CORPORATE FINANCE FOR LONG-TERM VALUE

Chapter 3: Corporate Governance

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The BIG Picture

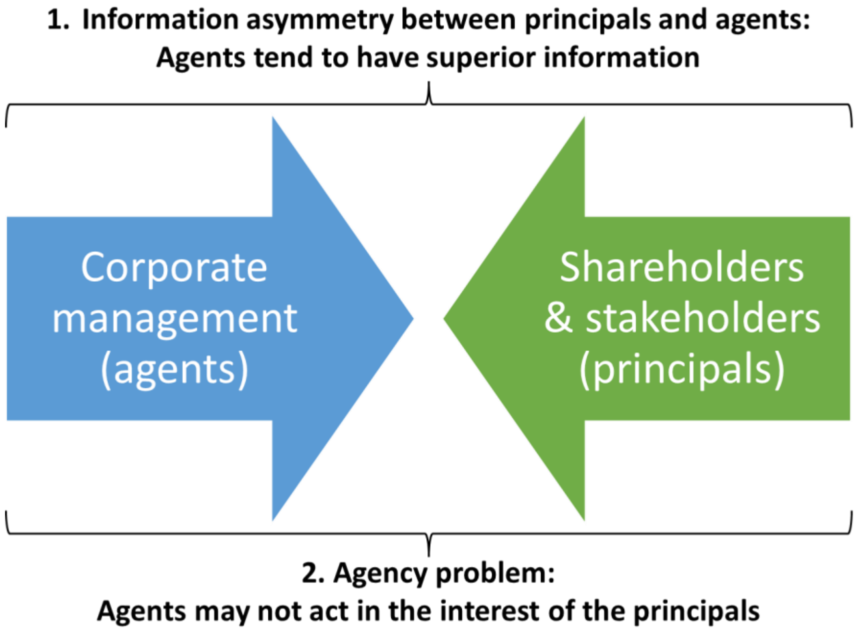
- Current corporate finance maximises financial value from financial shareholder perspective, ignoring social and environmental externalities
- Single objective facilitates accountability in corporate governance

Solution

- Expand company objective from FV to IV (= FV + SV + EV)
  - Include current and future generations as stakeholders, alongside shareholders
  - Broaden board diversity and expertise to deal with expanded objective
- Accountability: single integrated value measure facilitates accountability
- Incentives: include social and environmental KPIs in performance pay

Core problems in corporate governance

- *Corporate governance* refers to the mechanisms, relations and processes by which a company is controlled and directed
- At the core of corporate governance there are two problems:
  - *Information asymmetry* between principals and agents
  - *Agency problem*: agents may not act in interest of principals



Shareholder model

- *Agency theory* focuses on conflicts between owners (shareholders) as principals and managers as agents
- Accountability of managers and the scope for correction (removal of management)
- Managers might be incentivised to focus on short-term profits
- Common law countries (i.e., US, UK, Canada): dispersed shareholders & active trading in stock markets
- Civil law countries (i.e., Europe, Asia): controlling shareholders, less active market for corporate control and management is held less accountable

Stakeholder model

- *Stakeholder model* argues that managers should balance the interests of all stakeholders, including financial agents (shareholders and debtholders) and social agents (employees, consumers, suppliers)
- System of co-determination: both shareholders and employees can appoint representatives to a company's board
- *Corporate governance codes* define best practices in corporate governance
  - Codes have started to address the narrow shareholder perspective and short-termism
  - In NL and UK, codes include long-term value creation for stakeholders as a corporate objective

Governance and company value

- Well-run companies are better able to realise their long-term value potential by making better (investment) decisions
- Strong correlation between company-level governance and the broad institutional setting of a country
- Corporate scandals reveal classical agency problems in companies across the world:
  - Americas: Collapse of Enron in 2001
  - Asia: Olympus-scandal in 2011
  - Europe: Volkswagen-scandal in 2015

Comparing corporate governance models

Dimension	Shareholder model	Stakeholder model	Integrated model
Objective	Shareholder value	Stakeholder value	Integrated value
Optimisation	FV	$STV = FV + SV$	$IV = FV + SV + EV$
Stakeholders	Shareholders	Current stakeholders	Current and future stakeholders
Implications	• Simple decision-making and accountability • Social and environmental value considerations come second, if considered at all	• Multiple objectives requires balancing rules for decision-making and accountability • Environmental value considerations come second, if considered at all	• Multiple objectives requires balancing rules for decision-making and accountability • All values considered

Objective of the firm

- **Shareholder value** (Friedman, 1970; Jensen, 2002)
  - Division of labour: companies -> FV; governments -> SV + EV
  - But two problems
    1. externalities happen at level of companies (part of business model)
    2. regulation cannot effectively capture all externalities

- **Shareholder welfare** (Hart and Zingales, 2017; 2022)
  - Pro-social shareholders (which put weight on welfare of others) to address externalities
  - But also two problems
    1. shareholder preferences not representative for stakeholder preferences
    2. free-rider problem -> underprovision

Objective of the firm (2)

- **Stakeholder value** (Freeman, 1984; Magill, Quinzii and Rochet, 2015)
  - Current stakeholders: financial and social (employees, customers, suppliers)
  - But also two problems
    1. multiple objectives -> need for balancing rules
    2. future generations (environmental stakeholders) not included

- **Integrated value** (Schoenmaker and Schramade, 2019; 2023)
  - Inclusion of all stakeholders: current and future
  - But also problem
    1. multiple objectives -> need for balancing rules
  - Solution: integrated value as objective IV = FV + SV + EV

How can interests be balanced?

- Directors should act according to the company’s purpose (Mayer, 2018; 2021)
  - By making corporate values explicit, management becomes accountable to deliver on corporate purpose
- Edmans (2020) argues that value is only created when the social benefits exceed the social opportunity costs
- Three interrelated principles to deliver value to stakeholders:
  - Multiplication: do social benefits exceed private costs?
  - Comparative advantage: does the company deliver more value than other companies?
  - Materiality: are the benefitted stakeholders material to the company?

Integrated measure for societal value

- Basic model for integrated value (IV):

$$IV = FV + b \cdot SV + c \cdot EV$$

FV = financial value
SV = social value
EV = environmental value
b = weighting of social value
c = weighting of environmental value

(*FV* is weighted at 1)

- Allows for a structured balancing of stakeholder interests
- Board should set parameters (*b* and *c*) in advance and in dialogue with stakeholders
- Current regime is characterised by a very small weighting of social and environmental value ($b = c = 0.1$)

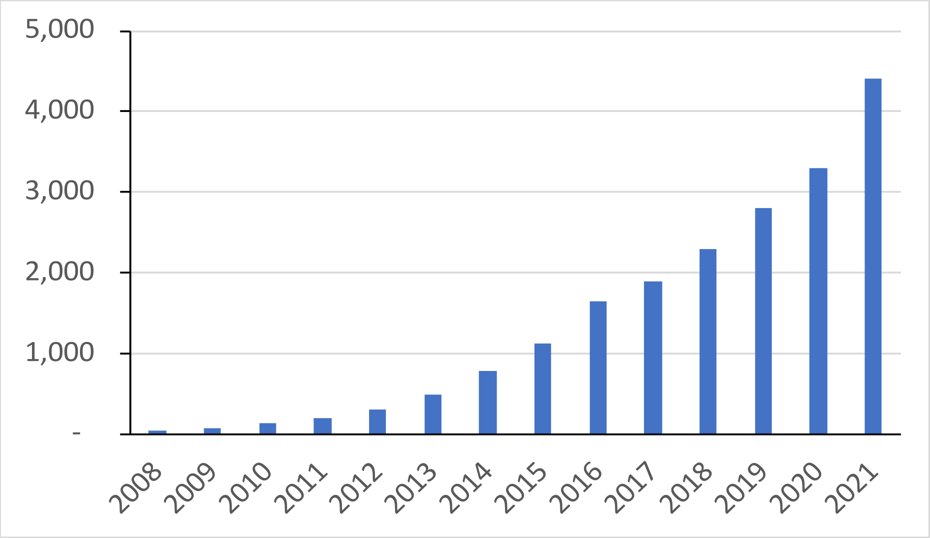
Organisational forms of companies

- Public company
  - Main corporate vehicle (especially in UK and US)
- Private Company
  - Financed by debt and/or private equity
  - Gaining in importance due to fewer agency problems
- Governmental organisation (state-owned or government intervention)
  - Public objective
  - Efficiency problems due to lacking profit motive

Organisational forms of companies (2)

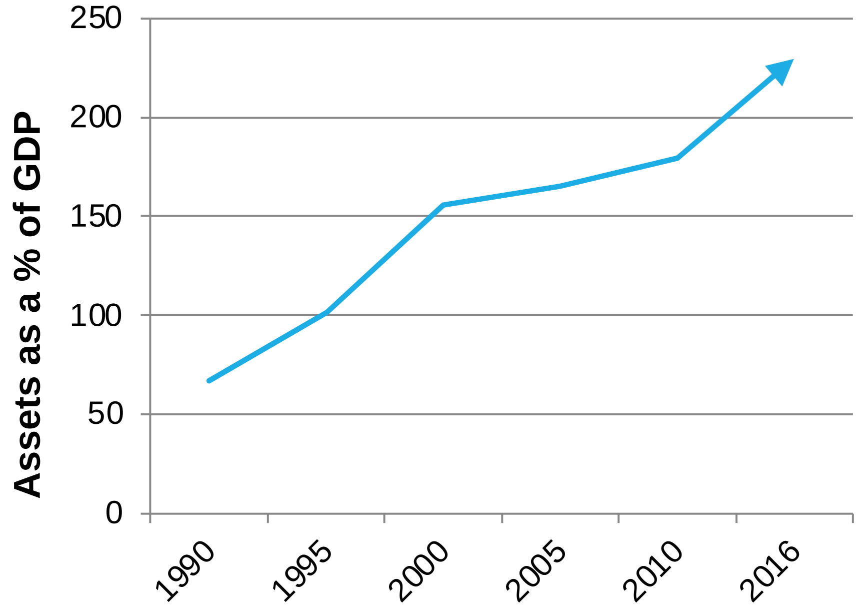
- B corporation
  - Company certified as meeting social and environmental standards
- Social enterprise
  - Non-profit with focus on societal impact
- Cooperation / Cooperative
  - Created by groups of people (customers, suppliers, employees) working together for common benefit instead of profit

Number of certified B corps



Role of institutional investors

- *Institutional investors* are financial institutions that manage investments for clients
  - Investment funds, pension funds, insurance companies, etc.
- Growing role: from 67% of GDP in 1990 to 230% of GDP in 2016



- Two choices for action to influence investee companies:
  - Voice (or direct intervention): engage with management or vote at AGMs
  - Exit (or divest): (threaten to) leave
- Rise of passive investments limits impact of voice or exit

Managing stakeholders' interests

- How to include the interests of the various stakeholders in board decision-making?
  - EU is most advanced in including interest of current and future stakeholders in legislation

- EU Sustainable Finance strategy:

1. Strengthening sustainability disclosure
2. Taxonomy of green investments
3. Clarifying investors’ duties regarding sustainability
4. Fostering sustainable corporate governance

Sustainability disclosure & taxonomy

- EU's Corporate Sustainability Reporting Directive (CSRD), effective 2025
  - Requires companies to disclose information on S and E issues
  - Helps stakeholders evaluate the sustainability performance of companies
  - Encourages these companies to develop a responsible approach to business

- EU Green Taxonomy
  - Classification system that establishes a list of environmentally sustainable economic activities
  - Creates security for investors, protects investors from greenwashing and helps companies to plan its transition
  - Expansion to (1) cover gray and brown investments (detrimental to sustainability); and (2) include social activities

Board mechanisms at company level

1. Formal stakeholder models
2. Board mandates for sustainability
3. Board composition and expertise
4. Stakeholder council
5. Incentive mechanisms

- *Formal stakeholder models:* Focus on particular stakeholder interests
- *Board mandates for sustainability:* Makes sustainability an explicit board priority
- *Board composition and expertise:* Representative and diverse boards are more sensitive to company's societal impact
- *Stakeholder council:* A council that discusses the sustainability performance of the company
- *Incentive mechanisms:* Executive compensation can include social and environmental KPIs to make management accountable for sustainability performance

Future design

- Developed in Japanese local politics, *future design* aims to solve the dilemma between current and future stakeholders
- In stakeholder councils, designated people take on the role of future generations
- People who become members of an ‘imaginary future generation’ truly change their lines of thought and points of view, becoming clearly aware of the interests of future generations
  - Very important to get voice of young/future generation in boards

Conclusions

- Corporate governance is about controlling and directing the company
  - Shareholder model: financial value maximisation
  - Stakeholder model: includes current stakeholders
  - Integrated model: includes current and future stakeholders
- The balancing of the interests of various stakeholders is central to corporate governance
- Integrated value can provide guidance on dealing with trade-offs between the interests of various stakeholders