CEOs Should Refresh Their Finance Skills

by Theo Vermaelen

Introduction

Theo Vermaelen is the Schroders professor of international finance and asset management at INSEAD, Fontainebleau, where he teaches Corporate Financial Strategy in Global Markets. He is a graduate of the Department of Applied Economics at the Catholic University of Leuven and obtained an MBA and PhD in finance from the Graduate School of Business, University of Chicago. He has taught at the University of British Columbia, the Catholic University of Leuven, the London Business School, UCLA, and the University of Chicago. Vermaelen has published articles on corporate finance and investment in leading academic journals, including the *Journal of Finance*, the *Journal of Financial Economics* and the *Journal of Banking and Finance*. He is coeditor of the *Journal of Empirical Finance* and associate editor of the *Journal of Corporate Finance* and the *European Financial Review*. He is also a consultant to various corporations and government agencies and program director of the Amsterdam Institute of Finance.

Finance Courses Today

The CEO of a major consulting firm recently gave a speech at INSEAD in which he argued that the financial crisis has shown that finance professors should no longer teach the concept of maximization of shareholder value. When I asked him afterwards how he could say such a thing, considering that the shareholders of Lehman Brothers lost all their money, he replied that “they were maximizing profits to maximize their bonuses.”

This exchange convinced me that there is a lot of ignorance and confusion about what is taught and what should be taught in finance courses. In this case, the consulting firm boss seemed to have confused profits and the pursuit of bonuses with shareholder-value maximization. Ignorance can only be defeated by education. Many CEOs of major companies have completely forgotten what they were taught in MBA programs, which is an argument for sending them back to school. Actually, shareholders should insist that money spent on CEO training should at least be partially devoted to acquiring financial knowledge. Currently, I have the impression that CEOs prefer to attend leadership courses where they are taught how to manage people, rather than how to forecast cash flows and value their businesses.

The Basic Message Should Be that Maximizing Shareholder Value Is Not the Same as Maximizing Profits or the Stock Price

Shareholder value is defined as the present value of future expected cash flows, from now until infinity. These cash flows are discounted at a rate that reflects the risks to these cash flows. Managers should be taught to build a spreadsheet that incorporates the relevant cash flows and risks. Subsequently, they should try to execute the strategy implied by the spreadsheet. Clearly, this is not the same thing as maximizing short-term objectives such as profits or earnings per share. For example, a private banker who sells a bad product to his clients may see bank profits rise as a result of the fees, but the value of his business will go down if, as a result of that sale, the client leaves the bank. In other words, the banker should consider the present value of all expected cash flows from his client.

If the market is efficient, maximizing the stock price would be the same as maximizing shareholder value. In this case the stock price reflects the strategy reflected in the spreadsheet, and then there is no difference between long-term and short-term shareholder value. However, if the market is not efficient, stocks could be overvalued or undervalued relative to the predictions of the spreadsheet. What most managers will do, and should do, is to ignore these deviations and focus on implementing the strategy. Occasionally, they may want to buy back stock if the shares seem undervalued and to issue new shares when they seem overvalued. In that case, the objective is to maximize long-term shareholder value to the existing shareholders.

Alternatively, the CEO may be encouraged to revise his forecasts as a result of “messages from the market.” For example, a sharp fall in the share price may make a CEO think about whether his strategic plans should be revised to reflect the new information revealed through stock price movements. In that case the stock price and shareholder value may converge again.

One fundamental risk of focusing on the spreadsheet and ignoring market movements is the risk of a takeover bid that is below the value reflected in the spreadsheet. Typically, takeover bids require the bidder to pay a premium of 30–40% above market prices. If the stock is trading at such a large discount from fundamental value, an argument can be made that one should make sure that takeover bids are avoided. This can be done by implementing various preemptive takeover defenses, with the risk that these measures allow value-destroying managers to retain their jobs. Alternatively, the company can try to “signal” that it is undervalued.

Based on empirical studies, the most convincing signaling mechanism is the buyback tender offer. In such an offer the company offers to buy back its own shares at a significant premium (more than 20%) above the market price. If the management owns a significant fraction of the shares and commits itself not to tender its shares, managers will incur a significant personal wealth loss if the tender price is above the fair value of the stock. This potential cost of “lying” makes the signal credible.

Corporate Governance Is Crucial

A typical corporate finance textbook teaches students how to maximize shareholder value. However, the fact remains that managers, like anyone else, maximize their own personal happiness subject to constraints. This agency problem can only be resolved by appropriate corporate governance, i.e. by providing the right carrots and sticks to ensure that the donkey walks. One thing we learned from the financial crisis is the importance of good governance and the alignment of incentive mechanisms with long-term shareholder value. Obviously, everyone likes to blame bankers’ bonuses tied to short-term profits, but agency costs also lie behind the sovereign debt crisis—i.e. the lack of concern of managers (politicians) for shareholders (the taxpayers).

I always give the example to students of a company that gives away its goods and services for free and where the CEO issues equity and borrows money to finance the investments. Moreover, the CEO can force shareholders to put up equity when necessary. The debt holders know this and are therefore willing to lend money at low interest rates to the company. At the same time, the CEO stays in power because not only shareholders, but also customers and workers, have voting rights.

When I ask students whether they know of such a company, many immediately recognize it as the government. They also realize that such poor governance systems are not sustainable as eventually shareholders will no longer be able to finance the company. This in turn will make lenders reluctant to lend, in which case we all end up like Greece.

So I believe that a significant part of corporate finance courses should be devoted to corporate governance: how to compensate managers so that they care about shareholder value, not short-term profits. Another matter that they should address is the performance of boards—in particular how to trade off the so-called objectivity of external directors against their relatively poor knowledge of the business operations.

Something that Promises a Higher Return Is Probably More Risky

When an Icelandic bank pays a higher return on deposits than a Dutch bank, the investors have to realize that such a difference in returns is likely to reflect higher risks. When a complicated financial instrument receives an A credit rating but promises a higher yield than a simple product that also has an A rating, then one has to expect that at least one of the ratings is probably incorrect. The basic idea of efficient markets cannot be repeated often enough: in a competitive world all assets are priced correctly. The only way to beat the market is to have access to superior information. Unless you are a company insider, you should choose your investments on the basis of your tolerance for risk, your tax situation, and your consumption preferences. But, as an outsider, it is difficult to make the case that an investment is “cheap” or “expensive.” If something is cheap, buyers will drive up the price, so that the expected rate of return (adjusted for risk) is the same for all assets.

Of course, CEOs can argue that they know their company better than the market and can occasionally observe mispricing. And indeed there is a fair amount of research that suggests that managers are able to time the market: companies tend to issue shares when they are overvalued and buy them back when they are cheap, and the market does not fully understand this.

Market Efficiency Does Not Mean Perfect Foresight

The efficient market hypothesis (EMH) invariably comes under fire whenever stocks go up a lot and then fall a lot, such as during the Internet bubble and the recent real estate bubble. The EMH argues that asset prices at time t reflect all publicly available information at time t. As new information becomes available, it is normal that stock prices adjust to this information—and sometimes quite substantially. The EMH does not predict these unexpected events. It also does not predict stable or steadily rising prices. Volatility as a result of changing expectations is a sign of efficiency.

During the Internet bubble investors overstated the extent to which the benefits from the Internet could be captured by shareholders. It turned out that most of the benefits went to consumers. Once this became increasingly clear after March 2000, technology stocks collapsed. This collapse did not lead to a banking crisis as banks were not lending to Internet companies. Most Internet companies financed their investments by issuing equity. Banks were lending to old-economy stocks, which did relatively well when the Internet bubble collapsed. What was different about the recent crisis was that here the driving force was the spectacular rise in the US real estate market from 2002 to 2007, which of course exposed the financial sector. Real estate prices are different from stock prices in that you can’t short real estate, so efficient pricing is more difficult to guarantee. So, if we have learned anything, it is that if you want to have an efficient market in the pricing of a particular asset, you should make it easy to short, so that undeserved bubbles get deflated sooner. Of course, this is exactly the opposite of the conclusions of many politicians who see short-sellers of, for example, Greek bonds as evildoers.

Debt Is Not Cheaper than Equity

The directors of banks should be reminded of the basic Miller–Modigliani theorems, in particular the proposition that if you borrow money and the cost of debt is lower than the return on assets, your return on equity will go up. But this is not creating value for your shareholders, as the remaining equity will become riskier. So the weighted average cost of capital will not fall if you borrow more money.

Bank CEOs seem to have failed to grasp this basic idea. If they had, why do they persist with setting return-on-equity targets, and why are they so strongly opposed to regulatory requirements that they should issue more equity? It is true that, once you incorporate the fact that interest is tax-deductible, shareholder value increases as leverage increases, but then you should also introduce the other market imperfections—i.e. the cost of financial distress. Setting return-on-equity targets encourages borrowing without consideration of these costs of financial distress.

The problem with the banking sector is that regulators set the capital structure, in the same way that the government sets the speed limit. Like a car driver who drives as fast as is legally permitted, bankers try to reach the government-recommended leverage without asking whether this limit corresponds to shareholder-value maximization.

Summary

Although I cannot really argue that taking such a course will prevent the next crisis, it seems to me that having a bit more finance training cannot hurt when the next crisis happens.

More Info

Book:

- Smith, N. Craig, and Gilbert Lenssen (eds). *Mainstreaming Corporate Responsibility*. Chichester, UK: Wiley, 2009.

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