

**The Challenge of Corporate Value Management:
A Financial Perspective**

George J. Papaioannou

Finance Department
Frank G. Zarb School of Business
Hofstra University

Published in *International Law Digest*, January 2002

Acknowledgment

I thank the participants of the Finance Seminar Series at the Zarb School of Business for helpful comments on an earlier version of these ideas.

The Challenge of Corporate Value Management: A Financial Perspective

I. Introduction

Modern finance theory is built on the premise that firms should be managed to create and maximize value, where by value we mean the total price a firm commands in the marketplace, i.e., the sum of the values of its equity and debt. Thus, criteria and rules for correct financial decisions are established on the condition that they are consistent with value maximization. In theory, value maximization is appealing because it is associated with efficient allocation of resources, provided of course that the capital market operates efficiently enough, that is, it rewards the most those firms which channel their resources to their best uses. Extensive empirical evidence on capital market behavior shows that prices of corporate securities indeed respond to firm decisions in ways that appear to be consistent with expectations about the creation or destruction of value (Fama, 1998)

Notwithstanding the importance of seeking value creation, the dichotomy between those delegated with managing and those financing the firm, as well as the tendency to compartmentalize managerial functions into their respective silos makes value management a challenging and even elusive corporate objective. The difficulties for successful value management are related to two concerns. First, how committed to total value maximization corporate executives are. Second, how well corporate executives understand the contribution and relationship of decisions from diverse corporate functions (i.e., finance, marketing, production, etc.) on their firm's value (Myers, 1993).

In this paper, I develop a synthesis that looks at the conditions that make value

management a challenging corporate objective. First, I explain what makes value management challenging and often elusive. Next, I outline the remedies and the tools firms can use to pursue value maximization. Finally, I conclude with some conclusions and implications.

II The Challenges to Value Management

The value of the firm reflects the capitalized value of the firm's future cash flow stream, that is, the price investors are willing to pay in exchange of receiving the firm's future cash flows. The capitalization process (i.e., going from a cash flow stream to a price) incorporates expectations about the magnitude and timing of the cash flows as well as the quality or risk of the cash flows. Firms adopt decisions that affect their assets and liabilities on the basis of such expectations. Value maximization dictates that firm managements give priority to the decisions that lead to maximum value.¹

In perfect markets, i.e., perfect competition, full and symmetric information, zero taxes and transaction costs, real and financial assets are traded at their fair values. Firms are price takers and transparency of information and costless monitoring ensure a value maximizing behavior by those who manage the firm. In such markets, the market value of the firm equals the sum of the replacement (and, hence, acquisition) values of its different assets. That is, there is no scope for excess market value or destruction of value, both rationalized within a market equilibrium context.

¹ The uni-dimensional value maximization objective has been challenged recently by the proposition that the firm should make decisions that consider the interests of all stakeholders not just those of equity- and debt-holders. For more on this topic and a rebuttal, see Jensen (2001).

It is the presence of market imperfections that creates opportunities for excess value creation or imposes conditions leading to the loss of value. Managing the firm within an environment of such imperfections is the main reason why value management is challenging and elusive. We can identify four major imperfections that are relevant to the management of firm value.

- a. Agency conflicts
- b. Asymmetric information
- c. Limited marketability and investor base
- d. Real market imperfections.

A. Agency conflicts

The need to exploit benefits from specialized managerial skills as well as differences in the types of claims different capital providers have on the assets and cash flows of the firm give rise to a variety of agency relationships and conflicts in the modern corporation. The first such relationship is the one between the managers (the agents) and the shareholders (the principals). Another agency relationship exists between inside (managing) shareholders and outside shareholders. The third agency relationship is the one between shareholders and creditors.²

The objective of value maximization implies that corporate decisions aim to maximize the firm's total value, i.e., the value of equity as well as the value of debt claims. There exist, however, two conditions which can work against this goal. First, managers, inside shareholders, outside shareholders and creditors have differential forms of compensation for their labor or

² In the interest of economy, I have left out other agency relationships between the firm and other stakeholders, such as its workforce, suppliers, customers and the community at large, which can affect firm valuation.

capital investment in the firm. Secondly, shareholders have voting rights that influence the selection of the firm's management (board of directors and top managers). These conditions in turn create conflicts of interest and thus moral hazard problems (Jensen and Meckling, 1976). Those delegated with the responsibility to manage the firm may seek to maximize their wealth or economic welfare at the expense of other classes of claimants. Thus, moral hazard in this case is associated with the transfer of corporate wealth from one class of claimants to another.

Managers versus shareholders. If the managers' compensation is not conditional on firm performance, then the managers' and shareholders' interests with respect to value maximization can diverge.

First, managers may try to disguise various perks as legitimate business expenses. This reduces the residual income of the firm which shareholders can claim. This amounts to a transfer of corporate wealth from the owners to the managers. A related possibility is the waste of free cash flow in projects which may enhance managerial welfare but destroy firm value. According to this free cash flow hypothesis (Jensen, 1986), managers may, for example, use excess cash flow to go on a corporate acquisitions spree which could enlarge their realm of authority (even raise their compensation if the latter is tied to firm size) without full concern about the value consequences of these takeovers.

Second, when managerial compensation is not related to firm performance, managers have reasons to be more concerned with securing the stability of their stream of salary and perks, thus, they may avoid decisions which increases the overall volatility of the firm's cash flows. For example, managers may invest in excessive liquid reserves or low risk projects (decisions that lower firm profitability) or maintain less debt than the firm can bear (which

deprives the firm the benefit of tax deductibility of interest). Excessive risk avoidance is not, however, optimal for shareholders since it is possible to increase firm risk and still reach a higher value for the firm's equity as long as the expected cash flows more than offset the required return on the invested capital. Shareholders are usually well-diversified investors whose fortunes do not depend on the specific volatility of one firm's earnings. What matters to them is the co-movement of the firm's earnings or stock returns with the returns of the whole market. In financial jargon, this means that shareholders's risk is measured by the systematic or non-diversifiable component of risk present in the overall volatility of the stock returns of a given firm. On the other hand, it is total volatility of firm returns that affects the fortunes of the less diversified managers.

There is finally a third possibility where managerial welfarism can take precedence over value maximization. Managers may get so entrenched in certain technologies that they may resist adopting investment ideas that call for the utilization of new methods, techniques and technologies over which managers feel they have limited expertise. Their fear that they may appear wanting in the new environment of doing business may deprive the firm from the opportunity to move into new entrepreneurial fields (witness for example the slow progress by established firms toward online business). The result of such managerial entrenchment is the loss of projects that could add value to the firm (Shleifer and Vishny, 1989).

Inside versus outside shareholders. Inside shareholders are involved in the management of the firm in addition to being also equity providers. Outside shareholders provide equity capital and thus are part owners but have no say in the firm's management. The value of equity that belongs to all, inside and outside, shareholders is determined by the capitalized value of the future stream

of free cash flow that belongs to equityholders. As managers, inside shareholders have an incentive to expropriate funds in the form of expenses which are disguised as incurred in the ordinary course of business (examples are excessive compensation, trips, plush office quarters, and the like). Jensen and Meckling (1976) have shown that this expropriation can increase the total wealth or compensation of inside shareholders but decrease the value of equity that belongs to outside shareholders. The reason for this asymmetric wealth effect is that while the instant monetary compensation of inside shareholders increases by each expropriated dollar, the value of their equity stake decreases less proportionally since the outside shareholders share in the loss of the capitalized free cash flow lost through expropriation. Rational outside shareholders will, however, anticipate the potential for wealth expropriation and will refrain from paying the full price the equity commands absent of expropriation by insiders. The result is an equity value that falls short of its maximum level.

Shareholders versus creditors. Shareholders as firm owners can claim only the residual cash flow of the firm, that is, what remains (net of taxes) after the creditors have been paid their interest and principal. Since revenues and expenses fluctuate over time, the shareholders's residual claim is non-constant and volatile. Creditors on the other hand are compensated with fixed amounts of interest and principal repayments. This difference in compensation as well as the fact that shareholders have ultimate authority over the management of the firm creates a conflict of interest and an opportunity for a moral hazard problem for creditors. Specifically, the shareholders can engage in various schemes which while increasing the value of the equity diminish the value of claims held by creditors. These schemes can result in equity value maximization without however a concomitant debt value maximization.

One possible scheme is risk shifting. After raising fresh debt capital, the firm shifts the proceeds toward projects of higher riskiness. Since the creditors expected their funds to be invested in less risky projects they have charged a lower interest rate. After the risk shifting, the market recognizes the higher default probability and raises the required yield on the firm's debt. Since the value of fixed income securities moves inversely with yields, the value of debt declines resulting in value losses for the creditors. For shareholders, however, risk shifting can have a beneficial effect on their value when the increase in the total risk (volatility) of the firm's earnings does not increase the systematic risk of the firm's stock returns.

Another scheme is diversion of funds to shareholders. In this scheme, the shareholders vote to pay themselves an extraordinary dividend out of the excess cash holdings the firm has accumulated. The use of cash reserves to pay dividends has a dual effect. First it transfers immediate wealth to shareholders and reduces the value of assets. Second it decreases the firm's ability to honor its promised payments to creditors and thus increases the overall cost of capital of the firm. The combined effect is a drop in the total value of the firm which weighs, however, disproportionately against the creditors. That is, the sum of dividends and new value of equity leaves the shareholders better off than before the dividend payout. The creditors, however, hold less valuable debt since their unchanged future receipts are capitalized at a higher yield.

A third scheme to consider is under-investment elaborated by Myers (1977). This scheme is most likely to occur in firms overburdened by debt. When firms fall in a state of financial distress the likelihood of meeting their debt obligations is low, and therefore the market value of their debt falls well below the maturity value of debt. Now suppose that such a firm has a growth opportunity whose estimated market value exceeds its set up cost, i.e., the opportunity

has a positive net present value. Although adopting such an opportunity will add value to the firm, the shareholders may be disinclined to do so since the value added will go to restore the value of debt not to increase the equity value.

B. Asymmetric information

Asymmetric information exists when different parties have differential information about the factors that determine the value of an asset. One kind of asymmetric information, identified in Myers and Majluf (1984) exists when firm insiders know more than outside investors about the actual value of the firm assets in place. Informational asymmetry may also exist across different classes of investors, that is, some investors are more informed than other investors about the firm's true value (Rock, 1986). Informational asymmetry gives rise to the problem of adverse selection. Less informed investors run the risk to buy (sell) overvalued (undervalued) securities (consider, for example, the recent case of Enron).

Under the Myers and Majluf type of asymmetric information, outside investors view corporate decisions to sell risky equity or debt with skepticism and are only inclined to deal with the firm at prices below the fair market value of the firm's securities. Unwilling to accept below fair market prices, which hurt the existing shareholders, firms will refrain from issuing new securities to finance profitable investments or will be compelled to hold excess liquid reserves to finance urgent new investments. Either way, the firm's value will not realize its maximum level possible in the absence of asymmetric information.

Similarly, Rock's type of asymmetric information (also called the winner's curse

hypothesis) affects firms that plan to sell new securities, especially when they do so for the first time, as through an initial public offering (IPO). If some investors are systematically uninformed they will succeed in receiving more often than not allocations of overpriced securities thus realizing net losses. To keep such investors in the market for new capital, firms and their underwriters must sell new securities which are on average underpriced. This will ensure that even uninformed investors realize a normal return on their investment.

When the distribution of information is asymmetric across insiders and outsiders or across investors, the firm will either be forced to pass up decisions that would maximize its value or alternatively will need to undertake costly actions in order to signal its true quality.

C. Limited marketability and investor base

Value maximization is also impaired when the firm's equity and debt claims (identified usually with stocks and bonds) are traded in markets with limited marketability and narrow investor base. Limited marketability implies that investors cannot trade securities under conditions of liquidity, that is, they are forced to trade them at prices above their fair market value when they buy or below their fair market value when they sell. To offset these costs, investors demand a higher rate of return which then has the effect of raising the firm's cost of capital and, hence, lowering the value of its future cash flows (Amihud and Mendelson, 2000).

Lack of a broad and diverse investor base can cause an insufficient interest in the securities of the firm (a cause in itself for reduced marketability) and an inefficient distribution of risk bearing attitudes across the investors holding the firm's securities. Consider, for example, a regional stock exchange in which the bulk of listed shares have been issued by firms

of the same industry that happen to employ most of the area's population. The result of a narrow investor base is also a higher cost of capital and lower firm valuation (Merton, 1987).

D. Real market imperfections

Finally, the fourth possibility is the presence of market imperfections in the real markets where the firm operates. Such imperfections include firm barriers to entry, development of specialized resources (through advertisement, marketing channels, patents, human capital), privileged access to factors of production, and build up of reputational capital among others. Exploitation of such imperfections enables the firm to acquire competitive advantages and earn economic returns, that is, profits above the normal rate. These rents become possible because the firm captures larger and more secured market share or successfully differentiates the attributes of its products and services from that of its rivals. As a result, the firm can generate greater and more stable revenues, and, hence, increase its value by the portion that is generated from the capitalization of the cash flows that represent economic rents (Shapiro, 1993).

Exploiting the market's imperfections in order to acquire competitive advantages can have, however, two mitigating effects. First, the sources of product differentiation and barriers to entry also create what is called "barriers to exit." A firm that has grown too large (in order to exploit economies of scale and discourage entry by others) or has developed tangible and intangible assets which are too specific to the firm's current products will have great difficulty reorienting its resources toward other uses should the economic conditions deteriorate in its output markets. In addition, firms with highly specialized resources are more likely to operate in oligopolistic or even monopolistic markets. Should such firms run into financial distress and

need to liquidate all or part of their assets for the sake of reorganization or orderly liquidation, they will be forced to sell at fire-sale prices since there would be few other firms to compete for their assets. The costs of exit barriers will bear negatively on the firm's value by the amount of their capitalized value.

The second unintended negative effect of exploiting real market imperfections refers to the very likely exacerbation or even emergence of the problems that emanate from agency conflicts and asymmetric information. Firms with competitive advantages possess specialized resources or assets in place as well as future investment opportunities whose exact nature the firm would prefer to cloak in secrecy. This leaves the market less informed about the true economic value of the firm, the result being the negative valuation effect due to the adverse selection problem faced by investors. Similarly, such firms generate conditions for underinvestment (in profitable opportunities) if the net gain is more likely to be captured by the creditors than the shareholders, as explained earlier .

III Responding to the Challenges

How can the firm respond to these market realities in order to protect and maximize value? The finance literature has identified a variety of remedies or mechanisms as well as tools that address this question. Some of these remedies are exerted from parties and forces outside the firm. For example creditors and large outside shareholders (e.g., pension funds, block holders) have an interest and the means to monitor the firm's actions. Creditors can also impose various negative clauses in debt contracts to prevent or minimize the potential for the expropriation of creditor value by shareholders. The market for corporate control also imposes

limits to management and inside shareholder proclivity to expropriate or waste corporate value. When the price of the firm's stock does not reflect the maximum potential value it can attain through efficient management, there is increased likelihood the firm will be taken over and its insiders will be dismissed. This serves to deter insiders from value destruction. Below, I focus rather on those remedies and tools that the firm itself can adopt in order to ensure the presence of conditions for value maximization.

A. Managing agency conflicts

We have said that agency conflicts manifest themselves in the actions taken by different agents within the firm with the purpose to maximize their respective economic returns. These actions are often at variance with the goal of value maximization. There are two remedies to this problem: monitoring and bonding. Monitoring the actions of firm agents has the purpose to circumscribe their behavior within the limits of value maximizing decisions. Bonding refers to actions or arrangements that seek to align the interests of agents with those of principals.

Corporate governance. The rules and mechanisms that determine how the firm is governed can provide effective tools for monitoring. The presence of independent directors on the board establishes a more detached and objective evaluation of the firm's decisions (see, for example, Dahya, McConnell and Travlos, 2002). The removal of charter provisions that increase the cost of takeover attempts against the firm ensures that the firm is not outside the realm of the market for corporate control and hence its insiders feel so entrenched as to disregard the priority of value creation.

Managerial compensation. If the managers's compensation is tied to the value of the firm, they

will have a keener interest in value maximization. Therefore, granting stock or stock options to managers is the standard tool used to align their economic interests with those of the shareholders (Jarrell, 1993). Similar compensation schemes are appropriate for the compensation of boards of directors so that they exercise more effective monitoring over management.

Corporate organization. A multi-divisional structure makes it more likely that division heads are loosely monitored and corporate resources are not employed efficiently (Denis and Denis, 1997). This possibility is all the more serious in firms that lack managerial expertise and technology to monitor far-flung operations. The empirical evidence in support of corporate focus (see, for example, Cusatis, Miles and Woolridge, 1994) suggests that firms can achieve more effective monitoring and bonding by adopting less complex organizational structures.

Equally important is the choice of private versus public ownership. Privately held companies operate outside the domain of regulatory disclosure and the scrutiny as well as pressure of public securities markets. They can, therefore, design compensation packages that align rewards to entrepreneurial risk taking. The greater concentration of firm capital in the hands of a limited number of capital suppliers - inside shareholders, venture capitalists and creditors, also creates greater incentives for close monitoring of the operations of privately held firms in order to avoid wealth transfers. Seeking such advantages was the main motivation behind the great wave of leveraged and management buy-outs of the 1980's. On the other hand, the monitoring and bonding advantages of the private form of ownership is counter-balanced by its disadvantages exemplified in lower liquidity of its securities and limitations to its financing choices and flexibility once the firm grows too complex and big.

Financial Policies. There is a rich variety of financial decisions that can help the firm enhance monitoring and bonding. For example, the firm can resort in short-term financing to fund long-term needs, that is, it can utilize a policy of staged financing. Myers (1977) provides the rationale why firms with future growth opportunities, and hence incentives for under-investment, can choose short-term financing. Since the insiders may refrain from exercising future investment options if they only benefit the creditors, the latter will refuse to finance the firm. If debt financing is value enhancing, borrowing on short maturities gives creditors the opportunity to monitor the firm and agree to debt renewal only if profitable investments are adopted. Schultz (1993) has also utilized the logic of stage financing to rationalize unit offerings, that is initial public offerings of shares and warrants that give the holder the right to buy more shares in the future. The warrants are exercised only if the firm makes efficient use of the initial equity capital raised in the IPO.

Another tool is the design of securities which create incentives for monitoring or otherwise neutralize the moral hazard problem. One such example is the case of convertible bonds. Convertibles reflect the value of the debt claims they embody as well as the value of the stock into which they can be converted. Brennan and Schwartz (1993) explain how the use of convertibles neutralizes the moral hazard problem faced by creditors when insiders take actions that transfer value from the creditors to the shareholders. Since the convertible holders have claims as both creditors and equityholders they can benefit either way.

Jensen's (1986) free cash flow hypothesis suggests that firms can minimize the wastage of cash flows by limiting the amount of earnings apportioned for retainment. This can be done if the firm either pays out its excess earnings as dividend or maintains a high debt level. High

indebtedness diverts more earnings to interest payments to support the higher debt and at the same time motivates insiders to make more efficient allocation of capital in order to avert the deleterious effects of financial distress.

Placement method. Finally, the firm can exercise its choice between public and private placement of its securities in order to enhance monitoring and bonding. Private placements are suitable to firms with high agency conflicts, which therefore need closer monitoring of their management. The greater flow of private information to the security buyers and the limited number of the latter allow closer scrutiny of the firm's decisions. In addition, private placement contracts allow the design of terms and features that can address agency problems in a less costly manner (Emerick and White, 1992).

B. Managing asymmetric information

When investors have less information about the firm, they fail to ascertain the economic value of the firm's decisions. This failure hurts mostly firms with good quality prospects. The most effective remedy a good quality firm has in this case is to attempt to separate itself from firms of lesser quality. That is, the firm needs to signal its true quality so that investors can assign the firm a higher value. Firms can use various signaling tools to accomplish that.

Financial policies. Financial economists identified very early two financial variables that can signal quality. Firms, for example, can announce increased dividend payouts. Since an unstable payout policy is perceived as signifying earnings volatility, managers are loath to changing payout ratios. Consequently, adopting a higher payout signals that the firm has positive private information that its future earnings will be high enough to sustain the higher

dividend payout. Similarly, the firm can use financial leverage to signal its quality. Higher indebtedness can have destructive effects on the firm's operations, including the compensation of managers and the wealth of shareholders. Therefore, the assumption of more debt signals the firm expects to generate the higher level of cash flows to support the new debt. Consistent with these signaling theories, empirical studies show that leverage and dividend payout increasing decisions are followed by a positive revaluation of the firm's value of equity and debt (Smith, 1993 and Handjinicolaou and Kalay, 1984).

Issuing underpriced securities. It is widely observed that new securities, especially IPO shares, are placed at offer prices below their market value. The signaling theory explains this underpricing as a deliberate strategy by good firms to separate themselves from poor quality firms. If positive (negative) information about the true condition of good (bad) firms is eventually released to the market before the firms need to make other subsequent decisions, like adopt new investments, pay dividends or sell more securities, good firms can use underpricing to separate themselves from bad firms. Good firms can afford to lose value from underpricing because they have investments with net present values that more than offsets the loss. Poor quality firms, however, cannot cover their losses from underpricing. Therefore, underpricing becomes a credible signal of superior quality that permits the firm to enjoy a better valuation of its subsequent decisions by the market. Although there is weak empirical evidence in support of signaling to explain IPO underpricing by private firms, the findings confirm the working of a signaling effect through underpricing in the case of privatization IPOs by state-owned firms.

Certification. Firms can also signal their quality by doing deals with reputable lenders and investment bankers or by retaining top tier auditing and law firms to certify their financial

statements or counsel them. A rich literature provides ample theoretical rationalization and empirical confirmation of the validity of certification as an effective signaling tool (Beatty and Welch, 1996) These third parties have built reputational capital which provides them with superior certification credentials. Since their business model is predicated on doing repetitive deals in which they serve as certifiers of the accuracy of information and value, they have a strong incentive to preserve their reputation. To this effect, they dedicate the requisite resources and prefer to do business with client firms of discernible quality in order to avoid the risk of endorsing a firm that turns out to be of poor quality.

A firm can also signal its quality through the certification power of the marketplace where it chooses to list its securities for trading. Listing criteria establish both qualitative standards (usually relating to corporate governance and information disclosure issues) and quantitative standards (relating to asset and earnings size, minimum share price, etc.). The listing standards imposed by stock exchanges, both for initial admission and continued listing, can have a certification effect. The more strict the standards are the greater is the confidence investors have that they are not excluded from access to material information (examples, like those of Enron and Cendant notwithstanding).

Corporate organization. As in the case of agency problems, simple organizational structures (single-division as opposed to multi-division organization) are conducive to greater flow of information that is easier to be understood and processed by investors.

Placement method. Private placement of securities allows greater exchange of complex information between the firm and its capital suppliers. Because of the small number of buyers involved this information exchange can be less costly, more extensive, and carry less risk that

important information will be utilized by the firm's rivals. Thus, securities can be placed privately with less informational asymmetry.

C. Managing marketability and investor base

To reduce its cost of capital due to limited liquidity and obtain a better price the firm needs to consider carefully the alternative trading venues where it can choose to list its securities. There are two choices to be evaluated in this connection.

Choosing the home market. Recently it has become more common to find more than one trading venue for the secondary exchange of securities within a given country. For example, in the U.S., a firm can choose one of the national markets, New York Stock Exchange (NYSE), American Stock Exchange (AMEX), or Nasdaq, or one of the five regional stock exchanges. In countries like the U.K., Germany, France, Japan, one can also find multiple securities markets. Provided that a firm satisfies the standards for initial listing, it should choose the market with the least trading costs and the best price discovery structure. Trading costs consists of the commission paid for the execution of orders, the spread between bid and ask prices, and the price impact (that is, the price decline or price rise for the execution of a sell or buy order of a given size). The size and rate of the order flow, the competition for order execution, and the information disseminated to investors are important factors, external to the firm's characteristics, in determining trading costs. Studies have shown, for example, that stocks of smaller less well known firms carry lower spreads if traded on the NYSE than the Nasdaq (see, Christie and Huang, 1994). In addition, how close the market prices come to their fair value level is an important criterion in judging the quality of price discovery. Price discovery can be

impacted by trading costs (high trading costs inhibit arbitrage), order execution (an auction versus a dealer market mechanism) and the size and composition of investor base. The greater the size and the diversification of the investor base, the more likely it is the security will be traded close to its full fair value. It is argued for example, that a listing on the NYSE creates greater publicity and attracts more, especially institutional, investors, thus improving monitoring, reducing asymmetric information and broadening the investor base (Kadlec and McDonnell 1994).

Choosing a foreign market. The motive to improve the investor base and increase investor awareness is even stronger in the decision to seek listing in foreign trading venues. The firms most likely to benefit from a foreign listing are those which domicile in countries with small and thin markets. These firms, besides overcoming their low liquidity (hence high liquidity cost) disadvantage, have the potential to improve the market prices of their securities by expanding their otherwise narrow and undiversified investor base. Even when their home market is well integrated in the global financial system, international investors are wary to investing in firms from countries of less recognized accounting, corporate governance and information disclosure standards. Studies have shown that foreign firms which seek listing on the U.S. markets through an ADR (American Depository Receipt) program experience a positive market price reaction (Kotharie, 1998). It is not as clear, however, whether U.S. firms listing their securities abroad reap any corresponding benefits.

Other firm actions. In addition to choosing the trading venue that best suits the characteristics and needs of the firm, managers can take other steps that can contribute to lowering the trading costs and improving the conditions for more effective price discovery. Amihud and Mendelson

(2000) describe a series of such steps, including efforts to reduce information asymmetry by releasing more information, communicating more extensively with financial analysts, and calibrating the level of the stock price (through stock splits, for example) to increase the investor base.

D. Managing real market imperfections

There are two aspects to the management of real market imperfections. One aspect refers to the exploitation of these imperfections for the purpose of creating competitive advantages for the firm. This task belongs mainly to managerial functions outside finance. Thus, the marketing function can create a brand image and consumer perception that differentiates the firm's products and leads to higher sales at higher prices. The production function can create technological qualities that can also help set the firm's products apart from the competition. The human resources function can fashion an environment that promotes creativity, strong motivation and quality workmanship, factors that can lead to high productivity levels. The other aspect of managing real market imperfections refers to the protection of the advantages the firm has established through the successful exploitation of such imperfections. Although the managerial functions mentioned above have also responsibility over this task, I will only outline here how the finance function can contribute in this area.

Financial policies. Once the firm has acquired certain competitive advantages, it needs to put in place a financial policy that will protect and preserve these advantages. It is critical that the financial policies of the firm are consistent with its strategic and operating plans. The components of financial policy are several.

One can start with the composition of the liabilities. In this regard, both the capital and the maturity structure of the liabilities are important factors. Capital structure, which defines the mix of equity and debt, is important for the long-run solvency of the firm. The superior cash flows of firms with competitive advantages are usually based on the creation of intangible assets like human creativity, patents, and successful R&D programs, as well as beneficial business arrangements. These resources are usually the byproduct of superior management skills. Should the firm run into financial distress because of heavy indebtedness, it is likely that managerial focus on these assets will be distracted and hence their value will decline. It is not surprising then that we observe very low debt ratios for firms that rely heavily on intangible assets to build competitive advantages. The maturity structure, that is the mix of short- and long-term debt is also important. It has been already mentioned that the use of short-term debt can mitigate the potential for under-investment due to moral hazard problems.

Another component of financial policy is the mix of current and fixed assets. For strategic and tactical reasons, firms that enjoy competitive advantages need to maintain excess liquidity which is a form of financial slack. These firms often need to implement investments quickly to preempt their rivals by capturing a first mover advantage. In other instances, they need to engage in tactical wars, like price cuts, additional promotion, etc, in order to fend off aggressive moves by their competitors. To do so, these firms need to have cash in hand that will allow them to engage in these protective moves without the time delays and frictions encountered in external financing (Lyn and Papaioannou, 1996).

The third component of financial policy is the structure of the net working capital of the firm, that is the relationship between current assets and short term liabilities. The portion of

current assets financed by short-term liabilities plays a significant role in the short-term solvency of the firm. A common predicament of fast growing firms is that they let their least liquid current assets like inventory and accounts receivable to grow disproportionately while at the same time they carry a lot of short-term debt. This can easily force the firm into insolvency and financial disarray.

Financial policy is optimal when while aggressive enough to maximize the beneficial effects from borrowing and minimize the costs of excess cash reserves, is also designed to afford the firm adequate flexibility in order to protect its competitive advantages.

IV Conclusions and Implications

The imperfections analyzed above have interesting distinctions and interrelationships. Agency conflicts, asymmetric information and limited marketability and investor base have the potential to hamper value creation; on the other hand, real market imperfections offer the firm the opportunity to increase the market value of its assets above their fair replacement cost and, thus, reap an excess market value. The first three imperfections also affect primarily the magnitude and distribution of cash flow and value to various claimants, like managers, owners and creditors, whereas real market imperfections impact the production of firm cash flows. Accordingly, agency conflicts, asymmetric information and limited marketability and investor base relate mainly to the management of firm liabilities while real market imperfections relate mainly to the management of the firm's assets. Consequently, the responsibility of dealing with the first three imperfections falls almost exclusively within the finance function while the responsibility of managing real market imperfections cuts across the managerial functions of

the firm, i.e., finance, marketing, production, human resources, and information.

It is also clear that these imperfections cannot be managed in isolation of each other. For example, the creation of competitive advantages based on real market imperfections gives rise to problems from agency conflicts and information asymmetry. Moreover, the tools and mechanisms available to the firm also affect more than one area of concern. For example, the choice of a multi-divisional structure in order to exploit synergistic benefits may run against the need to control and monitor managerial actions or to alleviate information problems. Finally, these remedies and tools cannot be applied without a cost. This implies that the firm must carefully weigh the benefits and costs of each choice in order to find the mix of instruments and policies that maximize its value. This makes financial evaluation of all corporate decisions an ongoing task.

References

- Amihud, Y. and Mendelson, H., 2000, The liquidity route to a lower cost of capital, *Journal of Applied Corporate Finance* 12, 8-25.
- Beatty, R. and Welch, I., 1996, Issuer expenses and legal liability in initial public offerings, *Journal of Law and Economics* 39, 545-602.
- Brennan, M. and Schwartz, E., 1993, The case for convertibles, The New Corporate Finance, ed. D. H. Chew, Jr., McGraw-Hill, New York.
- Christie, W. and Huang, R., 1994, Market structure and liquidity: A transactions data study of exchange listings, *Journal of Financial Intermediation* 3, 300-326.
- Cusatis, P., Miles, J. and Woolridge J., 1993, Restructuring through spinoffs, *Journal of Financial Economics* 33, 293-311.
- Dahya, J., McConnell, J. and Travlos, N., 2002, The Cadbury Committee, Corporate Performance and Top Management Turnover, *The Journal of Finance*, forthcoming.
- Denis, D., and Denis, D., 1997, Managerial incentives and corporate diversification strategies, *Journal of Applied Corporate Finance* 10, 72-80.
- Emerick, D. and White, W., 1992, The case for private placements: How sophisticated investors add value to corporate debt issues, *Journal of Applied Corporate Finance* 5, 83-91.
- Fama, E., 1998, Market efficiency, long-term returns, and behavioral finance, *Journal of Financial Economics* 49, 283-306.
- Handjinicolaou, G. and Kalay, A., 1984, Wealth redistributions or changes in firm value: An analysis of returns to bondholders and stockholders around dividend announcements, *Journal of Financial Economics* 13, 35-64.
- Jarrell, A. C., 1993, An overview of the executive compensation debate, *Journal of Applied Corporate Finance* 5, 76-82.
- Jensen, M., 1986, Agency costs of free cash flow, corporate finance, and takeovers, *American Economic Review* 76, 323-329.
- Jensen, M., 2001, Value maximization, stakeholder theory, and the corporate objective function, *Journal of Applied Corporate Finance* 14, 8-21.
- Jensen, M. and Meckling, W., 1976, Theory of the firm: Managerial behavior, agency costs, and ownership structure, *Journal of Financial Economics* 3, 305-360.

- Kadlec, G. and McConnell, J., 1994, The effect of market segmentation and liquidity on asset prices: Evidence from exchange listings, *The Journal of Finance* 49, 611-636.
- Kotharie, A., 1998, Sourcing equity internationally with Depository Receipt Offerings: Two exceptions that prove the rule, *Journal of Applied Corporate Finance* 10, 90-101.
- Lyn, E., and Papaioannou, G., 1996, Liquidity and the financing policy of the firm: An empirical test, *Advances in Working Capital Management* 3, 65-83.
- Merton, R., 1987, A simple model of capital market equilibrium with incomplete information, *The Journal of Finance* 42, 483-510.
- Myers, S., 1977, Determinants of corporate borrowing, *Journal of Financial Economics* 5, 147-175.
- Myers, S., 1993, Finance theory and financial strategy, The New Corporate Finance, ed. D. H. Chew, Jr., McGraw-Hill, New York.
- Myers, S. and Majluf, N., 1984, Corporate financing and investment decisions when firms have information that investors do not have, *Journal of Financial Economics* 13, 187-221.
- Rock, K. 1986, Why new issues are underpriced, *Journal of Financial Economics* 15, 187-212.
- Shapiro, A., 1993, Corporate strategy and the capital budgeting decision, The New Corporate Finance, ed. D. H. Chew, Jr., McGraw-Hill, New York.
- Schultz, P., 1993, Unit initial public offerings: A form of staged financing, *Journal of Financial Economics* 34, 199-230.
- Shleifer, A. and Vishny, R., 1997, A Survey of Corporate Governance, *The Journal of Finance* 52, 737-783.
- Shleifer, A. and Vishny, R., 1989, Management entrenchment: The case of manager-specific investments, *Journal of Financial Economics* 25, 123-140.
- Smith, C., 1993, Raising capital: Theory and Evidence, The New Corporate Finance, ed. D. H. Chew, Jr., McGraw-Hill, New York.

