

“In Information We Trust”

George J. Papaioannou

Department of Finance
Frank G. Zarb School of Business

Roundtable

on

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Information and Capital Markets

The role of capital markets: Allocate capital to the most highly-valued uses.

- Thus, scarce capital resources are utilized most efficiently.
- Then:
 - Firms with high-value projects raise capital at low cost (i.e., required rates of return) and command high prices for their equity and debt securities.
- Ideally, therefore....
 - ... Firm value becomes an indicator of how efficiently firms allocate and use capital resources.
- But ...
 - ... Capital allocation is impacted by the flow and quality of information about the benefits and costs of new investment projects and the intent of users.
- When such information is asymmetric or corrupted, firm value and economic efficiency become disconnected.
- The result is: Missallocation of capital resources and the presence of systematically undervalued, and overvalued firms.

It's All about Trust

- Can investors trust the information that is publicly available?
(I.e., do they know as much as insiders?)
This is the problem of *information asymmetry*.
- Can investors trust the intent of insiders and managers?
(I.e., will insiders manage for economic efficiency and value maximization?)
This is the *agency problem* related to corporate governance.

Thus,

- Firm Value is a *function* of Future Cash Flow (size and risk); and Trust
- Investor distrust leads to Undervaluation.
- Excessive investor trust leads to Overvaluation.

First, The Case of Undervaluation

Main causes:

- a. Agency problems: Investors do not trust the intent of insiders.
Ex.: bait and switch; excessive executive perks; sub-optimal investments, like takeovers.
- b. Informational asymmetry problems: Investors do not trust they know as much as insiders.
Ex.: raising new capital when inside information is negative; firm's business is too complex to evaluate from outside.

Results:

- a. Investors are suspicious of the size and quality of future cash flows (fear of adverse selection).
- b. Investors assign assets values below the fair level (in absence of distrust)

Consequences:

- a. Investors do not overpay since they factor the future cash flow losses into prices.
- b. Firms attract less capital and society loses part of its potential economic output.

The Case of Undervaluation (cont'd)

Incentives to remove undervaluation:

- Case of agency problems: Insiders must believe that recaptured value exceeds the present value of their private benefits.
- Case of information asymmetry: Information disclosure will produce more value gains than value losses. (Disclosure may be too expensive or benefit rival firms.)

Resolution:

- a. Signaling. Ex.: initiate or increase dividends; issue more debt; subject firm to greater monitoring; buy value certification from external institutions.
- b. Firm restructuring and contracting. Ex.: takeovers; redesign executive compensation; protective provisions in credit contracts.

Conclusions:

- a. Strong incentives to remove undervaluation caused by poor corporate governance through corporate restructuring, as long as markets are flexible and innovative.
- b. Undervaluation due to information asymmetry can be brought to an optimal level by balancing the marginal value gains and losses of additional disclosure.

The Challenging Case of Overvaluation

- If overvaluation means to pay more than an asset is worth, why should there be overvaluation?
- Are investors that naive?

Causes of overvaluation:

a. Market failure:

Case #1: Investors extrapolate superior past performance into the future and assign better prices than future performance warrants.

Ex.: The case of self-selected timing of corporate decisions like seasoned equity offerings and IPOs.

Case #2: Investor irrational exuberance (entry into the market of less informed retail investors).

b. Corporate manipulation of information: earnings smoothing; concealment of debt; undisclosed transaction terms.

Ex.: Enron, Xerox, Worldcom, Adelphia, Parmalat.

Reason: poor corporate governance.

- Stock and option-based compensation packages
- Earnings-based evaluation goals
- Inattentive auditing boards
- Inability to separate corporation from top executives and manage conflicts of interest.

Incentive: Greed.

c. Breakdown of the monitoring function of outsiders (delegated monitors), like investment and commercial banks, analysts, auditors.

Ex.: Top Wall Street firms; analysts like Blodget, Grubman; auditors like Arthur Andersen.

Incentive: Make new or retain old clients and earn fees, i.e., Greed again.

Result:

Investor over-optimism and reliance on unwarranted rosy information drives security values above fair level – investors overpay.

The Case of Overvaluation (cont'd)

The consequences of overvaluation for the firm

- Inevitable loss of the excess value as actual performance sets in and/or investor expectations become more realistic.
- More important: additional loss of core value due to
 - Investor distrust, and
 - Sub-optimal operating policies (excessive perks, poor investments and acquisitions, excessive debt).
 - Erosion of good corporate governance practices within overvalued firm.

Result: Firms turn from premium to lemon firms; thus, they become undervalued if not bankrupt (see Enron, Adelphia, Worldcom).

Are there incentives to remove overvaluation?

- Very difficult for CEOs and BoD's to accept "value resetting" to lower level, especially when overvaluation is due to market failure, as in a bubble case.
- Corrupt managements (that engineer overvaluation) cannot be reformed from within.
- Outsiders have no interest in overpaying to take control and reset value to lower level.

The Case of Overvaluation (cont'd)

Some possible solutions

- Educating managers on the enormous costs of overvaluation.
Lesson: Overvaluation is not value maximizing.
(Empirical evidence shows that firms that pursue overvaluation end up losing a lot more.)
- Value maximizing managements should guard against overvaluation (ex. Warren Buffett).
- Regulation. Ex.: The Sarbanes-Oxley Act.
(E.g., top executives must certify the truthfulness of financial statements.)
- Prohibitively high ex-post settlement costs.
Ex.: The Elliott Spitzer settlement of \$1.4 bil. involving about a dozen Wall Street firms.

A problem: It is difficult to devise financial policies that can stymie managements from overvaluation practices if they are so inclined.

Concluding remarks

- Investors must focus more on cash flow than accounting earnings. “Show me the money.”
- The “knowledge” economy requires greater disclosure of fundamental indicators (especially those related to human capital) in order to assess firm value. Without adequate disclosure, overvaluation may intensify, not decline.
- Unlike undervaluation, there are less compelling incentives for incumbent managements to remove overvaluation.
- Therefore, there will be greater reliance on regulation and criminalization of overvaluation acts to combat overvaluation.

International perspective: Overvaluation is the single most harmful phenomenon against capital market development. Once burned, investors abandon public securities markets for long periods, thus hurting good honest firms along with the bad ones.