

# FINA 3070 Notes 1

Ian Y.E. Pan

2020

## **1 Goals of a corporation**

- Many stakeholders

## **2 Focus on stockholders**

- Maximise total value of company's common stock, which will in turn maximise each stockholder's wealth.
- Create value by 'smart capital budgeting' and capital structure.

## **3 Capital budgeting**

- Long-term investments (real-assets) and projects for the firm.
- Decision trees and real options.

## **4 Capital management**

- Manage day-to-day finances of the firm (covered in FINA2010)

## **5 Capital Structure**

- Decide between more debt or more equity (to finance our assets).
- Related to cost of capital.
- Related to options.

## **6 Flow of cash (5 different types)**

- 3 parties: financial markets, financial manager, and firm's operations.

### **6.1 Flow from financial markets to financial manager**

- Cash raised from investors.

## **6.2 Flow from financial manager to firm's operations**

- Cash invested in firm.

## **6.3 Flow from firm's operation to financial manager**

- Cash generated (by operations).

## **6.4 Flow from financial manager to itself**

- Reinvestment.

## **6.5 Flow from financial manager back to financial markets**

- Cash returned to investors.

# **7 HK v.s. US**

## **7.1 Ownership structure differences between HK and US**

- Widely-held or closely-held?
- Institutional investors or individual investors?

### **7.1.1 US**

- A US corporation's equity is often widely-held (more evenly distributed) and mainly held by institutional investors.
- Institutional investors include: pension funds, mutual funds, insurance companies etc.

### **7.1.2 HK (and Asia in general)**

- More closely-held – the ownership of firms held by a small number of very wealthy families (individual investors).

# **8 Pyramid & Dual-class shares**

## **8.1 Dual-class shares (occasional in both US and HK)**

- Different/unequal 'classes' (levels) of shares.
- E.g. Facebook.A has 1 vote per share, while Facebook.B (superior) has 5 votes per share.

## 8.2 Pyramid (rare in US, common in HK)

- A party's voting rights of another company should be proportional to their investment on that company.
- However through pyramid shareholding, one's effective voting rights can be a lot greater than what one deserves according to one's investment.
- E.g. Wallenberg has 33% votes or more in each layer of the pyramid. Effective control of the bottom-level company is almost 100%.
- E.g. Consider a three-tier pyramid with the actual operating company at the bottom of the pyramid
  - Assume that 51% of the votes confer control at each tier.
  - Suppose that the second holding company, the highest one in the pyramid, holds a 51% controlling stake in a lower holding company, which in turn holds a 51% controlling stake in the operating company. A 51% stake in the highest holding company is really only a 26% stake in the operating company ( $.51 \times .51 = .26$ ).

## 9 Agency Problems

- Principals (stockholders) hire agents (managers) to represent his/her interest.
- Conflict of interest between principal and agent.

### 9.1 Agency problem differences between US and HK

#### 9.1.1 US

- Conflict between the principals and the agents.
- E.g. Dividend policy.

#### 9.1.2 HK

- Conflict between the one major stockholder and other stockholders.
- The one major stockholder him/herself is a principal, but is at the same time the agent/manager for other principals.

#### 9.1.3 More on US vs HK

- Agency problem in HK can be more severe than US (especially for small-cap or mid-cap HK firms).

### 9.2 More agency problems

- In capital structure (use debt/equity to finance), agency problem can exist between creditors (the ones who lend) and stockholders.
- This time, creditors are the principals and stockholders are the agents.

### **9.3 Regulations et al.**

#### **9.3.1 Protect minority shareholders from exploitation**

- SEC in US
- SFC in HK

#### **9.3.2 Board of Directors**

- SOX in US
  - At least 1/2 of all directors must be independent from managers
- HK
  - At least 1/3 of all directors must be independent from managers

### **9.4 Agency problems misc.**

#### **9.4.1 How shareholders can put pressure on managers**

- Elect new directors; fire CEO
- Sell shares (stock price goes down)

#### **9.4.2 Compensation**

- Stock options (bonus, incentive pay)