

FINA 3070 Notes 1

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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)