

Course: Economics of Industry



Lecture 5: Corporate Governance

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Learning objectives

- Corporate Governance and Competitiveness
- Investor Protection
- Role of Public Sector in Setting Framework for Good Corporate Governance
- Knowledge about theory of board operation and Role of directors
- Theories of board organization
- Regulation concerning corporate boards
- Practice in corporate boards

Corporate Finance, Corporate Governance and Valuation

- Corporate Governance is at the intersection of strategy, control and finance
- Corporate Governance is a primary driver of firm specific and market risk in valuation approaches

Review of Valuation Models

- Asset approach
- Market approach
 - Guideline Public Company method
 - Transaction Method or Direct Market Data Method
- Income approach
 - Discounted cash flows method
 - Capital Asset Pricing Model (CAPM)
 - Weighted Average Cost of Capital (WACC)

Review of Valuation Models

Understand concept of market efficiency and four techniques to determine value of common shares:

- 1) Dividend valuation model (DVM),
- 2) Book value,
- 3) Liquidation value, and
- 4) Price/Earnings (P/E) multiple.

Discounts and premiums

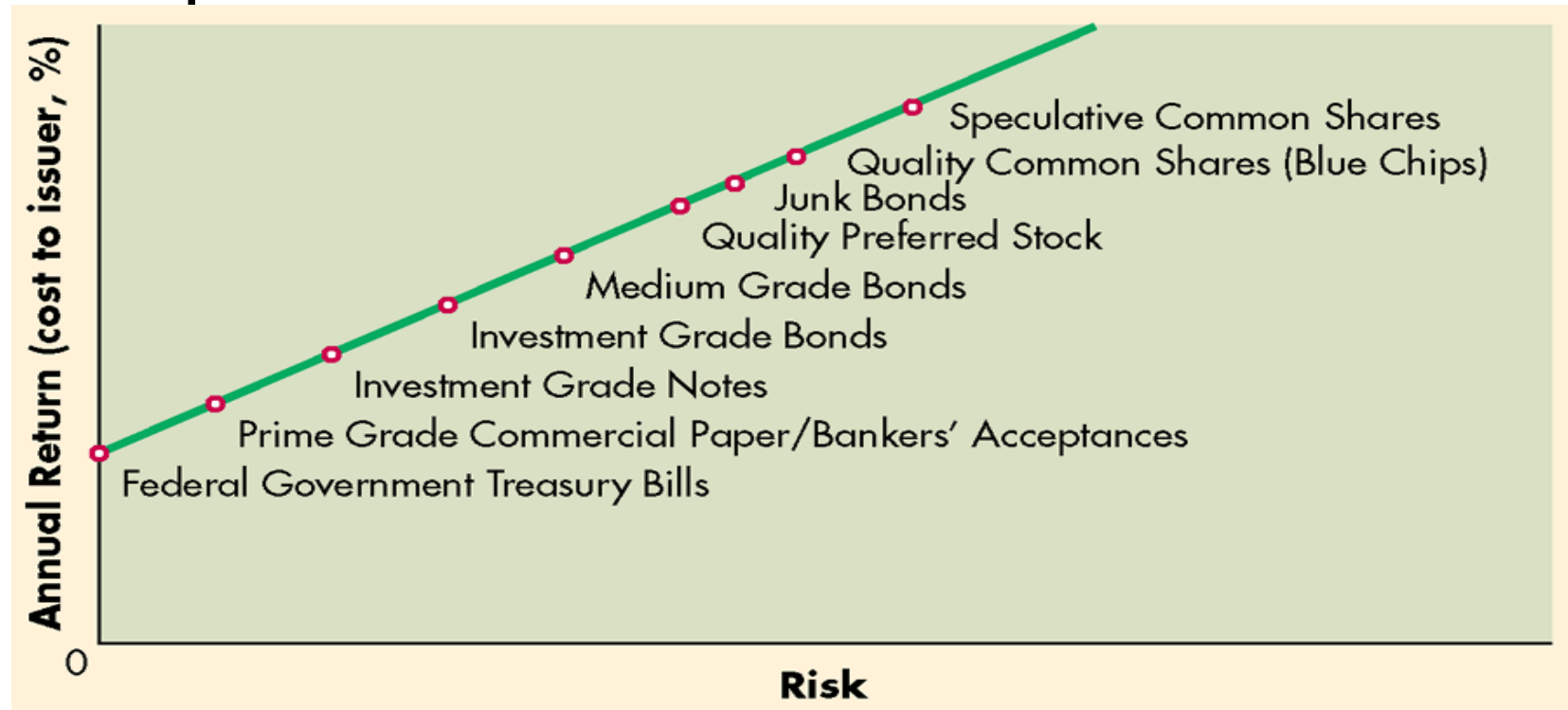
- Discount for lack of control
- Discount for lack of marketability
- Minority discount
- Control premium
- Lack of marketability
- Key person discount

Risk Premiums

- Risk Premiums vary with specific issuers and issue characteristics including:
 - Default risk,
 - Maturity risk,
 - Liquidity risk,
 - Contractual provisions, and
 - Tax risk.

Risk and Return

- Investors must be compensated for accepting greater risk with higher expected returns.



Why Russian market down so much more than US/Western Markets?

- BRIC effect – China off 60% Brazil off 21% India off 34% (Big gains in 2006 – 2007 – now investors cashing out to meet capital needs in western markets due to the credit crunch)
- Return of Country Effect
 - Stalled reform on corporate governance
 - Threats of government control (Mechel & Evraz)
 - Geopolitical risk reevaluation
 - Is your money safe in Russia?

Basic Valuation Model

- The value of any asset is the Present Value of all future cash flows it is expected to provide over the relevant time period.

$$V_0 = \frac{CF_1}{(1+k)^1} + \frac{CF_2}{(1+k)^2} + \dots + \frac{CF_n}{(1+k)^n}$$

V_0 = value of the asset at time zero

CF_t = cash flow expected at the end of year t

k = appropriate required rate of return (discount rate)

n = relevant time period

Cost of Capital Models

- CAPM $E(R_i) = R_f + \beta_i(E(R_m) - R_f)$.

- Where:

- $E(R_i)$ is the expected return on the capital asset
- R_f is the risk-free rate of interest
- β_i (the beta coefficient) is the sensitivity of the asset returns to market returns, or also β_i
- $E(R_m)$ is the expected return of the market
- $E(R_m) - R_f$ is the *market premium* or *risk premium* (the difference between the expected market rate of return and the risk-free rate of return)

Changes in Risk

- Although k is defined as the required return, it is directly related to the nondiversifiable risk, which can be measured by beta.
- Recalling the equation for the CAPM:
$$k_s = R_F + [\beta \times (k_m - R_F)]$$
- Thus, actions that increase risk contribute toward a reduction in value, and actions that decrease risk contribute to an increase in value.

Historical Tradition in Corporate Governance

- Formation of Open Joint Stock Companies in England and Holland 16th century
- Use of OJSC in US as public companies in 19th and early 20th Century as engines of industrial growth – Corporate governance scandals of the 19th far exceed recent scandals
- Securities Exchange Act of 1934 Securities Act of 1933
- Sarbanes-Oxley Act of 2002

Recent Corporate Failures

- Enron Corporation
- Worldcom
- Parmalat
- GlobalCrossing
- Aledphia



Even more recent failure related to risk in the market

- Fannie Mae & Freddie Mac
- BearSterns
- Meryl Lynch
- AIG
- Lehman Brothers

Corporate Governance Introduction

- What is Corporate Governance?
- Definition of “Governance” vs. “Administration,” “Management,” or “Control”
- Corporate Governance structures
 - Board of Directors
 - Chair of the Board
 - Corporate Secretary
 - Shareholders – General Meeting of Shareholders
- Why is it important to corporate finance? Cost of Capital

What is a Corporation?

“The business corporation is an instrument through which capital is assembled for the activities of producing and distributing goods and services and making investments. Accordingly, a basic premise of corporation law is that a business corporation should have as its objective the conduct of such activities with a view to enhancing the corporation’s profit and the gains of the corporation’s owners, that is, the shareholders.” *Melvin Aaron Eisenberg*

What is a Corporation?

“When they [the individuals composing a corporation] are consolidated and united into a corporation, they and their successors are then considered as one person in law . . . For all the individual members that have existed from the foundation to the present time, or that shall ever hereafter exist, are but one person in law – a person that never dies: in like manner as the river Thames is still the same river, though the parts which composite are changing every instant.” *Blackstone*

“An ingenious device for obtaining individual profit without individual responsibility.” *Ambrose Bierce, The Devil’s Dictionary*

Corporate Form

1. limited liability for investors;
2. free transferability of investor interests;
3. legal personality (entity-attributable powers, life span, and purpose); and
4. centralized management.

Purpose of a Corporation

- Human satisfaction
- Social structure
- Efficiency and efficacy
- Ubiquity and flexibility
- Identity
- Personality – morality ?

Measuring Performance

- Long term versus short term
- Market value
- EVA
- Human Capital
- Externalities

Corporate Governance Definitions

- OECD – “internal means by which a corporations are operated and controlled ... which involve a set of relationships between a company’s management, its board, its shareholders and other stakeholders.”

IFC – Russia Corporate Governance Manual

- Corporate Governance is a system of relationships, defined by structures and process. [Shareholders – Management]
- These relationships may involve parties with different and sometimes contrasting interests.
- All parties are involved in the direction and control of the company
- All this is done to properly distribute rights and responsibilities – and thus increase long term shareholder value.

Definitions

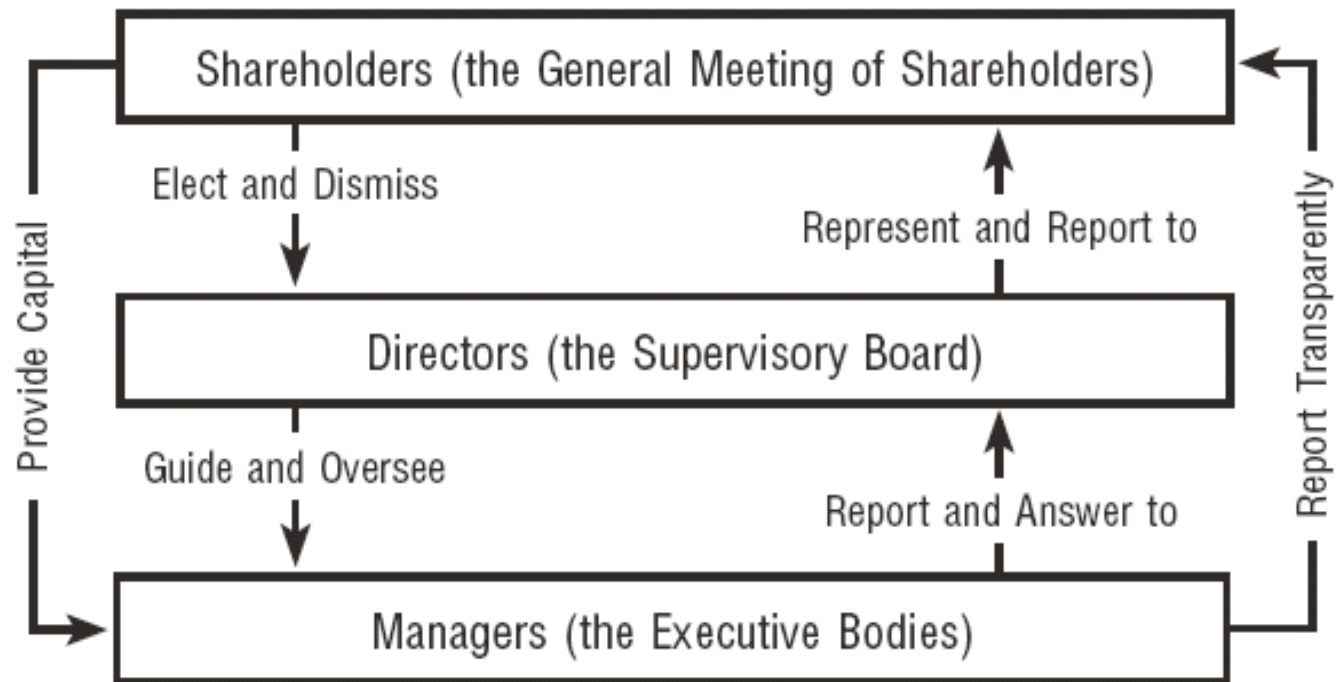
- “Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment”, The Journal of Finance, Shleifer and Vishny [1997, page 737].

Other Definitions

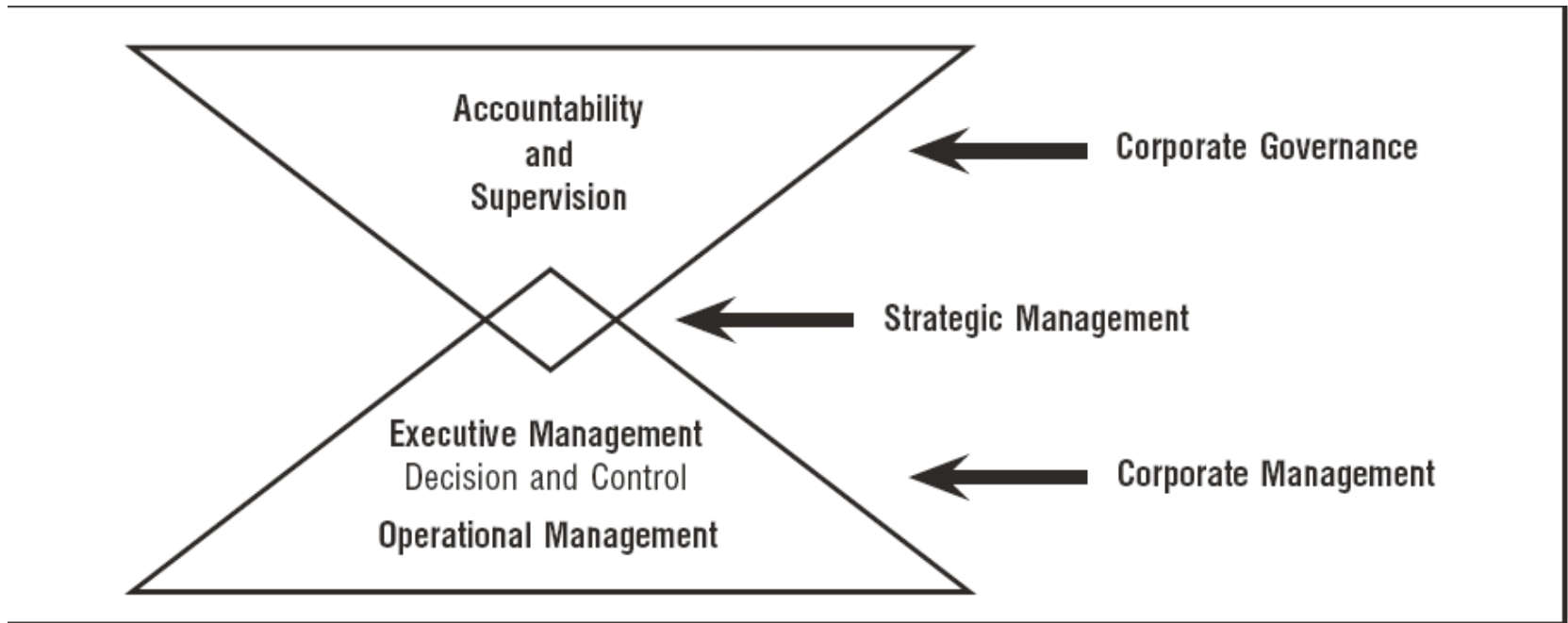
- "Corporate governance is about promoting corporate fairness, transparency and accountability" J. Wolfensohn, president of the World Bank, as quoted by an article in Financial Times, June 21, 1999.
- "The directors of companies, being managers of other people's money than their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own." Adam Smith, The Wealth of Nations 1776

Corporate Governance System

Figure 1: The Corporate Governance System



Corporate Governance



Source: Robert I. Tricker, Corporate Governance, 1984

Basics of Corporate Governance

- By issuing corporate securities, firms sell claims to control the companies` resources
 - The interests of the various security holders differ
 - Separation of ownership and control implies agency relationships.
 - Interests of agents (management) are different from those of security holders, particularly from those of stockholders.
 - Monitoring the activities of agents is costly - hence, full monitoring is not optimal.
 - The value forgone due to imperfect optimal monitoring is an explicit agency cost.

Legal and Economic Institutions

- Legal protection of shareholders
- Concentrated ownership strategy

Contract Theory of Corporate Governance

- Contract are arranged between principles (owners) and agent (managers)
- Contracts are also made between the firm and providers of capital
- Problems with contracts:
 - Moral Hazard
 - Incomplete contracts
 - Adverse selection bias
- Coase 1937, Jensen & Meckling 1976, Fama and Jensen 1983

Agency Problem

- Managerial discretion - Business judgement
- Managerial opportunism – self dealing
- Duty of loyalty of management to firm

Fiduciary Duty

- The fiduciary duty is a legal relationship between two or more parties (most commonly a "fiduciary" or "trustee" and a "principal" or "beneficiary") that in English common law is arguably the most important concept within the portion of the legal system known as equity.
- A fiduciary will be liable to account if it is proved that the profit, benefit, or gain was acquired by one of three means:
 - In circumstances of conflict of duty and interest
 - In circumstances of conflict of duty and duty
 - By taking advantage of the fiduciary position.
- Therefore, it is said the fiduciary has a duty not to be in a situation where personal interests and fiduciary duty conflict, a duty not to be in a situation where their fiduciary duty conflicts with another fiduciary duty, and not to profit from their fiduciary position without express knowledge and consent. A fiduciary cannot have a conflict of interest.

Agency Problem Duty of loyalty of management to firm

- Incentive contracts that align management interests with investors
- Agency costs – monitoring and compliance
- Shareholder actions- shareholder democracy, proxy fights, access to the proxy ballot, derivative lawsuits

Choice of Capital Structure

- Debt versus Equity as CG problem
- Creditor/owners ability to exert control
- Debt instrument can reduce the adverse selection bias by reducing the manager's insider information concerning repayment
- Collateral value opposed to firm value decides the cost of debt
- Debt provides greater protection to outsider financiers
 - in risky CG environments there are lower costs of capital for the issuance of debt

Shleifer and Vishny's Conclusions

- Investor protection and concentrated ownership are the best
- Corporate Governance system evolve to meet the current challenges of the day
- The type of Large Investor matters

Four core values of the OECD corporate governance framework

- **Fairness:** The corporate governance framework should protect shareholder rights and ensure the equitable treatment of all shareholders, including minority and foreign shareholders.
- **Responsibility:** The corporate governance framework should recognize the rights of stakeholders as established by law, and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

OECD Core Values

- **Transparency:** The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the company, including its financial situation, performance, ownership, and governance structure.
- **Accountability:** The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and shareholders.

Reference

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