LOS 2a: compare the financial claims and motivations of lenders and shareholders;

Comparison between Debt and Equity Claims

Debtholders, also known as lenders, provide finite-term financial capital to a company. In return, the issuers agree to make regular interest payments and repay the principal on predetermined dates.

Within the corporation, lenders do not possess decision-making authority. Still, the terms of the debt agreement can safeguard them by establishing financial requirements and legal claims on specific company assets if the debt is not repaid according to the agreed terms.

On the other hand, equity investors contribute permanent capital to the company. Issuers typically do not commit to providing future dividends or repayments to shareholders. Instead, equity represents a residual claim on the company's cash flows, meaning whatever is left after expenses, investments, and debt obligations have been satisfied. The distribution of cash to equity investors is subject to the discretion of the board of directors.

Unlike debtholders, equity investors hold voting rights in crucial company matters, such as selecting the board of directors responsible for appointing and overseeing management.

Apart from paying interest to debtholders, the company must meet other financial obligations before any distributions are made to shareholders. These obligations include payments to suppliers, employees, and taxes to the government. In the event of the company's dissolution and liquidation of assets, these priority claims must be settled before any proceeds go to equity investors.

Debtholder interest payments are usually considered tax-deductible expenses, reducing the company's taxable income, whereas dividends paid to shareholders do not offer the same tax benefits.

A summary of the comparison between debt and equity claims is given in the following table:

	Legal repayment obligation	Residual asset claim	Discretionary payments	Tax-deductible expense	Finite term	Voting rights
Debt	√			√	√	
Equity		√	√			√

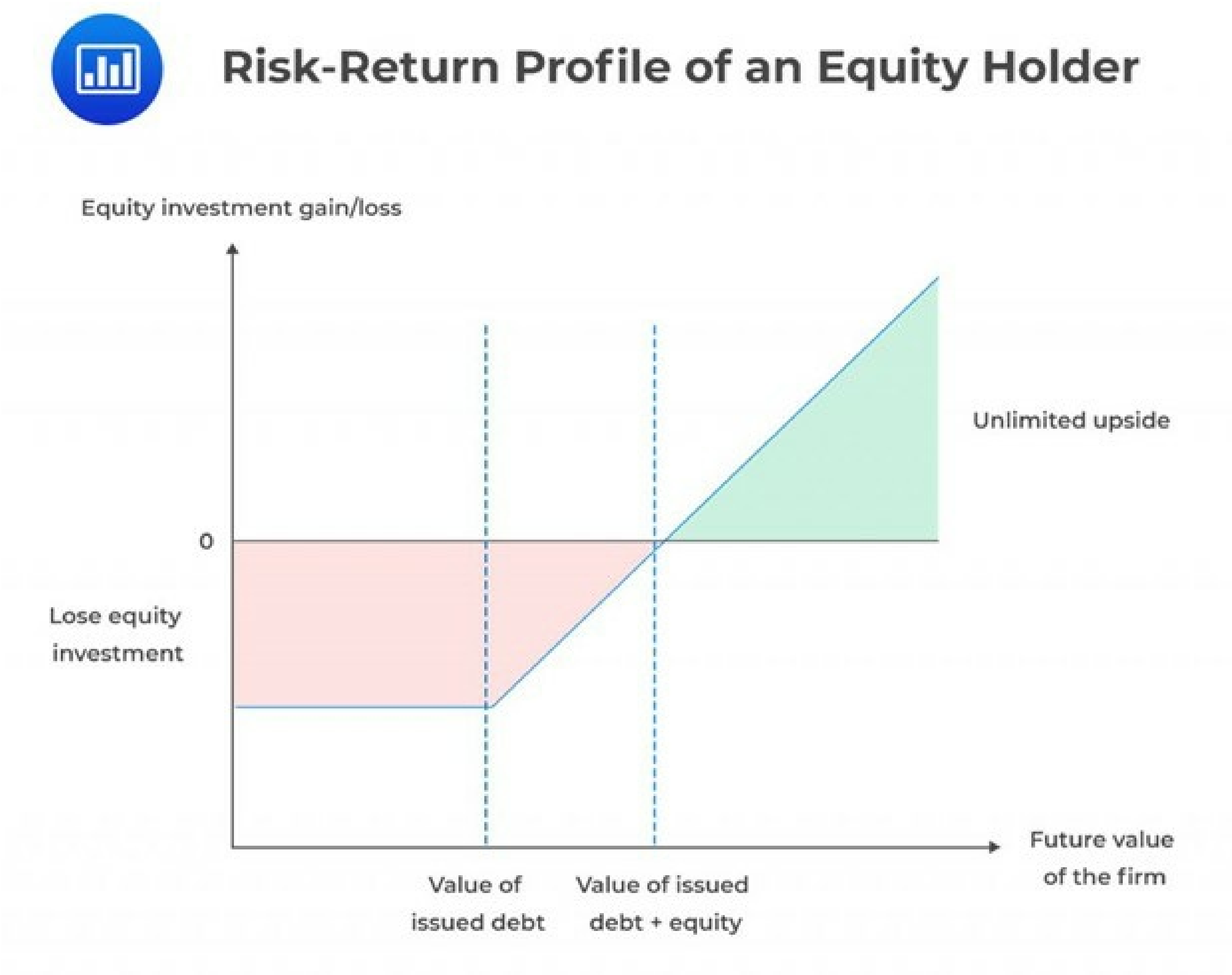
Equity and Debt Risk-return Profiles

Investor Perspective: Equity Holders

The maximum loss equity holders can incur is capped at their investment amount in a company. On the brighter side, equity holders gain an upside if the share prices increase in the future. In other words, there is no limit on the gains to an equity holder if a company succeeds.

Gains come not only in distributions from a company but also in the residual claim after a profitable corporation settles its obligations. This is equivalent to investment interest to investors.

Regarding risks, investment risk is higher for equity holders than bondholders. Stocks are riskier for investors since no contractual obligation is set to distribute risk to the shareholders or repay the capital investment. This implies that equity holders may lose entire investments if a company goes bankrupt.

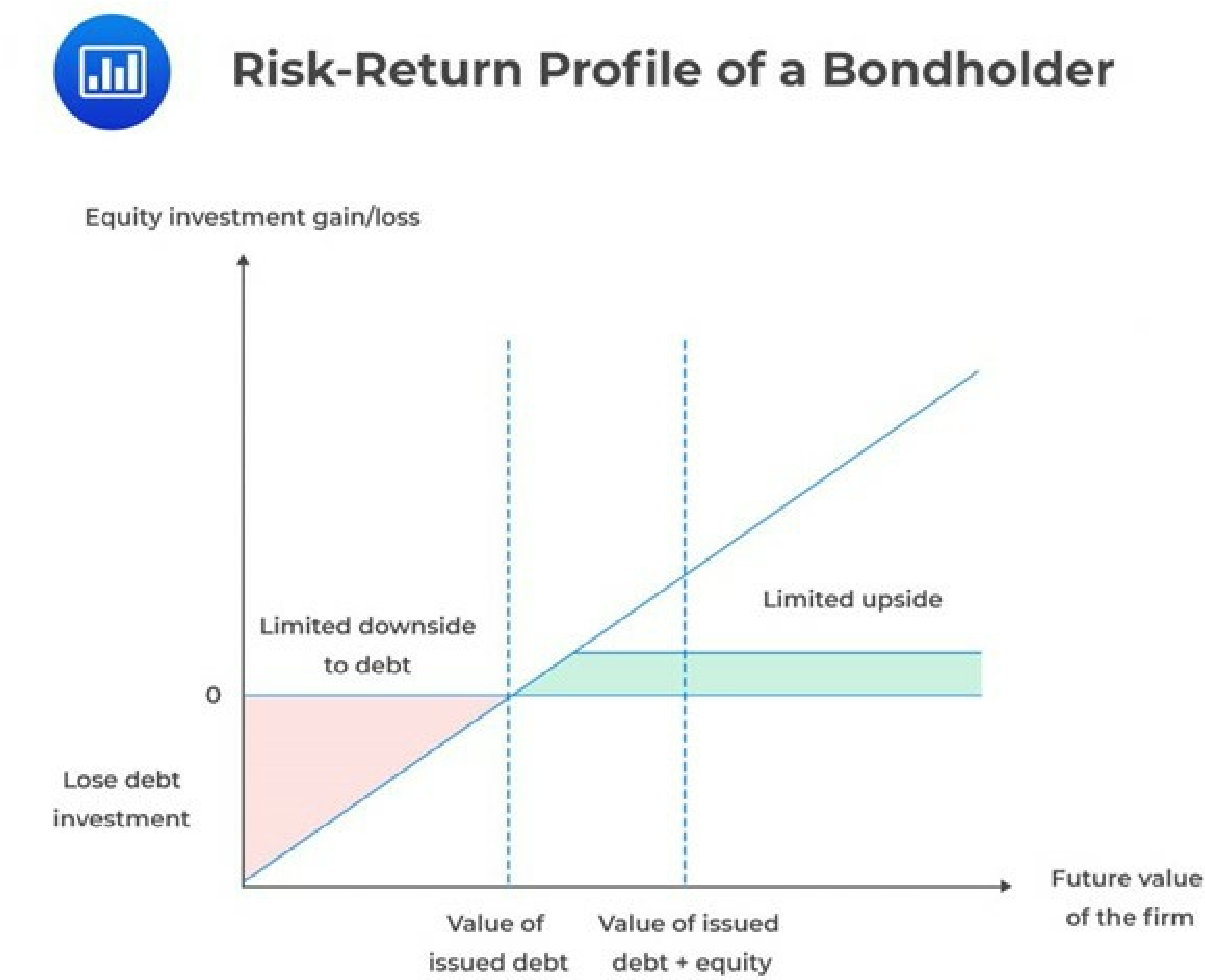


In conclusion, equity holders are interested in the continuous maximization of a company's net value. This interest is inspired by the fact that continuous net value maximization translates directly to shareholder share values.

Investor Perspective: Bondholders

Bondholders have fixed priority claims on a company through contractually promised interest payments and return of the principal amount. Unlike equity holders, bondholders do not receive more than the promised interest payments when a company becomes attractively profitable. However, there is a brighter side to this.

Investment risk is lower for bondholders than equity holders. When a company is financially healthy, bondholders are assured of their returns. This is the case considering such a company's capacity to service a loan easily. It is equally worth appreciating that a financially healthy company has sufficient assets that serve as collateral. Therefore, the upside gains to a bondholder are capped at the interest payments plus the principal. However, there are downside losses if a company falls below the book value of the debt.



In contrast to equity holders, bondholders have recourse opportunities when a company is in financial distress. Bondholder payments are prioritized in case of financial stress. Moreover, they can use the contractual agreement to force the issuer to liquidate assets to repay their debt. It is important to note that bondholders could lose their entire investment too.

Therefore, bondholders are keener on the default risk of a company and its ability to meet debt obligations. The debt soundness of a company is determined by the following:

- Assessing the issuer's creditworthiness and willingness to repay debt.
- Evaluating issuer's cash flow and quality of collateral.
- Estimating the probability of default and amount of loss given default.

Risk-return Profile: Issuer Perspective

Corporations prefer debt capital to equity capital. This is because the cost of debt is lower than that of equity capital, and the return to the lenders is capped. Moreover, equity capital dilutes ownership and is only appropriate when the issuer's cash flows are absent or unpredictable.

However, bonds are riskier than shares since they involve contractual agreements which must be honored. Bondholders elevate the risk to the corporation by increasing leverage. The opposite is true for investors. From shareholders' perspective, investment risk is lower because they cannot force the liquidation of assets in case of financial distress.

In extreme cases where an issuer cannot meet bondholders' obligations, it can avoid bankruptcy by renegotiating repayment terms with the bondholders. If the negotiation fails, the issuer can file for bankruptcy protection. In this case, assets will be liquidated to pay the bondholders. An extreme solution is reorganizing the company, where the bondholders take over.

Conflicts of Interest between Bondholders and Equity Holders

The interests of bondholders and equity holders often collide due to their contrasting risk and return preferences. Shareholders, as equity holders, have their losses capped at their initial investment, and they seek maximum returns, making them inclined towards a company's management investing in high-calculated risks with the potential for substantial gains. Their unlimited upside potential drives them to take on the risk of losing their investment if the company faces financial troubles.

In contrast, bondholders have a more conservative approach. Their potential return is limited to the face value of the bond and coupon payments, and they do not benefit from the company's risky investment decisions. As a result, bondholders favor investments in less risky projects that generate predictable cash flows, albeit small, to ensure timely interest and principal repayments.

Despite lacking control over a company's investment decisions, bondholders utilize covenants to safeguard their investment and impose contractual restrictions that protect their interests. This way, bondholders aim to maintain the stability of their investment and mitigate potential risks associated with uncertain ventures.

Question #1

Which of the following statements is *most likely* true?

A. Bondholders have residual claims on a company's assets after all other stakeholders have been paid.
B. Stocks are riskier than bonds to the issuer since shareholders are the residual claimants on the firm.
C. Equity and bondholders have comparable investor perspectives regarding maximum loss.

Solution

The correct answer is C.

The maximum loss for both the bondholders and equity holders is their initial investment amount. However, equity holders have unlimited return potential but are exposed to higher investment risk due to a lack of contractual obligation between them and the issuing company.

A is incorrect. Equity holders are the residual claimants of a company's cash flows and assets. This implies that they are only paid after all other stakeholders, such as creditors, suppliers, and government, have been paid.

B is incorrect. Stocks are riskier for investors because the issuing company has no contractual obligation to distribute dividends to shareholders or repay their capital investment. On the other hand, bonds are riskier than stock for the issuer because bonds increase the leverage risk to a company.

Question #2

Which of the following is *most likely* to have a residual claim on the issuer's profits:

A. Government

B. Shareholders

C. Lenders

Solution

B is correct. Shareholders have a residual claim to the company's profits after deductions of obligations (e.g., interest payment, taxes, employee benefits.)

A and C are incorrect. Only shareholders have a claim to the company's profits.

LOS 2b: describe a company's stakeholder groups and compare their interests;

A stakeholder is any individual or entity that has a significant interest in a company. Corporations have a complex ecosystem that includes not only the shareholders but also other stakeholders. These groups mutually relate with the company for economic success.

However, the short- and long-term objectives of these conflicts may conflict.

Shareholder and Stakeholder Theories

Corporate governance practices tend to vary from country to country. It is, nevertheless, not uncommon for different corporate governance systems to coexist within a country. Corporate governance systems generally reflect the influences of either shareholder theory, stakeholder theory, or a convergence of the two. Current trends, however, point to an increase in convergence.

Shareholder theory posits that the most critical responsibility of a company's management is to maximize shareholder returns. In other words, the interest of other stakeholders, such as creditors, employees, and society, is only considered if they affect the shareholder value.

On the other hand, **stakeholder theory** emphasizes the need for a company to consider the needs of all its stakeholders. This theory dissuades a company from giving preferential treatment to its shareholders, such as customers, suppliers, creditors, employees, and essentially anyone interested in the company, at the expense of stakeholders. Intuitively, a stakeholder primarily advocates for environmental, social, and governance (ESG).

Consideration of ESG factors by the stakeholder theory comes with some setbacks:

- Complexity in considering multiple objectives.
- Costs associated with compliance with ESG.
- Difficulty in competing globally with companies that do not consider ESG.

- There is no clarity in the definition, measurement, and balancing of non-shareholder objectives.

Stakeholder Groups

Investors

The investors of a company include the bondholders and the shareholders.

The debtholders provide the company with debt financing. The debtholders consist of private debtholders and public debtholders (bondholders).

Private Debtholders

Private debtholders include banks, credit facilities, institutions that provide loans and leases. They hold the debt of a company to maturity. Further, they can directly reach a company's management and access non-public information concerning a company. As such, they significantly influence a company since they can be the largest source of capital. Therefore, they can lower debt restrictions and extend more credit.

Public Debtholders

On the other hand, public debtholders depend on public information and credit rating agencies in their decision-making. They include institutional investors and asset managers. Public debtholders receive regular interest payments and capital repayment at maturity in return for the capital provided.

Moreover, public bondholders have little to no authority over the operations of the issuing company and hence rely on the terms of the debt contract with the company. However, bondholders can have significant influence over the company experiences financial distress, and the public debt needs to be restructured.

Public debtholders minimize downside risk thanks to their preference for operation stability and a company's performance. This is usually in contrast to a company's shareholders' interests – tolerance of high risk for higher return potential.

Debtholders always hold onto the same perspective: lower financial leverage, then lower risks. However, some private lenders may have different risk appetites, behavior and approach, and relationships with the companies they provide capital to. Some private lenders focus on asset value, equity positions, cashflows, value, and business forecasts.

Managers

Led by the chief executive officer (CEO), managers are tasked to formulate and implement a company's strategy. They do this under the stewardship of the board of directors. Additionally, they ensure the smooth running of a corporation's day-to-day operations.

Managers tend to benefit when a company performs well. Conversely, they are adversely affected when a company's financial position weakens. As such, they seek to maximize the value of their total remuneration while securing their jobs. Their interests are, therefore, not surprisingly different from those of shareholders, creditors, and other stakeholders.

The Board of Directors

The shareholders of a company elect the board of directors. It protects shareholders' interests, provides strategic direction, and monitors company and management performance. Also, the board hires the CEO of the company.

The board usually consists of inside directors and independent directors. The inside directors consist of the company's leading shareholders, founders, and senior managers. On the other hand, independent directors, as the name suggests, are not linked with the company concerning employment, ownership, and remuneration. As such, independent directors are elected because of their experience.

Types of Board Structures

The board can have a single-tier or two-tier structure. In a single-tier board, the company's board of directors includes executive directors (usually company executives) and non-executive directors (independent members without day-to-day involvement in company operations).

On the other hand, a two-tier board structure is a corporate governance model where a company's board of directors is divided into two separate boards: the management board and the supervisory board:

i. **Management Board:** The management board is responsible for the company's day-to-day operations and strategic management. It typically consists of executive directors who are actively involved in running the company and making operational decisions.
ii. **Supervisory Board:** The supervisory board oversees the management board and ensures it acts in the company's and its stakeholders' best interests. It usually comprises non-executive directors (often independent individuals) who are not directly involved in daily operations. The supervisory board's primary role is to provide guidance, monitor performance, and approve major decisions made by the management board.

Staggered Boards

Some companies have staggered boards. In these companies, directors are divided into groups and elected separately in consecutive years, resulting in a staggered rotation of board members. This approach creates a situation where it takes several years to replace the entire board.

The advantage of staggered boards lies in the continuity they offer to the company's leadership. By avoiding simultaneous turnover of board members, there is a reduced need for constant reassessment of strategy and oversight by new directors.

The downside of staggered boards is that they limit the ability of shareholders to effect a swift and major change of control at the company. With only a portion of the board up for re-election each year, shareholders may find it challenging to influence the board's overall composition and direction on time.

An optimal board of directors does not exist. As such, boards vary based on the company's size, structure, and type of operations. However, most governance codes stipulate that board members should reflect different expertise, backgrounds, and competencies.

Employees

To deliver its goods and services, a company relies on the knowledge and labour of its employees, or human capital. In return, workers often want competitive pay, room for advancement, steady employment, and a safe and comfortable work environment. Employees' interests are better aligned with the performance of the company when they have the option to participate in equity-based incentive schemes, in addition to their duties as employees.

Customers

Customers expect a company to satisfy their needs and give them the necessary benefits when they purchase its goods or services. Customers may receive continuous support, product guarantees, and after-sale service, depending on the products and services a company deals in.

Suppliers

Suppliers are the short-term creditors of a company whose main interest is to be paid as agreed for products or services delivered. Suppliers are interested in a company's financial health and seek long-term relationships with it for mutual benefits.

Governments

Governments and regulators seek to ensure that companies comply with the law and act in a manner that safeguards the interests and well-being of the public. Moreover, governments collect taxes from companies.

Question

Which one of the following is *least likely* considered a primary function of the board of directors?

A. Managing day-to-day operations of the company.
B. Approving major corporate strategies and transactions.
C. Overseeing the implementation of broad corporate policies.

Solution

The correct answer is **A.**

The board of directors is responsible for the governance of a company, which includes providing strategic direction and overseeing the overall operation at a high level, but it does not typically manage day-to-day operations.

That role is generally assigned to the company's executive management team, led by the CEO or managing director. The board's functions include overseeing the implementation of broad corporate policies and approving major strategies and transactions, ensuring that the company aligns with the goals and policies set forth for its successful operation.

LOS 2c: describe environmental, social, and governance factors of corporate issuers considered by investors

Debt and equity investors are progressively adopting a stakeholder viewpoint rather than a strictly shareholder-focused one. They prioritize Environmental, Social, and Governance (ESG) factors when making investment decisions. As such, corporate issuers need to incorporate these factors when setting goals regarding operating, investing, and financing decisions.

ESG is increasingly relevant for three main reasons:

- They have more significant negative financial effects on a company's fair value. Both debtholders and shareholders have lost substantial capital due to social controversies, poor governance, or environmental disasters and

- Increasing interest in the social and environmental effects of investments, especially among the younger demographic. Many young investors demand that their newly acquired or inherited money be handled using investing techniques that consider significant ESG concerns.

- Governments are increasingly prioritizing social policies and climate change. They have revised regulations forcing corporate issuers to align their business practices with the strict ESG criteria.

In response to stakeholder awareness and tightening restrictions, investors are incorporating environmental and societal costs into company financial statements and forecasts.

Introduction to Environmental, Social, and Governance Factors

Environmental Factors

When an ESG element is anticipated to have an effect on a company's long-term business model, it is deemed to be material. The environmental factors that are material include:

- Climate change
- Pollution and waste
- Resource and land use
- Ecological footprint
- Biodiversity

For instance, climate can be described as a physical risk or transition risk. Climate change can be a physical risk because it destroys assets due to bad weather. Physical risk can be insured.

Climate change as transition risk refers to losses associated with transitioning to a low-carbon economy resulting from regulations or shifts in consumer demand.

Strategic or operational choices based on subpar governance procedures or poor judgment can negatively impact the environment. Expenses such as legal fees, clean-up expenses, regulatory fines, and reputational damage can be costly.

Social Factors

Social factors pertain to the impact of the companies practices on:

- Employees and human capital
- Customers
- Community in which it operates.

By minimizing social risk, a company can lower its costs through increased employee productivity, lower employee turnover, and reduced legal and reputational risks.

Governance Factors

Stakeholder management and corporate governance address the following issues:

- Ownership and voting system of the company.

- The suitability of board members' skills and experience to meet present and future company requirements.

- How well management compensation aligns with the company's performance.

- The level of shareholder rights compared to other similar companies.

- The company's proficiency in managing long-term risks and sustainability.

These questions and areas provide valuable insights about sources of risk and management quality. This information is often found in sustainability reports, annual reports, and issuer's proxy statements.

Evaluating ESG Risks and Opportunities

Recall that debt and equity investors have different claims on a company. The influence of ESG factors on corporate cash flows depends on how they impact the value of debt and equity claims:

- Once identified, the financial impact of material ESG factors must be quantified in terms of how they positively or negatively affect the firm's future discounted cash flows.

- Significant long-term adverse ESG-related events typically have an immediate and disproportionate impact on equity claims since they represent residual claims to future company cash flows.

- Although adverse ESG-related events impact the value of debtholder claims, their effect is generally less pronounced compared to equity, except in cases where the company's ability to fulfill interest and principal payments is adversely affected.

- The effects of adverse ESG-related events often differ depending on the maturity of the debt. For example, a coal company facing long-term risks from potential asset write-downs due to regulatory changes or shifts in demand would likely have a greater negative impact on debt maturing in ten years compared to short-term debt maturing in twelve months.

In conclusion, analysts assess the potential positive and negative effects of significant ESG-related factors. These financial impacts are reflected in a company's projected financial statements and ratios. They use future expected cash flows discounted at an appropriate rate and employ sensitivity or scenario analysis to evaluate different outcomes for debt and equity holders.

Question

Which of the following is *most likely* an example of a social factor under environmental, social, and governance risks?

A. Deforestation.
B. Shareholder rights.
C. Equality and diversity.

The correct answer is C.

Equality and diversity are examples of social factors. Other examples of social factors include human rights and community relations.

A is correct. Deforestation is an example of an environmental factor. Other examples of environmental factors include waste management and energy efficiency.

B is incorrect. Shareholder rights are an example of a governance factor. Other examples of governance factors include bribery and corruption, and executive compensation.