THE OBJECTIVE IN CORPORATE FINANCE

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

Aswath Damodaran
First Principles

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 Financing Decision
Find the right kind of debt for your firm and the right mix of debt and equity to fund your operations

The Dividend Decision
If you cannot find investments that make your minimum acceptable rate, return the cash to owners of your business

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 optimal mix of debt and equity maximizes firm value.

The right kind of debt matches the tenor of your assets.

How much cash you can return depends upon current and potential investment opportunities.

How you choose to return cash to the owners will depend on whether they prefer dividends or buybacks.

Aswath Damodaran
The Objective in Decision Making

- 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.

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Existing Investments</td>
<td>Fixed Claim on cash flows</td>
</tr>
<tr>
<td>Generate cashflows today</td>
<td>Little or No role in management</td>
</tr>
<tr>
<td>Includes long lived (fixed) and</td>
<td>Fixed Maturity</td>
</tr>
<tr>
<td>short-lived (working capital)</td>
<td>Tax Deductible</td>
</tr>
<tr>
<td>assets</td>
<td></td>
</tr>
<tr>
<td>Expected Value that will be</td>
<td>Residual Claim on cash flows</td>
</tr>
<tr>
<td>created by future investments</td>
<td>Significant Role in management</td>
</tr>
<tr>
<td></td>
<td>Perpetual Lives</td>
</tr>
<tr>
<td>Assets in Place</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Equity</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Growth Assets</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Maximize firm value

Maximize equity value

Maximize market estimate of equity value

Aswath Damodaran
Maximizing Stock Prices is too “narrow” an objective: A preliminary response

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

- 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:
  - Allocating resources across scarce uses (which investments to take and which ones to reject)
  - how to finance these investments
  - how much to pay in dividends

Aswath Damodaran
The Classical Objective Function

**STOCKHOLDERS**
- Maximize stockholder wealth
- Hire & fire managers
  - Board
  - Annual Meeting

**BONDHOLDERS/LENDERS**
- Lend Money
- Protect bondholder interests

**MANAGERS**
- Reveal information honestly and on time

**FINANCIAL MARKETS**
- Markets are efficient and assess effect on value

**SOCIETY**
- No Social Costs
  - All costs can be traced to firm

Aswath Damodaran
What can go wrong?

STOCKHOLDERS
- Have little control over managers
- Managers put their interests above stockholders

BONDHOLDERS
- Lend Money
- Bondholders can get ripped off

Managers
- Delay bad news or provide misleading information
- Markets make mistakes and can over react

FINANCIAL MARKETS

Significant Social Costs
- Some costs cannot be traced to firm

SOCIETY

Aswath Damodaran
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 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...
Board of Directors as a disciplinary mechanism

- **Directors are paid well**: In 2010, the median board member at a Fortune 500 company was paid $212,512, with 54% coming in stock and the remaining 46% in cash. If a board member was a non-executive chair, he or she received about $150,000 more in compensation.

- **Spend more time on it than they used to**: A board member worked, on average, about 227.5 hours a year (and that is being generous), or 4.4 hours a week, according to the National Associate of Corporate Directors. Of this, about 24 hours a year are for board meetings. Those numbers are up from what they were a decade ago.

- **Even those hours are not very productive**: While the time spent on being a director has gone up, a significant portion of that time was spent on making sure that they are legally protected (regulations & lawsuits).

- **And they have many loyalties**: Many directors serve on three or more boards, and some are full time chief executives of other companies.
The CEO often hand-picks directors..

- **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..

- 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.

Aswath Damodaran
<table>
<thead>
<tr>
<th>Name</th>
<th>Title/Role</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reveta F. Bowers 1,5</td>
<td>Head of School</td>
</tr>
<tr>
<td></td>
<td>Center for Early Education</td>
</tr>
<tr>
<td>Roy E. Disney 3</td>
<td>Vice Chairman</td>
</tr>
<tr>
<td></td>
<td>The Walt Disney Company</td>
</tr>
<tr>
<td>Michael D. Eisner 3</td>
<td>Chairman and Chief Executive Officer</td>
</tr>
<tr>
<td></td>
<td>The Walt Disney Company</td>
</tr>
<tr>
<td>Stanley P. Gold 4,5</td>
<td>President and Chief Executive Officer</td>
</tr>
<tr>
<td></td>
<td>Shamrock Holdings, Inc.</td>
</tr>
<tr>
<td>Sanford M. Litvack</td>
<td>Senior Executive Vice President and Chief of Corporate Operations</td>
</tr>
<tr>
<td></td>
<td>The Walt Disney Company</td>
</tr>
<tr>
<td>Ignacio E. Lozano, Jr. 1,2,4</td>
<td>Editor-in-Chief, LA OPINION</td>
</tr>
<tr>
<td>George J. Mitchell s</td>
<td>Special Counsel</td>
</tr>
<tr>
<td></td>
<td>Verner, Liipfert, Bernard, McPherson and Hand</td>
</tr>
<tr>
<td>Thomas S. Murphy</td>
<td>Former Chairman</td>
</tr>
<tr>
<td></td>
<td>Capital Cities/ABC, Inc.</td>
</tr>
<tr>
<td>Richard A. Nunis</td>
<td>Chairman</td>
</tr>
<tr>
<td></td>
<td>Walt Disney Attractions</td>
</tr>
<tr>
<td>Leo J. O’Donovan, S.J.</td>
<td>President</td>
</tr>
<tr>
<td></td>
<td>Georgetown University</td>
</tr>
<tr>
<td>Michael S. Ovitz 3</td>
<td>President</td>
</tr>
<tr>
<td></td>
<td>The Walt Disney Company</td>
</tr>
<tr>
<td>Sidney Poitier 2,4</td>
<td>Chief Executive Officer</td>
</tr>
<tr>
<td></td>
<td>Verdon-Cedric Productions</td>
</tr>
<tr>
<td>Irwin E. Russell 2,4</td>
<td>Attorney at Law</td>
</tr>
<tr>
<td>Robert A.M. Stern</td>
<td>Senior Partner Productions</td>
</tr>
<tr>
<td>E. Cardon Walker 1</td>
<td>Former Chairman and Chief Executive Officer</td>
</tr>
<tr>
<td></td>
<td>The Walt Disney Company</td>
</tr>
<tr>
<td>Raymond L. Watson 1,2,3</td>
<td>Vice Chairman</td>
</tr>
<tr>
<td></td>
<td>The Irvine Company</td>
</tr>
<tr>
<td>Gary L. Wilson 5</td>
<td>Co-Chairman</td>
</tr>
<tr>
<td></td>
<td>Northwest Airlines Corporation</td>
</tr>
</tbody>
</table>

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  

Aswath Damodaran
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..

![Table: The Worst Boards of Directors]

Aswath Damodaran
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.
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: Acquisitions often are driven by management interests rather than stockholder interests.

Aswath Damodaran
Overpaying on takeovers

- 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.

Aswath Damodaran
A case study in value destruction: Eastman Kodak & Sterling Drugs

Kodak enters bidding war

- In late 1987, Eastman Kodak entered into a bidding war with Hoffman La Roche for Sterling Drugs, a pharmaceutical company.
- The bidding war started with Sterling Drugs trading at about $40/share.
- At $72/share, Hoffman dropped out of the bidding war, but Kodak kept bidding.
- At $89.50/share, Kodak won and claimed potential synergies explained the premium.

Kodak wins!!!!
Earnings and Revenues at Sterling Drugs

Sterling Drug under Eastman Kodak: Where is the synergy?

- Aswath Damodaran
Kodak Says Drug Unit Is Not for Sale ... but...

- 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. ısaly 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.
The connection to corporate governance: HP buys Autonomy... and explains the premium

![Chart showing the acquisition and value analysis of HP's purchase of Autonomy.](image)

- **Accountants reassessed value of assets on balance sheet and added $2,533 million to reflect "intangible" assets.**
- **The market was attaching a premium of $1,300 million to the post-deal book equity and $3,833 million to pre-deal book equity.**
- **HP paid a premium of $5,200 million over the market value.**
- **The difference between the acquisition price ($11,100) and the post-deal book equity (4,600) was recorded as goodwill ($6,500) on HP's balance sheet.**

Aswath Damodaran
A year later... HP admits a mistake...and explains it...

Aswath Damodaran
Application Test: Who owns/runs your firm?

- Look at: Bloomberg printout HDS for your firm
- Who are the top stockholders in your firm?
- What are the potential conflicts of interests that you see emerging from this stockholding structure?

### Control of the firm

- **Government**
- **Managers**
  - Length of tenure
  - Links to insiders
- **Employees**
- **Lenders**
- **Inside stockholders**
  - % of stock held
  - Voting and non-voting shares
  - Control structure
- **Outside stockholders**
  - Size of holding
  - Active or Passive?
  - Short or Long term?
Case 1: Splintering of Stockholders

Disney’s top stockholders in 2003

<table>
<thead>
<tr>
<th>Holder name</th>
<th>Portfolio Name</th>
<th>Source</th>
<th>Held</th>
<th>Dstld</th>
<th>Change Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Barclays Global</td>
<td>Barclays Bank PLC</td>
<td>13F</td>
<td>83.630M</td>
<td>4.095</td>
<td>1.750M</td>
</tr>
<tr>
<td>2Citigroup Inc</td>
<td>Citigroup Corporation</td>
<td>13F</td>
<td>62.057M</td>
<td>3.078</td>
<td>4.811M</td>
</tr>
<tr>
<td>Fidelity Management</td>
<td>Fidelity Management</td>
<td>13F</td>
<td>56.125M</td>
<td>2.748</td>
<td>5.992M</td>
</tr>
<tr>
<td>State Street</td>
<td>State Street Corpora</td>
<td>13F</td>
<td>54.635M</td>
<td>2.675</td>
<td>2.239M</td>
</tr>
<tr>
<td>Southeastern Asset M</td>
<td>Southeastern Asset M</td>
<td>13F</td>
<td>47.333M</td>
<td>2.318</td>
<td>14.604M</td>
</tr>
<tr>
<td>Gt Farm &amp; Auto</td>
<td>State Farm Mutual Au</td>
<td>13F</td>
<td>41.938M</td>
<td>2.054</td>
<td>120.599M</td>
</tr>
<tr>
<td>Vanguard Group</td>
<td>Vanguard Group Inc</td>
<td>13F</td>
<td>34.721M</td>
<td>1.700</td>
<td>-83.839M</td>
</tr>
<tr>
<td>Mellon Bank N A</td>
<td>Mellon Bank Corp</td>
<td>13F</td>
<td>32.693M</td>
<td>1.601</td>
<td>957.499M</td>
</tr>
<tr>
<td>Lord Abbott &amp; Co</td>
<td>Lord Abbott &amp; Co</td>
<td>13F</td>
<td>24.541M</td>
<td>1.202</td>
<td>5.385M</td>
</tr>
<tr>
<td>Montgomery Caldwell</td>
<td>Montgomery &amp; Caldwell Inc</td>
<td>13F</td>
<td>24.466M</td>
<td>1.190</td>
<td>-11.373M</td>
</tr>
<tr>
<td>Deutsche Bank AG</td>
<td>Deutsche Bank AG</td>
<td>13F</td>
<td>23.239M</td>
<td>1.130</td>
<td>-5.002M</td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>Morgan Stanley</td>
<td>13F</td>
<td>19.655M</td>
<td>0.962</td>
<td>3.482M</td>
</tr>
<tr>
<td>Price T Rowe</td>
<td>T Rowe Price Associa</td>
<td>13F</td>
<td>19.133M</td>
<td>0.937</td>
<td>2.925M</td>
</tr>
<tr>
<td>proxy</td>
<td></td>
<td></td>
<td>12.547M</td>
<td>0.859</td>
<td>-12.710</td>
</tr>
<tr>
<td>Alliance Capital Man</td>
<td></td>
<td></td>
<td>14.283M</td>
<td>0.699</td>
<td>69.353M</td>
</tr>
<tr>
<td>JP Morgan Chase &amp; Co</td>
<td></td>
<td></td>
<td>14.209M</td>
<td>0.696</td>
<td>-62.791M</td>
</tr>
</tbody>
</table>

Sub-totals for current page: 599.159M 23.340

Aswath Damodaran
Case 2: Voting versus Non-voting Shares & Golden Shares: Vale

Vale has eleven members on its board of directors, ten of whom were nominated by Valepar and the board was chaired by Don Conrado, the CEO of Valepar.

Aswath Damodaran
# Case 3: Cross and Pyramid Holdings

Tata Motor’s top stockholders in 2013

<table>
<thead>
<tr>
<th>Holder Name</th>
<th>Portfolio Name</th>
<th>Source</th>
<th>Opt</th>
<th>Amt Held</th>
<th>% Out</th>
<th>Latest Chg File Dt</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. TATA SONS LTD</td>
<td>n/a</td>
<td>Co File</td>
<td></td>
<td>702,333,345</td>
<td>26.07</td>
<td>09/30/13</td>
</tr>
<tr>
<td>2. CITIBANK NA</td>
<td>n/a</td>
<td>Co File</td>
<td></td>
<td>446,246,135</td>
<td>16.56</td>
<td>06/30/12</td>
</tr>
<tr>
<td>3. LIFE INSURANCE</td>
<td>n/a</td>
<td>Co File</td>
<td></td>
<td>168,754,477</td>
<td>6.26</td>
<td>-119,728,333/09/30/13</td>
</tr>
<tr>
<td>CORP OF I</td>
<td>n/a</td>
<td>Co File</td>
<td></td>
<td>147,810,695</td>
<td>5.49</td>
<td>09/30/13</td>
</tr>
<tr>
<td>4. TATA STEEL LTD</td>
<td>n/a</td>
<td>Co File</td>
<td></td>
<td>97,689,911</td>
<td>3.63</td>
<td>-877,871/09/30/13</td>
</tr>
<tr>
<td>5. CAPITAL GROUP</td>
<td>n/a</td>
<td>ULT-AGG</td>
<td></td>
<td>68,436,485</td>
<td>2.54</td>
<td>09/30/13</td>
</tr>
<tr>
<td>COMPANIES LTD</td>
<td>n/a</td>
<td>ULT-AGG</td>
<td></td>
<td>41,285,983</td>
<td>1.53</td>
<td>4,535,434/09/30/13</td>
</tr>
<tr>
<td>6. TATA INDUSTRIES</td>
<td>n/a</td>
<td>ULT-AGG</td>
<td></td>
<td>34,080,063</td>
<td>1.26</td>
<td>147,814/09/30/13</td>
</tr>
<tr>
<td>LTD</td>
<td>n/a</td>
<td>ULT-AGG</td>
<td></td>
<td>30,428,428</td>
<td>1.13</td>
<td>09/30/13</td>
</tr>
<tr>
<td>7. PRUDENTIAL PLC</td>
<td>n/a</td>
<td>ULT-AGG</td>
<td></td>
<td>30,093,943</td>
<td>1.12</td>
<td>3,997,149/06/30/13</td>
</tr>
<tr>
<td>8. NICL PRIVATE LTD</td>
<td>n/a</td>
<td>ULT-AGG</td>
<td></td>
<td>24,918,852</td>
<td>0.92</td>
<td>-2,157,750/08/31/13</td>
</tr>
<tr>
<td>9. WILLIAM BLAIR &amp;</td>
<td>n/a</td>
<td>MF-AGG</td>
<td></td>
<td>19,136,665</td>
<td>0.71</td>
<td>2,578,904/06/30/13</td>
</tr>
<tr>
<td>COMPANY LTD</td>
<td>n/a</td>
<td>ULT-AGG</td>
<td></td>
<td>14,100,725</td>
<td>0.52</td>
<td>-265,173/10/31/13</td>
</tr>
<tr>
<td>10. JPMORGAN CHASE &amp;</td>
<td>n/a</td>
<td>MF-AGG</td>
<td></td>
<td>10,762,579</td>
<td>0.40</td>
<td>01/12/31/12</td>
</tr>
<tr>
<td>CO</td>
<td>n/a</td>
<td>MF-AGG</td>
<td></td>
<td>10,056,366</td>
<td>0.37</td>
<td>324,353/09/30/13</td>
</tr>
<tr>
<td>11. SCHRADER</td>
<td>n/a</td>
<td>MF-AGG</td>
<td></td>
<td>10,025,000</td>
<td>0.37</td>
<td>09/30/13</td>
</tr>
<tr>
<td>INVESTMENT MM</td>
<td>n/a</td>
<td>MF-AGG</td>
<td></td>
<td>9,256,170</td>
<td>0.34</td>
<td>-151,323/09/30/13</td>
</tr>
<tr>
<td>COMP Ltd</td>
<td>n/a</td>
<td>MF-AGG</td>
<td></td>
<td>8,129,923</td>
<td>0.30</td>
<td>2,071,551/09/30/13</td>
</tr>
</tbody>
</table>

Aswath Damodaran
Case 4: Legal rights and Corporate Structures: Baidu

- **The Board:** The company has six directors, one of whom is Robin Li, who is the founder/CEO of Baidu. Mr. Li also owns a majority stake of Class B shares, which have ten times the voting rights of Class A shares, granting him effective control of the company.

- **The structure:** Baidu is a Chinese company, but it is incorporated in the Cayman Islands, its primary stock listing is on the NASDAQ and the listed company is structured as a shell company, to get around Chinese government restrictions of foreign investors holding shares in Chinese corporations.

- **The legal system:** Baidu’s operating counterpart in China is structured as a Variable Interest Entity (VIE), and it is unclear how much legal power the shareholders in the shell company have to enforce changes at the VIE.
Things change. Disney’s top stockholders in 2009
II. Stockholders' objectives vs. Bondholders' objectives

- In theory: there is no conflict of interests between stockholders and bondholders.

- In practice: Stockholder and bondholders have different objectives. Bondholders are concerned most about safety and ensuring that they get paid their claims. Stockholders are more likely to think about upside potential.
Examples of the conflict.

- **A dividend/buyback surge:** 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.

- **Risk shifting:** When a firm takes riskier projects than those agreed to at the outset, lenders are hurt. 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.
An Extreme Example: Unprotected Lenders?

RJR Nabisco’s Bonds Sink Following Announcement of the Leveraged Buyout

RJR Nabisco 30-year bond (8.4%, due 2016)
III. Firms and Financial Markets

- **In theory:** Financial markets are efficient. Managers convey information honestly and in a timely manner to financial markets, and financial markets make reasoned judgments of the effects of this information on '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 company performance.

- **In practice:** There are some holes in the 'Efficient Markets' assumption.
Managers control the release of information to the general public

- **Information management (timing and spin):** Information (especially negative) is sometimes suppressed or delayed by managers seeking a better time to release it. When the information is released, firms find ways to “spin” or “frame” it to put themselves in the best possible light.

- **Outright fraud:** In some cases, firms release intentionally misleading information about their current conditions and future prospects to financial markets.
Evidence that managers delay bad news?

DO MANAGERS DELAY BAD NEWS?: EPS and DPS Changes- by Weekday

Aswath Damodaran
Some critiques of market efficiency..

- **Investor irrationality**: The base argument is that investors are irrational and prices often move for no reason at all. As a consequence, prices are much more volatile than justified by the underlying fundamentals. Earnings and dividends are much less volatile than stock prices.

- **Manifestations of irrationality**
  - **Reaction to news**: Some believe that investors overreact to news, both good and bad. Others believe that investors sometimes underreact to big news stories.
  - **An insider conspiracy**: Financial markets are manipulated by insiders; Prices do not have any relationship to value.
  - **Short termism**: Investors are short-sighted, and do not consider the long-term implications of actions taken by the firm.
Are markets short sighted and too focused on the near term? What do you think?

- 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

- Allowing managers to make decisions without having to worry about the effect on market prices will lead to better long term decisions.
  a. I agree with this statement
  b. I do not agree with this statement

- Neither managers nor markets are trustworthy. Regulations/laws should be written that force firms to make long term decisions.
  a. I agree with this statement
  b. I do not agree with this statement

Aswath Damodaran
Are markets short term? Some evidence that they are not..

- **Value of young firms**: There are hundreds of start-up and small firms, with no earnings expected in the near future, that raise money on financial markets. Why would a myopic market that cares only about short term earnings attach high prices to these firms?

- **Current earnings vs Future growth**: 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. After all, studies suggest that low PE stocks are under priced relative to high PE stocks.

- **Market reaction to investments**: The market response to research and development and investment expenditures is generally positive.
If markets are so short term, why do they react to big investments (that potentially lower short term earnings) so positively?
But what about market crises?

- **Markets are the problem**: Many critics of markets point to market bubbles and crises as evidence that markets do not work. For instance, the market turmoil between September and December 2008 is pointed to as backing for the statement that free markets are the source of the problem and not the solution.

- **The counter**: There are two counter arguments that can be offered:
  - The events of the last quarter of 2008 illustrate that we are more dependent on functioning, liquid markets, with risk taking investors, than ever before in history. As we saw, no government or other entity (bank, Buffett) is big enough to step in and save the day.
  - The firms that caused the market collapse (banks, investment banks) were among the most regulated businesses in the market place. If anything, their failures can be traced to their attempts to take advantage of regulatory loopholes (badly designed insurance programs... capital measurements that miss risky assets, especially derivatives).
IV. Firms and Society

- **In theory:** All costs and benefits associated with a firm’s decisions can be traced back to the firm.
- **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 ..

- **Cannot know the unknown**: They might not be known at the time of the decision. In other words, a firm may think that it is delivering a product that enhances society, at the time it delivers the product but discover afterwards that there are very large costs. (Asbestos was a wonderful product, when it was devised, light and easy to work with... It is only after decades that the health consequences came to light)

- **Eyes of the beholder**: They are ‘person-specific’, since different decision makers can look at the same social cost and weight them very differently.

- **Decision paralysis**: They can be paralyzing if carried to extremes.
A test of your social consciousness: Put your money where you mouth is...

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 a million dollars a year, but it will create much-needed employment in the area, and may help revitalize it.

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 living up to your social responsibilities?
So this is what can go wrong...

STOCKHOLDERS

Managers put their interests above stockholders

Managers

Managers have little control over managers

Managers

Bondholders

Lend Money

Bondholders can get ripped off

FINANCIAL MARKETS

SOCIETY

Significant Social Costs

Some costs cannot be traced to firm

Markets make mistakes and can overreact

Aswath Damodaran
Traditional corporate financial theory breaks down when ...

- **Managerial self-interest**: The interests/objectives of the decision makers in the firm conflict with the interests of stockholders.
- **Unprotected debt holders**: Bondholders (Lenders) are not protected against expropriation by stockholders.
- **Inefficient markets**: Financial markets do not operate efficiently, and stock prices do not reflect the underlying value of the firm.
- **Large social side costs**: Significant social costs can be created as a by-product of stock price maximization.
When traditional corporate financial theory breaks down, the solution is:

- **A non-stockholder based governance system**: To choose a different mechanism for corporate governance, i.e. assign the responsibility for monitoring managers to someone other than stockholders.
- **A better objective than maximizing stock prices?** To choose a different objective for the firm.
- **Maximize stock prices but minimize side costs**: To maximize stock price, but reduce the potential for conflict and breakdown:
  - Making managers (decision makers) and employees into stockholders
  - Protect lenders from expropriation
  - By providing information honestly and promptly to financial markets
  - Minimize social costs

_Aswhath Damodaran_
I. An Alternative Corporate Governance System

- 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 it very difficult for outsiders (including investors in these firms) to figure out how well or badly the group is doing.
II. Choose a Different Objective Function

- 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
III. 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.

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

Aswath Damodaran
The Stockholder Backlash

- Activist Institutional investors have become much more active in monitoring companies that they invest in and demanding changes in the way in which business is done. They have been joined by private equity funds like KKR and Blackstone.

- Activist individuals like Carl Icahn specialize in taking large positions in companies which they feel need to change their ways (Blockbuster, Time Warner, Motorola & Apple) and push for change.

- Vocal stockholders, armed with more information and new powers: At annual meetings, stockholders have taken to expressing their displeasure with incumbent management by voting against their compensation contracts or their board of directors.
The Hostile Acquisition Threat

- 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)
In response, boards are becoming more independent...

- **Boards have become smaller over time.** The median size of a board of directors has decreased from 16 to 20 in the 1970s to between 9 and 11 in 1998. The smaller boards are less unwieldy and more effective than the larger boards.

- **There are fewer insiders on the board.** In contrast to the 6 or more insiders that many boards had in the 1970s, only two directors in most boards in 1998 were insiders.

- **Directors are increasingly compensated with stock and options in the company, instead of cash.** In 1973, only 4% of directors received compensation in the form of stock or options, whereas 78% did so in 1998.

- **More directors are identified and selected by a nominating committee rather than being chosen by the CEO of the firm.** In 1998, 75% of boards had nominating committees; the comparable statistic in 1973 was 2%.

*Aswath Damodaran*
Disney: Eisner’s rise & fall from grace

- In his early years at Disney, Michael Eisner brought about long-delayed changes in the company and put it on the path to being an entertainment giant that it is today. His success allowed him to consolidate power and the boards that he created were increasingly captive ones (see the 1997 board).

- In 1996, Eisner spearheaded the push to buy ABC and the board rubberstamped his decision, as they had with other major decisions. In the years following, the company ran into problems both on its ABC acquisition and on its other operations and stockholders started to get restive, especially as the stock price halved between 1998 and 2002.

- In 2003, Roy Disney and Stanley Gold resigned from the Disney board, arguing against Eisner’s autocratic style.

- In early 2004, Comcast made a hostile bid for Disney and later in the year, 43% of Disney shareholders withheld their votes for Eisner’s reelection to the board of directors. Following that vote, the board of directors at Disney voted unanimously to elect George Mitchell as the Chair of the board, replacing Eisner, who vowed to stay on as CEO.
Eisner’s concession: Disney’s Board in 2003

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

1. Required **at least two executive sessions of the board**, without the CEO or other members of management present, each year.
2. Created the **position of non-management presiding director**, and appointed Senator George Mitchell to lead those executive sessions and assist in setting the work agenda of the board.
3. Adopted a **new and more rigorous definition of director independence**.
4. Required that a **substantial majority** of the board be comprised of directors meeting the **new independence standards**.
5. Provided for a **reduction in committee size and the rotation of committee and chairmanship assignments among independent directors**.
6. Added new provisions for **management succession planning and evaluations of both management and board performance**
7. Provided for **enhanced continuing education and training** for board members.

*Aswath Damodaran*
Eisner’s exit... and a new age dawns? Disney’s board in 2008

<table>
<thead>
<tr>
<th>Board Members</th>
<th>Occupation</th>
</tr>
</thead>
<tbody>
<tr>
<td>John E. Pepper, Jr.</td>
<td>Retired Chairman and CEO, Procter &amp; Gamble Co.</td>
</tr>
<tr>
<td>(Chairman)</td>
<td></td>
</tr>
<tr>
<td>Susan E. Arnold</td>
<td>President, Global Business Units, Procter &amp; Gamble Co.</td>
</tr>
<tr>
<td>John E. Bryson</td>
<td>Retired Chairman and CEO, Edison International</td>
</tr>
<tr>
<td>John S. Chen</td>
<td>Chairman, CEO &amp; President, Sybase, Inc.</td>
</tr>
<tr>
<td>Judith L. Estrin</td>
<td>CEO, JLabs, LLC.</td>
</tr>
<tr>
<td>Robert A. Iger</td>
<td>CEO, Disney</td>
</tr>
<tr>
<td>Steven P. Jobs</td>
<td>CEO, Apple</td>
</tr>
<tr>
<td>Fred Langhammer</td>
<td>Chairman, Global Affairs, The Estee Lauder Companies</td>
</tr>
<tr>
<td>Aylwin B. Lewis</td>
<td>President and CEO, Potbelly Sandwich Works</td>
</tr>
<tr>
<td>Monica Lozano</td>
<td>Publisher and CEO, La Opinion</td>
</tr>
<tr>
<td>Robert W. Matschullat</td>
<td>Retired Vice Chairman and CFO, The Seagram Co.</td>
</tr>
<tr>
<td>Orin C. Smith</td>
<td>Retired President and CEO, Starbucks Corporation</td>
</tr>
</tbody>
</table>

Aswath Damodaran
But as a CEO’s tenure lengthens, does corporate governance suffer?

1. While the board size has stayed compact (at twelve members), there has been only one change since 2008, with Sheryl Sandberg, COO of Facebook, replacing the deceased Steve Jobs.

2. The board voted reinstate Iger as chair of the board in 2011, reversing a decision made to separate the CEO and Chair positions after the Eisner years.

3. In 2011, Iger announced his intent to step down as CEO in 2015 but Disney’s board convinced Iger to stay on as CEO for an extra year, for the “the good of the company”.

4. There were signs of restiveness among Disney’s stockholders, especially those interested in corporate governance. Activist investors (CalSTRS) starting making noise and Institutional Shareholder Services (ISS), which gauges corporate governance at companies, raised red flags about compensation and board monitoring at Disney.

Aswath Damodaran
What about legislation?

- Every corporate scandal creates impetus for a legislative response. The scandals at Enron and WorldCom laid the groundwork for Sarbanes-Oxley.

- You cannot legislate good corporate governance.
  - The costs of meeting legal requirements often exceed the benefits
  - Laws always have unintended consequences
  - In general, laws tend to be blunderbusses that penalize good companies more than they punish the bad companies.

Aswath Damodaran
Is there a payoff to better corporate governance?

- In the most comprehensive study of the effect of corporate governance on value, a governance index was created for each of 1500 firms based upon 24 distinct corporate governance provisions.
  - Buying stocks that had the strongest investor protections while simultaneously selling shares with the weakest protections generated an annual excess return of 8.5%.
  - Every one point increase in the index towards fewer investor protections decreased market value by 8.9% in 1999.
  - Firms that scored high in investor protections also had higher profits, higher sales growth and made fewer acquisitions.
- The link between the composition of the board of directors and firm value is weak. Smaller boards do tend to be more effective.
- On a purely anecdotal basis, a common theme at problem companies and is an ineffective board that fails to ask tough questions of an imperial CEO.
The Bondholders’ Defense Against Stockholder Excesses

- 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

- 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 investor access to information improves, 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.

- When firms mislead markets, the punishment is not only quick but it is savage.

Aswath Damodaran
The 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 socially irresponsible.
The Counter Reaction

**STOCKHOLDERS**
- 1. More activist investors
- 2. Hostile takeovers
- Managers of poorly run firms are put on notice.

**BONDHOLDERS**
- Protect themselves
- 1. Covenants
- 2. New Types

**Managers**
- Firms are punished for misleading markets
- Corporate Good Citizen Constraints
- 1. More laws
- 2. Investor/Customer Backlash

**SOCIETY**
- Investors and analysts become more skeptical

**FINANCIAL MARKETS**
So what do you think?

☐ 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, with no constraints
b. Maximize stock price, with constraints on being a good social citizen.
c. Maximize stockholder wealth, with good citizen constraints, and hope/pray that the market catches up with you.
d. Maximize profits or profitability
e. Maximize earnings growth
f. Maximize market share
g. Maximize revenues
h. Maximize social good
i. None of the above
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 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)
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 Financing Decision
Find the right kind of debt for your firm and the right mix of debt and equity to fund your operations

The Dividend Decision
If you cannot find investments that make your minimum acceptable rate, return the cash to owners of your business

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 optimal mix of debt and equity maximizes firm **value**

The right kind of debt matches the **tenor of your assets**

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

Aswath Damodaran