Corporate Finance

Lecture 10: Separation of Ownership from Control and Problems of Agency

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Today's Lecture

- Separation of ownership and control and its problems
- Partial solutions and capital structure
- Agency problems and executive compensation

Separation of Ownership and Control

- Corporations controlled by managers, owners of (at most) small participations
- Managers care about…
  - Investors (equity and debt holders)
  - Customers and suppliers
  - Employees
  - Themselves!
- Sometimes there might be a conflict of interests
- (Anecdotal) evidence:
  - Sometimes departure (e.g due to retirement) of a manager increases stock price
  - Investors believe that a new CEO may be more willing to make tough (but value enhancing) decisions

Why Shareholders Can't Control Managers?

- Given that managers have low levels of ownership:
  - Median of 0.25% in the Forbes compensation survey (Jensen and Murphy, 1990)

- However, shareholders may be dispersed
- Private costs of disciplining managers and shared benefits (free-rider problem!)
- *Proxy fight*: organising of shareholders to oust board of directors

Why ownership is dispersed?

- CAPM suggests that shareholders should hold diversified ownerships
- Therefore there is a cost of holding a significant share in a given company

- However, there are also benefits:
  - Monitor the management (shared)
  - Expropriation of minority shareholders (private)
- Many firms have a large individual shareholder or institution (Morck et al. 1988 and Demsetz and Lehn 1985)

(One) Role of Financial Institutions

- Mutual funds can…
  - Pool money from individual investors
  - Invest a significant amount in each company while being diversified
- Therefore, they are more able to monitor
- Until recently, US financial institutions (unlike others) could not play this role
- Pension funds also play an increasingly important role

Managerial Ownership

- Sometimes managers own a large part (e.g. Bill Gates in Microsoft)
- Reasons:
  - Taxes
  - Sale communicates bad news
  - Lower extent of agency conflict (largest shares in industries with higher incentives problems, e.g Media)
- When going public, higher prices if larger stake is retained (Downes and Heinkel 82)
- Higher management ownership increases firm value up until a point, e.g. 5% (Morck et al. 88)

Specific Distortions

- Significant benefits from controlling a large corporation
- Investments choices to remain in the job…
  - Investments fitting manager's expertise ("entrenchment") (Shleifer and Vishny 89)
  - Investing in projects that pay off early
  - Investing in order to reduce risk
  - Investing in order to increase the size of the firm ("empire building")

Partial Solutions

- Higher levels of debt may increase risk of bankruptcy and limit manager discretion
- Managers have incentives to have lower-than-optimal debt ratios
- Outside shareholders may force firms to take on more debt
- Mehran (1992): firms are more leveraged when
  - Their managers (and those who monitored them) have strong interests on stock market price

Executive Compensation

- Owner-manager can be viewed as a principal-agent relation:
  - Principal hires an agent to take actions on her behalf
  - Actions cannot be observed by the principal, and value-enhancing actions are costly for the agent
  - To induce effort by the agent, the principal offers a contract tied to payment of the principal
  - Not completely tied because this involves too much risk for the agent, better borne by the principal

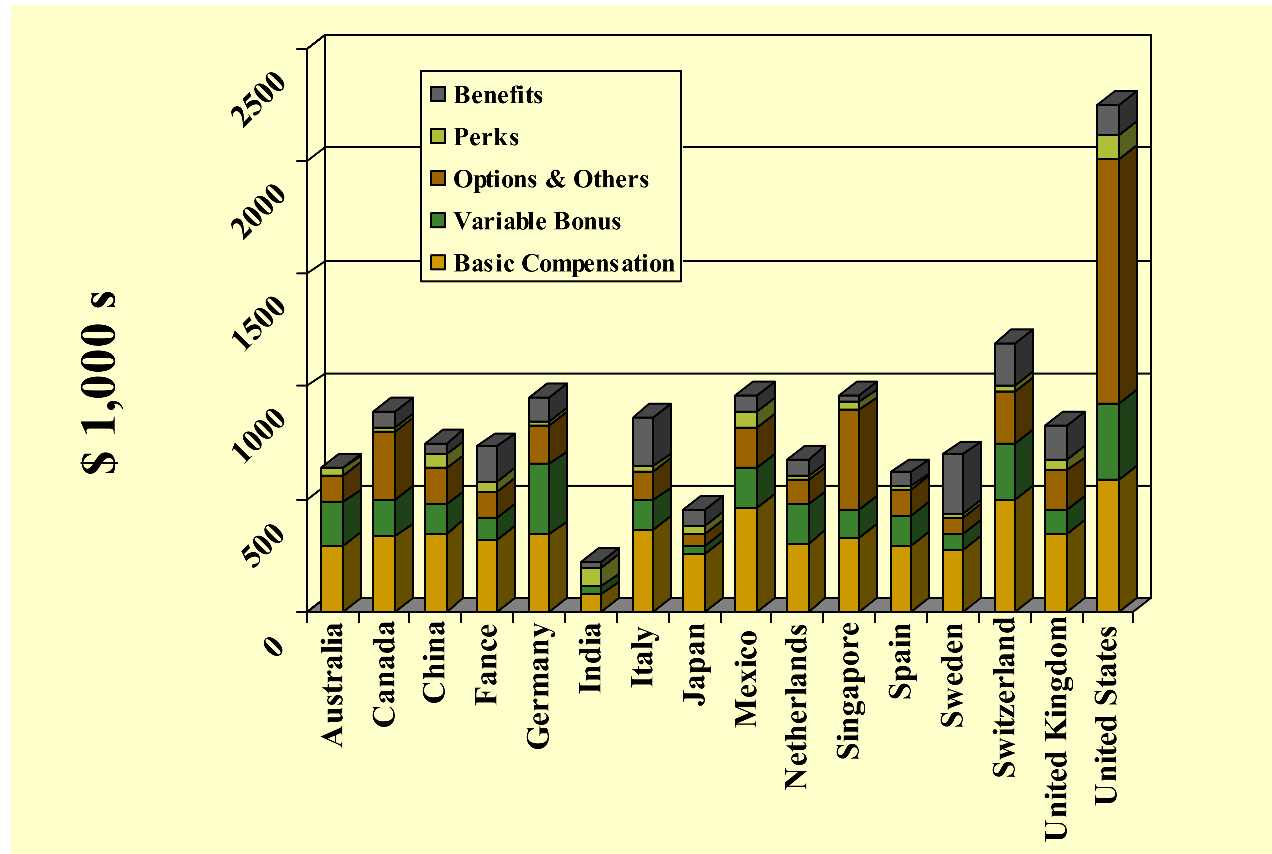
Monitoring

- If the principal could observe the actions, the problem will be lessened
- For example, she could…
  - Measure the input: monitor the agent to ensure that she exerts effort
  - Measure the output: indirectly measure the agent's effort by observing the output
- By relying on the second the firm…
  - Can better describe good and bad performance
  - Can specify it in a contract

Evidence

- High level of pay-per-performance and increasing over time (Hall and Liebman 1998)
- But also dependant on the industry, e.g. more in media and less in regulated utilities (Murphy, 1999)
- Firms perform better if pay-per-performance is higher (Tehranian and Waegelein 1985)
- Some small evidence of relative performance (Murphy 1999)

CEO Compensation 2003-04



Performance-Based Contracts

- Stock-based compensation contracts:
  - Advantage: motivates to increase stock price
  - Disadvantage: exogenous uncertainty
- Earnings-based compensation contracts:
  - Advantage: available also for non-traded companies
  - Disadvantages: easy to manipulate and includes noise
- Value-based management:
  - Used by consultants to transform accounting cash flows into economic cash flows