

**Applied Corporate Finance**  
**Third Edition**

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## Chapter 2

1.

Annual Meeting: Stockholders may not show up at annual meetings or be provided with enough information to have effective oversight over incumbent management. In addition, the corporate charter is often tilted to provide incumbent managers with the advantage, if there is a contest at the annual meeting.

Board of Directors: Directors are often chosen by the incumbent managers (rather than by stockholders), own few shares and lack the expertise/information to ask tough questions of incumbent managers.

2.

(a) An increase in dividends: Make existing debt riskier and reduce its value.

Bondholders can protect themselves by constraining dividend policy.

(b) A leveraged buyout: If the existing debt is not refinanced at the “new” interest rate, existing bondholders will find the value of their holdings are lower after the LBO.

Bondholders can protect themselves by inserting protective puts into their debt, allowing them to put the bonds back to the firm and receive face value.

(c) Acquiring a risky business: If a risky business is acquired, existing bondholders may find themselves worse off since the underlying debt is now riskier. Bondholders can protect themselves by restricting investment policy.

3.

The fact that markets are volatile, by itself, does not imply that they are not efficient. If the underlying value of the investments traded in the market is changing a lot from period to period, prices should be volatile. Even if the underlying value is not moving as much as prices are, the fact that markets make mistakes (which is what the noise is) does not imply that the prices are not unbiased estimates of value. Put another way, it takes more than mistakes made by markets to prove that markets are inefficient.

4.

The empirical evidence does not support the notion that all investors focus on short term results. In particular, the evidence that high growth stocks are able to command high price-earnings multiples, and that stock prices go up, on average, on the announcement of R&D and major investments can be viewed as consistent with a market where some investors at least focus on the long term.

5.

This strategy is likely to work if higher market share leads to higher profits and cash flows in the long term. If, on the other hand, the higher market share is obtained by cutting prices and sacrificing long-term profitability, the strategy is unlikely to work.

6.

If the incumbent management is efficient and runs the firm for the benefit of existing stockholders, anti-takeover amendments will help in two ways –

(1) it may relieve them of the distraction of unwanted takeover attempts and allow them to focus on maximizing cash flows and value, and

(2) it may allow incumbent managers to extract a much higher price in the case of a hostile takeover.

7.

The ability to obtain equity capital without having to give up voting rights reduces the danger for managers that they will be called to account for bad actions. Obviously this means that shareholders cannot effectively fulfill their roles as monitors of managers.

8.

To some extent, yes. By tying the wealth of managers to the value of the firm's stock price, the granting of options increases the incentive for managers to make value maximizing decisions. However, this would also increase the incentive for managers to take on risky projects that they might not have taken otherwise, because the value of options increases with the variance of returns of the underlying asset. This also reduces the market value of bonds issued by the company.

9.

I would be concerned at the limited extent of stockholder oversight of managerial actions. I would try to push management to convert non-voting shares to voting shares. I would also try to ensure that the Board of Directors is independent and active, so that they can perform some of the duties that activist shareholders could have performed if they had voting rights.

10.

If the bank's stake in the firm as a lender is more important, then it might use its voting power as a stockholder to ensure that the firm does not take risky projects even if the NPV of these projects is positive. The bank might also push the company to grow through value decreasing methods, so that the assets available for it as collateral increase.

11.

It is entirely possible that maximizing value and being socially responsible go hand in hand. For this to happen, two factors have to come into play. The consumers of the firm's products must factor in social responsibility when they decide what to buy and who to buy it from. Investors also have to direct their money to companies that are socially responsible. Thus, a retail firm that is socially responsible may market its products on that basis and be successful both in terms of attracting more customers and a higher stock price

12.

If the Turkish stock market is not efficient, then the firm manager might have to take actions that might lead to a lower stock price at the current time, as long as the true value of stockholder wealth would be increased by those actions. In such a situation, an alternative proxy for shareholder wealth should be constructed and maximization of that proxy (such as excess returns or earnings growth) should be the manager's goal.

13.

The idea is that bond holders by converting their bonds into equity would be able to participate in the upside potential if stockholders attempt to increase the riskiness of the firm. This would decrease the incentive for stockholders to expropriate wealth from bondholders in this fashion.

14.

The problem is not entirely resolved by the passage of such legislation because it has to be enforced, and enforcement of laws is not costless. Furthermore, not all social costs are easily observable (at least at the time that they are created) and by the time they are, it may be too late.

15.

First of all, it is not clear how destruction of a well-run firm would be desirable for a stockholder, who has taken over the firm. However, even if this could happen, it is not clear that legislation preventing hostile takeovers is the solution. The reason for this is that such legislation would also unduly shield managers from market monitoring.