Corporate Finance Continuous Assessment

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Abstract- 144 words

The porpoise of this paper is the discussion of the following statement: '*The only legitimate objective of any business is Long Term Maximization of Shareholder Wealth'*. The arguments contained in the following are therefore oriented to a precise understanding of the objectives, the techniques and the possible conflicts present in every public limited company. The theoretical first part, greatly inspired by 'Watson & Head Corporate Finance Principles & Practices chapter 1', is supported by an empirical section where the theories and principles described are tested through the analysis of the company Cairn Homes PLC. The aim of this empirical study is to investigate over the display of a public limited company, seeking confirmations and disagreements with the theories enlisted in the first part. A particular focus is dedicated to the right application of theoretical principles concerning the resolution of existing conflicts within the company.

The Theoretical Discussion- 1,506 words

In todays' world, Public Limited Companies may differ for the sector in which they operate, the clients to which they provide goods and services, or their corporate governance, but they all share one particular objective: the maximization of shareholders wealth. Shareholders are people and organizations that invest in a company, providing it the capability of operating in the market and, in more general terms to exist. From the strong dependence that the company has towards its shareholders arise two obligations: money and power. Power in the form of the possibility of taking crucial decisions during the shareholders annual meeting and money in the form of dividends and capital gain. The maximisation of shareholders' wealth relies therefore on two factors: the paying of dividends and the increase of the share value. Whereas dividends are the portion of the company profits that are devolved to its shareholders as a return on the investment they made, a capital gain is the difference between the selling and buying prices of an asset at the time it is sold [3]. The ultimate indicator to address how the company is performing in terms of maximisation of shareholders wealth is the share price, apart from easily providing the eventual capital gain given by its change in value over time, the share prices also 'reflect future dividend payments as well as investor views about the long-term prospects of the company and its expected cash flows. The surrogate objective is therefore to maximize the current market price of the company ordinary share and hence maximise the total market value of the company' (Watson&Head, 2006, pp10).

The ways in which the market value of the company, and therefore its shareholders wealth, is maximised are different and non-exhaustive, meaning that a magic formula to be a successful company doesn't exist. The reason behind this claim is that all companies have to interact with a multiplicity of external factors that are not under their control, but nevertheless responsible of increasing or decreasing their share price. First and foremost, the market, whose efficiency in converting the company performances into appropriate share price is a determinant factor for shareholders' wealth. Policies, competitors, and unforeseen turnovers, such as Covid-19, are all decisive external factors as well. It wouldn't result inappropriate therefore to say, that companies shape the majority of their short-term strategies, and some long-term ones, according to external factors, deciding what would benefit its shareholders wealth the most in that particular moment. The technique that may seem as the most reasonable to pursue, the maximization of profits, is at the same time an abstract concept that must be deeply analysed. Problems related to the concept of the maximization of profits arise from three prospectives: the low consideration of risk, which imposes a conflict between profit and dividends, the difficulty in defining a unique profit arising from differences in measurement and calculations, and the timescale over which profit should be maximized. This last consideration offers a great point of discussion about a second way of wealth maximisation: the maximisation of sales. When the timescale chosen for the maximisation of profits is a short-term window of time, managers of a company might want to maximize the sales, with the linked risk of ending up in a situation of overtrading and potential insolvency. It is incredibly important therefore for a company that wants to maximise profits, whether short or long term profits, to evaluate risk. Without this important analysis, a conflict between the different nature of dividends pay and profit performance may arise: dividends are paid in cash and cash does not consider ratios, mark-ups or risk. In a year of global economic recession, for example, a company may have been successful in generating higher profits than its sector benchmarks yet paying lower dividends when compared to previous years. Although a good year on the profit side, it cannot be considered a good year for shareholders wealth because cash doesn’t take into account the risk associated with the produced profit, but just the comparable amount over years. As economic recession years are nowadays common, the companies’ top management may change the strategy deciding to implement the survival. This strategy has the objective of avoiding unpleasant conditions such as insolvency or liquidation and, although it cannot be considered a long-term objective, survival can be an effective strategy to maximize shareholders wealth in difficult times. Lastly, some organisations adopt as primary corporate objective the social responsibility, which consists in highly evaluating the social framework the company faces in order to achieve shareholders wealth. Although a noble mission, being fully responsible under a social point of view is unpractical for a company because, on the lung-run, it will force the managers to choose between stakeholders’ satisfaction and shareholders’ wealth, making it impossible to pursue both objectives.

Conflicts emerging within companies, as the one just described, have the capability of undermining shareholders’ maximisation of wealth, the way in which companies deal with them is therefore crucial to achieve their ultimate objective. Whether political, social or economic, all conflicts of the history of humankind derive from one fundamental economic principle: the scarcity of resources. Resources are, by definition, scarce and any possible allocation of them cannot satisfy everyone involved at the very best as this would be possible only if anybody could have an infinite and unconditional access to resources. Comprises exist to survive, to avoid conflicts and to prevent divergences from erupting, scenarios that strongly depend on how does the allocation of resources take place. Such as every human group, whether it is a neolithic tribe or a modern society, companies have to deal with conflicts emerging from this immutable truth which, in the case of public limited companies, most frequently present themselves in two forms: shareholders against stakeholders and shareholders against managers.

Stakeholders are all those people who have an interest in the company, which can affect or being affected by the business operations and performances of it [3]. Shareholders are a minimal part of the stakeholder group and when referring to the previously cited conflict, with stakeholders are intended all parties present in the group, apart from the shareholders. The most known stakeholders of a company are its suppliers, costumer, employees, communities and government. Having clear who is this group made of, and remembering the stated basic economic principle, it is easy to see where the conflict comes from. Considering money, and therefore purchasing power, as the primary resource in contemporary society, the divergence emerges from the fact that every individual would want to accumulate more of it, intended in avoiding scarcity and thus surviving. Suppliers would therefore want to be paid more, as well as employees, while costumers would prefer to pay less, requests that would decrease shareholders wealth and therefore their capability in accumulating resources. At this point, it is clear that if resources were infinite, no sort of clashes would ever emerge, and comprises wouldn't be needed to solve this kind of disputes. In our contemporary society these frictions are worked out by the competitiveness of the market, which obliges everyone participating in sacrificing some of the eagerness in accumulating resources to ensure a capital return.

A second relevant conflict in companies materializes between shareholders and managers, it has been at the centre of corporate discussion since Jensen and Meckling studies in 1976 and has been theorized by Stephan Ross and Barry Mitnick in 2013 under the name of 'agency theory'. This kind of divergence emerges when the ownership and the control of a company are in two different hands: the agents, or managers, have the power of control, but they work on the behalf of the owners, or shareholders, not for their interests. The conflict is caused by the already mentioned scarcity of resources, which influences and provoke the misalignment of interests: managers are more willing to maximize their own resources rather than the one of the shareholders and can therefore use the asymmetry of information at their disposition to manipulate the information given to the owners, preventing them to recon whether their interested are represented or not. The agency problem can be solved in two ways: by monitoring the performances of the managers, or by realigning the owners and agents' interest. Even though it has been argued that the costs of monitoring exceed the real benefit that it carries, the unique implementation of a reward scheme based on the bonus payments in share is not sufficient to prevent the agency problem from happening. Modern public limited companies have therefore gone through a structural change in their governance, as suggested by the 'Code of Best Practices' promulgated through the Cadbury Report, 1992, and have introduced share bonus payments in the top-managers contracts. While the first change has introduced figures such as Independent Non-Executive Directors, committees and audits whose role is to report to the shareholders the performances of the Executive Directors, the second one has given incentives to the managers in seeking the maximisation of the share price of the company, which points out the new alignment with the shareholders' interest.

The Empirical Study- 794 words

The empirical study made as a support to the theoretical discussion, has the objective of understanding in a practical way how a public limited company implement strategies to fulfill its objectives, and what are the ways in which it solves conflicts and disputes emerging due to the scarcity of resources. This empirical analysis has been made on the basis of the 2022 Annual Report of the Cairn Homes PLC, the housing company with the highest market capitalization in Ireland as of today.

As stated by the Chairman of the Board, John Reynolds, '2022 has been a milestone year for Cairn'. The results achieved during this year are remarkable and the numbers enlisted by the CFO, Shane Doherty, during his statement prove it: 'the company was able to increase their sale by a 36 percent, the revenue grew by 46 percent and the operating profit by 76 percent (compared to 2021 ed.), becoming the first company in Ireland to deliver over 1,500 new homes in a calendar year.' The increase of profits and sales perpetuated during the year enabled the company to successfully accomplish the 'only legitimate objective of any business': the maximisation of its shareholders wealth. In 2022 a total wealth of €117 million was returned to shareholders, through the payment of 6.1% dividend per ordinary share (€42 million in total and 40.7% of the operating profit), and through the starting of a €75 million share buyback programme [2]. A buyback programme allows companies to invest in themselves through the purchasing of its own shares from the market. This kind of initiative reduces the availability of the shares on the market, increasing its price and therefore shareholders wealth [3]. The elements presented show how greatly has the company managed to recover from the prior years affected by the pandemic recession which had badly stricken housing market. In 2019 and 2020, Cairn Homes had in fact suspended dividend payments and buyback programmes initiated before, while in 2021 the operating profit was €58.4 million, compared to the €103 million of 2022. During 2022, the company has proven to be robust and attractive for investors, reaching a Return on Capital Employed ratio of 11.07%, surpassing the benchmark set by the only other house building company listed in the Irish stock market, Glenveagh Homes PLC, whose ROCE in 2022 was 9.20% [4]. ROCE is a relevant ratio in evaluating the management performances of a company because it assesses the effectiveness of capital allocation decisions and the ability to generate returns on invested capital [3].

While being able of delivering strong returns to its shareholders, Cairn Homes PLC, has demonstrated to care about its stakeholders' wellbeing, as said by the Chairman of the Board, John Reynolds introductive statement: 'Our focus at Cairn is not simply building houses. Our commitment is to build homes that have been thoughtfully designed, are sustainable and deliver high quality for our customers […] We also aspire to remain a business which contributes to our society, and it is an attractive place to work' [2]. Declaring a vision, common for all the members of the company, is important as it acknowledges the external world with the intent of the corporate, nevertheless it would be a pointless effort if any practical arrangement wasn't done in support of it. In this sense, Cairn Homes have launched in 2022, its Customer Care Portal, which provides clear insight about the degree at which customers are satisfied and it has continued to carry on the Supplier Relationship Management ("SRM") which increase the company's engagement with its supply chain. As a support for the community, Cairn Homes PLC has implemented several well-being initiatives, such as Home Together, a programme aiming at engaging with community leaders and local stakeholders with the intent of aligning ideas related to growth and sustainability. Employees value has been expressed by the semestral surveys taking places for all the members of the staff and by the extension of the health insurance, up to €3000 per family.

The Corporate Governance of Cairn Homes PLC is clear and well working, the following of the UK Corporate Governance Code and the Irish Corporate Governance Annex, has led to the existence of Audits and Committees since 2015, year in which the company was listed in stock market. These independent bodies have proven their efficiency through the implementation of policies and regulations aiming at solving managers misconduct or aligning their interests with the one of the shareholders. The last proposal of the Remuneration Committee was to defer the 33% of the annual bonus paid to Executive Directors in shares [3]. Although it still has to discussed by the Board members, this proposal shows the benefits that External Directors may bring to a company, representing the interests of both shareholders and Executive Directors.

References

1. Watson & Head 'Corporate Finance Principles & Practices' textbook, Chapter 1.
2. Cairn Homes PLC '2022 Annual Report'.
3. www.investopia.com
4. Glenveagh Homes PLC '2022 Annual Report'