, that raise money on financial markets

The market response to research and development and investment expenditure is generally positive

IV. Firms and Society

Theory

- There are no costs associated with the firm that cannot be traced to the firm and charged to it.

Practice

- Financial decisions can create social costs and benefits where,
  - 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.
- These costs/benefits tend to be difficult to quantify

A hypothetical example

Assume that you work for The Home Depot and that you have an opportunity to open a store in an inner-city neighborhood. The store is expected to lose about $100,000 a year, but it will create much-needed employment in the area, and may help revitalize it.

Questions:

- Would you open the store?
  - ☐ Yes
  - ☐ No
- If yes, would you tell your stockholders and let them vote on the issue?
  - ☐ Yes
  - ☐ No
- If no, how would you respond to a stockholder query on why you were not

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Given these agency issues, is stock price maximization really the best objective?

Alternate objectives

- maximizing earnings
- maximizing firm size
- maximizing market share

Do any of these better serve the purpose?

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.

Management, board of directors, and active investors

Exchange-specified requirements for board of directors

Increased awareness of the deficiencies of and quality of boards

- Research has shown that board size matters
- Public lists of best and worst boards

Increase in institutional activism

- ex., CALPERS

Changing compensation structures

Bondholders protection

More restrictive covenants on investment, financing and dividend policy have been incorporated into both private lending agreements and into bond issues

New types of bonds have been created to explicitly protect bondholders against sudden increases in leverage or other actions that increase lender risk substantially.

- 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.

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Financial market response

Regulatory changes

- Regulation Fair Disclosure (2000) – develops standards by which information is to be released to the public and financial community by firms.
- Sarbanes-Oxley (2002) – sets regulations for the behavior and characteristics of the board and firm, specifically as it relates to auditing.

Increased importance of ethical behavior

Increased availability of information and ease of trading

Societal response

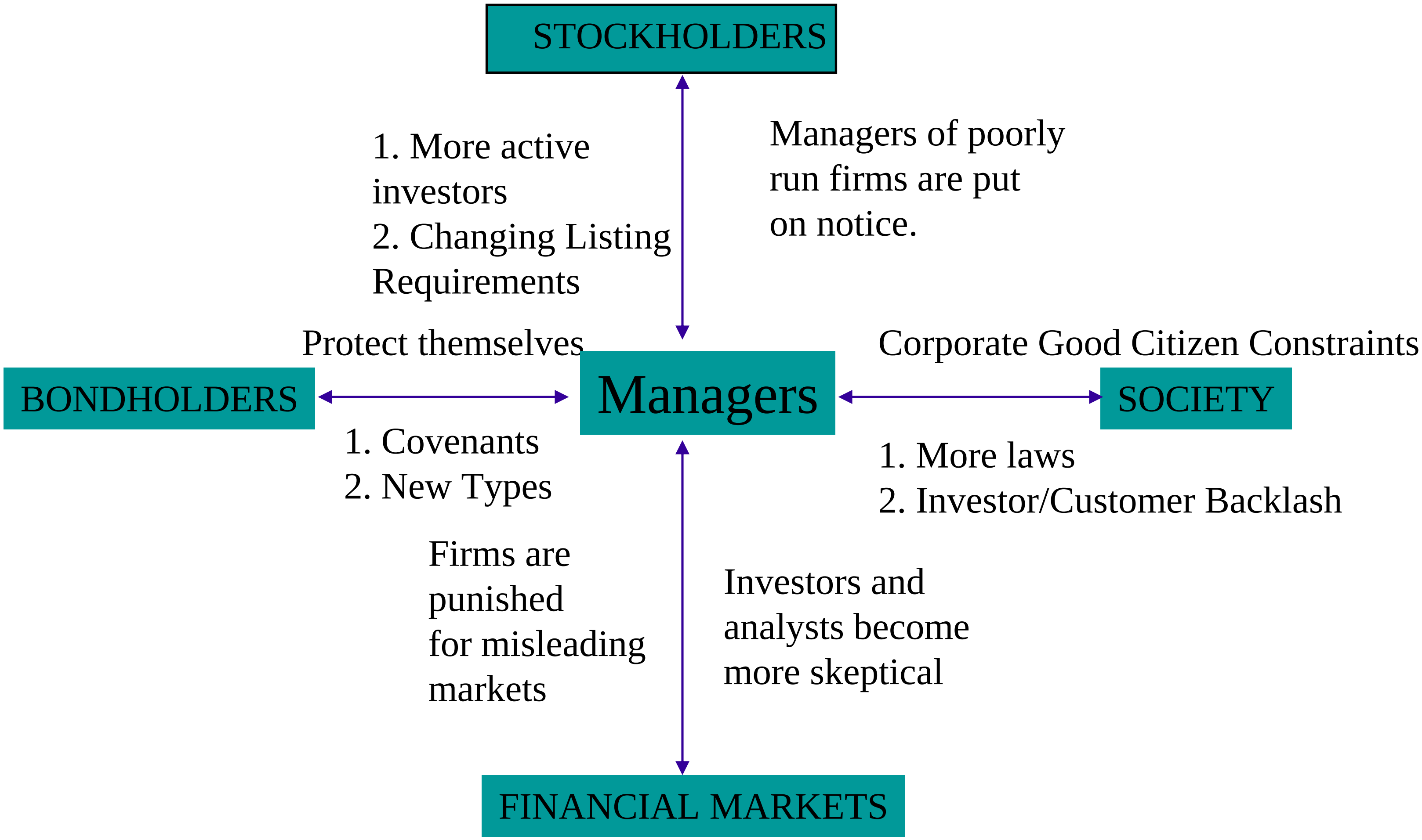
If firms consistently flout societal norms and create large social costs, the governmental response (especially in a democracy) is for laws and regulations to be passed against such behavior.

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 business and value

Finally, investors may choose not to invest in stocks of firms that they view as social outcasts.

- Growth of "socially responsible" funds

Counter-reaction to agency costs..



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 private firms, maximize stockholder wealth (if lenders are protected) or firm value (if they are not)

Corporate governance defined

"Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance," **OECD** April 1999.

The value of good corporate governance

Studies have found that firms with better corporate governance characteristics tend to perform better. Stock returns of firms with “good” corporate governance practices are significantly greater than returns for firms with “bad” corporate governance practices

- Reduced expropriation of corporate resources by managers
- Lenders and investors more willing to provide funds leading to lower costs of capital.

Institutional Shareholder Services (ISS) provides a relative measure of corporate governance quality known as the Corporate Governance Quotient (CGQ).

How do we define “good” corporate governance?

Board members act in the best interest of shareholders.

The company acts in a lawful and ethical manner in all their dealings.

All shareholders have the same right to participate in company governance and are treated fairly by the Board and management.

The board and committees act independently of management

All relevant company information is provided in a timely manner

How do we evaluate the corporate governance structure of a firm?

Board of directors

- What is the composition of the board and committees? Is there sufficient independent director representation?
- Do the board members have the necessary expertise to make informed decisions?
- Does the board have the authority to hire outside consultants without management approval?
- Are there independent directors that are active in decision making and that are compensated based on firm performance?
- Does the company engage in outside business relationships (related-party transactions) with management or Board members and relations?
- Does the company meet or surpass exchange guidelines?

How do we evaluate the corporate governance structure of a firm?

Management

- Does the company have a formal code of ethics?
- How is management's compensation structured?
- Does the company allow management personal use of company assets?
- Are managers significant stockholders in the firm?
- Has the company been posted in any black list (ex. CALPERS)?

How do we evaluate the corporate governance structure of a firm?

Shareholders

- Does the company allow proxy voting?
- What is the approval process for corporate structure changes? Are supermajority votes required?
- Have there been managerial actions that are inconsistent with stock price maximization (green mail, golden parachute, actions during a takeover, etc.)?
- Can we consider the shareholders to be active where active participation in decision making is proxied by larger institutional investment in the firm?
- How many of the top 15 investors are institutional investors?
- What is the company's ownership structure? Are the dual classes of shares?

How do we evaluate the corporate governance structure of a firm?

Bondholders

- What kind of protective covenants exist?
- How is the debt structured, i.e., are there equity components or options?

Firms and Financial Markets

- Does management provide market with timely information?
- Is the firm followed by many, independent analysts?
- Is there high trading volume in the stock?

Firm and Society

- Does the company highlight its social responsibilities and actions?.

How do we evaluate the corporate governance structure of a firm?

Sources of information for corporate governance analyses:

- Company website
- Corporate governance section of a company's annual report
- Company's articles of organization or by-laws
- Annual corporate governance report to shareholders
- News searches
- General finance websites

Owner Stakeholders & Corporate Governance

The controversy over executive pay

- American executives receive pay packets astronomically higher than counterparts in comparable economies
- Increasing disparity between executive and worker pay
- Are American CEOs overpaid?
- Is the pay system ethical?
- Equally importantly, is it economically efficient?

Governance Problems

Bonding mechanisms

- Incentive alignment schemes in executive compensation
  - Stock options, performance-linked bonuses
  - Options link executive compensation to shareholder value creation
  - A manager receives options to buy company stock at $80. If the market price is $100, he makes $20 per share. If it is $200, he makes $40. So the higher he is able to keep the share price, the greater his pay will be.
  - What happens if the price goes below $80? How much will he make/lose then?
  - So there is a phenomenal upside, but limited downside risk

Governance Problems

Do Bonding mechanisms work?

- Stock options
  - We saw there is a phenomenal upside, but limited downside risk
  - This may lead to behavior by managers aimed at keeping stock prices high at all costs
  - Auditors may be induced to look the other way while the firm follows questionable accounting practices
  - Bad news may be suppressed while management attempts to profit from inside information

Governance Problems

Bonding mechanisms

- The market for corporate control
  - What happens if the other resolution mechanisms don’t work?
  - The firm is poorly managed and its market price falls below its intrinsic value
  - It becomes an attractive target for a corporate raider, because it is now cheaper to buy a business than set up a new one
  - The aggressor firm, post-takeover, replaces the target’s management and board with its own people
  - The target may be retained or sold within a few years

Owner Stakeholders & Corporate Governance

Takeovers:

- External effects on corporations
- control of shares
- friendly & hostile

Takeover Tactics:

a. Tender offers:

- Public offer to <u>all</u> shareholders
- exchange v. cash

b. Beach head acquisitions & proxy fights :

- Initial purchase of a block of shares
- Secure proxies
- Elect favorable Board

Owner Stakeholders & Corporate Governance

c. LBO

- Make public company private
- usually by management
- interest burden

d. Greenmail

- Aggressor sells back his acquisition to target at a premium
- Profitable (green) blackmail

Owner Stakeholders & Corporate Governance

Takeover Defenses:

a. Crown jewel defense

b. Scorched Earth e.g.. Long- term loan (burning crops to deny the enemy food sources)

c. poison pill defense

— issue shareholders shares to be exchanged for cash on takeover

d. Pac Man defense

e.White Knight defense

f. Golden Parachute

Owner Stakeholders & Corporate Governance

Limitations of takeover defenses

- Acceptance/resistance of takeover responsibility of the board
- Board expected to meet standards of loyalty and care
- Fending off takeovers may have serious legal repercussions

Delicate balance

- Keeping the firm viable while satisfying society's displeasure with some aspects of governance