Corporate Issuers

Investors and Other Stakeholders

Exam Focus

- Debtholders vs. equity investors
  - Distinguish between debtholders (lenders) and equity investors, including key risks and benefits
- Corporate stakeholders and governance
  - Identify corporate governance characteristics and key stakeholder groups and their features
- ESG considerations
  - Identify the key features of E, S, and G risks

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Financial Claims of Lenders and Shareholders

Corporate issuers can be financed either with debt or equity.

- **Debtholders** (lenders) provide *finite* capital:
  - Legal claim to the principal and interest
  - Higher priority of claims than equity holders
  - Upside is limited to full repayment; no decision-making power
- **Equity investors** (shareholders/owners) provide *permanent* capital. They have a residual claim to assets after all other claims have been paid.

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Debt vs. Equity Risk and Return

- **Debtholders:** Debt financing has lower costs to an issuer, but it has higher risks (contractual obligation to pay principal and interest; lender restrictions). Use of debt increases **leverage**.
- **Equity investors:** They have theoretically unlimited upside return, but they have higher risk in terms of priority. **Dilution**, or reduced fractional ownership from new equity issue, is a risk.

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Debt vs. Equity Risk and Return: Example

Maximum return and maximum loss

When it comes to (theoretically) maximum return and loss assessment, debtholders and equity investors differ:

	Maximum return	Maximum loss
Debtholders	Capped; p+i	Initial investment; priority of claims
Equity investors	Unlimited	Initial investment; residual claims

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Debt vs. Equity: Example

Corporate equity and debt holders share the same investor perspective with respect to:

A. maximum loss.

B. investment risk.

C. return potential.

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Debt vs. Equity: Example

All of the following are characteristics of debt except:

A. limited liability.

B. unlimited return.

C. priority in payment.

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Corporate Stakeholders and Governance

Shareholder theory: Focus on interests of the company's owners; other entities are considered, but only to the extent that they impact share value.

Stakeholder theory: Consider all stakeholder interests. Focus on managing potential conflicts among interests of stakeholder groups. ESG is often a consideration.

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Corporate Stakeholders and Governance

Corporate governance: This aims to minimize and manage potential conflicts between the company and its many stakeholders.

Stakeholders include all entities with a vested interest in the company:

- Debt and equity investors
- Board of directors
- Managers
- Employees
- Customers, suppliers
- Governments

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Stakeholders: Example

The complex case of Volkswagen AG (VW)

- VW, a German auto manufacturer, went public in 1960. At the time, the German state of Lower Saxony retained 20% voting rights.
- The VW Law was then passed, requiring over 80% of votes for major matters to pass; this effectively gave Lower Saxony veto power.
- VW merged with Porsche in 2007. The Porsche family has majority voting rights.
- However, its 20% share in VW and the VW Law allows Lower Saxony to veto matters that would adversely impact union employees, including domestic plant closures, cost reductions, and other measures.

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Stakeholders: Example

Limiting shareholders' ability to affect change

When comparing inside versus independent directors, and staggered versus non-staggered boards, shareholders would face the greatest challenges in affecting change in a company's management when:

- the board has ***majority inside directors***, who may be more resistant to change, and
- the ***board is staggered***, which would allow shareholders to vote out only a portion of the board each year, requiring several years to affect change.

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Stakeholders: Example

Applying the stakeholder theory of corporate governance requires:

A. balancing multiple objectives only.

B. measuring non-shareholder objectives only.

C. both balancing multiple objectives and measuring non-shareholder objectives.

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Stakeholders: Example

Which of the following board structures would most limit shareholders' ability to effect a major change in the management of a firm?

A. Majority inside, staggered.

B. Majority independent, staggered.

C. Majority independent, non-staggered.

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ESG Considerations

Companies need to consider **environmental, social, and governance (ESG)** factors in their decisions, including negative societal impacts (**negative externalities**). ESG factors include the following:

Environmental	Social	Governance
• Climate change • Air and water pollution • Biodiversity • Deforestation • Energy efficiency • Waste management • Water scarcity	• Customer satisfaction • Data protection and privacy • Gender and diversity • Employee engagement • Community relations • Human rights • Labor standards	• Board composition • Committee structures • Bribery and corruption • Executive compensation • Lobbying • Political contributions • Whistleblowers

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Evaluating ESG Risks and Benefits

ESG impacts, both negative and positive, should include the following:

- An assessment as to whether the ESG factor is material (or not)
- Quantifying ESG factors and include in discounted cash flow analysis
- An assessment on company performance and ratios
- An assessment on impact of debtholders and equity investors
- Evaluating short- and long-term risks of ESG factors
  (e.g., long-term risks include potential asset write-downs)

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ESG: Example

A company's effectiveness in managing long-term risks and sustainability is best classified as a:

A. social factor.

B. governance factor.

C. environmental factor.

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Solutions

Debt vs. Equity: Example

Corporate equity and debt holders share the same investor perspective with respect to:

A. maximum loss.

B. investment risk.

C. return potential.

For both equity and debt holders, their initial investment represents their maximum possible loss.

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Debt vs. Equity: Example

All of the following are characteristics of debt except:

A. limited liability.

B. unlimited return.

C. priority in payment.

Shareholders, not debtholders, have the potential for unlimited return.

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Stakeholders: Example

Applying the stakeholder theory of corporate governance requires:

A. balancing multiple objectives only.

B. measuring non-shareholder objectives only.

C. both balancing multiple objectives and measuring non-shareholder objectives.

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Stakeholders: Example

Which of the following board structures would most limit shareholders' ability to effect a major change in the management of a firm?

A. Majority inside, staggered.

B. Majority independent, staggered.

C. Majority independent, non-staggered.

A board with a majority of inside directors could more easily resist outside change than one with a majority of directors who were independent of management. With a staggered board, it would take several years to replace a majority of directors.

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ESG: Example

A company's effectiveness in managing long-term risks and sustainability is best classified as a:

A. social factor.

B. governance factor.

C. environmental factor.

Corporate governance and stakeholder management address issues that include a company's effectiveness in managing long-term risks and sustainability.

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