

ASIL SHAAR (CORPORATE FINANCE (FINN3300))

Chapter 2

Chapter 2

Topic: Corporate Governance

The objective in decision-making

الهدف من اتخاذ القرارات

objective: what a firm is trying to accomplish

Example: Maximize profit

Maximize revenues

Maximize shareholders wealth

Minimize risk

Minimize costs / expenses

Maximize firm value

Maximize stock price

الهدف دائما ان يكون هدف واحد

Corporate Theory

According to Corporate theory

The goal of a firm could be one of the following.

- ① Maximize Firm value (Least restrictive)
- ② Maximize shareholders wealth.
- ③ Maximize stock price (most restrictive)



Characteristic of a good objective:

- ① Clear and unambiguous ان لا يكون غامضاً
- ② measurable قابل للقياس
- ③ should not create costs to ^{other} groups or entities

ما يربط أفراد الجماعة الأخرى في المجتمع

مثل: الدخان من حرق بالدمج الشركة لا يكون له فيها

to maximize profit بهدف تعظيم قيمة الشركة

معية

① Maximize firm value (least restrictive)

This objective can be justified if the following assumptions hold:

a. No social cost, and if there is any it can be traced back to the firm

~~b. No conflict of interest between stockholders and managers~~ لا يوجد تكاليف اجتماعية وأنا وجبت يمكن أرجاعها إلى الشركة

b. No conflict of interest between stockholders and managers (agency problem)

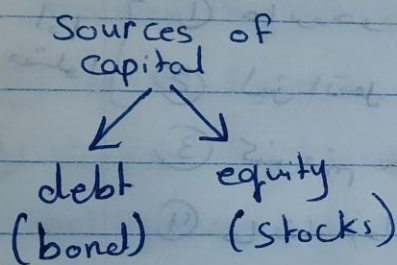
⇒

② Maximize shareholders wealth

This objective can be justified if the following assumptions hold:

a + b (1) risks

(c) No conflict of interest between bondholders & stock holders



③ Maximize stock price (most restrictive)

This objective can be justified if the following assumptions hold:

a + b + c

(d) Financial markets are efficient and investors are rational

1. Relationship between managers and stockholders

Theory: Managers work for the best interest of shareholders because they fear being fired or replaced by shareholders
Voting in the annual general meeting (AGM) or by the board of directors (BOD)

* Two Mechanisms that should discipline management:

(a) AGM

(b) BOD

- ① ما يردحوا على الاجتماع سويدي الستير
- ② لين اتحل تكاليف وانظر
- ③ كثير منهم يكون passive
- ④ فإفادتها جدا

Reality: Stockholders have ^{little} ~~little~~ control over the firms, managers put their interest first.

The annual general meeting failed to discipline management for the following reasons:

- ① Minority stockholders usually don't attend the meetings because they feel they cannot make a difference.
- ② It does not make financial sense to do so.
- ③ They don't fill their proxies



④ passive investors (financial institutions)

usually vote with their feel.

Board of directors has failed to discipline management for the following reasons:

① Most of the directors don't spend enough time on board

because they sit on other boards لا يقفون وقتهم لعضوية الإدارة وقتاً

② lack of expertise . نقود الخبرة

③ Inside directors and even independent directors have in reality some relation with the CEO .

العلاقة الداخلية والاعتماد على المستقلين من
في الواقع لديهم بعض العلاقة مع CEO

④ Directors usually own small stakes of equity

(They don't care about the stock price)

حصة صغيرة من الأسهم
لذلك لا يهتمون بسعر الأسهم

⑤ CEO / Chairman duality

هو نفسه رئيس مجلس الإدارة
أزدواجية الرئيس التنفيذي / الرئيس

1] AGM

2] BoD

3] powerlessness of stockholders (ownership structure)

a) voting right: single class vs multiple classes of

Shares حقوق التصويت: فئة واحدة مقابل فئات متعددة من الأسهم

→

المالك / المؤسس
(b) founder / owner

(c) passive investors vs. active investors

(d) Stockholders with competing interests
(ex: government / employees) إطمان المصالح المتنافسة

(e) Corporate cross holdings (pyramid structure)

المقتنيات المتنافسة للمؤسس

Consequences

(1) Fighting hostile takeovers via green mail,
golden parachute or poison pills

تجارية عمليات الاستحواذ المعقدة عن طريق

تعيينه للقيادة

~~CEO~~

إذا شركة A اتتحت على شركة B ف CEO لـ B
يجب يحضر شغله

- green mail: the manager will buy the stocks at a price even higher than the price offered by the acquirer with stockholders' money in order not to lose his/her job.



المستشري المدير الامم بسعر اعلى من السعر الذي يعرضه المستشري مع اموال المساهمين حتى لا يفقد وظيفته

active investors
(Mergers and Acquisitions)

(3)

تسمح المدير بالمسؤول على مبلغ معين من المال في حالة الاستحواذ

- **golden parachute**: allows the manager to receive a certain amount of money in case of a takeover.

- **poison pills**: making the company unattractive to takeover (difficult and costly to be acquired)

جعل الشركة غير جذابة للاستحواذ (من الصعب والمكلف الحصول عليها)

② Anti takeover amendments

عنان يكون موجودة بالشركة



تعديلات مكانة الاستحواذ

Stockholder الحاجة لموافقة holder

have the same objective as green mail and poison pills. They require the consent of the stockholders to be instituted.

ex: **super majority amendment** → to takeover

تعديل الأغلبية الفائقة

a firm that adopts this amendment, an acquirer has to acquire more than 51% that would normally be required to gain control.

للاستحواذ على شركة تبين هذا التعديل يجب ان يحصل المخطوب على اكثر من 51% وهو امر مطلوب عادة للحصول على السلطة

③ paying too much on acquisitions (over paying in case of a takeover)

دفع الكثير على عمليات الاستحواذ



الحلول

Remedies:

كيف تقلل من أثره السكلم

How to reduce the agency problem?

- ① Make managers think like stockholders by having equity stakes in the firm
- ex: Stock compensation with long-term liquidation

لدي اقل ابلدراء يتكرر مثل المساهمين عند حلول اموالهم في الشركة

Condition.

تعميرهم بمشورون مع حالة التنمية على المدى الطويل

- ② More effective BoD

a - smaller BoD

اقل BoD

b - fewer insiders

اقل الداخلين

c - limited number of directorships.

عدد محدود من عضوية في السو الادارة

d - Directors are increasingly compensated

تعميرهم المتزايد بشكل متزايد

e - More director are selected by a nominating

Committee and not by the CEO

يتم اختيار المزيد من اعضاء لجنة الادارة من قبل لجنة الترشيح وليس من قبل الرئيس التنفيذي

f - A lead director must be appointed in case of

duality.

لدى تحديد المخرج الرئيسي في حالة الازدواجية

g - The CEO must be evaluated on annual basis.

يجب تقييم الرئيس التنفيذي على اساس سنوي

③ Increase shareholders power by promoting activism, having single class shares, more updated information and having the major stockholder part of management. زيادة قوة المساهمين من خلال تعزيز المشاركة وإقتلاع
الهيمنة فئة واحدة، وزيادة من المعلومات الحديثة وجعل الأسهم الرئاسية جزءاً من الإدارة

④ Maintain the threat of a takeover as a disciplinary mechanism الحفاظ على التهديد بالسيطرة كأداة تأديبية

2. Relationship between bondholders and stockholders.

bondholder يملك على stockholder يملك

Theory: The lenders of the firm are fully protected from expropriation by stockholders.

تعرضوا الشركة حصصها بالكامل في مشاركة للقيمة من قبل المساهمين

Reality: Bondholders are taken advantage of in three ways (mainly due to the differences) in cash flow rights \Rightarrow Creditors have priority claim on assets and income. In addition, bondholders don't share in the upside of the project but they bear significant cost if the firm fails)



الاستثمار في الشركات
a. Investing in risky assets (projects)

b. Additional borrowing → probability of default risk increase, when debt ratio increases

Debt ratio = $\frac{\text{total debts}}{\text{total assets}}$ bond rating drops, the price of the bond falls to reflect higher default risk.

c. Additional dividend payment → Cash available to repay debt decreases → Debt is more risky.

Stock prices will increase while bond price will decrease.

Consequences:

wealth transfer from bondholders to stockholders. This can also affect the firm's reputation.

Remedies:

① Covenants: restrictions placed on the issuer to

protect the bondholders.

* Debt Covenants that restrict the firm's investment, dividend and additional debt policies.

→ $\frac{\text{Debt}}{\text{Equity}}$ \rightarrow $\frac{\text{Debt}}{\text{Equity}}$ \rightarrow $\frac{\text{Debt}}{\text{Equity}}$

- أصبحوا مساهمين في طرف السندات القابلة للتحويل
- ② Become shareholders via convertible bonds.
- ③ ^{السندات القابلة للتحويل} puttable bonds → par de bond → bondholders gives the bondholders the right to put the bond back to the issuer at par

يعني عملة السندات المحققة في إعادة السداد على par

③ Relationship between the firm and the financial markets:

Theory & managers of the firm do not mislead or lie to the markets about the firm's future prospects, investors are rational and are able to assess all information and thus the prices reflect the true value of the companies.

Reality: ① Information problem & prices are based on public and private information. Sometimes, information is delayed specially when it is bad news or the information can be misleading.

② Market problem: inefficient markets → overreacting when bad news or good news are announced

إعلان
⇒

لا يوجد ضمان بأن سعر السوق ليسكون تقديراً غير متحيز للقيمة الحقيقية

فمنهنا
Consequences: No guarantee that the market price will be unbiased estimate of the true value

فمنهنا انه لا يوجد التقدير الحقيقي للأسعار

Remedies:

1. Improve the quality of information either by law or by creating a market for information through (analysts.)
2. Enhance the efficiency of the market by lowering the trading cost, free access to information and investors earning rewards when they invest in good stocks and they pay the price when they invest in bad stocks

[4] Relationship between the firm and the society.

Theory: No social cost and if there is any it can be ignored or traced back to the firm.

لا يوجد تكلفة اجتماعية ما ينطبق الأمر بحدوث

وإذا وجدها المجتمع الأمر لدينا لنفعل

لا يوجد تكلفة اجتماعية وإذا كان هناك يمكن تجاهلها أو

ارجاعها إلى الشركة

قد تكون التكاليف الاجتماعية كبيرة ولكن لا يمكن
ارجاعها للشركة . هناك معضلة اخلاقية ، تعظيم
قيمة الشركة مقابل المصلحة الادنى للمجتمع

Reality : Social Costs could be considerable

but cannot be traced to the firm . There is
always an ethical dilemma , maximizing firm
value vs broader interest of society .

Consequences : Society pays a high price while
socially irresponsible firms maximize their value .

للدفع الموجه تمناً بإهتزاز بينما الشركات غير
المسؤولة اجتماعياً تزيد ثروتها

Remedies :

① laws القوانين

② Customers boycotting the products of مقاطعة العمل بالشركة
the firms that are socially irresponsible . الشركات التي لا تعمل اجتماعياً

③ Investors boycotting the stocks/bonds of مقاطعة المستثمرين
firms that are not acting socially well . الشركات التي لا تعمل اجتماعياً

④ Make it an economic interest to firm to be a نكّل
good citizen . اجعل من المصلحة الاقتصادية للشركة أن تكون

مواظماً على