Chapter 18: Managerial inducements

This chapter focuses on two elements. The first one is to deliver a more realistic picture of how financial decisions are made by organizations, taking into account the potential inducement problems that can exist between managers and shareholders. The second element is to re-examine how financial decisions should be made in this more realistic setting, accounting for inherent manager-shareholder conflicts.

Many huge companies are successfully controlled by managers, who hold a small amount of shares in the company. There is a separation of control and ownership in large corporations. This causes problems, because the interests of managers are usually not aligned with those of shareholders. Shareholders want to maximize the value of their shares, while managers must trade off the interest of customers, shareholders and debt holders.

External shareholders normally cannot force managers to maximize share prices, because their ownership is too small. The *free-rider problem* arises because it is not in the interest of any individual shareholder to take action that discipline in a non-value-maximizing manager. Shareholders who want to challenge the policies of management must stage *proxy fights*, which require organizing shareholders to oust the incumbent board of directors by electing a new board that supports an alternative policy. Proxy fights are very expensive and outsiders who attempt to organize outside shareholders to vote against incumbent management usually don't win them.

The Capital Asset Pricing Model (CAPM) holds that all shareholders hold the same market portfolio, entailing that a shareholder's equity in any individual organization must be very small. A shareholder who wishes to acquire enough shares to control management would usually have hold an undiversified portfolio. Organizations with concentrated ownership probably be improved manages. However, shareholders who take large equity stakes may be inadequately diversified. All shareholders benefit from improved management; however the costs of having a less diversified portfolio are borne only to the large shareholders. Because of the costs of bearing firm-specific risk, ownership is likely to be less concentrated than it would be if management efficiency were the only considerations.

For a number of reasons, we believe that the corporate bonds of directors are becoming more effective monitors of management. First, corporate bonds are smaller, and the percentage of directors who are not directly affiliated with the company has raised. In addition, board members are receiving an increasingly higher percentage of their compensation in the form of stock and stock options, which aligns their interests with those of shareholders.

Despite the diversification motive holded by portfolio theory, the ownership of shares in many corporation is actually quite concentrated. Many of the large shareholders are the company's founders. Holding a large number of shares tells the shareholders that the entrepreneur is confident about the organization's prospects and that he or she plans on implementing a strategy that maximises the value of the company's shares. Entrepreneurs may get a higher price for their shares if they commit to holding a larger fraction of the organization's outstanding shares.

The entrepreneur's inducements to hold shares is higher for those organizations with the largest inducements to "consume on the job". The inducement to hold shares is also related to risk aversion.

Closed-end mutual funds are publicly traded mutual funds with a fixed number of shares that can be bought and sold on the open market.

Open-end mutual funds are mutual funds that are being bought and redeemed directly from the fund at their net asset values.

The ratio of the share price of the closed-end mutual fund to the net asset value per share of the portfolio it holds provides an excellent measure of the value created by the fund's managers, since the net asset value of the fund provides an excellent measure of the market value that could be achieved without the manager.

Analyzing the separation between ownership and control of corporations provides an insight into how an organization makes investment decisions.

Managers may favour investments that improve their own human capital and minimise risk:

1. Managers may favour large, more diversified organizations;
2. Managers may favour investment that pay off more quickly than those that would maximise the value of their shares.

Large outside shareholders, knowing that managers have a tendency to skew decisions that benefit them personally, have an inducement to reduce management's discretion. Allowing management discretion has benefits as well as costs:

- The benefits of discretion are greater in uncertain environments;
- The costs of discretion are greater when the interests of managers and shareholders do not coincide.

Therefore, we might expect to find more concentrated ownership and more managerial discretion in organizations facing more uncertain environments.

Extra debt may prevent a manager from expanding the organization more quickly than would be optimal. Higher debt ratios also raise the risk of bankruptcy. Therefore, raised debt can persuade management to avoid policies they might personally favour but which reduce organization value. The shareholders of an organization that is run by "self- interested" management may favour a higher leverage ratio than one would find in organizations that are managed in the shareholder's interest. As a result, forms that are more strongly influenced by shareholders, have higher leverage ratios.

A large debt obligation restricts the abilities of management to use corporate resources in ways that do not benefit resources. Debt of an organization is a determinant of how much the organization will invest in the future and it can be used to move the organization toward investing the appropriate amount. Normally, capital structure cannot by itself persuade managers to invest optimally.

Bank debt is preferred over public bonds since it is possible for the organization to reduce the free-rider and information problems if it is dealing with one banker instead of a large number of bondholders. Another benefit of borrowing through a commercial bank arises for organizations with proprietary information.

Suppliers of private equity may deliver monitoring services that are the same as those banks deliver. There are three reasons for this:

1. They usually take substantial equity stakes in the businesses that they invest in;
2. Their shares cannot be sold as easily, giving the private shareholders a greater stake in the long-term profitability of the organizations they invest in;
3. They have personnel with the kind of expertise that can help the organizations in which they invest create value for their shareholders.

The relationship between owners and management is called a principal-agent relationship, stockholders are the principals and management are the agents hired by the principals to take actions on their behalf. To solve the agency problem we can compensate agents in order to motivate them to behave on our behalf.

Agency costs is the difference between the value of an actual organization and the value of a hypothetical organization which would exist in a more perfect world where management and shareholder inducements are perfectly aligned. Agency problems arise because of imperfect information and risk aversion. Agency costs thus can be reduced by improving the flow of information and by reducing risk. To minimise the risk borne by managers, optimal compensation contracts should remove as much extraneous risk as possible. To minimise the risk borne by managers, optimal compensation contracts should remove as much extraneous risk as possible.

Relative performance contracts are contracts that reward managers for performing improved in relation to the market or the industry. The advantage of relative performance contracts is that the contracts take away the effect of some of the risks that a manager cannot help. The disadvantage of these contracts is that the contracts may cause forms to compete too aggressively, which would reduce industry profits.

There are two types of performance-based compensation contracts: *stock based compensation contracts*, which are executive stock options and other contracts that provide an executive with a payoff tied directly to the organization's share price, and *earnings or cash flow compensated contracts,* which is based on non market variables like earnings.

1. *Stock based compensation* motivates to higher the stock prices, but stock prices change for reasons that a manager cannot help.

2. *Earnings based compensation* has the advantage of compensating managers on the basis of earnings and cash flows, the numbers are usually available for the individual business unit of an organization as well as for non traded companies that cannot easily base compensation on an observable stock price. However, it is hard to compute the cash flow that would be appropriate for the use of evaluating performance.

Value based management methods turn accounting cash flows into economic cash flows so that they more accurately measure the economic cash flows that are most useful in compensating managers.

A cash flow-based compensation plan that appropriately adjusts for capital costs may provide the best method for motivating managers in these cases.

Spin off is transforming a division into a new company by distributing shares of the new company to the organizations existing shareholders;

Carve out a division is making it an independent operating organization.

Announcements of spin offs and carve outs usually lead to a favourable reaction in stock prices. Improved management inducements provide one motivation for corporate spin-offs and divestures.

Divestures of corporate divisions –achieved via spin offs carve outs or direct sales to a third party- are the opposite of mergers, which combine separate organizations into a single entity. Conglomerate mergers may weaken the inducements of executives at the various divisions.