

APPLIED CORPORATE FINANCE

Fourth Edition

Summarisation

تلخيص مساق الإدارة المالية لشركات Finn3300

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The Objective In Decision Making

Chapter 2

- Every corporation needs an ultimate objective to specify what management is trying to achieve.

• تحتاج كل شركة إلى هدف نهائي لتحديد ما تحاول الإدارة تحقيقه.

- Why do we need only one ultimate objective not many?

✓ لماذا نحتاج فقط إلى هدف نهائي واحد غير كثير؟

Because we need a systematic way of decision making, competing objectives can be contradictory

✓ لأننا نحتاج إلى طريقة منهجية لاتخاذ القرار ، يمكن أن تكون الأهداف المتنافسة متناقضة.

❖ Objective of Corporate finance / what a corporate is trying to accomplish?

- 1) Maximize firm value (Least restrictive) (.) تعظيم قيمة الشركة (الأقل تعقيداً)
- 2) Maximize shareholders wealth. تعظيم ثروة المساهمين.
- 3) Maximize share price (most restrictive) (.) تعظيم سعر السهم (الأكثر تعقيداً)
- 4) Maximize profits . تعظيم الأرباح .
- 5) Maximize revenues . تعظيم العوائد .
- 6) Minimize risks . تقليل المخاطر .
- 7) Minimize costs . تقليل التكاليف .

❖ characteristics of a good objective :

- i. clear and unambiguous .

واضح وخالية من الغموض.

- ii. Measurable .

قابلة للقياس .

- iii. does not create costs for other entities.

لا تنشئ تكاليف للكيانات الأخرى.

❖ The goal of a firm objective could be one of the following :

1) Maximize firm value → least restrictive. (الأقل تعقيداً) تعظيم قيمة الشركة

⇒ Assumptions that must hold : الافتراضات التي يجب أن تحمل :

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

لا توجد تكلفة اجتماعية وإذا كان هناك أي تكلفة يمكن إرجاعها إلى الشركة .

B. No conflict of interest between stockholders and the managers

لا يوجد تضارب في المصالح بين المساهمين والمديرين.

2) Maximize shareholder's wealth تعظيم ثروة المساهمين

⇒ Assumptions that must hold : الفرضيات :

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

لا توجد تكلفة اجتماعية وإذا كان هناك أي تكلفة يمكن إرجاعها إلى الشركة .

B. No conflict of interest between stockholders and the managers .

لا يوجد تضارب في المصالح بين المساهمين والمديرين.

C. No Conflict of interest between stockholders and bondholders.

لا تضارب في المصالح بين المساهمين وحملة السندات.

3) Maximize stock prices → most restrictive. (الأكثر تعقيداً) تعظيم أسعار الأسهم

⇒ Assumption that must hold : الفرضيات :

A. No social cost, and if any, they can be traced back to the firm .

لا توجد تكلفة اجتماعية وإذا كان هناك أي تكلفة يمكن إرجاعها إلى الشركة .

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C. No conflict of interest between stockholders and bondholders.

لا تضارب في المصالح بين المساهمين وحملة السندات.

D. financial markets are efficient and investors are rational.

الأسواق المالية فعالة والمستثمرون عقلانيون.

1) Relationship between managers and shareholders

- **Theory** : Managers work for the best interest of shareholders because they fear being fired or replaced by:

النظرية: يعمل المديرون لمصلحة المساهمين لأنهم يخشون طردهم أو استبدالهم بما يلي:

a. *shareholders voting in the annual General meeting (AGM)* .

أ. تصويت المساهمين في اجتماع الجمعية العمومية السنوي (AGM)

b. *The board of directors (BOD)* .

ب. مجلس الإدارة.

- **Reality** : 1) *The annual meeting* : Stockholders have little control over the firms, managers put their interest first.

الحقيقة: 1) الاجتماع السنوي: يمتلك المساهمون القليل من السيطرة على الشركات ، ويضع المديرون اهتمامهم أولاً .

2) *The board of directors (BOD)* مجلس الإدارة

⇒ **they have failed to discipline management because:** :

فشلوا في تأديب الإدارة للأسباب التالية :

A. Most of them don't spend enough time on the board, because they sit on other boards.

لا يقضي معظمهم وقتًا كافيًا على السبورة ، لأنهم يجلسون على ألواح أخرى.

B. lack of expertise. نقص الخبرة .

C. Inside directors and independent directors have some relation. with the CEO. المديرين الداخليين والمديرين المستقلين لديهم بعض العلاقة. مع الرئيس التنفيذي.

D. Directors usually own small stake of equity, they even receive their stocks as part of their remuneration.

عادة ما يمتلك المديرون حصة صغيرة من الأسهم ، بل إنهم يتلقون أسهمهم كجزء من أجورهم.

E. Duality → The CEO is the chairman of the board of directors

الازدواجية ← الرئيس التنفيذي هو رئيس مجلس الإدارة.

3) Powerlessness of stockholders عجز المساهمين

⇒ comes from the ownership structure: يأتي من هيكل الملكية

A. Voting rights → single class vs multiple classes of shares.

حقوق التصويت ← فئة واحدة مقابل فئات متعددة من الأسهم .

B. Founder owner. مالك مؤسس

C. Passive investors VS active investors . المستثمرين السلبيين مقابل المستثمرين النشطين

D. Stockholders with competing interest → government, employees as shareholders .

المساهمون ذوو المصالح المتنافسة ← الحكومة والموظفون كمساهمين.

E. Corporate cross holdings → pyramid structure.

المقتنيات المتقاطعة للشركات ← هيكل هرمي.

❖ Reasons for the failure of AGM to discipline managements :

أسباب فشل الجمعية العمومية العادية في تأديب :

⇒ Stockholders usually don't attend the annual meeting :

عادة لا يحضر المساهمون الاجتماع السنوي

- i. It wouldn't make a financial sense to do so . لن يكون منطقي القيام بذلك من الناحية المالية .
- ii. they don't fill their proxies. لا يملأون وكلائهم
- iii. They don't feel they can change . لا يشعرون انهم يستطيعون التغير .

• **Consequences:** الآثار

1. Fighting hostile takeover by → using greenmail golden parachute, poison pills .

محاربة الاستيلاء العدائي عن طريق ← استخدام المظلة الذهبية ، حبوب السم

2. Anti-takeover amendments تعديلات مكافحة الاستيلاء

3. Paying too much on acquisitions دفع الكثير على عمليات الاستحواذ

- **Remedies:**

كيف تقلل من مشكلة الوكالة ؟ ؟ How to reduce the agency problem?

1) **Make managers think like shareholders by having equity stakes in the firm .**

اجعل المديرين يفكرون مثل المساهمين من خلال امتلاك حصص في الشركة.

2) **Increase shareholder power : زيادة قوة المساهمين**

A. promoting activism .

B. having single class share . تعزيز النشاط.

الحصول على حصة فئة واحدة.

C. provide the stockholders with enough and better informations .

تزويد المساهمين بمعلومات كافية وأفضل.

3) **more effective board of directors : مجلس إدارة أكثر فعالية**

A. limiting the number of directorships.

الحد من عدد أعضاء مجلس الإدارة.

B. Smaller BOD more effective.

مجلس الإدارة الأصغر أكثر فعالية.

C. fewer insider and more independent investors.

عدد أقل من المستثمرين المطلعين والمستقلين.

D. more directors are selected by a nominating committee.

يتم اختيار المزيد من المديرين من قبل لجنة الترشيح.

4) **Maintain the threat of takeover as a disciplinary mechanism.**

الحفاظ على تهديد الاستيلاء كآلية تأديبية.

2) Relationship between stockholders and bondholders.

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

النظرية: مقرضو الشركة محميون بالكامل من مصادرة الملكية من قبل المساهمين.

- **Reality:** Bondholders are taken advantage of in three ways which are :

الحقيقة : يتم الاستفادة من حملة السندات بالطرق التالية :

1. Cash flow rights creditors have fixed claimants on firm's cash flows
لدى دائني حقوق التدفق النقدي مطالبون ثابتون من التدفقات النقدية .
2. They do not share in the upside risk if projects succeed.
إنهم لا يشاركون في مخاطر الصعود إذا نجحت المشاريع
3. They bear a significant cost if projects fail
يتحملون تكلفة كبيرة إذا فشلت المشاريع.

- examples of the conflict : امثلة على الصراع :

1. Investing in risky assets (projects .) : stockholders are tempted to take risky investments while bondholders are not .

الاستثمار في الأصول الخطرة (المشاريع): يميل المساهمون إلى القيام باستثمارات خطيرة في حين أن حملة السندات لا يفعلون ذلك.

2. Additional borrowing → probability of default risk increases, when debt ratio increases, bond rating drops, the price of bonds fall to reflect the higher default risk.

الاقتراض الإضافي ← تزداد احتمالية مخاطر التخلف عن السداد ، فعند زيادة نسبة الدين وانخفاض تصنيف السندات ، ينخفض سعر السندات ليعكس ارتفاع مخاطر التخلف عن السداد.

3. Additional dividend payment → cash available to repay debt decreases , debt is more risky. stock price will increase while bond prices decrease .

المدفوعات المقسمة الإضافية ← النقدية المتاحة لسداد الديون تتناقص ، والديون أكثر ر خطورة سوف يرتفع سعر السهم بينما تنخفض أسعار السندات.

- **Consequences:** Wealth transfer from bondholders to shareholders this also can affect the firm's reputation.

العواقب: يمكن أن يؤثر تحويل الثروة من حملة السندات إلى المساهمين أيضًا على سمعة الشركة.

- **Remedies:** الحلول

- A. **Covenants:** that restrict firms investment, dividend and additional debt policies.

التعهدات: التي تقيد استثمار الشركات وسياسات الديون المقسمة والإضافية.

- B. **Become shareholders via convertible bonds (at the bondholder option) .**

أن يصبحوا مساهمين من خلال السندات القابلة للتحويل (حسب خيار حامل السندات).

- C. **Put able bonds:** gives the bondholder , the risk to put the bond back to the issue at par .

طرح السندات القادرة: يعطي حامل السند مخاطر إعادة السند إلى الإصدار على قدم المساواة .

3) Relationship between the firm and financial markets

- **Theory:** Managers of the firm do not mislead or lie to markets about the firms' future prospects, investors in return are rational and able to assess all the information and thus the price .

النظرية: مديرو الشركة لا يضللون أو يكذبون للأسواق بشأن الآفاق المستقبلية للشركات ، والمستثمرون في المقابل عقلانيون وقادرون على تقييم جميع المعلومات وبالتالي السعر.

- **Reality:** there are two problems: هناك مشكلتان

- i. **Information problem:** the price is based on public and private information. Sometimes information is delayed especially when it is bad news (publishing on Friday afternoon after market closure) or information can be misleading .

مشكلة المعلومات: السعر يعتمد على المعلومات العامة والخاصة. في بعض الأحيان تتأخر المعلومات خاصة عندما تكون أخبارًا سيئة (تنشر بعد ظهر يوم الجمعة بعد إغلاق السوق) أو قد تكون المعلومات مضللة .

ii. Market problem: inefficient markets, overreacting, not assimilating information well into price.

مشكلة السوق: الأسواق غير الفعالة ، المبالغة في رد الفعل ، عدم استيعاب المعلومات بشكل جيد في السعر.

- **Consequences:** No guarantee that the market price will be unbiased estimate of true value.

العواقب: لا يوجد ضمان بأن سعر السوق سيكون تقديرًا غير متحيز للقيمة الحقيقية .

- **Remedies:** الحلول

1. Improve the quality of information either by laws or by creating market for information (analysts) .

تحسين جودة المعلومات سواء من خلال اللوائح الداخلية أو عن طريق إنشاء سوق للمعلومات (محللون)

2. Enhance the market efficiency by lowering the trading cost, free access to information, earning reward when investing in good stock and pay the price when investing in a bad stock.

تعزيز كفاءة السوق من خلال خفض تكلفة التداول ، وحرية الوصول إلى المعلومات ، وكسب المكافآت عند الاستثمار في الأسهم الجيدة ودفع الثمن عند الاستثمار في الأسهم السيئة.

4) Relationship between firm and society

- **Theory:** Social costs are trivial enough either that they can be ignored or that they can be priced and charged to the firm.

النظرية: التكاليف الاجتماعية تافهة بما فيه الكفاية بحيث يمكن تجاهلها أو يمكن تسعيرها وتحملها على الشركة.

- **Reality:** Social costs could be considerable but can not be traced to the firm. There is an ethical and moral dilemma; maximizing firm value vs. broader interest of society.

الحقيقة: قد تكون التكاليف الاجتماعية كبيرة ولكن لا يمكن إرجاعها إلى الشركة. هناك معضلة أخلاقية ومعنوية. تعظيم قيمة الشركة مقابل المصلحة الأوسع للمجتمع.

- **Consequences:** Society pays a high price while socially irresponsible firms maximize their wealth.

العواقب: يدفع المجتمع ثمناً باهظاً بينما الشركات غير المسؤولة اجتماعياً تزيد ثروتها .

- **Remedies:** الحلول

1. **Make it an economic interest to the firm to be a good citizen .**

اجعل من المصلحة الاقتصادية للشركة أن تكون مواطناً صالحاً .

2. **Laws .** القوانين

3. **Customer boycotting the products of firms that are not acting socially well .**

مقاطعة العميل لمنتجات الشركات التي لا تعمل اجتماعياً بشكل جيد .

4. **Investors boycotting the stocks/bonds of firms that are not acting socially well.**

مقاطعة المستثمرين لأسهم / سندات الشركات التي لا تعمل اجتماعياً بشكل جيد .

THE END ❤️

Problems and solutions chapter 2

1) Annual Meeting: Stockholders may not show up at annual meetings or be provided with enough information to have effective oversight over incumbent management. In addition, the corporate charter is often tilted to provide incumbent managers with the advantage, if there is a contest at the annual meeting. **Board of Directors:** Directors are often chosen by the incumbent managers (rather than by stockholders), own few shares and lack the expertise/information to ask tough questions of incumbent managers.

2) (A) An increase in dividends: Make existing debt riskier and reduce its value. Bondholders can protect themselves by constraining dividend policy.

(b) A leveraged buyout: If the existing debt is not refinanced at the “new” interest rate, existing bondholders will find the value of their holdings are lower after the LBO. Bondholders can protect themselves by inserting protective puts into their debt, allowing them to put the bonds back to the firm and receive face value. **(c) Acquiring a risky business:** If a risky business is acquired, existing bondholders may find themselves worse off since the underlying debt is now riskier. Bondholders can protect themselves by restricting investment policy.

5) This strategy is likely to work if higher market share leads to higher profits and cash flows in the long term. If, on the other hand, the higher market share is obtained by cutting prices and sacrificing long-term profitability, the strategy is unlikely to work.

- 7)** The ability to obtain equity capital without having to give up voting rights reduces the danger for managers that they will be called to account for bad actions. Obviously this means that shareholders cannot effectively fulfill their roles as monitors of managers.
- 10)** If the bank's stake in the firm as a lender is more important, then it might use its voting power as a stockholder to ensure that the firm does not take risky projects even if the NPV of these projects is positive. The bank might also push the company to grow through value decreasing methods, so that the assets available for it as collateral increase.
- 13)** The idea is that bond holders by converting their bonds into equity would be able to participate in the upside potential if stockholders attempt to increase the riskiness of the firm. This would decrease the incentive for stockholders to expropriate wealth from bondholders in this fashion.
- 14)** The problem is not entirely resolved by the passage of such legislation because it has to be enforced, and enforcement of laws is not costless. Furthermore, not all social costs are easily observable (at least at the time that they are created) and by the time they are, it may be too late.

Format

- 1) The objective in corporate finance is to maximize firm value. In practice, this is often narrowed down to maximizing the stock prices, for publicly traded firms. For the two objectives to be equivalent, which of the following assumptions do you need to make?
- A. Bondholders/ Lenders interests are fully protected .
 - B. Financial markets are efficient and rational .
 - C. Information about the firm is provided both timely and unbiased .
 - D. All of the above .
 - E. None of the above .
- 2) In publicly traded firms, the managers are “hired” and “fired” by stockholders and one of the mechanisms used to exercise this control is the annual meeting. Stockholders who are unable to go to the annual meeting can vote by “proxy”, but many of them don’t exercise that right. Barring a change in the corporate charter, what happens to these “unvoted” proxies at most US companies?
- A. They are not counted as votes at the annual meeting.
 - B. They are counted as votes against management at the annual meeting
 - C. They are counted as votes for the management at the annual meeting .
 - D. They are split evenly for and against management at the annual meeting .
 - E. None of the above .
- 3) In most publicly traded firms, institutional investors (mutual funds and pension funds) hold a significant proportion of the stock. Which of the following statements best characterizes how “most” of these investors behave ?
- a. They are long term investors who take an active role in how the company is run, pushing managers to put stockholder interests first.
 - b. They tend to go along with incumbent managers and if they are unhappy with a company’s direction, they sell their shares.

4) Which of the following is the primary mission of a board of directors in a publicly traded firm?

- a. To provide advice and counsel to the top managers of the firm.
- b. To protect incumbent managers from stockholder pressures and defend them against criticism .
- c. To ensure that top managers are acting in the best interests of the stockholders .
- d. To protect society's best interests.
- e. None of the above.

5) When stockholders have little power over managers, managers put their interests over stockholder interests. Which of the following is a clear example of managerial interests being put ahead of stockholder interests?

- a. Borrow large amounts to fund a firm's operations.
- b. Don't pay dividends .
- c. Refuse to do acquisitions.
- d. Pay "greenmail" to a hostile acquirer.
- e. Push stockholders to add anti-takeover amendments to the corporate charter.

good attempt ❤️

Quizzes

- 1) An activist investor manages to get three of his nominees elected to the board of directors at the expense of management nominees. This leads to
 - A. Management Power increases.
 - B. **Stockholder Power increases.**
 - C. No Effect.

- 2) The state passes a law restricting hostile takeovers. This leads to
 - A. **Management Power increases**
 - B. No effect
 - C. Stockholder Power increase

- 3) Poorly managed firms with stock that has under performed the competition are more likely to be targets of hostile acquisitions than well-managed firms.
 - A. **True**
 - B. False

- 4) Boards with more insiders are generally more effective at corporate governance than boards with fewer insiders.
 - A. True
 - B. **False**

- 5) Most decisions made by corporations create costs to society. Which of the following is the most efficient way to reduce these social costs? (Efficiency implies that the costs created for the non-guilty are minimized.)
 - A. Make it illegal to create social costs.
 - B. **Convince customers to stop buying the firm's products and investors to sell it's stock.**
 - C. Make managers take ethics classes.
 - D. Sue companies that create costs for society.

- 6) Which of the following is a clear and unambiguous example of managers putting their interests over stockholder interests? (Pick only one)
- A. **Paying greenmail to a bidder to avoid being taken over (in a hostile bid).**
 - B. Negotiating for a large compensation contract .
 - C. Acquiring another company.
 - D. Paying a large dividend.
 - E. Focusing on increasing the market share of the company.
- 7) Financial markets tend to react negatively to investment **announcements** (R&D, new project) made by firms.
- A. True.
 - B. **False.**
- 8) The stock prices of companies often jump when they report their earnings. In an efficient market, you would expect stock prices to increase when companies report an increase in earnings and to drop when they report lower earnings.
- A. **False.**
 - B. True.
- 9) If you were a bondholder lending to a firm and you were worried that stockholders would take advantage of you, which of the following actions would concern you the most? (Pick only one)
- A. **Expansion into a risky new business**
 - B. A reduction in debt
 - C. Accumulation of cash in the company
 - D. A cut in the dividends paid to stockholders.
 - E. A new stock issue.

- 10) If we choose firm value maximization as our objective in decision making, we do not need to assume that markets are efficient.
- A. **True.**
 - B. False.
- 11) Which of the following objectives makes the most sense in an inefficient market where lenders are not fully protected from stockholder expropriation?
- A. **Maximize firm value.**
 - B. bondholder wealth.
 - C. Maximize stock prices.
 - D. Maximize stockholder wealth.
- 12) The firm decides to expand its board of directors from 11 members to 22 members and allows the CEO to pick the additional directors. This action will leads to
- A. Stockholder Power increases.
 - B. **Management Power increases.**
 - C. No Effect.
- 13) A closely held firm (insiders hold 40% of the 100,000 shares) issues 500,000 new nonvoting shares to the public to raise fresh capital. This leads to
- A. Stockholder Power increases
 - B. **No Effect**
 - C. Management Power increases

14) The firm decides to expand its board of directors from 11 members to 22 members and allows the CEO to pick the additional directors.

- A. Stockholder Power increases.
- B. **Management Power increases.**
- C. No Effect.

15) An activist investor manages to get three of his nominees elected to the board of directors at the expense of management nominees.

- A. Stockholder Power increases.
- B. Management Power increases.
- C. No Effect.

16) The state passes a law restricting hostile takeovers.

- A. Stockholder Power increases.
- B. **Management Power increases.**
- C. No Effect.

17) Three inside directors on the board are replaced with outside directors, chosen by the CEO.

- A. Stockholder Power increases.
- B. Management Power increases.
- C. **No Effect.**

18) A lender to the firm (a bank) is given a large equity position in the firm to compensate for missed interest payments.

- A. Stockholder Power increases.
- B. Management Power increases.
- C. No Effect.

19) The CEO of another firm in the same industry is replaced because of poor stock price and earnings performance.

- A. **Stockholder Power increases.**
- B. Management Power increases.
- C. No Effect.

20) CalPers, the California Employees Pension fund with a history of activism, buys 5% of the outstanding stock in the firm.

- A. Stockholder Power increases.
- B. **Management Power increases.**
- C. No Effect.

21) The firm's stock, which is currently followed by no analysts, is added to the list of followed companies at four investment banks.

- A. **Stockholder Power increases.**
- B. Management Power increases.
- C. No Effect.

22) The corporate charter is changed so that only one-third of the board of directors gets replaced each year, instead of the entire board.

- D. Stockholder Power increases.
- E. **Management Power increases.**
- F. No Effect.

23) The CEO exercises her right to convert 10 million options she was granted as part of compensation packages in prior years.

- A. Stockholder Power increases.
- B. **Management Power increases.**
- C. No Effect.

24) Boards with fewer directors are generally more effective at corporate governance than boards with more directors.

a) **True**

b) False

25) Boards with more insiders are generally more effective at corporate governance than boards with fewer insiders.

a. True

b. **False**

26) The marginal investor in a stock is the investor who holds the most stock in the company

a. True

b. **False**

good luck ❤️