



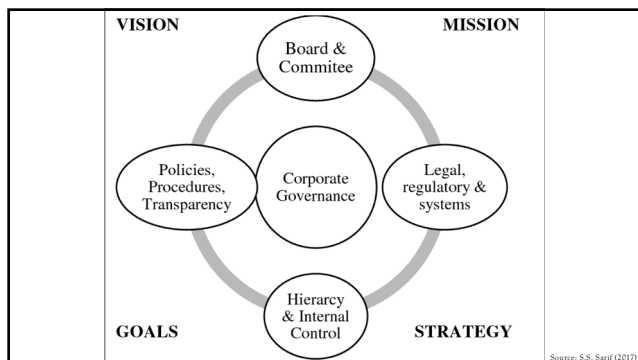
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What is corporate governance?

Relationship among stakeholders, used to determine and control strategic direction of firm

Used in corporations to establish order between owners and managers

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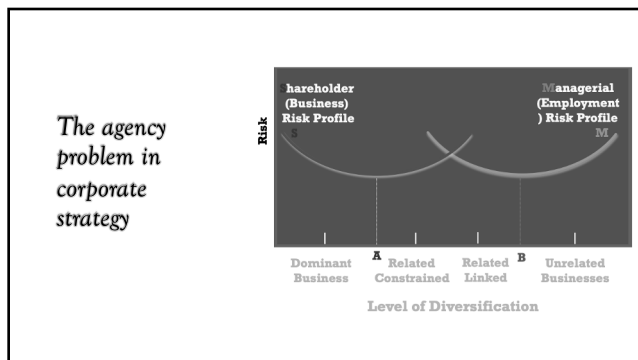


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The agency problem

- ◆ An agency relationship exists when the owner and manager (principal and agent) are different entities
- ◆ Principal hires agent for expertise, decision making, running the business
- ◆ Who carries the risk?
- ◆ The agency problem exists when objectives of principal and agent conflict and it is difficult/expensive for principal to verify that agent has behaved appropriately
- ◆ Typical case: overdiversification leads to lower management employment risk and greater compensation

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Agency costs: incurred when using governance mechanisms

- ▶ Incentive
- ☑ Monitoring
- 🤝 Enforcement
- 📈 Individual financial losses

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Outcomes of corporate governance

Governance is concerned with finding ways to ensure that strategic decisions are made effectively

Managerial interests prevail when governance mechanisms are weak

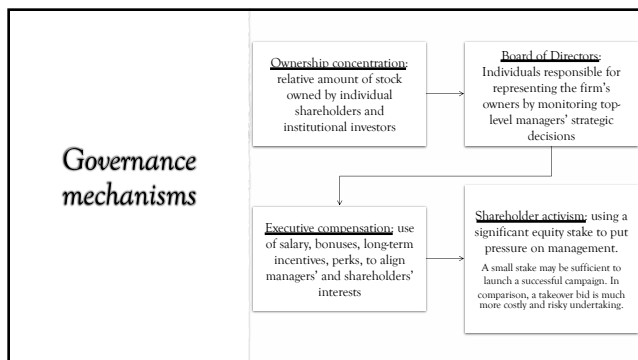
If board of directors controls managerial autonomy or other strong mechanisms are used, firm strategy should better reflect shareholder interests

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What data is important?

- Identify owners and managers (is there overlap)
- What is the ownership structure?
- What types of shareholders? (individual, institutional)
- What are the major holdings? (votes, power, etc.)
- What type of equity accounts? (common stock, preferred stock, etc.)

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Ownership concentration

- ◆ Number of large-block shareholders and the total percentage of shares they own (>5% file a report with SEC)
- ◆ Large shareholders are active in demanding effective corporate governance
- ◆ Diffuse ownership (many shareholders with small holdings) produces weak monitoring of managers' decisions
- ◆ Institutional owners: mutual funds, pension funds, etc., more likely to engage in shareholder activism

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Board of directors

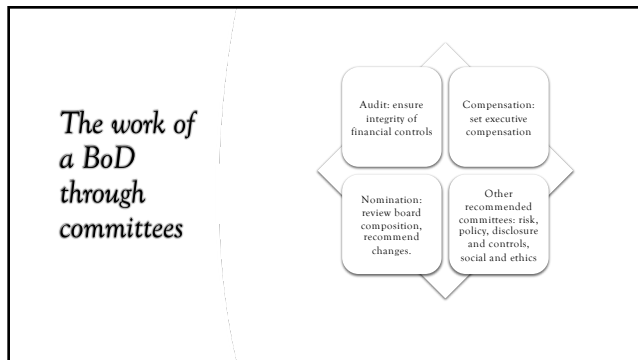
- Formally monitor and control the firm's top-level executives
- Hire, fire, and set compensation of CEO
- May lack contact with day-to-day operations

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Types of board members

- Insiders**
a firm's CEO and other top-level managers
- Related outsiders**
individuals not involved with a firm's day-to-day operations, but who have a relationship with the company
- Outsiders**
independent of a firm's day-to-day operations and other relationships

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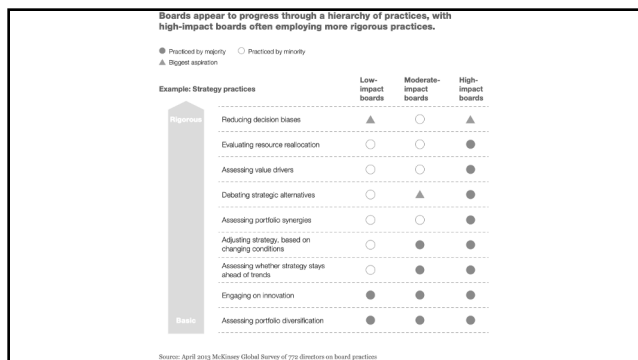


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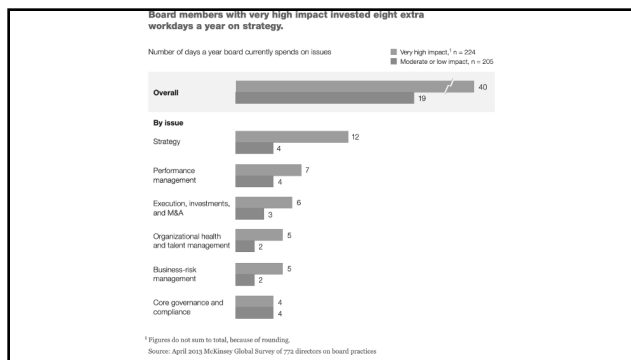
Board of directors

HOW DO YOU BUILD AND WORK WITH A BOARD? HIGH PERFORMING BOARDS: WHAT'S ON THEIR AGENDA? (BHAGAT & KEHOE, 2014, MCKINSEY)

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Executive compensation

| Definition | Objectives |
|--|---|
| <ul style="list-style-type: none"> Executive pay is a governance mechanism composed of financial compensation and non-financial awards received by an executive It is designed to align the interests of managers and owners | <ul style="list-style-type: none"> Attract skilled and experienced executives Retain them to fulfill the goal of their employment Motivate them to perform optimally |

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Components of Executive compensation

- Salaries
- Annual bonuses
- Long-term incentives
- Supplemental benefits
- Perquisites

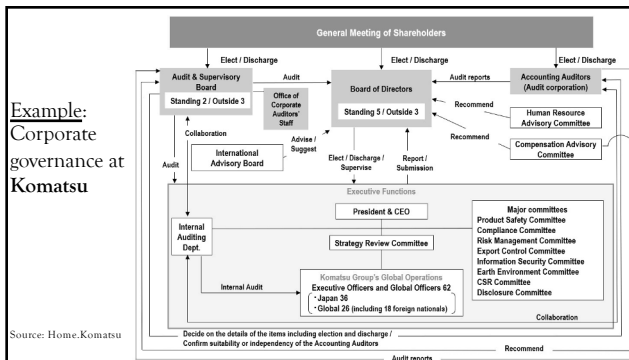
Stock options: a mechanism which links the executive's performance with that of the company

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Management defense tactics

- ◆ Objective: increase the costs of mounting a takeover
- ◆ Outcome: entrench current management
- ◆ Golden parachute raises the cost of making changes at a take-over target due to the need to pay fired executives large severance packages
- ◆ Greenmail company money is used to repurchase stock from a corporate raider, to avoid takeover
- ◆ Poison pill takeover target does something to make itself unpalatable to a suitor (e.g., assume large debt and issue dividends with the money)

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What is an activist investor

- ◆ Investor that buys significant share in public company (individual, group)
- ◆ Aims to influence how company is run
- ◆ Will use seats on BoD as leverage
- ◆ Typical targets for shareholder activists:
 - ◆ Mismanagement (i.e., management does not fulfill interests of owners, agency issues)
 - ◆ Excessive costs, operational issues (business level)
 - ◆ No parenting advantage (corporate level)
 - ◆ Value to shareholders not maximized (e.g., large cash pile but no dividends/share buybacks)

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What is a proxy fight?

- ◆ One or a group of shareholders join forces/voices to affect change in a corporation, via corporate governance mechanisms.
- ◆ Proxy contest is a campaign to solicit votes (proxies) in opposition to management or other board members.
- ◆ Proxy votes allow dissatisfied shareholders to gain critical voting mass.
- ◆ Typical outcomes: changes of board composition or management.
- ◆ SEC regulates the solicitation of proxies.

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Dealing with activist investors

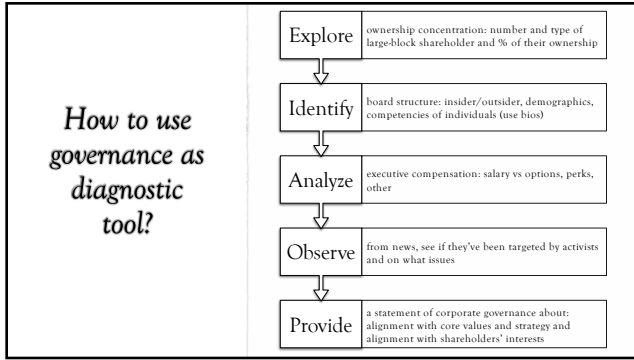


Watch video at McKinsey

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How should firms align core values with corporate governance?

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