THE OBJECTIVE IN CORPORATE FINANCE: REALITY STRIKES

Reality intrudes!
The Investment Decision
Invest in assets that earn a return greater than the minimum acceptable hurdle rate

Hurdle Rate
4. Define & Measure Risk
5. The Risk free Rate
6. Equity Risk Premiums
7. Country Risk Premiums
8. Regression Betas
9. Beta Fundamentals
10. Bottom-up Betas
11. The "Right" Beta
12. Debt: Measure & Cost
13. Financing Weights

Investment Return
14. Earnings and Cash flows
15. Time Weighting Cash flows
16. Loose Ends

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

Financing Mix
17. The Trade off
18. Cost of Capital Approach
19. Cost of Capital: Follow up
20. Cost of Capital: Wrap up
21. Alternative Approaches
22. Moving to the optimal

Financing Type
23. The Right Financing

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

Dividend Policy
24. Trends & Measures
25. The trade off
26. Assessment
27. Action & Follow up
28. The End Game

Valuation
29. First steps
30. Cash flows
31. Growth
32. Terminal Value
33. To value per share
34. The value of control
35. Relative Valuation

36. Closing Thoughts
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 **hurdle rate** should reflect the riskiness of the investment and the **mix of debt and equity** used to fund it.

The **return** should reflect the magnitude and the **timing** of the cashflows as well as all side effects.

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

The optimal mix of debt and equity maximizes firm value

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

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

Maximize the value of the business (firm)
When traditional corporate financial theory breaks down, the solution is:

- To choose a different mechanism for corporate governance, i.e., assign the responsibility for monitoring managers to someone other than stockholders.
- To choose a different objective for the firm.
- 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
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 its 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. A Market Based Solution

STOCKHOLDERS

1. More activist investors.
2. Hostile takeovers

Corporate Good
Citizen Constraints

Managers

1. More laws
2. Investor/Customer Backlash

BONDHOLDERS

1. Covenants
2. New Types

Firms are punished for misleading markets

Protect themselves

FINANCIAL MARKETS

Investors and analysts become more skeptical
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.
- In October 2005, Eisner stepped down as CEO, to be replaced by Bob Iger.
A Market Solution: Eisner’s exit... and a new age dawns? Disney’s board in 2008

<table>
<thead>
<tr>
<th>Board Members</th>
<th>Occupation</th>
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<tr>
<td>John E. Pepper, Jr. (Chairman)</td>
<td>Retired Chairman and CEO, Procter &amp; Gamble Co.</td>
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<tr>
<td>Susan E. Arnold</td>
<td>President, Global Business Units, Procter &amp; Gamble Co.</td>
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<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>
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<tr>
<td>Judith L. Estrin</td>
<td>CEO, JLabs, LLC.</td>
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<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>
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<td>Monica Lozano</td>
<td>Publisher and CEO, La Opinion</td>
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<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>
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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.
Task
Based on it’s actions, assess your company’s objective.

Read
Chapter 2