THE OBJECTIVE IN CORPORATE FINANCE

“If you don’t know where you are going, it doesn’t matter how you get there”
Maximize the value of the business (firm)

**The Investment Decision**
Invest in assets that earn a return greater than the minimum acceptable hurdle rate.

- The **hurdle rate** should reflect the riskiness of the investment and the mix of debt and equity used to fund it.
- The **return** should reflect the magnitude and the timing of the cashflows as well as all side effects.

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

- The **optimal mix** of debt and equity maximizes firm value.
- The **right kind** of debt matches the tenor of your assets.

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

- How much cash you can return depends upon current & potential investment opportunities.
- How you choose to return cash to the owners will depend on whether they prefer dividends or buybacks.

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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.
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.

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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
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
- All costs can be traced to firm

No Social Costs
- All costs can be traced to firm

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What can go wrong?

STOCKHOLDERS

Managers put their interests above stockholders

Managers

Managers have little control over managers

BONDHOLDERS

Lend Money

Bondholders can get ripped off

FINANCIAL MARKETS

Delay bad news or provide misleading information

BONDHOLDERS

Significant Social Costs

Some costs cannot be traced to firm

SOCIETY

Markets make mistakes and can over react

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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 their directorial duties 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.

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