

Fall 2008, Hitotsubashi University
Monetary Economics 1
(Corporate Finance)

LECTURE 11
コーポレート・ガバナンスとM&A

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Hit-Lec11: Corporate Governance+M&A

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Key characteristic of corporate capitalism

- corporate capitalism = publicly held corporations
 - Business owned by the manager
- Separation of management and ownership
- Whom do managers represent?
 - Investors
 - Customers and suppliers
 - Employees

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Influences on managerial incentives

- Example 1: Longer the manager stays in his/her position and spends more time with employees, it will be difficult to restructure the firm workers.
- Example 2: A manager who owns more stocks will care more about valuation of stocks (Jensen and Meckling).
- Management interests are likely to deviate from shareholder interests → Agency problem

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Why shareholders cannot control managers ?

- Ownership is too diffuse
 - Create free-rider problem
 - Concentrated ownership is better for monitoring.
 - Diversification vs block shareholding
- Financial institutions as monitors
 - Japanese main banks
 - Private Equities
 - Large pension funds: CALPERS

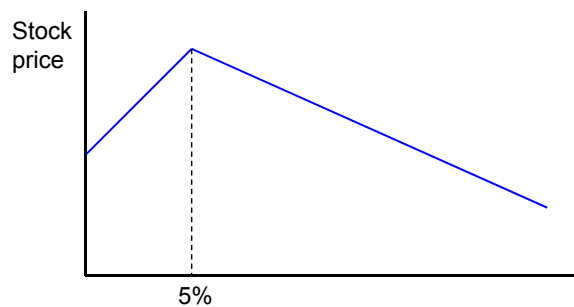
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Management shareholding

- Shareholding by founders
- The effect of large shareholder



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Investment choices management prefer

- Managers may prefer larger, more diversified firms.
- Managers may prefer investments that pay off more quickly than those that would maximize the value of their shares.

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Example:

“Diversification destroys value”

- US M&A waves in 1980s and in 90s
 - Purchased the firm → Divide firms into small parts and sell them separately = increase of managerial efficiency
 - Free-cash flow theory by Jensen
 - Empirical evidence on losses from diversification: Lang and Stulz (1994); Berger and Ofek (1996)
- Japan
 - Investment expenditure by group (Keiretsu) firms are more stable.
 - Profit margins of group firms are lower. R&D expenditures are more vulnerable to current earnings.

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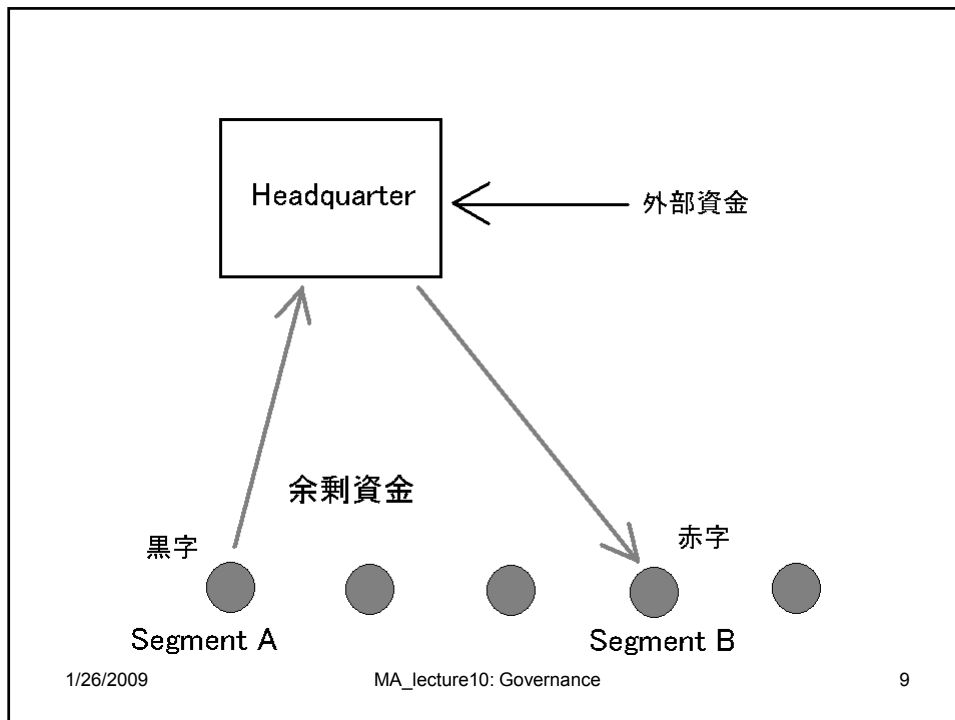
Organization theory and corporate finance

- Spinouts vs Conglomerate
- Business concentration vs diversification
- Corporate finance
 - Pros for diversification
 - When external funds are too costly due to asymmetric information problem, internal capital market will attain more efficient resource allocation.
 - Cons for diversification
 - Scharfstein: Intra-corporation socialism
 - Profits from one segment are drained for making up losses in the other segment (e.g. Kanebo).

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Further problems with internal capital market

- Rent-seeking behaviors by segments in the firm
- Influence activity by management (exercise of managerial power)
- Rent-seeking behaviors will be more problematic when there were segments with different sizes and profit levels (Rajan, Servaes, and Zingales, JF, 2000).
 - Rent-seeking behaviors by smaller and weaker segments
 - E.g. Rent-seeking behaviors by local governments.

Executive compensation (1)

- Is executive pay closely tied to performance?
- Perhaps not
 - Why not?
 - Managers are usually risk averse
 - The principal (=shareholders) cannot directly observe manager's input.
 - Otherwise, it is optimal to let manager hold all stock of the company.

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Executive compensation (2)

- Pay-for-performance sensitivities
 - Media companies vs public utility companies
 - Stock-based vs earning-based
 - Stock-option
- In last 20 years, executive compensation become much more sensitive to performance

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Executive compensation (3)

- Problems
 - Accounting manipulations to inflate earnings report and/or stock prices
 - Enron, Worldcom
 - Management will be more shortsighted

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Free-cash flow theory

- The firms with higher leverage ratio will be more efficient
 - Michael Jensen: Originally, rational for takeovers in 1980s
 - Managers will not have “free-cash flows”
 - Bankruptcy risk will induce managerial efforts
 - Influence of shareholders will be larger

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The information conveyed by financial decisions

- A dividend signaling model
 - Paying dividends is more costly for unproductive firms.
 - Increasing dividend payments signals the firm is efficient and productive
 - Stock price responds positively to the increase of dividend payments
 - MM theorem
- Share repurchases are the same

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Merger and Acquisitions (M&A)

- Strategic acquisitions
 - Operating synergies
 - IBM's purchase of Lotus
- Financial acquisitions
 - Make managers to work for shareholders or replace managers
 - "Disciplinary takeover"
 - Gaining the efficiency of corporate governance

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Merger waves in the U.S.

Figure 2

All Acquisition Volume as Percent of Average Total Stock Market Capitalization
(1968–1999)



Source: Mergerstat, authors' calculations.

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M&A waves in the US in 1980s

- Mostly hostile takeovers
- Many firms went 'private'
- Explanations
 - Free-cash flow theory (Jensen)
 - Disappointment to conglomerates in 1970s
 - Large institutional investors gained the power

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Figure 3
Net Equity Issuance of U.S. Non-financial Corporate Business
(as percent of average total stock market value, 1968–1999)



Source: Flow of Funds Accounts of the U.S., author's calculation.

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M&A waves in the US in 1990s

- Decline at the beginning of 1990s
- Another peak at 1999-2000
- Many firms went 'public' → IPO boom
- Very few hostile takeovers
- Instead heavy use of stock options
 - Management's incentive becomes more stock-market friendly

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Summing up U.S. in 1980s-90s

- Shift of the power from the inside stakeholders of the firm (management, employees) to outside shareholders.
- By products
 - Management cares so much about stock market valuation
 - Manipulation in accounting values
 - Misbehaviors of analysts
 - Enron and Worldcom scandals

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日本におけるM&A

- 1990年代までは、“disciplinary takeover”は、事実上存在しなかった。
- 2000年代に入って、「大M&A時代」の到来
 - 企業再建
 - グローバル化：国際競争力強化のための巨大化競争
 - 金融機関・損保；化学・薬品；百貨店；家電
 - （特に外資による）フリーキャッシュフロー／内部留保の処分による効率化
- 一般論としてM&Aの増大は、日本企業の効率化に貢献している。

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問題点

- ITバブルを背景とした, 詐欺的なM&A
 - 会計上のmanipulation
- アクティビスト・ファンドの功罪
 - 村上ファンド
 - TCIのJ-Power株買取
 - スティール、ブルドック・ソース株買取
- 企業規模を追求したM&Aは本当に効率性を上昇させているのか？