

International Comparison of Corporate Governance

基礎企業ガバナンス論

Lecture 3: Measuring company
performance under “financial capitalism”

4 November 2011

Overview of the previous class

Changes in the incentives of managers

- 1930s-1970s: “managerial capitalism”
- 1980s-1990s: the move to “financial capitalism”

What has changed?

- *Managers’ incentives have become closely linked to short-term profits and the short-term movements of share prices*
- (1) Pay in shares or stock options
- (2) Performance evaluation by using short-term financial indicators (see the slides below)
- (3) Higher job turnover

Overview of the previous class

- Changes in the way of thinking about corporations
→ the concept of shareholder value
株主価値重視経営
- **Companies' main goal is to deliver more (short-term) benefits to their shareholders**
- Shareholders should be given higher priority against the interests of other groups (stakeholders)
利害関係者
- For example, using net profit for larger dividends and share buybacks (自社株買い戻し), instead of for raising wages or employing more people

Short-term financial indicators showing “shareholder friendliness” I

- **(1) Net profit (in \$)** 当期純利益
- Can be found in the company's income statement
損益計算書
- Net profit is divided into dividends 配当金 and retained earnings 内部留保
- **(2) Net profit margin (%)**: net profit / revenue
- **(3) Dividend yield (DY, %)**: annual dividend per share / share price 配当利回り
- Example: if the dividend is \$1 per share and the share price is \$20 → the DY is 5%

Short-term financial indicators showing “shareholder friendliness” II

- **(4) ROE (%)**: net profit / shareholders' equity
株主資本利益率
Shareholders' equity 株主資本 can be found from the balance sheet 貸借対照表
- **(5) ROA (%)**: net profit / total assets
総資産利益率
- **(6) earnings per share (EPS, in \$)** : (net income – dividends on preferred stock) / number of common shares
一株当りの利益
- **(7) price-to-earnings ratio (P/E ratio, %)** : share price / annual EPS
株価収益率

The proportion of companies doing “share buybacks”

- *A higher percentage of companies buying back their own stock (e.g. “share buybacks”)*

自社株買い戻し

- Share buybacks reduce the number of outstanding shares and may therefore lead to a higher share price

Reasons for doing a “share buyback”:

- **(1) to improve the company’s p/e ratio** (EPS should increase as a result of a smaller number of outstanding shares)
- **(2) to reward the holders of shares and stock options** (in case the “share buyback” leads to a higher share price)

The proportion of companies doing “stock splits”

- *A higher percentage of companies doing “stock splits”*
株式分割
- Stock split: an increase in the number of outstanding shares but the share price is adjusted so that the market capitalization (時価総額) remains the same
- Example: a company with 100 shares and share price of \$50
- If the stock is split “two-for-one”, existing shareholders will receive two shares for each of their shares → 200 shares and share price of \$25
- Splits make a company’s stock more attractive because more investors can afford to buy shares

Agency theory (AT) and the emphasis on shareholder value (SV)

- *AT: the fact of separation of ownership (shareholders) and control (managers)*
- *AT: the hypothesis of opportunism (selfish, utility maximizing behavior by managers)*

Two main arguments in favor of SV

- (1) the objective of firms under capitalism is to maximize profits (e.g. returns on capital provided by the shareholders)
- (2) compared to other groups like employees and creditors, shareholders bear a higher level of risk (because their reward is not defined in the contract that binds them to the company)

Historical cases showing conflicts related to shareholder value I

- (1) “Dodge vs. Ford Motors” (1919)
- Even though it had lots of cash, Ford Motors decided not to pay dividends to its shareholders and the Dodge brothers (minority shareholders) sued in court
- Henry Ford owned about 60% and the Dodge brothers 10% of the capital
- Henry Ford argued that the cash was needed for new investment (to build another car factory)
- ***The Michigan court ruled in favor of the minority shareholders/ against the board (the management) that withheld the payment of dividends***

Henry Ford (1863 – 1947) and the T Model (1920)



Historical cases showing the conflicts related to shareholder value II

- (2) “Shlensky vs. Wrigley” (1968)
- Some shareholders of Wrigley Corporation sued the company’s directors for failing to install lights in Chicago’s baseball field
- They claimed that if the field had lights, the Chicago Cubs baseball team could play at night, leading to higher revenues
- The president, William Wrigley III, was opposed because of his belief that night games are bad for the neighborhood
- William Wrigley III was also the controlling shareholder
- ***The Chicago court ruled against the shareholders***
- Eventually, lights were installed in 1988

William Wrigley Jr. (1861-1932) and the Chicago Cubs baseball field

