ECON 4245 Corporate Governance

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Seminars: Matteo Alpino, office ES 1033, matteo.alpino@econ.uio.no

13 lectures; 8 seminars

Lecture slides available before each lecture at:
http://www.uio.no/studier/emner/sv/oekonomi/ECON4245/h16/

Seminar topics – tentative plan

1. Introduction. Fixed-investment model.
2. More fixed-investment model. Variable-investment model.
3. Liquidity management.
4. Asymmetric information. Financing multiple projects.
5. More liquidity management.
6. Monitoring.
7. More monitoring.
8. Miscellaneous.

Contact student?

ECON4245 – Corporate Governance – Fall 2016

Department of Economics, University of Oslo

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Textbook: Tirole, *The Theory of Corporate Finance.* Princeton University Press, 2006.

Lectures: Tuesdays 08:15-10:00, ES Aud 4.
Seminars: Thursdays 16:15-18:00, HH 201.

Lecture dates: Lectures start on 23 Aug. There is no lecture on Tuesday 30 Aug. The lecture on Tuesday 27 Sep is in GS Aud 2.
[This plan is subject to change. Any changes will be announced on the website of the course.]

Seminar dates: 15 Sep; 29 Sep; 13 Oct; 27 Oct; 3 Nov; 10 Nov; 17 Nov; and 24 Nov.

Exam: Thursday 1 Dec at 14:30-17:30.

Lecture plan

Theme 1. Introduction to corporate governance. Tirole, chs 1-2. [Lecture 1]

Theme 2. Outside financing capacity. Tirole, ch 3, incl supplement. [Lecture 2]

Theme 3. Determinants of borrowing capacity. Tirole, ch 4, incl supplement. [Lectures 3-4]

Theme 4. Multi-stage financing: liquidity management. Free cash flow. Tirole, ch 5. [Lectures 5-6]

Theme 5. Asymmetric information. Tirole, ch 6. [Lecture 7]

Theme 6. Product markets. Earnings manipulations. Career concerns. Risk taking. Tirole, ch 7. [Lecture 8]

Theme 7. Monitoring. Investor activism. Tirole, chs 8-9. [Lectures 9-10]

Theme 8. Control rights. Corporate governance. Takeovers. Tirole, chs 10-11. [Lectures 11-12]

Theme 9. Summary of the course. [Lecture 13]

Course topic: **the firm**

- The firm has relationships with
    - Investors
    - Creditors
    - Suppliers
    - Employees (managers)
    - [customers, government, …]

- Applying *economics* to understand these relationships
    - The economics of information
    - Contract theory
    - Three essential informational problems
        - Hidden action
        - Hidden information
        - Non-verifiable information

- At the centre stage: the firm/investor relationship
    - How are firms managed?
    - How are firms financed?
    - How do informational problems affect these questions?

Textbook: Jean Tirole, *The Theory of Corporate Finance*

- A unified treatment of the topic
- Building on a simple model
  - Hidden action (moral hazard)
- Required reading: chapters 1 through 11, including supplementary sections (unless noted otherwise).

Overview

- Basics: one-stage financing – fixed and variable investment models. Applications.
- Multistage financing: liquidity management
- Financing under asymmetric information.
- Exit and voice in corporate governance.
- Control rights.

(in the book, but not in the course:
macroeconomic implications of corporate governance;
political economy of corporate governance)

Corporate governance

- How *suppliers of finance* to a firm make sure they get returns on their investments.
    - Investors
    - Creditors
- How *corporate insiders* can credibly commit to returning funds to outside investors, thus attracting external finance
    - Insiders: management; current owners
- A narrow definition
    - Stakeholders vs shareholders
        - Employees, customers, suppliers, communities
    - *Case*: Supply ship owners in Herøy.
        - *Dagens Næringsliv* 18 Aug 2016

The separation of ownership and control

- Berle and Means, *The Modern Corporation and Private Property* (1932).
    - Shareholder dispersion – managerial discretion
- Corporate insiders may not act in the interest of the providers of funds.
- How to deal with this problem?
    - Incentives
    - Monitoring

Hvis rederiene forsvinner blir det trist og mørkt her ute

Offshorereder Stig Remøy frykter Sunnmøres maritime klynge kan bli ødelagt av oppkjøp. Han mener Kjell Inge Røkke-eide Akers overtagelse av Rem Offshore var et varsko.

OLJESERVICE

Rune Ytreberg og Jacob Schultz
Fosnavåg/Oslo

De ruvende offshorebåtene ligger i opplag langs kaiene i Ålesund, hagene ved Fiskarstrand og verftene i Ulsteinvik. I hjertet av den maritime klyngen på Sunnmøre ligger nye og dyre båter uten oppdrag. For hver båt er 40 sjøfolk uten jobb.

– Sjøfolkene er veldig urolige, de frykter konsekvensene av restrukturering av flåten, og hva som blir igjen av den norske sjømann, sier ordfører Arnulf Goksøyr (H) i offshorekommunen Herøy.

Kommunen med 8000 innbyggere har 550 sjøfolk, og regionsenteret Fosnavåg er hjem for de fire offshorerederiene Rem Offshore, Havila Shipping, Olympic Shipping og franskeide Bourbon Offshore.

Krisen har rammet hardt, og næringen sliter med dårligere dagrater selv om mange båter er lagt i opplag.

– Vi har tre store rederier som kjemper for livet, sier Goksøyr.

Han sier at arbeidsledigheten i kommunen har steget til 5,4 prosent.

«Tvangsekteskap»

Det Kjell Inge Røkke-kontrollerte Aker-konsernet har inntatt førersetet i å konsolidere offshorebransjen, og bruker det Skudeneshavn-baserte rederiet Solstad Offshore som sitt verktøy, etter å ha gått inn som aksjonær og støttespiller. Aker blokkerte en foreslått refinansiering av Rem Offshore etter å ha kjøpt seg inn i et av selskapets obligasjonslån, og Rem fusjonerte deretter med Solstad Offshore i det Rem-hovedeier Åge Remøy (66) beskrev som «et tvangsekteskap» etter et «bakholdsangrep».

– Dette er en viktig start på konsolideringen i offshorebransjen. Men mulighetene og behovet for videre konsolidering i sektoren er fortsatt stort. Aker ønsker å være en leder i denne prosessen, sa Aker-sjef Øyvind Eriksen da.

Åge Remøy stilte krav om at supplybåtene skal styres fra Fosnavåg slik at en beholder arbeidsplassene der.

Nedenfor rådhuset i Fosnavåg ligger kontoret til Olympic Shipping, som har tre skip i opplag. Både ordføreren og reder Stig Remøy i Olympic frykter at oppkjøp av lokale rederier kan true lokalt eierskap og hele den maritime klyngen på Sunnmøre.

– Hvis rederiene forsvinner blir det trist og mørkt her ute. Konsolidering vil påvirke mange arbeidsplasser. For det maritime clusteret på Sunnmøre er det helt avgjørende at rederiene blir her, sier Remøy.

Stig Remøy (57) er Åge Remøys (66) lillebror.

2016 DN grafikk/GeoAtlas

Olympic Shipping

- Offshorerederi i Fosnavåg med 23 skip, der tre er lagt i opplag.
- Gjeld på 4,9 milliarder kroner, samt et obligasjonslån på 800 millioner kroner som forfaller i september 2017.
- Stig Remøy er daglig leder, styreleder og hovedeier i selskapet.

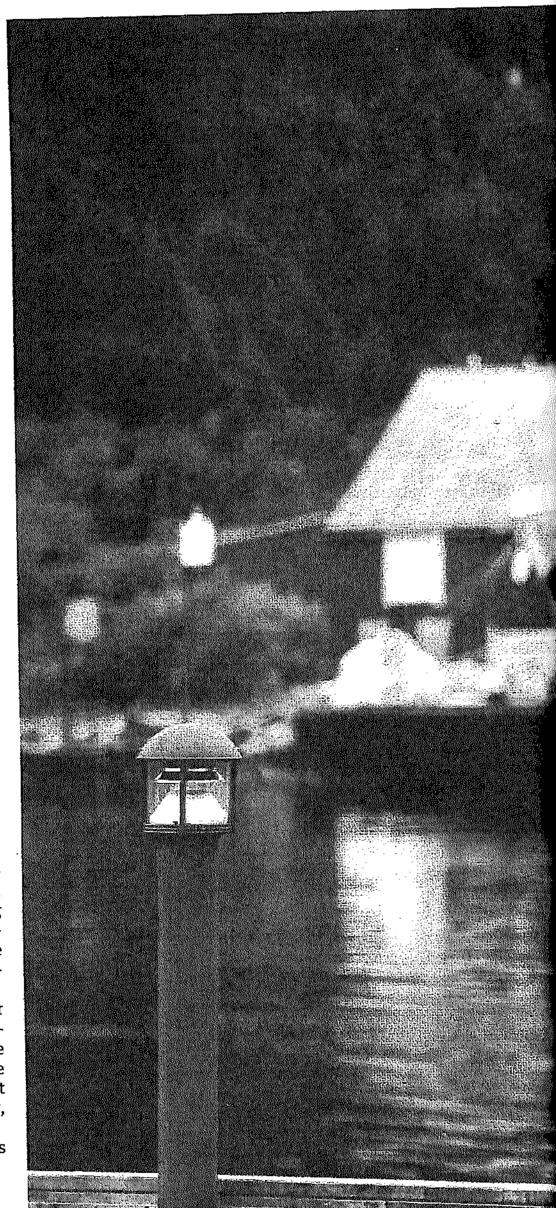
Internasjonal interesse

Også de London-baserte investorene og milliardærene Kristian Siem og John Fredriksen har signalisert interesse for å bidra til konsolidering og restrukturering av bransjen.

Remøy tror det er «veldig sannsynlig» at det blir færre rederier fremover.

– Alle rederiene har for mye gjeld med dagens utfordrende marked. Det er ikke mulig å betale avdrag som normalt. En nedbetalingsplan for bankgjeld på under ti år kunne håndteres ved å låne opp igjen på enkeltskip dersom verdiene tillot dette. Denne muligheten er borte nå og har skapt press på kapitalsituasjonen, sier Stig Remøy.

– Deler av selskapets verdi ligger i det lokale samarbeidet mellom rederier, verft og sjøfolk. Innovasjonskraften og denne kunnskapen kan forsvinne dersom oppkjøp er basert på å plukke billige skip fra bankene. Det er helt avgjørende for rederiene å kunne jobbe sammen med verft, leverandører og sjøfolk for å levere gode båter, sier Remøy, som mener det er behov for mer enn et rederi for å ta vare på konkurransen og innovasjonen i næringen.



Nei til Røkke

Også Olympic Shipping er tynget av gjeld og arbeider med refinansiering, men Remøy vil ikke la Røkke kjøpe selskapet.

– Røkkes fremgangsmåte med overtagelsen av Rem Offshore var et varsko. Akers modell passer ikke oss. Nå er Rem Offshore vekk, gone, for Sunnmøre. Det er en større tragedie for Sunnmøre at Sunnmøre mistet kontrollen over Rem Offshore, enn at vi tapte 100 millioner kroner på vår investering i Rem Offshore, sier Remøy.

Han mener Fredriksen kan være en god investor.

– Du skal ikke se bort ifra at John Fredriksen ser på Sunnmøre, sier Remøy, som håper det er mulig å bevare lokalt eierskap til offshorerederiene på Sunnmøre.

– Om det lages en bærekraftig modell håper jeg det er penger på Sunnmøre til det.

– Hvem har de pengene?

– Det vil vise seg, sier Remøy, som ikke vil navngi noen investorer.

Remøy presiserer at han ikke er mot investeringer og kapital utenfra, men tror det smarteste for investorer er å samarbeide med de lokale rederiene.

– De investorene som spiller på lag med den maritime klyngen på Sunnmøre vil få den beste avkastningen, sier Remøy.

Han går ned til kaia ved kontoret, slår ut med armen og peker på Fosnavågs nye svarte konserthus,

The moral-hazard problem

- *Moral hazard* is an awkward term but the one commonly used
    - No implication of immoral behavior
    - Behavioral risk; hidden action
- Owner/manager conflict
    - Manager does not always act in the interest of owners
- Insufficient effort
    - Insufficient internal control of subordinates
- Allocation of effort across tasks
    - Workforce reallocation, supplier switching
- Overinvestment
    - Pet projects, empire building, acquisitions
- Entrenchment
    - Managers making themselves indispensable
    - Manipulating performance measures
    - Being excessively conservative in good times, excessively risk-taking in bad times
    - Resisting takeovers
    - Lobbying against shareholder activism
- Self-dealing
    - Perks: private jets, big offices, etc.
    - Picking successor
    - Illegal activities: theft, insider trading, etc.

When corporate governance does not work

- Lack of transparency
  - Shareholders do not observe compensation details, such as perks and stock options

- Level of compensation
  - Tripling of average CEO compensation in the US 1980-1994, a further doubling until 2001.
  - Average CEO/worker income ratio in the US went from 42 in 1982 to 531 in 2000.
  - CEO/worker compensation ratio among top US firms was at 296 in 2013, according to the Economic Policy Institute.
  - Proponents argue this is a byproduct of more performance-based pay.
  - Norway: average CEO/worker compensation ratio at 10 in 2005
    - Smaller companies than the US ones
    - Report by Randøy and Skalpe (2007)

- Fuzzy links between performance and compensation
  - Bebchuk and Fried, *Pay without Performance* (2004).
  - Compensation in an oil company based on stock price, when management has little control over the oil price.
  - Golden parachutes when leaving.

- Accounting manipulations
  - The Enron scandal.
  - Manipulating stock price, and therefore compensation.
  - Hiding bad outcomes and therefore protecting against takeovers.

Managerial incentives

- Monetary incentives
    - Compensation
        - Salary: fixed
        - Bonus: based on accounting data
        - Stock-based incentives: based on stock-market data
    - Bonuses vs. stock-holdings
        - Bonuses provide incentives for short-term behavior
        - Shares provide incentives for long-term behavior
        - The two are complements, not substitutes
    - The compensation base
        - Relative performance
    - Shares vs. stock options
        - Stock options provide stronger incentives
        - … but do not perform well after a downturn (excessive risk, lack of credibility).
    - Too low managerial incentives in practice?
        - In the US in the 1980s, the average CEO kept 3‰ of shareholder wealth; later estimate: 2.5%.
        - But incentives are costly to owners, because of manager risk aversion.
    - folk.uio.no/toreni/NilssenOpsjoner.pdf

- Implicit incentives
    - Keeping the job
        - Firing or takeover following poor performance
        - Bankruptcy
    - Career concerns
    - Explicit vs implicit incentives
        - Substitutes: Strong implicit incentives lower the need for explicit incentives
        - … but this is difficult to trace empirically.

Managerial incentives, cont.

- Monitoring
  - Boards of directors
  - Auditors
  - Large shareholders
  - Large creditors
  - Stock brokers
  - Rating agencies
- Active monitoring
  - Interfering with management in order to increase the value of one's claims in the firm.
    - Linked to control rights
  - Forward looking
  - Examples
    - large shareholders sitting on the board
    - resolutions at general assembly
    - takeover raids
    - creditor negotiations during financial distress
- Speculative monitoring
  - Not linked to control rights
  - Partly backward looking, aiming at *measuring* value, rather than at enhancing it.
  - Example: stock-market analysts, rating agencies
  - Provides incentives by making firm's stock value more informative about past performance.
- Product-market competition
  - Relative performance is easier
  - Exogenous shocks are filtered out
- The board of directors
  - Independence; attention; incentives; conflicts
  - Many differences across countries.

Investor activism

- Active monitoring requires control
- Formal control vs real control
    - Majority owner has formal control
    - Minority owners may have real control, convincing other owners of the need to oppose management
- Ownership structure important for the scope of investor activism
    - Institutional investors: pension funds, life insurers, mutual funds
    - Cross-shareholdings
        - Firms owning shares in each other
    - Ownership concentration: huge variations across countries
        - For example: US vs Italy
    - Ownership stability: again international variation
- Limits to active monitoring
    - Monitoring the monitor: incentive problems inside institutional investors
    - Externalities from monitoring
        - One shareholder's monitoring benefits all shareholders – underprovision of monitoring?
    - Costs of monitoring
        - Illiquidity
        - Focus by management on short-term news
        - Incentives for manipulating accounts

The market for corporate control

- Takeovers
  - Keep managers on their toes
  - Make managers act myopically
- Takeover bids: tender offer
- Takeover defenses
  - Corporate charter defenses
    - Making it technically difficult to acquire control
    - Staggered board
    - Supermajority rules
    - Differential voting rights
  - Diluting the raider's equity
    - Scorched-earth policies: selling out those parts of the firm that the raider wants
  - Poison pills
    - Current shareholders having special rights to purchase additional shares at a low price in case of a takeover attempt
  - White knight
    - An alternative acquirer who is friendly to the current management
  - Greenmail
    - Repurchases of stock from the raider, at a premium
    - Management colluding with the raider, at the expense of other owners.
- Leveraged buyout (LBO)
  - Going private, borrowing to finance the share purchase
  - Management buyout (MBO): an LBO by management

The role of debt in corporate governance

- Debt provides management discipline
  - Management must make sure there is cash flow available in the future for paying back debt
  - Management has less cash available for perks
  - If the firm does not pay back debt, creditors can force the firm into bankrupty
- Debtholders are more conservative then equityholders
  - Debtholders suffer from bad projects, but get no extra benefit from good projects.
- But there are limits to debt
  - Debt means the firm is less liquid, which is costly.
    - Internally generated funds are the cheapest source of capital available for firms.
  - Bankruptcy is costly.

International comparison

- Two broad legal traditions
  - Common law
    - Independent judges
    - Limited codification
    - US, UK
  - Civil law
    - Politically appointed judges
    - Codification
    - France, Germany, Scandinavia

- Differences across legal systems
  - Shareholders have more protection in common law countries.
  - Correspondingly, common-law countries have a higher ratio of external capital to GDP.
  - Common-law countries have a more dispersed ownership of firms.

Shareholders vs stakeholders

- Corporate social responsibility.
- The shareholder-value position: taking care of stakeholders through regulations and contracts.

Note: Supplementary section to Tirole's ch. 1 is *not* required reading.