

# The Objective in Corporate Finance

“If you don’t know where you are going, it does not matter how you get there”

# First Principles

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- Invest in projects that yield a return greater than the minimum acceptable hurdle rate.
  - The hurdle rate should be higher for riskier projects and reflect the financing mix used - owners' funds (equity) or borrowed money (debt)
  - Returns on projects should be measured based on cash flows generated and the timing of these cash flows; they should also consider both positive and negative side effects of these projects.
- Choose a financing mix that minimizes the hurdle rate and matches the assets being financed.
- If there are not enough investments that earn the hurdle rate, return the cash to the owners of the firm (if public, these would be stockholders).
  - The form of returns - dividends and stock buybacks - will depend upon the stockholders' characteristics.

**Objective: Maximize the Value of the Firm**

# The Classical Viewpoint

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- **Van Horne:** "In this book, we assume that the objective of the firm is to maximize its value to its stockholders"
- **Brealey & Myers:** "Success is usually judged by value: Shareholders are made better off by any decision which increases the value of their stake in the firm... The secret of success in financial management is to increase value."
- **Copeland & Weston:** The most important theme is that the objective of the firm is to maximize the wealth of its stockholders."
- **Brigham and Gapenski:** Throughout this book we operate on the assumption that the management's primary goal is stockholder wealth maximization which translates into maximizing the price of the common stock.

# 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.
- All other goals of the firm are intermediate ones leading to firm value maximization, or operate as constraints on firm value maximization.

# The Criticism of Firm Value Maximization

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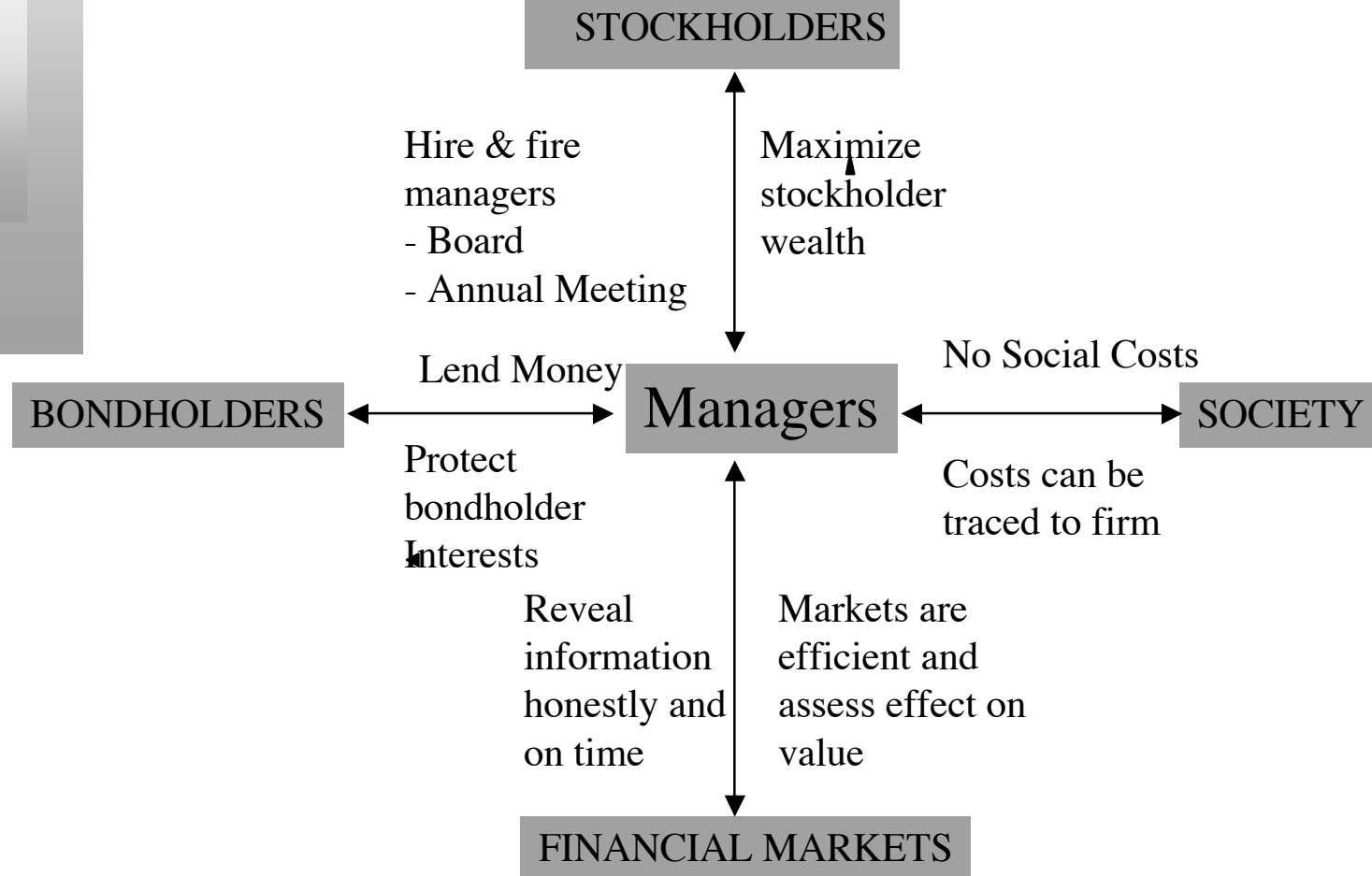
- Maximizing stock price is not incompatible with meeting employee needs/objectives. In particular:
  - - Employees are often stockholders in many firms
  - - Firms that maximize stock price generally are firms that have treated employees well.
- Maximizing stock price does not mean that customers are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

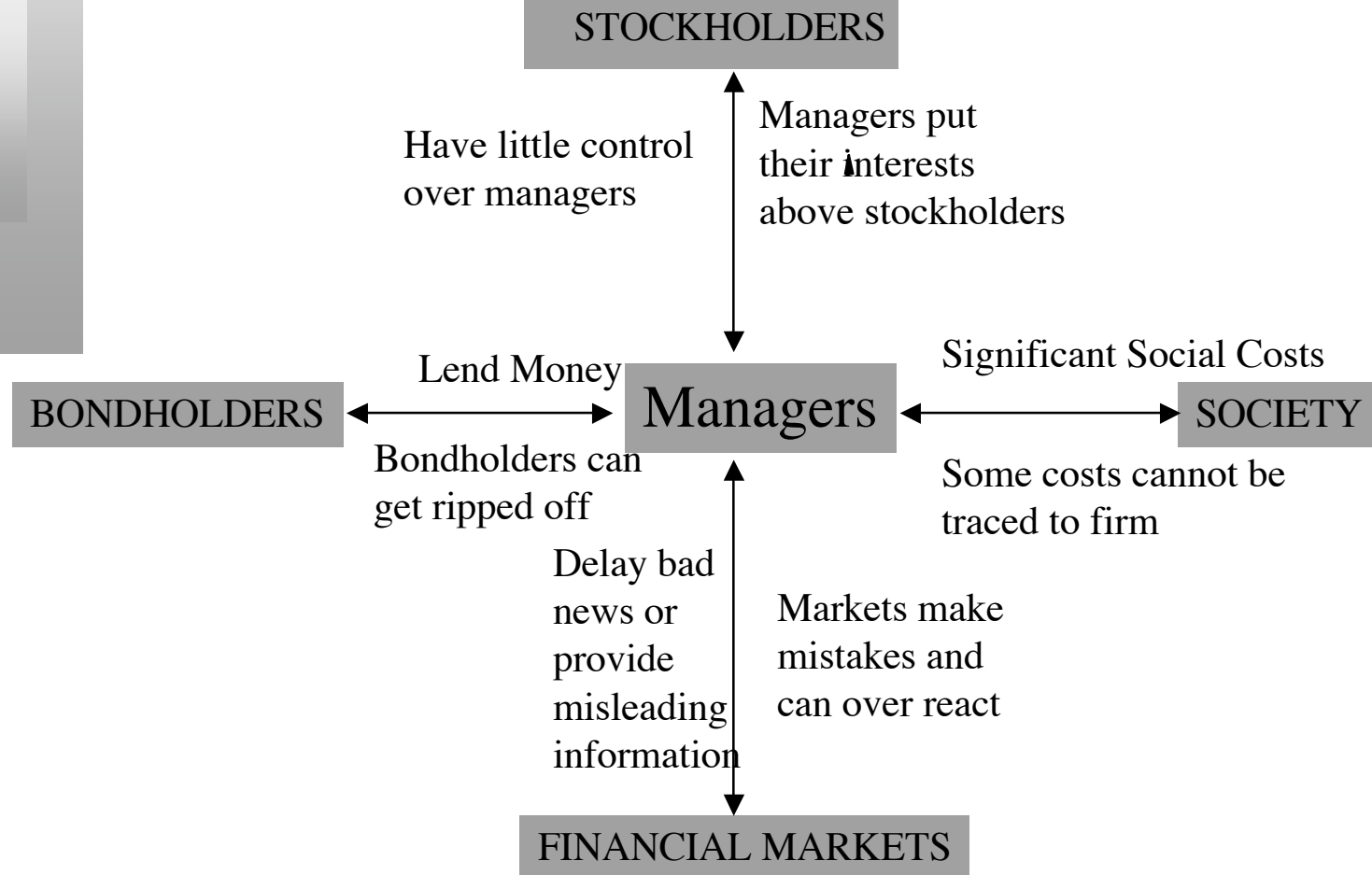
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- Stock price is easily observable and constantly updated (unlike other measures of performance, which may not be as easily observable, and certainly not updated as frequently).
- If investors are rational (are they?), stock prices reflect the wisdom of decisions, short term and long term, instantaneously.
- The objective of stock price performance provides some very elegant theory on:
  - how to pick projects
  - how to finance them
  - how much to pay in dividends

# The Classical Objective Function



# What can go wrong?





# I. Stockholder Interests vs. Management Interests

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- **Theory:** The stockholders have significant control over management. The mechanisms for disciplining management are the annual meeting and the board of directors.
- **Practice:** Neither mechanism is as effective in disciplining management as theory posits.

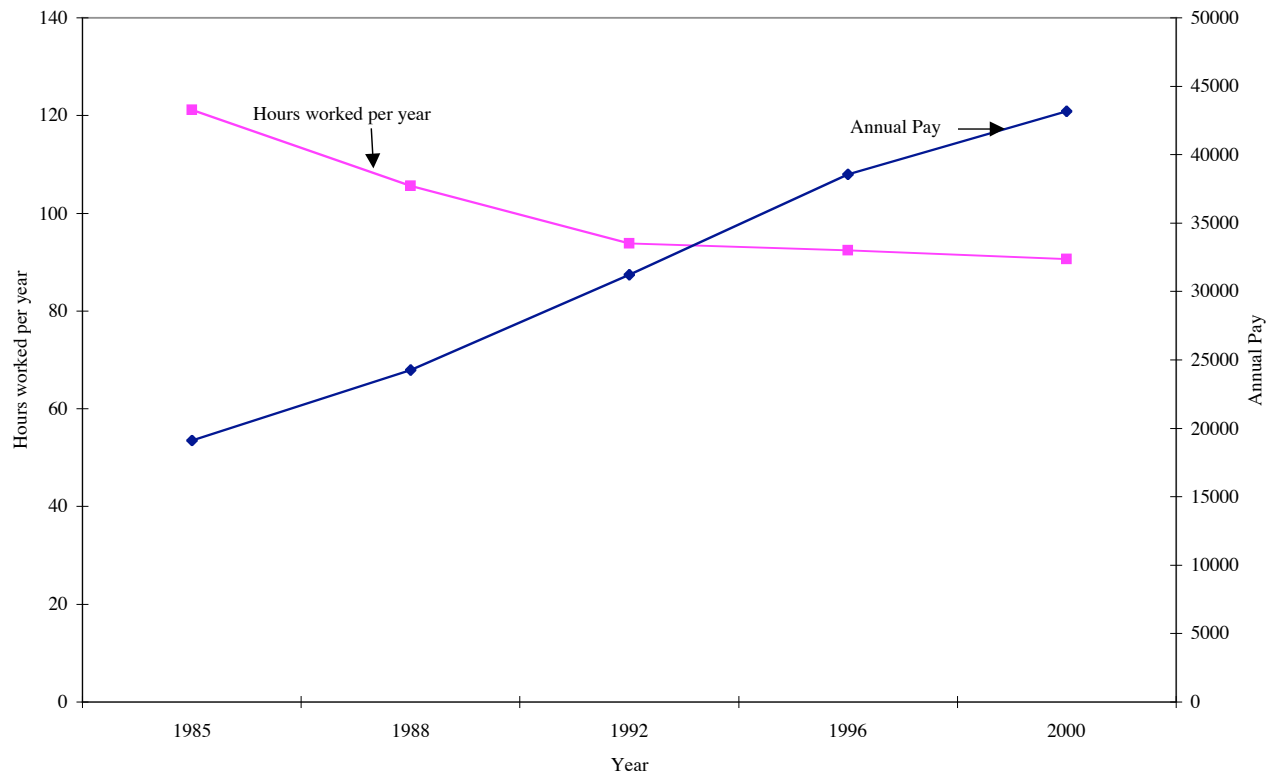
# The Annual Meeting as a disciplinary venue

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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 exercising 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.

# Board of Directors as a disciplinary mechanism

*The Average Director: Underworked and Overpaid*



## The CEO hand-picks most directors..

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- The 1992 survey by Korn/Ferry revealed that 74% of companies relied on recommendations from the CEO to come up with new directors; Only 16% used an outside search firm.
- Directors often hold only token stakes in their companies. The Korn/Ferry survey found that 5% of all directors in 1992 owned less than five shares in their firms.
- Many directors are themselves CEOs of other firms.

## Directors lack the expertise to ask the necessary tough questions..

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- The CEO sets the agenda, chairs the meeting and controls the information.
- The search for consensus overwhelms any attempts at confrontation.

# The Best Boards in 1997...

THE BEST BOARDS OF DIRECTORS												
RANK	FIRM	OVERALL SCORE	SURVEY SCORE	ANALYSIS SCORE	DETAILS	BOARD PERFORMANCE POLL				GOVERNANCE GUIDELINE ANALYSIS		
						SHAREHOLDER ACCOUNTABILITY	BOARD QUALITY	BOARD INDEPENDENCE	CORPORATE PERFORMANCE	SHAREHOLDER ACCOUNTABILITY	BOARD QUALITY	BOARD INDEPENDENCE
1.	CAMPBELL SOUP	87.1	43.1	44.0	Board involvement in recent CEO change rewrites the book on how to do it	9.7	9.0	9.1	9.2	9.2	6.0	10.0
2.	GENERAL ELECTRIC	74.7	45.7	29.0	Won most votes in poll for best board; outside directors own lots of GE stock	8.6	8.6	6.8	9.1	6.0	7.6	4.8
3.	COMPAQ COMPUTER	72.8	28.3	44.5	Model board with nonexecutive chair has delivered big results for investors	9.6	9.2	8.8	10.0	9.2	8.4	9.0
4.	MICROSOFT	69.1	36.6	32.5	Small board wins praise from investors who don't worry about CEO succession	8.0	8.3	7.0	9.2	7.2	6.0	6.4
5.	IBM	68.0	30.5	37.5	Turnaround by board-recruited CEO keeps major shareholders happy	8.5	8.1	7.4	7.8	9.2	6.8	8.0
6.	CHRYSLER	67.8	27.3	40.5	Leader in many governance practices, though many directors on too many boards	9.0	8.7	8.2	8.5	10.0	3.6	9.4
7.	GENERAL MOTORS	67.2	26.2	41.0	Among first to publish guidelines; only weakness: overextended directors	7.0	7.2	6.7	5.7	10.0	2.8	10.0
8.	INTEL	67.1	27.5	32.0	Board gains high marks from investors; directors own lots of stock	9.1	8.4	6.4	9.3	6.4	7.6	8.8
9.	COLGATE PALMOLIVE	66.9	26.4	40.5	All directors own significant stock; only one insider on board: the CEO	8.5	9.3	9.0	9.3	8.0	8.4	8.0
10.	TEXAS INSTRUMENTS	64.9	26.4	38.5	Pays half of retainer in stock; outsiders average more than \$400K of stock	9.5	9.0	8.8	8.8	8.0	6.8	8.0

# And the Worst Boards in 1997..

THE WORST BOARDS OF DIRECTORS											
EW RANK	OVERALL SCORE	SURVEY SCORE	ANALYSIS SCORE	DETAILS	BOARD PERFORMANCE POLL				GOVERNANCE GUIDELINE ANALYSIS		
					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

# Who's on Board? 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



# A Contrast: Disney vs. Campbell Soup in 1997

<i>BEST PRACTICES</i>	<i>CAMPBELL SOUP</i>	<i>DISNEY</i>
Majority of outside directors	Only one insider among 15 directors	7 of 17 members are insiders
Bans insiders on nominating committee	Yes	No: CEO is chairman of panel
Bans former execs from board	Yes	No
Mandatory retirement age	70, with none over 64	None
Outside directors meet w/o CEO	Annually	Never
Appointment of 'lead director'	Yes	No
Governance committee	Yes	No
Self-evaluation of effectiveness	Every two years	None
Director pensions	None	Yes
Share-ownership requirement	3,000 shares	None

## ⌚ Application Test: Who's on board?

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- Look at the board of directors for your firm. Analyze
  - 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?

# So, what next? When the cat is idle, the mice will play ....

When managers do not fear stockholders, they will often put their interests over stockholder interests

- **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.
- **Shark Repellents:** Anti-takeover amendments are also aimed at dissuading hostile takeovers, but differ on one very important count. They require the assent of stockholders to be instituted.
- **Overpaying on takeovers**

■ No stockholder approval needed..... Stockholder Approval needed

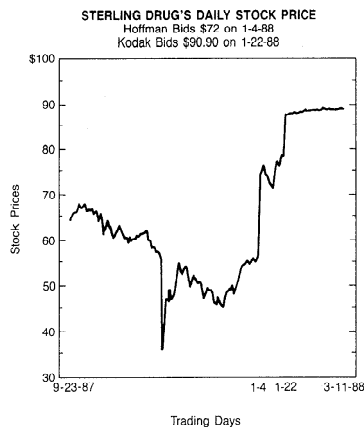
# Overpaying on takeovers

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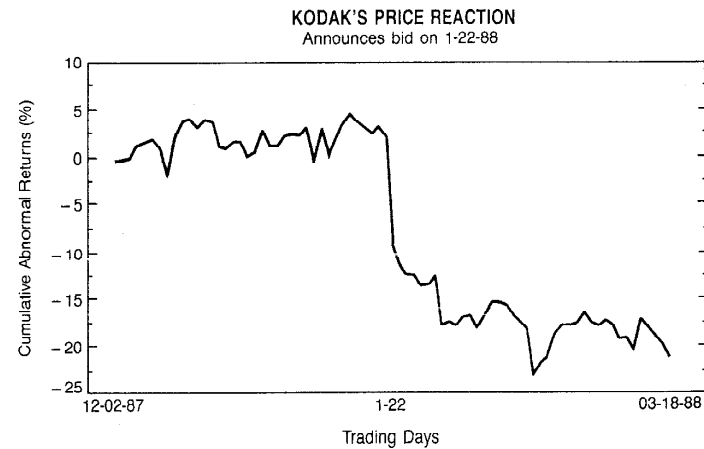
- The quickest and perhaps the most decisive way to impoverish stockholders is to overpay on a takeover.
- The stockholders in acquiring firms do not seem to share the enthusiasm of the managers in these firms. Stock prices of bidding firms decline on the takeover announcements a significant proportion of the time.
- Many mergers do not work, as evidenced by a number of measures.
  - The profitability of merged firms relative to their peer groups, does not increase significantly after mergers.
  - An even more damning indictment is that a large number of mergers are reversed within a few years, which is a clear admission that the acquisitions did not work.

# A Case Study: Kodak - Sterling Drugs

## ■ Eastman Kodak's Great Victory



**KODAK'S PRICE REACTION**  
Announces bid on 1-22-88



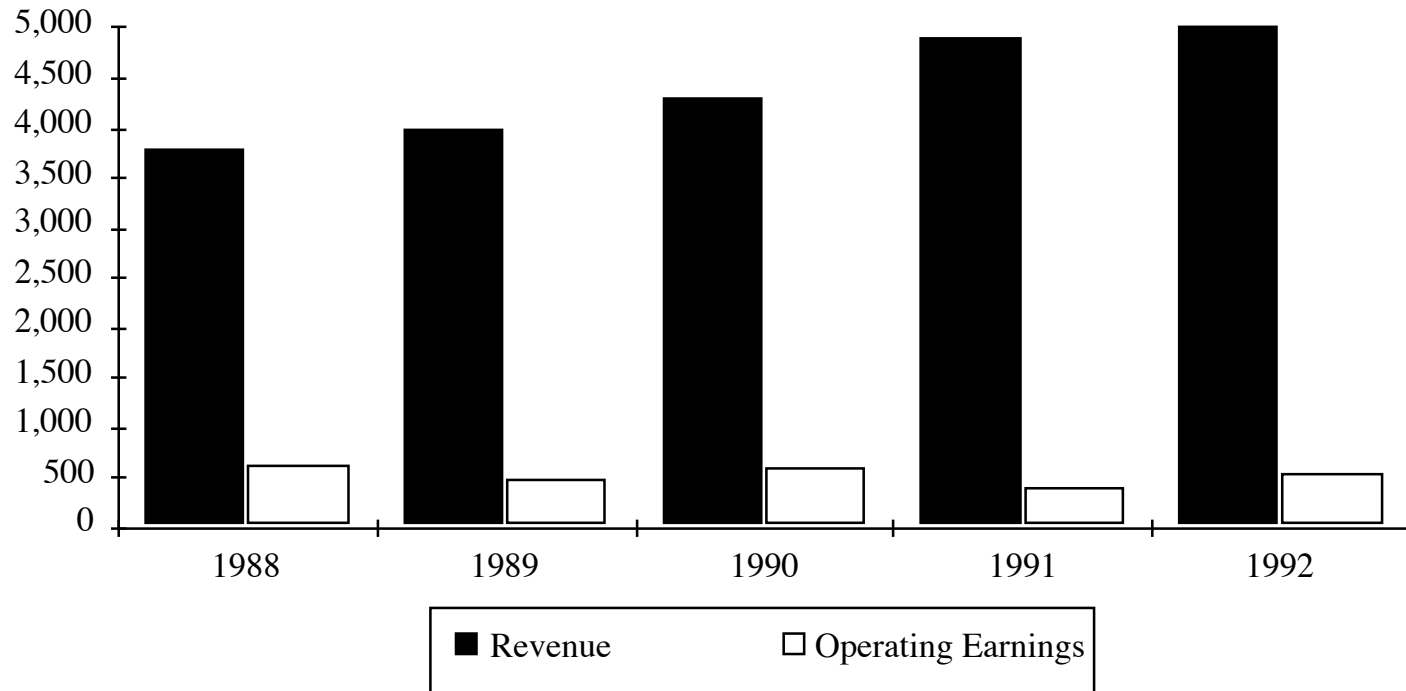
Kodak's market reaction indicates that investors expected no synergies:

Kodak's bid =	\$5.1 billion
Sterling's market value 30 days prior to announcement =	<u>3.0 billion</u>
Premium bid	\$2.1 billion
Decrease in Kodak's market value =	\$2.2 billion

SOURCE: The Aclar Group, Inc.

# Earnings and Revenues at Sterling Drugs

**Sterling Drug under Eastman Kodak: Where is the synergy?**



# Kodak Says Drug Unit Is Not for Sale (NYTimes, 8/93)

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- An article in the NY Times in August of 1993 suggested that Kodak was eager to shed its drug unit.
  - In response, Eastman Kodak officials say they have no plans to sell Kodak's Sterling Winthrop drug unit.
  - Louis Mattis, Chairman of Sterling Winthrop, dismissed the rumors as “massive speculation, which flies in the face of the stated intent of Kodak that it is committed to be in the health business.”
- A few months later... Taking a stride out of the drug business, Eastman Kodak said that the Sanofi Group, a French pharmaceutical company, agreed to buy the prescription drug business of Sterling Winthrop for **\$1.68 billion**.
  - Shares of Eastman Kodak rose 75 cents yesterday, closing at \$47.50 on the New York Stock Exchange.
  - Samuel D. Isaly an analyst , said the announcement was “very good for Sanofi and very good for Kodak.”
  - “When the divestitures are complete, Kodak will be entirely focused on imaging,” said George M. C. Fisher, the company's chief executive.
  - The rest of the Sterling Winthrop was sold to Smithkline for \$2.9 billion.

## ⌚ Application Test: Who owns/runs your firm?

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Look at: Bloomberg printout **HDS** for your firm

- Looking at the top 15 stockholders in your firm, are top managers in your firm also large stockholders in the firm?
- Is there any evidence that the top stockholders in the firm play an active role in managing the firm?



# Disney's top stockholders in 2003

<HELP> for explanation. dgp Equity HDS  
 Enter #<GO> to select aggregate portfolio and see detailed information

001189658224-000		HOLDINGS SEARCH		CUSIP 25468710	
DIS	US	DISNEY (WALT) CO		Page 1 / 100	
Holder name	Portfolio Name	Source	Held	Percent Outstd	Latest Filing Change Date
1BARCLAYS GLOBAL	BARCLAYS BANK PLC	13F	83,630M	4.095	1,750M 09/02
2CITIGROUP INC	CITIGROUP INCORPORAT	13F	62,857M	3.078	4,811M 09/02
3FIDELITY MANAGEM	FIDELITY MANAGEMENT	13F	56,125M	2.748	5,992M 09/02
4STATE STREET	STATE STREET CORPORA	13F	54,635M	2.675	2,239M 09/02
5SOUTHEASTERN ASST	SOUTHEASTERN ASSET M	13F	47,333M	2.318	14,604M 09/02
6ST FARM MU AUTO	STATE FARM MUTUAL AU	13F	41,938M	2.054	120,599 09/02
7VANGUARD GROUP	VANGUARD GROUP INC	13F	34,721M	1.700	-83,839 09/02
8MELLON BANK N A	MELLON BANK CORP	13F	32,693M	1.601	957,489 09/02
9PUTNAM INVEST	PUTNAM INVESTMENT MA	13F	28,153M	1.379	-11,468M 09/02
10LORD ABBETT & CO	LORD ABBETT & CO	13F	24,541M	1.202	5,385M 09/02
11MONTAG CALDWELL	MONTAG & CALDWELL IN	13F	24,466M	1.198	-11,373M 09/02
12DEUTSCHE BANK AK	DEUTSCHE BANK AG	13F	23,239M	1.138	-5,002M 09/02
13MORGAN STANLEY	MORGAN STANLEY	13F	19,655M	0.962	3,482M 09/02
14PRICE T ROWE	T ROWE PRICE ASSOCIA	13F	19,133M	0.937	2,925M 09/02
15ROY EDWARD DISNE	n/a	PROXY	17,547M	0.859	-126,710 12/01
16AXA FINANCIAL	ALLIANCE CAPITAL MAN	13F	14,283M	0.699	69,353 09/02
17JP MORGAN CHASE	JP MORGAN CHASE & CO	13F	14,209M	0.695	-462,791 09/02
Sub-totals for current page:			599,159M	29.340	

\* Money market directory info available. Select portfolio, then hit IP<GO>.  
 Australia 61 3 8377 8600 Brazil 5511 3048 4300 Europe 44 20 7339 7500 Germany 49 69 928410  
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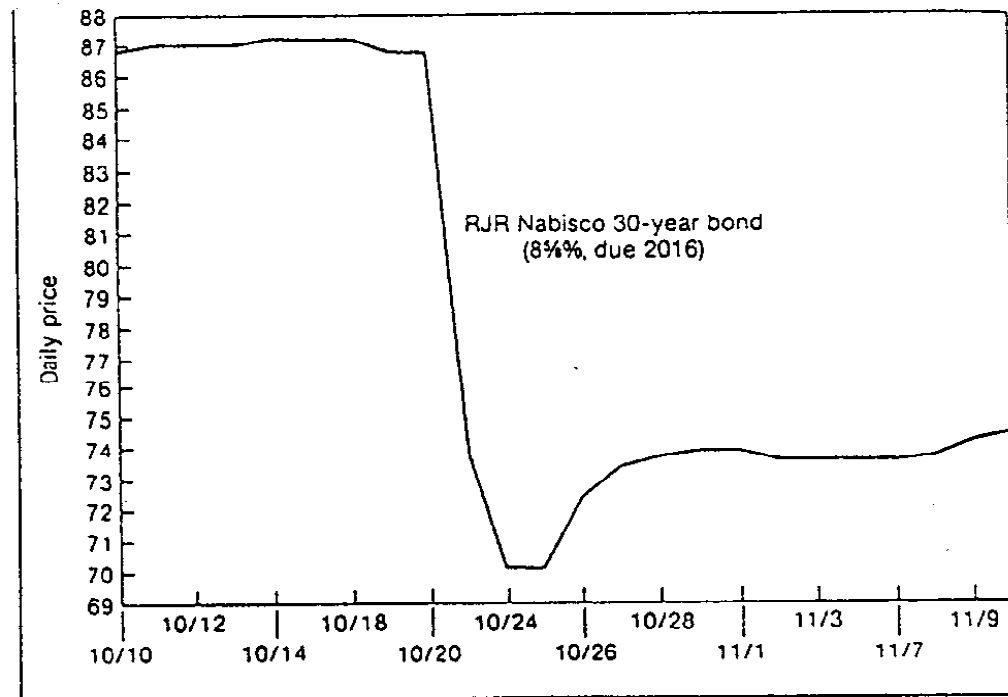
## II. Stockholders' objectives vs. Bondholders' objectives

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- In theory: there is no conflict of interests between stockholders and bondholders.
- In practice: Stockholders may maximize their wealth at the expense of bondholders.
  - Increasing dividends significantly: When firms pay cash out as dividends, lenders to the firm are hurt and stockholders may be helped. This is because the firm becomes riskier without the cash.
  - Taking riskier projects than those agreed to at the outset: Lenders base interest rates on their perceptions of how risky a firm's investments are. If stockholders then take on riskier investments, lenders will be hurt.
  - 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.

# Unprotected Lenders?

RJR Nabisco's  
Bonds Sink Follow-  
ing Announcement  
of the Leveraged  
Buyout



# III. Firms and Financial Markets

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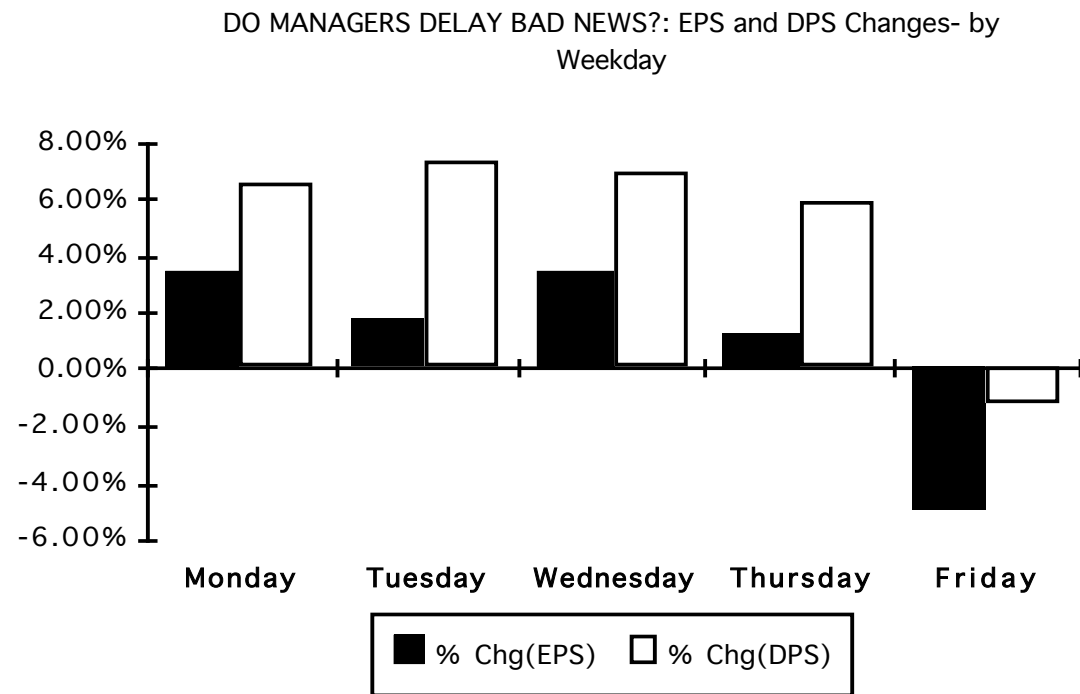
- **In theory:** Financial markets are efficient. Managers convey information honestly and truthfully to financial markets, and financial markets make reasoned judgments of 'true value'. As a consequence-
  - A company that invests in good long term projects will be rewarded.
  - Short term accounting gimmicks will not lead to increases in market value.
  - Stock price performance is a good measure of management performance.
- **In practice:** There are some holes in the 'Efficient Markets' assumption.

# Managers control the release of information to the general public

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- There is evidence that
  - they suppress information, generally negative information
  - they delay the releasing of bad news
    - bad earnings reports
    - other news
  - they sometimes reveal fraudulent information

# Evidence that managers delay bad news..



# Even when information is revealed to financial markets, the market value that is set by demand and supply may contain errors.

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- Prices are much more volatile than justified by the underlying fundamentals
  - Eg. Did the true value of equities really decline by 20% on October 19, 1987?
- financial markets overreact to news, both good and bad
- financial markets are short-sighted, and do not consider the long-term implications of actions taken by the firm
  - Eg. the focus on next quarter's earnings
- financial markets are manipulated by insiders; Prices do not have any relationship to value.

# Are Markets Short term?

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Focusing on market prices will lead companies towards short term decisions at the expense of long term value.

- a) I agree with the statement
- b) I do not agree with this statement



# Are Markets Short Sighted? Some evidence that they are not..

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- There are hundreds of start-up and small firms, with no earnings expected in the near future, that raise money on financial markets
- If the evidence suggests anything, it is that markets do not value current earnings and cashflows enough and value future earnings and cashflows too much.
  - Low PE stocks are underpriced relative to high PE stocks
- The market response to research and development and investment expenditure is generally positive

# Market Reaction to Investment Announcements

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<i>Type of Announcement</i>	<i>Abnormal Returns on</i>	
	<i>Announcement Day</i>	<i>Announcement Month</i>
Joint Venture Formations	0.399%	1.412%
R&D Expenditures	0.251%	1.456%
Product Strategies	0.440%	-0.35%
Capital Expenditures	0.290%	1.499%
All Announcements	0.355%	0.984%

## IV. Firms and Society

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- **In theory:** There are no costs associated with the firm that cannot be traced to the firm and charged to it.
- **In practice:** Financial decisions can create social costs and benefits.
  - 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.
    - -environmental costs (pollution, health costs, etc..)
    - Quality of Life' costs (traffic, housing, safety, etc.)
  - Examples of social benefits include:
    - creating employment in areas with high unemployment
    - supporting development in inner cities
    - creating access to goods in areas where such access does not exist

## Social Costs and Benefits are difficult to quantify because ..

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- They might not be known at the time of the decision (Example: Manville and asbestos)
- They are 'person-specific' (different decision makers weight them differently)
- They can be paralyzing if carried to extremes

# A Hypothetical Example

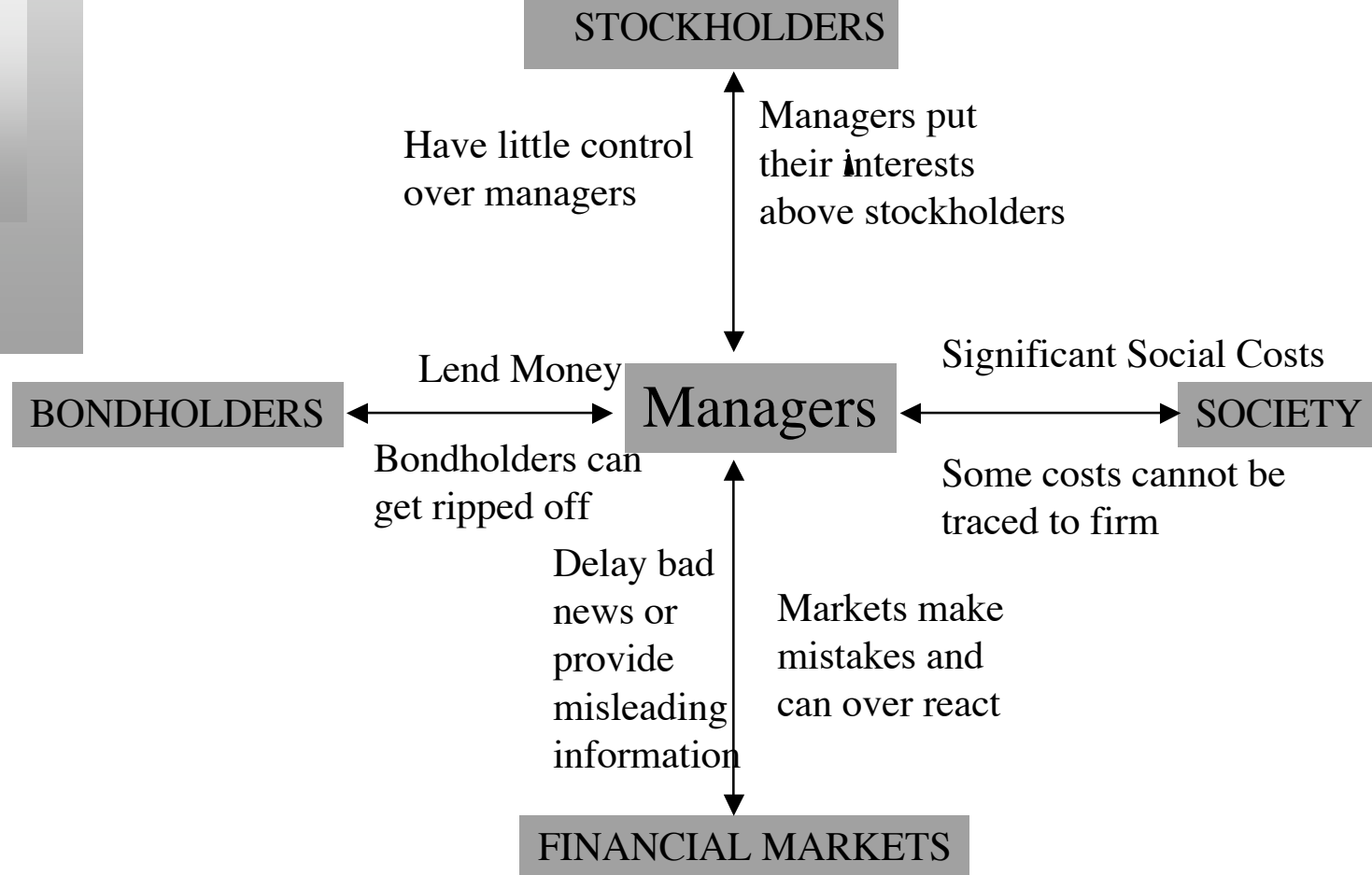
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Assume that you work for Disney and that you have an opportunity to open a store in an inner-city neighborhood. The store is expected to lose about \$100,000 a year, but it will create much-needed employment in the area, and may help revitalize it.

■ Questions:

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

# So this is what can go wrong...



# Traditional corporate financial theory breaks down when ...

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- The interests/objectives of the decision makers in the firm conflict with the interests of stockholders.
- Bondholders (Lenders) are not protected against expropriation by stockholders.
- Financial markets do not operate efficiently, and stock prices do not reflect the underlying value of the firm.
- Significant social costs can be created as a by-product of stock price maximization.

## When traditional corporate financial theory breaks down, the solution is:

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- To choose a different mechanism for corporate governance
- To choose a different objective:
- To maximize stock price, but reduce the potential for conflict and breakdown:
  - Making managers (decision makers) and employees into stockholders
  - By providing information honestly and promptly to financial markets



# An Alternative Corporate Governance System

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- Germany and Japan developed a different mechanism for corporate governance, based upon corporate cross holdings.
  - In Germany, the banks form the core of this system.
  - In Japan, it is the keiretsus
  - Other Asian countries have modeled their system after Japan, with family companies forming the core of the new corporate families
- At their best, the most efficient firms in the group work at bringing the less efficient firms up to par. They provide a corporate welfare system that makes for a more stable corporate structure
- At their worst, the least efficient and poorly run firms in the group pull down the most efficient and best run firms down. The nature of the cross holdings makes its very difficult for outsiders (including investors in these firms) to figure out how well or badly the group is doing.

# Choose a Different Objective Function

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- Firms can always focus on a different objective function. Examples would include
  - maximizing earnings
  - maximizing revenues
  - maximizing firm size
  - maximizing market share
  - maximizing EVA
- The key thing to remember is that these are intermediate objective functions.
  - To the degree that they are correlated with the long term health and value of the company, they work well.
  - To the degree that they do not, the firm can end up with a disaster

# Maximize Stock Price, subject to ..

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- 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
- In the context of our discussion,
  - managers taking advantage of stockholders has lead to a much more active market for corporate control.
  - stockholders taking advantage of bondholders has lead to bondholders protecting themselves at the time of the issue.
  - firms revealing incorrect or delayed information to markets has lead to markets becoming more “skeptical” and “punitive”
  - firms creating social costs has lead to more regulations, as well as investor and customer backlashes.

# The Stockholder Backlash

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- Institutional investors such as CalPERS and the Lens Funds have become much more active in monitoring companies that they invest in and demanding changes in the way in which business is done
- Individuals like Michael Price specialize in taking large positions in companies which they feel need to change their ways (Chase, Dow Jones, Readers' Digest) and push for change
- At annual meetings, stockholders have taken to expressing their displeasure with incumbent management by voting against their compensation contracts or their board of directors

## Disney's Board in 2003

<i>Board Members</i>	<i>Occupation</i>
Reveta Bowers	Head of school for the Center for Early Education,
John Bryson	CEO and Chairman of Con Edison
Roy Disney	Head of Disney Animation
Michael Eisner	CEO of Disney
Judith Estrin	CEO of Packet Design (an internet company)
Stanley Gold	CEO of Shamrock Holdings
Robert Iger	Chief Operating Officer, Disney
Monica Lozano	Chief Operation Officer, La Opinion (Spanish newspaper)
George Mitchell	Chairman of law firm (Verner, Liipfert, et al.)
Thomas S. Murphy	Ex-CEO, Capital Cities ABC
Leo O'Donovan	Professor of Theology, Georgetown University
Sidney Poitier	Actor, Writer and Director
Robert A.M. Stern	Senior Partner of Robert A.M. Stern Architects of New York
Andrea L. Van de Kamp	Chairman of Sotheby's West Coast
Raymond L. Watson	Chairman of Irvine Company (a real estate corporation)
Gary L. Wilson	Chairman of the board, Northwest Airlines.

# The Hostile Acquisition Threat

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- The typical target firm in a hostile takeover has
  - a return on equity almost 5% lower than its peer group
  - had a stock that has significantly under performed the peer group over the previous 2 years
  - has managers who hold little or no stock in the firm
- In other words, the best defense against a hostile takeover is to run your firm well and earn good returns for your stockholders
- Conversely, when you do not allow hostile takeovers, this is the firm that you are most likely protecting (and not a well run or well managed firm)

# The Bondholders' Defense Against Stockholder Excesses

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- More restrictive covenants on investment, financing and dividend policy have been incorporated into both private lending agreements and into bond issues, to prevent future “Nabiscos”.
- New types of bonds have been created to explicitly protect bondholders against sudden increases in leverage or other actions that increase lender risk substantially. Two examples of such bonds
  - Puttable Bonds, where the bondholder can put the bond back to the firm and get face value, if the firm takes actions that hurt bondholders
  - 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.

# The Financial Market Response

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- While analysts are more likely still to issue buy rather than sell recommendations, the payoff to uncovering negative news about a firm is large enough that such news is eagerly sought and quickly revealed (at least to a limited group of investors)
- As information sources to the average investor proliferate, it is becoming much more difficult for firms to control when and how information gets out to markets.
- As option trading has become more common, it has become much easier to trade on bad news. In the process, it is revealed to the rest of the market (See Scholastic)
- When firms mislead markets, the punishment is not only quick but it is savage.

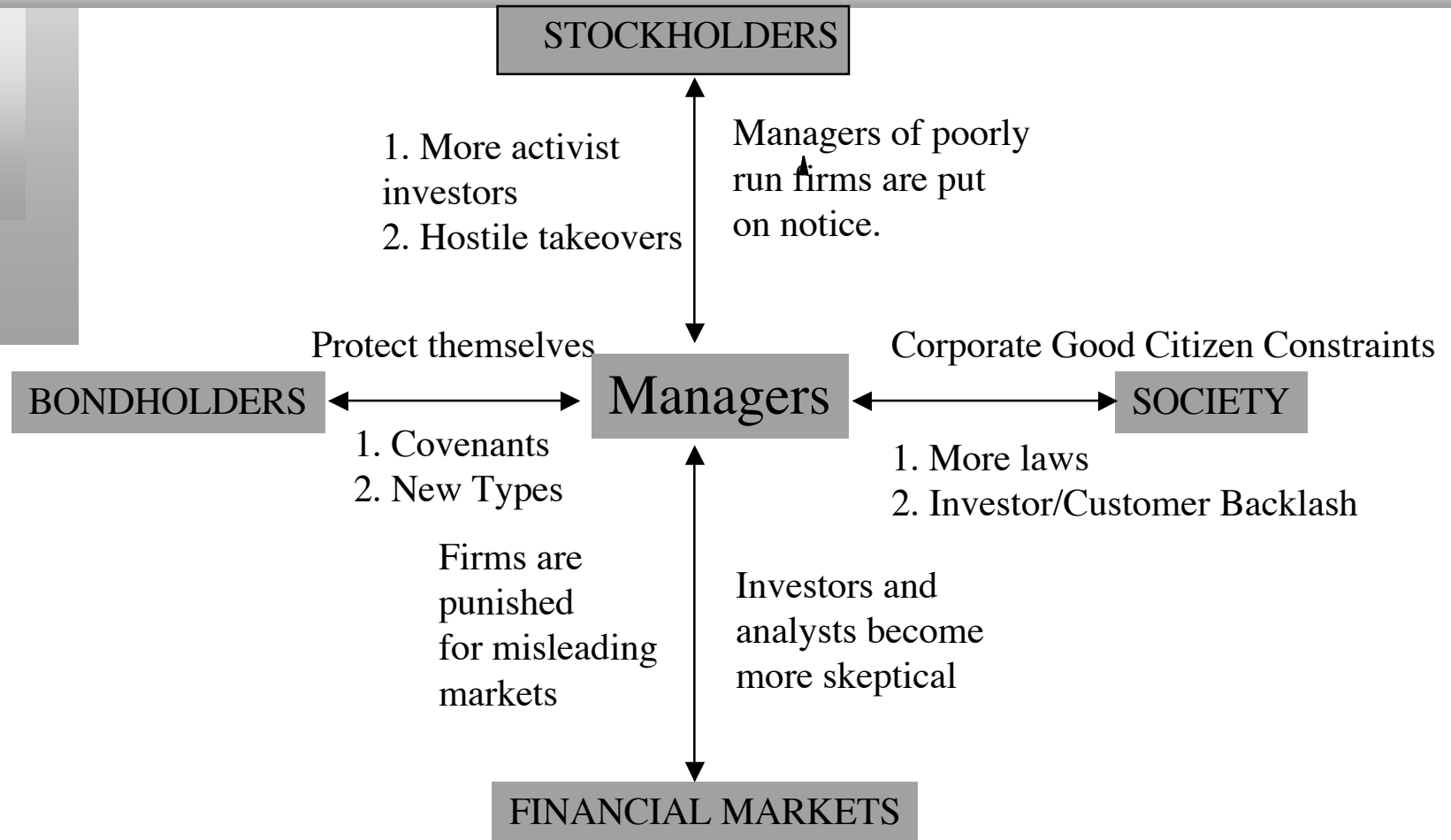


# The Societal Response

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- 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.
  - e.g.: Laws against using underage labor in the United States
- 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
  - e.g. Specialty retailers being criticized for using under age labor in other countries (where it might be legal)
- Finally, investors may choose not to invest in stocks of firms that they view as social outcasts.
  - e.g.. Tobacco firms and the growth of “socially responsible” funds (Calvert..)

# The Counter Reaction



# So what do you think?

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- At this point in time, the following statement best describes where I stand in terms of the right objective function for decision making in a business
  - a) Maximize stock price or stockholder wealth, with no constraints
  - b) Maximize stock price or stockholder wealth, with constraints on being a good social citizen.
  - c) Maximize profits or profitability
  - d) Maximize market share
  - e) Maximize Revenues
  - f) Maximize social good
  - g) None of the above

# The Modified Objective Function

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- For publicly traded firms in reasonably efficient markets, where bondholders (lenders) are protected:
  - Maximize Stock Price: This will also maximize firm value
- For publicly traded firms in inefficient markets, where bondholders are protected:
  - Maximize stockholder wealth: This will also maximize firm value, but might not maximize the stock price
- For publicly traded firms in inefficient markets, where bondholders are not fully protected
  - Maximize firm value, though stockholder wealth and stock prices may not be maximized at the same point.
- For private firms, maximize stockholder wealth (if lenders are protected) or firm value (if they are not)