



JERRY SAYS HELLO TO HIS NEW SHAREHOLDERS: AGENCY COSTS AND CORPORATE GOVERNANCE

1. The Growing Clout of External Investors

Jerry's need for capital to finance his growing lemonade business means he must get acquainted with new stakeholders — the shareholders who just purchased the \$5 million of shares in the IPO. This means talking and listening to them. Particularly the big investors who purchased blocks of shares and the bankers and analysts who seem keenly interested in the future of his business.

After having lunch with Bob Butterfield, he understands that being questioned by the company's debt and equity financiers is part of the process of running a publicly-held firm. Bob explained what was happening — Jerry was spending his time reassuring external financiers that the agency costs arising from debt and equity financing were not going to be a problem in his business. Understanding *agency costs* was essential to truly understanding the sources of Value Evaporation and the interplay between the different components of the Value Sphere.

2. The Essence of Agency Costs

An agency problem arises whenever one party to a contract can take actions that can exploit the other party. For example, an employee may shirk in the work he does for an employer. Or a borrower may put a bank loan to a riskier use than the bank expected. The waste arising from such exploitation and the attempts to limit it is called an *agency cost*. There are agency costs associated with both debt and equity financing.

Jerry's first encounter with agency costs was when he got excited about the prospects for expanding his lemonade business near US army bases. An investor who bought \$500,000 of the IPO called Jerry to tell him of a great business opportunity to open lemonade stores near US army bases. Serving this "captive" market of US personnel stationed at these bases could be highly profitable. This venture could also serve as a model of selling in other settings, such as colleges and hospitals. This potential had attracted this investor to buy many shares of Jerry's IPO.

Jerry liked this idea so much he went directly to his banker. Unfortunately, the banker did not share Jerry's enthusiasm. In his mind, it was just too risky to expand when the lemonade business was just getting underway.

He also reminded Jerry about the protective covenants in his bank loan contract. The bank loan was expressly limited to the purchase of assets listed in the agreement. To make matters worse, the depreciation on the additional assets that would be acquired in the expansion would surely reduce earnings in the short term to levels that did not comply with the covenants.

Jerry interjected, "This is a great idea. One that we must act on quickly before others grab it. Don't forget there is lots of money to be made selling to the armed forces personnel. Can't we just change the loan agreement?"

"Look Jerry, I am your friend and your advisor," replied the banker. "I want to see you succeed. But think of the bank's position. If you succeed, you can easily pay off the bank and keep the remaining money for the shareholders. If you fail, given your status as a company with limited liability, you file for bankruptcy protection and the bank is left holding the bag. That is why it is my job to *monitor* your behavior and protect the bank. We insisted on the protective covenants to protect our investment and to make sure you don't do something reckless with our money. I am sorry, Jerry, but I will not alter the loan covenants to let you expand to military bases."

Jerry related this conversation angrily to Bob. Bob chuckled and said, "Welcome to the *agency costs of debt!* What you have to realize is that the banker's interests differ from yours and those of the other shareholders. The bank's potential return is limited to the interest and principal payments you agreed to in the debt contract. In contrast, the shareholders' potential gain is unlimited. Once the bank is paid back, shareholders get to keep all that is left. That's why we refer to shareholders as residual owners. Given this status as *residual owners*, coupled with limited liability if the business fails, there is a great incentive to invest in high-payoff but risky endeavors. If they succeed, the shareholders win big. If they lose, the shareholders walk away. It's as if the shareholders flip a coin and tell the creditors, 'Heads we win, tails you lose.' The costs this imposes on the bank are part of the agency costs of debt."

“Wait a minute, Bob. I’m not that kind of guy. I always pay my debts,” Jerry protested.

“I know that, Jerry,” Bob responded. “However, you are new at this lemonade business. You have no track record. The bank doesn’t really know how you will respond if the business falters. The only thing they can be sure of is the loan contract you signed. That’s why they insisted on those protective covenants, on questioning you periodically, and on audited financial statements. These are all *agency costs* associated with monitoring your behavior to protect the bank’s interests. It’s not that they don’t personally trust you, Jerry. It’s just that years of experience have conditioned them to be cautious with borrowers. This is why the true “cost” of debt financing is higher than the stated interest cost. The costs this imposes on the bank are part of the agency costs of debt.”

As Bob and Jerry continued their lunch, Jerry related an incident that had occurred between him and another large shareholder. Jerry had an idea to expand the business to include California. He thought he should travel there to check out the idea, potential sites, etc. on a first-hand basis. He had been working hard, especially with the growth of the business, the IPO, and the many conversations with bankers and investors. And he had never been to California. He and Sallie could sure use a break. It would be a nice vacation. He had heard how businessmen creatively linked business travel with personal vacations. An ideal combination trip. It would not be a bad idea to also invite the operations manager and his wife.

His operations manager literally ate, drank, slept, and dreamt lemons. He knew everything there was to know about lemons. Jerry thought it would be a nice gesture of recognition if he and his wife got a “free” trip to California. The two of them could quickly assess business opportunities. If there were any lemonade stores there, they could do some competitive benchmarking.

Jerry had mentioned the California expansion idea and the trip to a large IPO investor. His reaction surprised Jerry. In a rather nasty tone, he said, “Jerry, this trip is a dumb idea. I didn’t invest millions of dollars of my hard-earned money in our business so you and your employees can cavort around the country. I invested in the lemon store business, not a travel agency! And who’s going to run the business when the two of you are gone? If you want my advice, don’t go!”

Jerry asked Bob why the investor would be so upset about the trip.

Bob replied, “Welcome to the *agency costs of equity*! There are agency costs associated with equity, just as there are with debt. What you have to realize is that *external* shareholders view the situation differently from you, an *internal* shareholder and an employee of the business. There is now a separation of ownership by the investors and control by the managers.”

“But all of us are shareholders,” Jerry responded. “Don’t we have the same interests?”

“Well, both of you are very interested in the financial returns earned from the lemonade business. In that regard, both of you are interested in maximizing the value of the business. On the other hand, as a shareholder and an employee, you care about more than just the value of the business. You are also concerned about the leisure time you have away from the business. And, you are legitimately concerned about providing positive incentives to your employees. You think they need rewards, such as the trip, to keep them motivated. External shareholders need to be convinced that corporate expenditures on leisure, incentives, and the like are absolutely necessary. Otherwise they view these as coming out of their own pocket. Nothing more than value evaporation that hurts their rate of return.”

Jerry thought for a moment and then said, “First it’s the banker, then shareholders. Everybody thinks we are going to steal their money.”

“I sympathize with you,” Bob interjected, “but these conflicts occur in all businesses. Agency costs of debt and equity are not unique to your business. Creditors will insist on protective covenants in their loan agreements, will monitor behavior, and will require periodic reporting to measure compliance. External equityholders will seek representations on the board of directors to monitor behavior and performance. If large investors get upset with your actions, they may use their significant shareholdings to seek a change in the company’s management. In fact, this has happened in numerous large corporations, such as General Motors, Eastman Kodak, and Disney. All that creditors and external equityholders are doing is protecting their positions. In the end, it helps value retention. You shouldn’t take it personally.”

3. Bob Gets a Job Offer

“Bob, I’ve had some time to think about this and I’d like you to join the company. We’ve grown a lot. I now realize that being a public company requires someone to be in charge of finance. Someone to communicate with the bankers, shareholders, accountants, and lawyers. I’ve always admired your financial knowledge and wisdom, and I’d like you to be my Chief Financial Officer (CFO). As CFO, you’ll have free reign over all matters of finance. You’ll also be in charge of our real estate activities and information technology. These two areas are really growing as we expand the number of our locations. What do you say, Bob?”

“I am flattered,” Bob said. “You have a very good business here and the growth potential looks outstanding. That’s what I find attractive about joining the company as CFO. It would also be great to have the chance to apply what I’ve been teaching,

researching, and consulting about over the years. But I also like my present job. It's hard to give up a tenured faculty position, you know. Let's talk some more."

After numerous discussions about Bob's compensation and persuasion by Jerry, Bob accepted the offer.

4. What Really Counts

After lunch, Bob and Jerry set out to discuss how they should assess the success of their lemonade business. Bob knew that it was really important for Jerry to understand how the financial market keeps score when evaluating a business. To begin the discussion, Bob introduced the notion of a balanced scorecard. This concept, first articulated by Kaplan and Norton,³² is described below.

4.1. The balanced scorecard

The essence of the balanced scorecard is that business performance should be judged from a multidimensional perspective. Goals and measures are identified for four perspectives linked with basic questions:

- Financial: "How do we look to shareholders?"
- Customer: "How do customers see us?"
- Internal Business: "What must we excel at?"
- Innovation and Learning: "Can we continue to improve and create value?"

The key is to find measures in all four areas that typically span the company's agenda. This is related to the performance metrics segment of the Value Sphere. Moreover, the innovation and learning perspective is related to the resource allocation process and people and organization culture segments of the Value Sphere. Thus, there are some similarities between the spirit of the balanced scorecard and the Value Sphere. After some discussion, Bob and Jerry came up with the balanced scorecard for their business shown in Fig. 4.1.

These measures would be used across the company and many at each location. By comparing measures at each location, Jerry and Bob thought they could identify the best performers in each area and then be in a position to share best practices with all of the other locations. The inherent continuous improvement in this process should yield superior performance. Many companies have adopted the balanced

³²Robert S. Kaplan and David P. Norton, "The Balanced Scorecard — Measures that Drive Performance," *Harvard Business Review*, January–February 1992, pp. 71–79.

Financial perspective goals	Measures
1. Survive	● Cash flow and income
2. Succeed	● Increased sales at each location
	● Increased market share in each locality
3. Prosper	● Increasing stock price
Customer perspective goals	Measures
1. New products	● Percent of sales from new products introduced in the last 2 years
2. Responsiveness/Time	● Percent of customer orders filled in less than 3 minutes
	● Process tie from order to customer delivery
3. Quality of service	● Customer satisfaction rating
4. Cost	● Customer survey ranking
	● Percentage comparison with average costs at McDonald's, Wendy's, and Starbucks
Internal business perspective goals	Measures
1. Productivity	● Location's sales per employee on payroll
2. Quality service	● Customer survey of employee behavior
	● Performance on random corporate inspection of each location
3. Cycle time	● Number of steps and time of each from order to customer delivery
4. Cost	● Unit cost per item
	● Labor cost as a percent of COGS
	● Customer survey of product value
5. Control	● Number of hours to issue weekly and monthly reports to each location
Innovation and learning perspective goals	Measures
1. Employee training	● Average number of hours of training for each employee per year
2. Business processes	● Number of business process improvements in past year
3. New products	● Cycle time to develop new products
	● Number of product ideas each month vs. number implemented
	● Number of new locations each year

Fig. 4.1. Balanced scorecard.

scorecard idea. Examples are Whirlpool and Ingersoll-Rand. In fact, most companies incorporate performance measures other than financial ones.

Although the balanced scorecard is helpful to encourage improvements and to assess business performance, a significant problem remains. What happens, for

example, if the decision to be taken is at different ends of the spectrum along two or more dimensions? An investment may be highly innovative, resulting in a high proportion of future sales coming from the new product. But what if the project also promises to earn less than the cost of capital? Since such conflict among the dimensions is unavoidable, there needs to be an overarching goal, one that supersedes all others. Shareholder value maximization is that overarching goal.

Jerry interrupts the discussion by asking, “Why is shareholder value maximization a goal that supersedes the interest of other stakeholders like customers, employees, and the rest?”

Bob responded, “In part because shareholders have the highest control rights vested in them. And they must have the highest control rights because they have the lowest-priority financial claims. Think of the income statement we produce to monitor performance each month. The prices we charge customers are included in the revenues earned and are related to expenditures on quality improvements. Suppliers are represented in the cost of goods sold and the general and administrative expenses. Employees show up in the salaries and wages paid. In fact, the community is represented by the well-being of all participants in the company’s affairs — customers, suppliers, employees, shareholders, bankers, and competitors. The government is represented in the amount of taxes paid. What goes to the shareholders is what is left over after all these parties are paid off.

“When viewed from the income statement point of view, it is clear then that shareholders are the residual owners. If shareholders did not have the highest control rights, there would be nothing left for them. If we adopt the right approach to maximizing shareholder value, we will also make decisions that maximize the interests of those above them in the income statement.”

Jerry protested, “But couldn’t the business cut employee wages, marketing expenditures or R&D spending in order to report higher profits this quarter?”

“Yes, that may be true, Jerry. But shareholder value is, by definition, a long-term concept, driven by corporate strategy. You know that sacrificing long-term profits for short-term gains is a pact with the devil. When the financial markets learn that you have made short-sighted decisions and jeopardized the long-run profitability of the company, they will lower the value of your shares. My advice, Jerry, is to run the lemonade business for long-run performance. That is the way to insure financial success and balance the interests of all people connected to the business.”

“Are there any other reasons to believe that shareholder value maximization should be the overarching goal of my lemonade business?” Jerry asked.

“For sure,” Bob responded. “Remember our discussion of the lukewarm response to your California trip? Well, that is why the maximization of shareholder value creation and retention needs to be at the top of our agenda. If you do not

provide value, and external shareholders are disappointed, they will launch a bid to take over the company and run it as they see fit. Since shareholders have the highest *control rights* attached to their stock, they can wrest control of the company from the managers. They would then change the direction and strategy of the company to improve shareholder value.”

“This is all fine, Bob. But do you have any concrete examples that I can relate to?”

“Sure, Jerry.” Bob proceeded to give Jerry three case studies that he had used in class.

5. Coca-Cola

Coca-Cola has been one of the most spectacular creators of shareholder value in the last two decades. Roberto Goizueta was revered as an outstanding CEO of a major corporation in the United States, and the Coke brand name has long been the envy of not only the beverage industry but many others. During Goizueta’s 16-year tenure as Coke CEO, the company’s market value grew 34-fold from \$4.3 billion to \$148 billion.³³

All that changed when Goizueta died in the fall of 1997 and was replaced by Douglas Ivester. Return on shareholders’ equity was 56.5% in 1997. But it fell to 42% in 1998 and then to 35% in 1999. The company’s market value at the end of 1999 was no different from what it was when Ivester took over. Net income, which was \$4.1 billion in 1997, fell to about \$3.2 billion by 1999. The stock price performance during Ivester’s tenure lagged the S&P 500. Hardly the performance anyone expected from a man who once said, “I know how all the levers work, and I could generate so much cash I could make everybody’s head spin.”

Eventually, major investors and the Board of Directors of Coca-Cola lost confidence in Ivester. At a meeting in Chicago, directors Warren Buffett (representing Berkshire Hathaway which owned 8.1% of Coca-Cola) and Herbert Allen (who owned about 0.4%) met with Ivester and asked him to consider stepping down. Ivester complied.

What were the reasons for Ivester’s ouster? At one level, the answer is obvious. He failed to deliver shareholder value at the level that his predecessor had. Investor expectations at Coca-Cola were very high due to past performance. Even if the company had done better than it did under Ivester, it may not have been enough to satisfy major shareholders.

³³The discussion here is based in part on Betsy Morris and Patricia Sellers, “What Happened at Coke,” *Fortune*, January 10, 2000, pp. 114–116.

But we should look deeper. What were the *reasons* why shareholder value was not created?

The reasons fell in three categories. First, Ivestor did not put enough emphasis on perceptions. He was a CEO who took pride in emphasizing substance over style. But to a brand-driven company like Coke, perceptions are supremely important. An example of failures brought about by inadequate attention to perceptions included the pursuit of an inflexible and aggressive acquisition strategy in Europe in the face of anti-big-American-business backlash. This cost Coke the Orangina and Cadbury Schweppes business in most of Europe as well as investigations into alleged anti-competitive practices in Austria, Italy and elsewhere. Another example is his treatment of the crisis created by Belgian school children getting sick after drinking Coke that had bad carbon dioxide. While Ivester viewed it as a minor health hazard, it ended up being a publicity disaster.

Second, Ivester seemed to pay inadequate attention to marketing. By demanding rigorous financial justification for proposed market expenditures, he seemed to have implicitly sent the message that he wanted his troops to concentrate on “sure-thing” marketing campaigns instead of risky but potentially high-impact campaigns. The issue here was not that financially justifying marketing campaigns is a bad thing. On the contrary, rather, the point is that the metrics that were being used to judge marketing outlays were inappropriate.

Finally, he alienated the powerful bottling companies who controlled 90% of Coke’s business. In part, he did this by raising concentrate prices. He added to his woes by making comments about developing vending machines that would charge higher prices when the weather was warmer.

The most important lesson to be learned from this case is that before you can create shareholder value, you have to understand the *key value drivers* in your business. Only by optimally managing these value drivers consistently can you hope to develop the right corporate strategy and succeed. For Coke, important value drivers were managing perceptions of the brand, devoting appropriate resources to marketing, and managing the company’s relationships with its bottlers. The second important lesson is that a flawed management system — one that has poor metrics or misguided resource allocation processes — often leads to Value Evaporation.

6. Ceridian Corporation

Ceridian Corporation, which split off from Control Data Corporation (CDC), is also a testament to the shareholder value imperative. In 1992, after a decade of very poor performance, CDC was dramatically restructured into two new companies: Control Data Systems and Ceridian Corporation.

Lawrence Perlman, Chairman and CEO of Ceridian, outlined his view of shareholder activism in a published article.³⁴ He stated that shareholder activism is a positive development because:

It makes it very clear to those who lead public companies that those companies are not their private preserve and that their primary task is, in a responsible manner, to build shareholder value. Only with that orientation can the responsibilities corporations owe to customers, employees, and their communities be met.³⁵

In the case of Ceridian, institutional investors own about 75% of the company's stock, and the 10 largest holders own over 50%. Such percentages are not unusual for a public company.

The history of Ceridian's business certainly helped shape Mr. Perlman's views on shareholder activism and corporate governance. In the 1980s, CDC lost 90% of its shareholder value. Its financial performance ranked near the bottom. Investors were very critical of the firm's performance and its apparent disregard for shareholders.

To turn the company around, in particular to improve clarity of strategy and the shareholder-value focus of the organization culture, it was split in two. This meant the birth of a new company — Ceridian — and a new business portfolio in employee services and information management. To inform the large shareholders of Ceridian's new opportunities and strategies, Mr. Perlman called a meeting with them and the Board of Directors to discuss major issues facing the new company. Since the investors own the company and the directors run it, he felt it was important for them to talk to each other as the company got started as a new entity and began establishing its own performance record. This dialog set the stage for future meetings to insure shareholder value did not evaporate at Ceridian the way it did at its predecessor, CDC. Thus, in this case, managing the CDC Value Sphere was so complex that there were gains to refocusing by creating two different businesses, each with its own unique Value Sphere challenges.

7. Daimler-Benz

Shareholder activism, coupled with management resolve to create shareholder value, is no longer a concern just for Anglo-Saxon firms. In fact, Daimler-Benz, the

³⁴Lawrence Perlman, "A Perspective on the New Shareholder Activism," *Journal of Applied Corporate Finance*, Vol. 6, No. 2 (Summer 1993).

³⁵Lawrence Perlman, "A Perspective on the New Shareholder Activism," *Journal of Applied Corporate Finance*, Vol. 6, No. 2 (Summer 1993).

German industrial giant, had been undergoing its own shareholder value revolution even prior to the merger with Chrysler that created Daimler-Chrysler.

The company first broke ranks with the established German industrial companies by listing its stock on the New York Stock Exchange in 1993. This meant that, under SEC rules, the company would have to report financial performance under US accounting standards.

The results were startlingly different under the US accounting system. The German system, which subordinates the informational needs of shareholders to the secrecy needs of management and bankers, permits companies more latitude that may disguise true financial performance. A major difference in the accounting systems is that provisions for future losses or expenses are allowed to a much greater extent in the German system, through the creation of “hidden reserves.” These reserves make it possible to conceal information about poor economic earnings in lean times and thus smooth reported profits through time.

The other factor that has sustained such practices is that German firms have traditionally relied on domestic financing sources, and the pressures of corporate governance have simply not been as intense in Europe as in the United States. In addition, family holdings also help to insulate most German firms from takeovers. But this traditional reliance on banks and other domestic sources of capital was being challenged by the country’s need to finance the consolidation with East Germany. This called for more diversified funding sources.

Daimler-Benz’s decision to list its shares on the NYSE was motivated by the desire to diversify its sources of capital in order to optimize the resource allocation component of the Value Sphere. With that listing, the company had to be more responsive to the corporate governance dictate to earn rates of return higher than the cost of capital in order to create shareholder value. Among other things, these changes involved equipping employees with the decision-making tools needed to maximize shareholder value and to make the organization culture more shareholder-value conscious. In the case of Daimler-Benz, major corporate changes have been made to accommodate this.

The company has sold off major pieces of business operations, closed plants, reshuffled top management, and embarked on a major shift in strategy, culminating in the \$30 billion merger with Chrysler Corporation to form Daimler-Chrysler. The chairman, Juergen Schrempp, reaffirmed his commitment to creating shareholder value.³⁶

Another important Schrempp move was to try to drive home the new and strange concept of shareholder value, something that was countercultural on a continent where social consciousness ruled.

³⁶Jay Palmer, “Shake-up Artist,” *Barron’s*, March 23, 1998, pp. 35–40.

Daimler had arranged for its stock to be traded on the NYSE in November 1993 and, as part of that move, has been reporting its results according to generally accepted accounting principles ever since. Still, even if the company's accounts were no longer quite as mysteriously opaque as most German financials, Daimler's top executives were not in the habit of putting shareholders first. To sell the idea of shareholder value, Schrempp started calling colleagues at random and asking them for Daimler's current stock price. At first, he says, 'seven didn't know and three were wrong. Nowadays they can tell me. I was bitterly attacked, but I think I have sold the idea that only a profitable company can be a socially responsible company.'

The issue of whether the merger with Chrysler under Schrempp's leadership was a shareholder-value-maximizing move is quite another matter altogether, and one we will return to in a later chapter.

Main Lessons

- Both debt and equity financing have agency costs associated with them.
- As a result of agency costs, investors insist on monitoring the behavior of the company's managers and influencing their actions to minimize Value Evaporation and enhance value retention.
- Shareholder value maximization should be the overarching goal of the corporation.
- A balanced scorecard *may* help assess the performance of a company in a manner consistent with long-run shareholder value performance.
- The Coke, Ceridian, and Daimler-Benz cases illustrate the importance of managing the Value Sphere to the benefit of shareholders.

End-of-Chapter Exercises

1. How does your company communicate with its shareholders? Who are the major shareholders of your company? Are there "special efforts" taken to keep major owners informed about the company? Are the major shareholders becoming active, i.e., making managerial proposals directly to the company?
2. What is your company's Mission Statement? Does it, or any other similarly-visible statement, include shareholder value creation as a goal?

3. What covenants and restrictions are included in your firm's debt obligations? Could they affect future strategic actions of the company? How easily can the restrictions be removed?
4. How does your company assess operational performance? Are there elements of the balanced scorecard in place? How would you change the assessment?
5. How does your company balance the short term and the long term to optimize the Value Sphere in the best interests of the shareholders?
6. Gather some of the key employees in your company and ask them to write an imaginary newspaper article about your company 5 years into the future. The headline should be "Company XYZ (your company name) experiences 90% decline in market value over the past 5 years." Ask these employees to write the article to focus on the agency problems that led to this situation. Then ask them to assess how realistic this threat is and what they can do to deal with it.

Practice Problems

1. What are agency costs? Why do they occur?
2. What are the agency costs of equity? How would you attempt to minimize them? Can you relate the mechanisms you are proposing to those observed in practice? (*Hint: Focus on executive compensation.*)
3. What are the agency costs of debt? How would you attempt to minimize them? Can you relate the mechanisms you are proposing to those observed in practice?