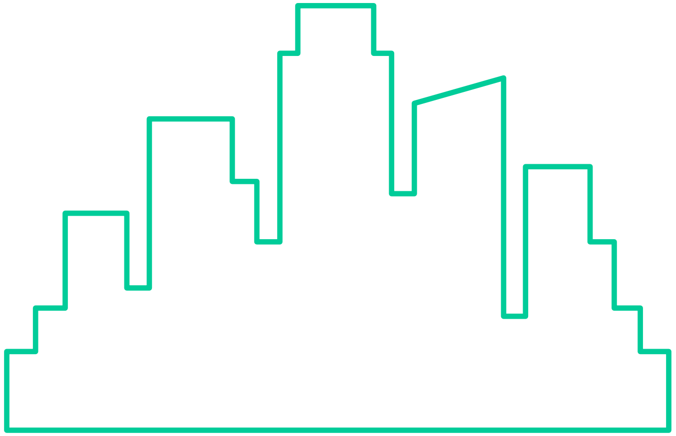
Chapter 1: Introduction



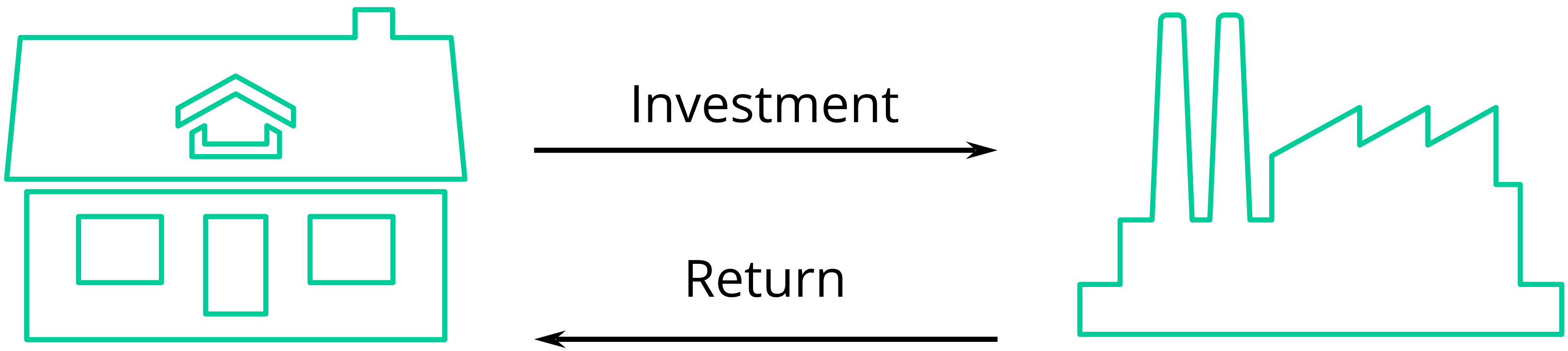
What Is Finance?

“The oil in the engine of the economy”

Sources of capital

“Real” Assets

(uses of capital)



Savers

(Investors)

Borrowers

(Companies, governments, households)

How does this transfer happen?

- Financial securities are issued (sold) by firms, to investors, in exchange for money.
  - Two broad categories of securities: **Bonds** and **Stocks**.
  - Bonds are promises to repay (or serious consequences ensue).
  - Stocks (equity) are a claim on leftover resources, after promises are kept
- Therefore, it’s important that we understand firm objectives, structures, resources and incentives to pay claimants.

Necessary Tools

- Jargon!
- Discounting cash flows (time value of money).
- Understanding financial statements.
- Tradeoff between **risk** and **return**.

Lay of the Land

Firm Objectives
and Related Issues

Corporate Environment

- “Shareholders” = “Owners”
  - a.k.a equity holders or stockholders.
  - They have indirect control (vote to elect board).
  - Have **limited liability**.
- Separation of Ownership and Control.
- Debt holders lend funds **to shareholders**.
- Two other notable characteristics of firms:
  - Disclosure/reporting requirements.
  - Double taxation of equity income.

Financial Decisions

- Investment decisions.
  - Where/how should capital be invested?

- Financing decisions.
  - How should capital be raised?
    - Debt or equity? Public or private markets?

- Payout decisions.
  - What should be done with profits?
    - Pay to shareholders or reinvest back into firm?

Objectives

- What goal drives firms' decision making process?
- Maximizing…
  - Value to society?
  - Value to employees?
  - Value to debt holders?
  - Shareholder value?

Maximize Shareholder Value

- Shareholders own the firm and will do what’s in their own self-interest. This is the reality.

Maximize shareholder wealth

↓

Maximize return to shareholders

Pros and Cons

Of the ‘Maximize Shareholder Wealth’ Objective

Ethical Implications

- Example: “Chainsaw” Al, CEO
  - Tries to turnaround unprofitable, financially fragile companies. Usually begins by firing a large proportion of the work force.
  - **Unethical**:
    - Fired 10,000 workers to line the pockets of shareholders.
  - **Ethical**:
    - Saved 40,000 jobs by keeping company alive.
    - Many of those shareholders are pension plans and retirees.

Ethical Implications

- Other Perspectives:
  - Max shareholder value results from good corporate behavior?
    - Fortune Magazine's 100 Best Companies to work for have stocks that outperform in the long-run (Edmans, 2011 JFE).
  - Businesses owned by the government might maximize **utility** to the public, but at what cost to the economy?

Economic Implications of Shareholder Wealth Maximization

- Efficiency (of production).
  - Firms reduce costs and improve products.

- Induces monopolistic behavior.
  - Drives out competition; hurts consumers.

- Abuse of public goods.
  - e.g. Water and air pollution.

Societal Response

- Regulation
  - Antitrust: EU $6B suit against Google (4/15/15).
  - Pollution: Clean Air & Water Acts; Cap & Trade.
- Consumer Activism
  - Exxon oil spill.
  - 80’s Apartheid boycott of South Africa.
- Investor Activism
  - “Socially responsible” investment.

TIAA-CREF's
"Social Choice Equity Fund"

"The fund's investments are subject to certain environmental, social and governance criteria. The evaluation process favors companies that are strong stewards of the environment; devoted to serving local communities; committed to higher labor standards; dedicated to producing high-quality and safe products; and those managed in an exemplary or ethical manner."

(Initial) Summary

Pros

- Produce desired items
- Efficient production

Cons

- Uncompetitive behavior
  - Antitrust regulation mitigates?
- Abuse of social goods
  - Regulation?
  - Consumer backlash.
  - Investors backlash.

What else should we be aware of?

Principal-Agent Problems (a.k.a. "Agency Problems")

- What's an **agent**?
  - Someone hired on behalf of the **principal**.
  - For example, I hire a real-estate agent to sell my house.

- What's the problem?
  - The agent's interests are not always aligned with the principal's interests.
  - The real-estate agent wants sell the house fast, but I may want to wait for a higher price.

Debtholders vs Shareholders

- Who is the principal and who is the agent?
- Maximizing stock return may harm debt-holders.
- **Example** Firm borrows $100 at 10% and is choosing between 2 projects that cost $100 each:
  - Project A pays $111 with certainty.
  - Project B pays $90 or $115 with equal probability.
- Which project will the debtholders prefer?
- Which project will shareholders prefer?

- Project A
  - Debt-holders get paid their $100 plus their 10% interest for a total of $110, guaranteed!
  - After paying off debt-holders, shareholders split $1 ($111-110).
- Project B
  - Debt-holders get $90 half of the time and $110 the other half. They get $100 on average.
  - Equity gets $0 half of the time and $5 the other half. They get $2.50 on average.

Debt-holder Response

- Covenants
  - Restrict investment, dividends, leverage, etc.
- Secured Debt
- Convertible Debt (part debt, part equity)
- Poison (protective) puts
  - Triggered by covenants, especially leverage and corporate events (LBO/MBO etc.)
- **Reputation!**

These are all "costly" because they constrain the firm. Hence, we talk about "agency costs."

Shareholder-Manager Conflict

- Companies “managers” are CEO, CFO, CIO, etc.
- Are managers’ interests always the same as shareholders?
- Not exactly:
  - Golf vs. work?
  - Greenmail
  - Golden parachutes
  - Antitakeover devices
    - Poison Pills (a.k.a. “Shareholder rights plans”), Staggered Boards
  - Empire building

Aligning the Incentives

- Performance based compensation
  - Pay managers with shares
  - Executive stock options
  - Does this always work?
- Takeovers
- Shareholder Activism
  - Proxy contests (Board members are elected!)
  - Institutional Investors
- Outside board members

At the end of the day…

- Corporate structure has costs and benefits.
- We try to maximize the benefits and minimize the costs, but they often conflicting.
- The corporate form facilitates access to financial capital for major investment:
  - Limited liability
  - Disclosure / reporting
- Financial capital is the key.